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Protecting the Sacred Writing: The Operating Agreement

Abstract

This column provides practical steps toward protecting an LLC's written operating agreement from claims of oral or implied-in-fact modification. Such claims undercut the purpose of “reducing the agreement to writing,” replacing definiteness with uncertainty and substituting swearing matches for the written word.

Disciplines

Business Organizations Law

Protecting the Sacred Writing: The Operating Agreement

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My previous column in *Business Law Today* explained how, "Like Great Britain, a Limited Liability Company May Have an Oral Constitution" and noted some of the resulting dangers. This column shifts focus and provides practical steps toward protecting a written operating agreement from claims of oral or implied-in-fact modification. Such claims undercut the purpose of "reducing the agreement to writing," replacing definiteness with uncertainty and substituting swearing matches for the written word. See, e.g., *Laurel Hill Advisory Grp., LLC v. Am. Stock Transfer & Tr. Co., LLC*, 112 A.D.3d 486, 486, 977 N.Y.S.2d 213, 214–15 (2013) ("The dispute over the validity of the written agreement and the inconsistent terms between that agreement and the alleged oral agreement raise factual issues that cannot be resolved at this juncture [on a motion to dismiss]").

Understanding the Context—Governing Law and Contract Law

The Three Bulwarks from Contract Law: SOF, PER, NOM

Contract law provides three principal bulwarks to protect written agreements: statutes of frauds, "no oral modification" provisions, and the parol evidence rule. As you will recall, a statute of frauds specifies a type of contract (e.g., "a contract for the sale of goods for the price of $500 or more," U.C.C. § 2-201) and makes unenforceable an oral agreement of the specified type. For example, *Filippi v. Filippi,* 818 A.2d 608, 618 (R.I. 2003), applied the statute of frauds to an alleged oral agreement to transfer land owned by a limited partnership to one of its partners. Equally important, in most instances and jurisdictions, if a contract is subject to a statute of frauds, the statute will preclude an oral modification unless the modification takes the contract out of statute. Restatement (Second) of Contracts § 149. But see *Grp. Hosp. Servs., Inc. v. One & Two Brookriver Ctr.,* 704 S.W.2d 886, 890 (Tex. App. 1986) ("Not every oral modification to a contract within the Statute of Frauds is barred. The critical determination is whether the modification *materially* effects [sic] the obligations in the underlying agreements.") (Emphasis in the original). Judge-made law and some statutes provide exceptions to some statutes of frauds; in most instances reliance is a necessary (though not sufficient) element.

A "no oral modification" (NOM) provision amounts to a statute of frauds adopted by private agreement. Both the phrase and its acronym are misnomers; if the provision is properly drafted, it precludes implied-in-fact modification as well. A better acronym would be WMO—written modifications only.

In any event, "as a general rule, no-oral-modification clauses are disfavored in the law." *Bank of Am., N.A. v. Corporex Realty & Inv., LLC,* 875 F. Supp. 2d 689, 701 (E.D. Ky. 2012). In the words of Justice Cardozo, "Those who make a contract may unmake it. The clause which forbids a change may be changed like any other. The prohibition of oral waiver may itself be waived." *Beatty v. Guggenheim Expl. Co.,* 225 N.Y. 380, 387, 122 N.E. 378, 381 (1919) (superseded by statute). We will revisit this disfavor below.

Although the statute of frauds (when applied to modifications) and NOM/WMO provisions both aim at post-formation claims, the parol evidence rule addresses the contract formation process. If a written agreement fully integrates the parties' deal, the rule bars evidence of prior agreements, statements, understandings, etc. if the evidence is offered to vary or contradict the writing.

Choosing the Governing Law

Choosing the jurisdiction of formation for a limited liability company chooses the governing law for the internal affairs of the company, and that law includes not only the jurisdiction's LLC statute, but also the jurisdiction's law of contracts. Some LLC statutes are better than others with regard to protecting written operating agreements. The same is true with regard to the common law of contracts. Thus, protecting the operating agreement begins with choosing the jurisdiction of formation.

The most important criterion is the LLC statute's approach to NOM/WMO provisions. Some statutes seek to supersede the judicial disfavor. For example, the Uniform Limited Liability Company Act (2006) (Last Amended 2013) supports NOM/WMO provisions in two separate sections. Section 105(a)(4) states that "the operating agreement governs . . . the means and conditions for amending the operating agreement." Section 107(a) states in relevant part: "An operating agreement may specify that its amendment requires . . . the satisfaction of a condition. An amendment is ineffective if its adoption does not . . . satisfy the specified condition." An official comment notes, "Because '[a]n operating agreement may specify that its amendment requires . . . the satisfaction of a condition,' an operating agreement can require that any amendment be made through a writing or a record signed by each member." The Delaware LLC statute has a similar provision. Del. Code Ann. tit. 6, § 18-302(c).

