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Don't Dabble in Delaware

Abstract

When a litigator argues for a particular choice of law, the litigator seeks retrospectively the law most favorable to a particular claim or claims. When a business lawyer chooses a state of formation for a business entity, the lawyer seeks prospectively the governing law whose characteristics most favor the client's interests.

Although in particular situations one characteristic may dominate, in general the business lawyer should look for governing law that is clear, comprehensive, coherent, accessible, and stable (or at least predictable). With these five metrics in mind, this column explains why lawyers forming limited liability companies should not dabble in Delaware.

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Don't Dabble in Delaware

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Prologue—Choice of Law

When a litigator argues for a particular choice of law, the litigator seeks retrospectively the law most favorable to a particular claim or claims. When a business lawyer chooses a state of formation for a business entity, the lawyer seeks prospectively the governing law whose characteristics most favor the client's interests.

Although in particular situations one characteristic may dominate, in general the business lawyer should look for governing law that is clear, comprehensive, coherent, accessible, and stable (or at least predictable). With these five metrics in mind, this column explains why lawyers forming limited liability companies should not dabble in Delaware.

The Preeminence of the Delaware Law of LLCs

Although Wyoming, not Delaware, pioneered the modern limited liability company, Delaware has long since overcome that embarrassing origins story. Most experienced LLC practitioners consider the Delaware Limited Liability Company Act (Delaware Act or Act) to be the statute of choice for sophisticated ventures organized as LLCs, and in many deals involving entrepreneurs or investors from more than one state, the lawyers routinely “default” to using the Delaware Act rather than the LLC statute of any of the states actually involved in the deal.

According to Bishop & Kleinberger, *Limited Liability Companies* ¶ 14.01[2], “Delaware law seems to exert an almost gravitational pull on attorneys.” For example, at the ABA Section of Business Law's 2016 LLC Institute, the discussion of recent case developments allocated approximately equal time to Delaware case law and to case law from the other 49 states, the District of Columbia, and U.S. territories.

The Delaware Act

The Delaware Act is a complex, sophisticated, and eminently flexible statute that exalts freedom of contract even to the point of permitting an operating agreement to eliminate some or all fiduciary duties. However, the Act's attractiveness has little to do with its inherent qualities. To the contrary, the Act's drafting style is arcane, with substantive requirements embedded in definitions, sentences in which length seems a virtue, and provisions that overlap and intertwine so as to require substantial efforts of deconstruction. For example, [section 18-101\(7\)](#) of the Act's definition of “limited liability company agreement” comprises 411 words, and in the Act's provisions on protected series, subsection [18-215\(b\)](#) comprises 577 words.

As Delaware's own Supreme Court has written in *Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999), “To understand the overall structure and thrust of the Act, one must wade through provisions that are prolix, sometimes oddly organized, and do not always flow evenly.” In sum, the Delaware Act lacks clarity, coherence, and ease of access.

As for comprehensiveness, the Delaware Act has only a skeletal set of default rules, unlike the Uniform Limited Liability Company Act (2006) (Last Amended 2013) (ULLCA) and the LLC statutes of most nonuniform states. As for stability, Delaware amends the Act every year. Sometimes the changes are inconsequential; sometimes they are fundamental. Moreover, Delaware eschews the normal “strike and underline” method for showing statutory changes and uses instead an antiquated method requiring decryption. The result is more symbolic than substantive, but consider for example [section 9 of 2007 Del. Laws, chapter 105](#):

Amend § 18-201(d), Chapter 18, Title 6 of the Delaware Code by deleting the word “may” in the first place where such word appears therein and substituting in lieu thereof the word “shall”, by inserting the words “or otherwise existing” immediately after both appearances of the words “entered into”, and by inserting the words “or reflected by” immediately after the words “as provided in”.

As for substance, many other states have statutes offering comparable flexibility and an essentially equal commitment to enforcing agreements made by LLC members. The Delaware Act does stand out by authorizing an operating agreement to eliminate all fiduciary duties, but the LLC acts of several other states do so as well. Moreover, in Leo E. Strine Jr. & J. Travis Laster, “The Siren Song of Unlimited Contractual Freedom,” *Research Handbook on Partnerships, LLCs and Alternative Forms of Business Organizations* (Robert W. Hillman and Mark J. Loewenstein, eds.), two of Delaware’s leading jurists have criticized that approach as resting on false premises and being otherwise misguided. In any event, even under a Delaware operating agreement that successfully waives all fiduciary duties, the implied contractual covenant of good faith and fair dealing remains in place to constrain unduly opportunistic behavior. See [“In the World of Alternative Entities What Does ‘Good Faith’ Mean?”](#) and [“Delineating the Implied Covenant and Providing for ‘Good Faith’”](#).

The Inherent Quality of the Delaware Judiciary

Why, then, do many non-Delaware practitioners choose Delaware when forming LLCs? The answer lies in the reputation of the Delaware judiciary. The Delaware Court of Chancery has jurisdiction over claims relating to the internal affairs of a Delaware LLC, and that court is the preeminent business court in the United States. It is comfortable with business disputes and is capable of handling esoteric and even arcane issues of law. The Delaware Supreme Court is likewise comfortable and capable; many of its judges have served previously in the Court of Chancery.

