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Like Great Britain, a Limited Liability Company May Have an Unwritten Constitution

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Under Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999), the operating agreement is indubitably the "cornerstone" of a limited liability company. This column examines the problems arising when that cornerstone is unwritten.*

Under Most LLC Statutes the Operating Agreement Need Not Be in Writing

Almost 20 years ago, while on an ABA-ULC project, I made the acquaintance of a leading practitioner in the field. Although today he is as skilled and adept with limited liability companies as with corporations, he was then first entering the world of unincorporated business organizations. His reaction upon first hearing that an operating agreement may be oral was memorable. He was incredulous.

From a corporate perspective, his reaction made sense. Who, for example, has ever heard of oral by-laws? Generally, however, LLC law follows partnership law as to the governance of internal affairs, and the law of general partnerships has always accepted oral partnership agreements.

Although most LLC statutes require a limited liability company's basic management template to be not only in writing, but also "of record," with very few exceptions LLC statutes embrace the partnership approach and expressly authorize oral operating agreements. In many statutes, the authorization appears in the very definition of the concept. For example, ULLCA (2013) § 102(13) contemplates the operating agreement being "oral, implied, in a record, or in any combination thereof," and the Delaware statute begins its definition of "limited liability company agreement" with the phrase "any agreement (whether referred to as a limited liability company agreement, operating agreement or otherwise), written, oral or implied." Del. Code Ann. tit. 6, § 18-101(7). Consistent with the common law of contracts, these definitions also authorize terms and even entire agreements "implied in fact" (i.e., conduct of the parties). (Some statutes do not go so far. For example, the Georgia LLC statute provides: "Operating agreement, means any agreement, written or oral, of the member or members." Ga. Code Ann., § 14-11-101(18). The Delaware statute was similarly limited until 2007, when the legislature added "or implied" to the definition. Del. Laws, c. 105, § 1 (2007).)

Unwritten Operating Agreements and the Problem of Indeterminacy

Authorized, however, is not the same as advisable; traps for the unwary abound. At the most basic level is the question of content. To what did the parties actually agree? As explained in the Restatement of Contracts, "The parties to an agreement often reduce all or part of it to writing. Their purpose in so doing is commonly to provide reliable evidence of its making and its terms and to avoid trusting to uncertain memory." Restatement (Second) of Contracts (1981)

(R.2dC), Chapter 9, Topic 3, Intro. Note. Put more colloquially, writings help avoid swearing matches.

Writings also help clarify understandings. As explained in an R. Guidon cartoon, "Writing is nature's way of letting you know how sloppy your thinking is." Or, as put more elaborately by various wags, "I know you think you understand what you thought I said but I'm not sure you realize that what you heard is not what I meant."

In the LLC context, establishing content involves additional uncertainties. For example, although governance and economic relationships within limited liability companies may have similarities, none are so regular as to constitute "a usage having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to a particular agreement. R.2dC § 222(1) (defining "usage of trade"). "Course of dealing," waiver, and estoppel may usefully apply in a limited liability company with only two members, but the concepts are fundamentally problematic in a company with more than two members:

> When [such] doctrine[s] operate[] in the typical, bilateral situation, the benefits are confined to the party that relied to its detriment and the prejudice is confined to the party whose conduct occasioned the reliance. In contrast, such congruence will not necessarily exist in an LLC with more than two members. Estoppel and waiver may benefit parties who have not relied and prejudice parties who did directly occasion the reliance.

Bishop and Kleinberger, Limited Liability Companies: Tax and Business Law, ¶ 5.06[3][c][iii].

The "content" problem is especially acute when a limited liability company admits a new member. Under the uniform act, "a person that becomes a member is deemed to assent to the operating agreement," ULLCA (2013) § 106(b), and any other result would produce chaos. Prudence thus demands that the existing, oral agreement be memorialized because otherwise the new member is doing worse than buying "a pig in a poke," i.e., it, she, or he is agreeing sight unseen to whatever the existing members remember the operating agreement to be. Or, as stated less colloquially: "Given the possibility of oral and implied-in-fact terms in the operating agreement, a person becoming a member of an existing limited liability company should take precautions to ascertain fully the contents of the operating agreement." ULLCA (2013) § 106(b).

Another Trap for the Unwary: Unwritten Agreements Authorized . . . Except Not Completely

Ironically, problems also arise because an LLC's statute authorization of oral and implied-in-fact agreements may be incomplete. Some statutes permit unwritten operating agreements in general, but then identify particular statutory rules that may be changed only by a signed writing. For example, Ga. Code Ann. §§ 14-11-304(a) and 14-11-403, respectively, provide that "[u]nless the articles of organization or a written operating agreement [provide otherwise],

management of the business and affairs of the limited liability company shall be vested in the members," and likewise that profits and losses are allocated per capita unless provided otherwise in articles of organization or written operating agreement. Presumably, such provisions are so important that they warrant the evidentiary and cautionary protections that Professor Fuller identified as among the *raisons d'étre* for legal formalities. Lon L. Fuller, *Consideration and Form,* 41 Colum. L. Rev. 799 (1941).