A related criterion is whether the LLC statute ousts the statute of frauds. To the surprise of many practitioners (especially those who "dabble in Delaware"), the Delaware statute does exactly that: "A limited liability company agreement is not subject to any statute of frauds . . . ." Del. Code Ann. tit. 6, § 18-101(7). It is thus theoretically possible for a Delaware limited liability company to assert that under an oral term of the company's operating agreement, a member has transferred to the company title to land, or vice versa. (Delaware enacted this statute to negate a decision of the Delaware Supreme Court applying the one-year provision of the statute of frauds to operating agreements. *Olson v. Halvorsen*, 986 A.2d 1150, 1161 (Del. 2009). However, a good NOM/WMO provision should cover this problem.)

As to the law of contracts, the most important criterion is whether the jurisdiction follows Williston or Corbin on the parol evidence rule:

> Under the restrictive 'plain meaning' view [advanced by Williston] of the parol evidence rule, evidence of prior negotiations may be used for interpretation only upon a finding that some language in the contract is unclear, ambiguous, or vague. . . . . Under the view embraced by Professor Corbin and the Second Restatement [of Contracts], there is no need to make a preliminary finding of ambiguity before the judge considers extrinsic evidence.

Taylor v. State Farm Mut. Auto. Ins. Co., 175 Ariz. 148, 152, 854 P.2d 1134, 1138 (1993). Clearly, transactional lawyers wish to party down with Williston, not Corbin.

Secondary criteria include:

- the strength of the judicial antipathy to NOM/OWM provisions and what the law requires to establish waiver in the face of a no-waiver provision. See *EWB-I, LLC v. PlazAmericas Mall Texas, LLC,* 527 S.W.3d 447, 468 (Tex. App. 2017) (noting the "general view . . . that [a] party to written contract can waive [a] contract provision by conduct despite existence of antiwaiver or failure-to-enforce clause in [the] contract"); and
- whether the jurisdiction treats merger clauses as dispositive.

Drafting Techniques

The Duty to Scriven with Precision

Clear, comprehensive drafting is important in every term of a written contract, and "the [lawyer's] duty to scriven with precision," is enhanced when he or she drafts provisions disfavored by the courts. *Willie Gary LLC v. James & Jackson LLC,* No. CIV.A. 1781, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006), *aff'd*, 906 A.2d 76 (Del. 2006). For example, in *EWB-I, LLC v. PlazAmericas Mall Texas, LLC,* 527 S.W.3d 447, 468 (Tex. App. 2017), the court considered the following nonwaiver provision:

> No delay or omission by any Party hereto in exercising any right or power *accruing upon the non-compliance or failure of performance by any other Party* under the provisions of this Agreement shall impair any such right or power or be construed to be a waiver thereof. A waiver by any Party of any of the covenants, conditions or agreements herein *to be performed by any other Party* shall not be construed to be a waiver of any subsequent breach or of any other covenant, condition or agreement herein contained.

(Emphasis added by the court.) Noting that "[t]his nonwaiver clause addresses waiver premised on inaction—the failure to demand that another party comply with contractual

requirements"—and that the claim of waiver rested in part on action taken by the other party, the court reversed a summary judgment based on the nonwaiver clause. *Id.*

In contrast, the Maine Supreme Court approved the following language as sufficient to protect a written lease from parol evidence:

> [S]ection 17.06 of the lease addresses integration, providing that "[n]o oral statement or prior written matter shall have any force or effect. [Tenant] agrees that it is not relying on any representations or agreements other than those contained in this Lease. This Lease shall not be modified or cancelled except by writing subscribed by all parties." Through this unambiguous integration clause, the parties clearly expressed their intention to treat the lease as the complete integration of their agreement. The court therefore correctly concluded that it could not consider evidence extrinsic to that clause in deciding whether the contract was integrated.

Handy Boat Serv., Inc. v. Prof'l Servs., Inc., 1998 ME 134, ¶ 12, 711 A.2d 1306, 1309.

Do We Really Want to Exclude Evidence of Course of Dealing/Performance and Usage of Trade?

When writing a NOM/WMO provision, it is worthwhile to consider what to say about course of performance, course of dealing, and usage of trade. A comment to U.C.C. Section 1-303 provides the best explanation for allowing these constructs to affect the words of a contract, no matter how carefully scrivened:

> The Uniform Commercial Code rejects both the "lay-dictionary" and the "conveyancer's" reading of a commercial agreement. Instead the meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context, which may explain and supplement even the language of a formal or final writing.