Both the Court of Chancery and the Delaware Supreme Court accept and adhere to the policy of the Delaware Act “to give maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements” under [section 18-1101\(b\)](#). Indeed, Delaware courts are conservative about contracts in general. They lean away from modernist notions that all agreements are necessarily indeterminate and toward the old-fashioned approach that a contract is a contract and that a court is not a proper forum for salving the pain of “buyer’s remorse.”

But Delaware case law has its disadvantages. First, keeping pace is almost a full-time job. As a court of equity, the Court of Chancery often ladens its decisions with voluminous statements of facts. Fifty-page decisions are not unusual, and some decisions can be understood only in the context of previous decisions in the same case. For example in *Renco Grp., Inc. v. MacAndrews AMG Holdings LLC*, No. CV 7668-VCN, 2015 WL 394011, at *1, n.1 (Del. Ch. Jan. 29, 2015), the court states that it “focuses on the facts related to the specific disputes in the pending motion and assumes general familiarity based on

related proceedings.” For that familiarity, the court refers to two of its earlier decisions in the same matter.

Second, a “Delaware LLC lawyer” must stay up to date on more than just LLC law; Delaware LLC and limited partnership law are reciprocally precedential. Knowledge of Delaware contract law is also essential. For example, B.M. Gottesman & S.E. Swenson state in “More Than Bargained For? Topics for Consideration in the Issuance and Acceptance of Delaware LLC Opinions,” 81 N.Y. St. B.J. 20, 22 (2009), that when an attorney is asked for a formal legal opinion pertaining to a Delaware limited liability company, “[i]t is . . . the responsibility of the opinion-giver to navigate Delaware common law [especially contract law] prior to rendering a Delaware LLC opinion, and to keep abreast of its shifting landscape.”

Third, sometimes a “Delaware LLC lawyer” must take into account Delaware corporate law. On more than one occasion, the Court of Chancery has applied that law to resolve a dispute among members of a Delaware LLC. For example in *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. CIV. A. 3658-VCS, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009), the court noted that “[t]he LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation.” Similarly, in a case in which an LLC member sought judicial dissolution, *Haley v. Talcott*, 864 A.2d 86, 96–97 (Del. Ch. 2004), the court gave pivotal importance to 8 Del. C. § 273, a corporate statute addressing dissolution of a joint venture corporation having two stockholders.

Moreover, Delaware corporate law can be inordinately complicated. For example, for many years “new standards of [judicial] review [of director conduct] proliferated when a smaller number of functionally-thought-out standards would have provided a more coherent analytical framework,” according to William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1292 (2001).

Fourth, Delaware entity law is not especially stable. For example, *Smith v. Van Gorkom*, 488 A.2d 858, 864 (Del. 1985), shocked the corporate bar and led to prompt corrective action—i.e., exculpation statutes adopted in Delaware and around the country. For unincorporated business organizations, *Gotham Partners, LP v. Hallwood Realty Partners, LP*, 817 A.2d 160, 167–68 (Del. 2002) provides a similar example. In *Gotham Partner*, the Delaware Supreme Court criticized dicta in Court of Chancery opinions, indulged in its own dicta, and stated that a limited partnership agreement could restrict but not eliminate fiduciary duty. This dicta, equally applicable to limited liability companies, prompted another legislative correction: 2004 Del. Laws, [ch. 275](#) (HB 411), §§ 13, 14 (expressly stating that an LLC operating agreement may eliminate fiduciary duties); 2004 Del. Laws, [ch. 265](#) (SB 273), §§ 15 and 16, and [ch. 266](#) (SB 274), §§ 3 and 4 (same as to limited partnership agreements and general partnership agreements). The most recent example comprises *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012) and 2013 Del. Laws, [ch. 74](#), § 8. The case called into question whether fiduciary duties even exist in a limited liability company; the statutory, albeit obliquely, that in the default mode, LLC law includes “rules of law and equity relating to fiduciary duties.”

A Report Card and an Explanation

Thus, Delaware LLC law does not fare well under the five metrics set forth at the beginning of this column (clarity, comprehensiveness, coherence, accessibility, and stability). Yet Delaware remains

fundamentally important to the law and practice of limited liability companies, and in countless sophisticated circumstances, a Delaware LLC is the most effective and practicable vehicle available.

This situation is no conundrum. For the *cognoscenti*, the drawbacks in the Delaware law are immaterial. For a lawyer whose practice centers on Delaware LLCs, assiduous study and continuous attention dissipate the drawbacks of the Delaware Act. The Delaware case law is indeed lengthy and plentiful almost to the extent of being fulsome, but the decisions: (i) address issues of great importance that often require sophisticated analysis and subtlety; and (ii) are authored by carefully vetted jurists for whom concepts like *ROI*, *waterfall distributions*, *dilution*, and *marginal cost* hold no mysteries. For transactional lawyers focused on Delaware LLCs, the weekly “assigned reading” has a more than acceptable “average cost.”

But for any dabbler in these mysteries, the average cost is insupportable, and the resulting risks are substantial. Therefore, don't dabble in Delaware.