The rationale is less clear for writing requirements with a narrower scope—for example, Cal. Corp. Code § 17352(c), which provides that: "Except as otherwise provided in the articles of organization or a written operating agreement, the managers or members winding up the affairs of the limited liability company pursuant to this section shall be entitled to reasonable compensation." The provision is important in and of itself, especially considering that at one time the law of general partnerships provided the opposite result. But why is this particular provision more worthy of Fuller-type protection than, for example, the statutory rule allocating distributions among members? See Cal. Corp. Code § 17704.04(a).

Some writing requirements are sufficiently counter-intuitive as to warrant the label "trap for the unwary." Texas law provides a good example. On the one hand, Tex. Bus. Orgs. Code Ann. § 101.001(1) defines "[c]ompany agreement" to mean "any agreement, *written or oral*, of the members concerning the affairs or the conduct of the business of a limited liability company." On the other hand, Tex. Bus. Orgs. Code Ann. § 1.002(53)(A) defines "member . . . in the case of a limited liability company" to mean "a person who is a member or has been admitted as a member in the limited liability company *under its governing documents*." See *Perez v. Le Prive Enterprises, L.L.C.*, No. 14-15-00291-CV, 2016 WL 3634298, at *4 (Tex. App. July 7, 2016) (citing the governing-documents requirement in rejecting defendants' contention that they and plaintiff had orally agreed to be members of a Texas limited liability company). (Emphasis added)

What About the Statute of Frauds?

The writing requirements just discussed could be styled as statutes of frauds, although they do not follow the template—that is, historically a statute of frauds provides that a contract pertaining to a specified subject matter is unenforceable unless evidenced by a signed writing.

The template does appear in several LLC statutes, which provide a statute of frauds for promises to make a contribution. For example, under Ohio Rev. Code Ann. § 1705.09(B): "A promise by a member to contribute to the limited liability company is not enforceable unless it is set forth in a writing signed by the member." Given the general power of the operating agreement, this type of requirement is likely a default rule, although its override is probably subject to an implied condition—namely, that the relevant term of the operating agreement (rendering oral promises enforceable) be itself in writing and appropriately signed.

What of the generally applicable statutes of frauds? For example, may an oral operating agreement bind a member to contribute real property to the limited liability company, bind the

company to employ a member as manager for three years, or obligate one member to guarantee the promised contributions of another? Does statutory authorization of unwritten operating agreements override the various written requirement imposed by statutes of frauds?

Most likely the answer is "no." Almost by definition, a general authorization of oral agreements cannot oust generally applicable statutes of frauds. After all, Parliament adopted the original statute of frauds, 29 Charles II, c. 3, §§ 4,17 (1677), in the face of common-law rules making oral contracts generally enforceable.

The leading LLC case reflects this point. In 2009, the Delaware Supreme Court applied the statute of frauds to an alleged oral term of an operating agreement, reasoning that: "The legislative history of the LLC Act does not demonstrate the General Assembly's intent to place LLC agreements outside of the statute of frauds." *Olson v. Halvorsen*, 986 A.2d 1150, 1161 (Del. 2009) (applying the one-year provision to an alleged oral buy-out agreement).

The next year, the Delaware legislature overrode *Olson,* 2010 Del. Laws, ch. 287 (H.B. 372), §§ 1, 31 (putting LLC agreements outside all statutes of frauds), and Illinois has gone at least part way: "An operating agreement is enforceable whether or not there is a writing signed or record authenticated by a party against whom enforcement is sought, even if the agreement is not capable of performance within one year of its making." 805 Ill. Comp. Stat. Ann. 180/1-46.

However, in the absence of such specific legislation, *Olson*'s reasoning still holds. Moreover, *Olson* is consistent with case law concerning oral partnership agreements: "Partnership agreements, *like other contracts*, are subject to the Statute of Frauds. *Abbott v. Hurst,* 643 So. 2d 589, 592 (Ala. 1994). (Emphasis added)

In any event, ousting the statute of frauds can cause considerable problems. For example, suppose RayandAndy, LLC (RayandAndy) is a Delaware limited liability company with four members and an unwritten operating agreement. RayandAndy owns several parcels of undeveloped land, which are to be sold to private developers "as the market matures." However, just as RayandAndy prepares to make its first sale, Asha, one of its members, asserts a right of first refusal (ROFR).

In any other context, Asha's claim would fall to the statute of frauds. If a lawsuit were to ensue, Asha's failure to plead the necessary writing would entitle RayandAndy to judgment on the pleadings. In contrast, in the context of a Delaware limited liability company, Asha could avoid judgment on the pleading merely by pleading that the ROFR is part of RayandAndy's unwritten operating agreement. In addition, unless the evidence were so one-sided as to compel a finding that no oral ROFR exists, Asha's claim would also survive a motion for summary judgment.

For all the above-mentioned reasons, an unwritten operating agreement is "a consummation devoutly [not] to be wished." (W. Shakespeare, Hamlet act 3 sc. 1) Transactional lawyers routinely advise their clients to memorialize "the deal," which in the case of a limited liability company is what a good operating agreement does. However, even a well-written agreement

can have an Achilles heel—namely, claimed oral modifications and separate oral agreements. The next article in this two-part series will describe these threats and suggest ways to anticipate and deflect them.