U.C.C. § 1-303. Course of Performance, Course of Dealing, and Usage of Trade., cmt. 1.

However, in the context of an operating agreement, course of dealing and performance are prime targets for a well-drafted NOM/WMO provision. As for usage of trade, the concept is a nonsequitur in a business organization. In a commercial transaction, it makes sense to look at any "practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question," U.C.C. § 1-303(c). But relations among members of a limited liability company are *sui generis*—whatever vocation or trade the company pursues.

Think of the Operating Agreement as the Owners' Manual and Draft Accordingly—in Plain English

Oliver Wendell Holmes taught us that "The life of the law has not been logic; it has been experience." Oliver Wendell Holmes, Jr., The Common Law (Boston, 1881). Similarly, if experience (conduct) suggests one rule and a writing states another, the deviation threatens the writing. But how often do clients think of an operating agreement (or any other contract) as the relevant rules of the game?

In my experience, seldom. The problem comes from lawyer's language (and byzantine formulations) that are incomprehensible and therefore alienating to business people. How can a lawyer expect such language to be the ready reference for LLC managers and members?

The solution is to draft operating agreements in language the members can understand and live by. Granted, if the deal is complex, its expression will probably be complex, but business people can understand complex concepts. For example, the business analysis of whether and how to terminate a manufacturing company's highest volume dealer is as complex as any legal rule (except perhaps for the rule against perpetuities, the rule of 78s, and the Treasury Regulations sections on "substantial economic effect"). In addition, keep in mind the background and training of those who will be reading the language if the operating agreement later becomes an issue in litigation.

Assuming the language of the operating agreement is accessible to the members whose deal it expresses and governs, it is important to teach the client(s) the importance of conforming conduct to language or vice versa. A longstanding deviation evidences a modification implied in fact or a waiver. A good NOM/WMO provision will refer to and reject claims of "agreements implied in fact, whether labeled course of performance, course of dealing, usage of trade, or otherwise, or not labeled at all." (drafted by the author)

Nonetheless, a sustained, substantial deviation between word and deed invites a court to reject even a well-written NOM/WMO provision. Moreover, the deviation raises the specter of waiver, which is perhaps the most difficult assertion to negate early on in litigation.

Shift the Burden

Finally, in addition to a merger provision (parol evidence rule) and a NOM/WMO provision, consider obliging members to speak up before relying on either alleged conversations or patterns of conduct. I offer the following suggestion, based on a model operating agreement drafted some 20+ years ago for the first edition of Bishop & Kleinberger, *Limited Liability Companies: Tax and Business Law*. The language presupposes a well-written merger provision (i.e., "entire agreement" for PER purposes) and an equally well written NOM/WMO provision.

SECTION 3.03. Invalidity and Unreasonableness of Expectations Not Included in This Agreement

(A) The Members fear the uncertainty and the potential for discord that would exist if:
  (1) the unstated expectation, expectancy, understanding, or other belief ("expectation of belief") of one or more Members can be used to gain advantage through litigation; or
  (2) an expectation or belief stated or expressed outside the confines of this Agreement can become actionable even though not all Members agree with the expectation or belief or have assented to them and even though some Members have expressed or may harbor conflicting expectations or beliefs.

(B) The Members therefore agree that:
  (1) it is unreasonable for any Member to have or rely on an expectation or belief that is not reflected in this Agreement;
  (2) any Member who has or develops an expectation or belief contrary to or in addition to the contents of this Agreement has a duty to:
    (a) immediately inform [the Managers and] all other Members; and
    (b) promptly seek to have this Agreement amended to reflect the expectation or belief;
  (3) if a Member who has or develops an expectation or belief contrary to or in addition to the contents of this Agreement neglects or fails to obtain an amendment of this Agreement as provided in Section 3.03(B)(2)(b):
    (a) is evidence that the expectation or belief was not reasonable; and
    (b) bars the Member from asserting that expectation or belief as a basis for any claim against the Company or any other Member;
  (4) no Member has a duty to agree to an amendment proposed under Section 3.03(B)(2)(b) if the Member:
    (a) holds an inconsistent expectation or belief, regardless of whether the expectation or belief:
      (i) is reasonable; or
      (ii) has been previously expressed to the Company or any other member of the Company; or
    (b) believes that the amendment is not in the best interests of the Company or is contrary to the legitimate self-interests of the Member, regardless of whether the belief is reasonable.

In the next column, we change gears and consider Remedies – Beginning with the Distinction between Direct and Derivative Claims.