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Corporate Governance Group

Client Alert

DELAWARE COURT OF CHANCERY REFUSES TO DISMISS ACTION SEEKING DISSOLUTION OF A DEADLOCKED JOINT VENTURE

Also Refuses to Dismiss Claims for Breach of Fiduciary Duty and the Implied Covenant of Good Faith and Fair Dealing

Fifty/fifty joint ventures that are not successful often lead to disputes between the partners and, in some cases, may produce noteworthy judicial decisions. Such is the case with *Lola Cars International Limited v. Krohn Racing, LLC, et al.*,[1] in which the Delaware Court of Chancery recently refused to dismiss claims arising out of a deadlocked joint venture structured as a limited liability company ("LLC"), including a request by one of the members for a judicial dissolution of the LLC pursuant to Section 18-802 of the Delaware Limited Liability Company Act (the "Act"). While courts are generally reluctant to interfere with contractual relationships negotiated by sophisticated partners, the *Lola Cars* ruling demonstrates that Delaware courts will intercede when partners are genuinely deadlocked and specific allegations of bad faith are made, even if remedies to address the deadlock are available under the contract.

Background

In March 2007, Lola Cars International Ltd., a company specializing in the manufacture and sale of race car chassis and parts, and Krohn Racing, LLC, a company which operates a "Grand Am" automobile racing team, became partners in a venture named Proto-Auto, LLC. Proto-Auto was established to manufacture and sell specific "Daytona prototype" race cars. To this end, each member was responsible for distinct tasks: Lola was in charge of evaluating, testing and developing a Lola chassis

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[1] *Lola Cars International Limited v. Krohn Racing, LLC, et al.*, C.A. No. 4479-VCN (Del. Ch. Nov. 12, 2009), *available at* http://www.delawarebusinesslitigation.com/.

for the prototype racing car, while Krohn was tasked with purchasing from Proto-Auto and testing two of these vehicles for competition, as well as providing the venture's chief executive officer.

Although Lola owned 51% of Proto-Auto and Krohn owned the remaining 49%, the parties agreed to equal representation on Proto-Auto's governing board, with each member initially appointing one member. Krohn appointed Jeff Hazell, who had managed Krohn since its creation in 2005, as its board designee. Krohn also agreed to provide Hazell's services as Proto-Auto's chief executive officer to fulfill its primary obligation under Proto-Auto's LLC operating agreement.

After two years, Proto-Auto proved not to be a successful enterprise. Lola contended that in an attempt to improve the performance of Proto-Auto, it requested a meeting with Krohn to discuss replacing Hazell as chief executive officer. Krohn apparently refused to meet with Lola to discuss this managerial change.

In response, Lola filed suit against Krohn and Hazell, alleging that Krohn had breached the LLC operating agreement in several respects, and that Hazell had breached his fiduciary duties of loyalty and care by mismanaging Proto-Auto and providing Krohn with "sweetheart" terms when Proto-Auto sold certain parts to Krohn. Lola also alleged that Krohn had violated the implied covenant of good faith and fair dealing in the LLC operating agreement by refusing to meet with Lola to discuss replacing Hazell as chief executive officer.

Lola's complaint sought dissolution of Proto-Auto and the appointment of a liquidating receiver on the basis that "the Company can no longer realize or attempt to realize its stated business purpose," as well as injunctive relief and damages. The defendants, Krohn and Hazell, countered with a motion to dismiss, arguing that (i) Lola's dissolution action was preempted by a buy-out provision contained in Proto-Auto's LLC operating agreement that was triggered by a deadlock on the board, (ii) Lola's action against Hazell was in the nature of a derivative claim for the benefit of Proto-Auto and, therefore, demand first should have been made on the board to bring such a claim, and (iii) Krohn had no obligation under the LLC operating agreement to consent to Hazell's removal as chief executive officer. The Court refused to dismiss Lola's complaint.[2]

The Court's Analysis

Dissolution

As an initial matter, the Court noted that Section 18-802 of the Act makes it clear that judicial dissolution of an LLC is warranted "whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." The Court categorically rejected the defendants' contention that the statutory "reasonably practicable" standard required that the business "has been abandoned or that its purpose is not being pursued," stating that "[t]o hold that judicial dissolution is appropriate only when the business had been abandoned would belie the language of the Act." Instead, the Court relied on the three

[2] A second action brought by Lola seeking to invoke a termination clause under the LLC operating agreement was dismissed by the Court largely on procedural grounds, but without prejudice to Lola's ability to satisfy those grounds and bring a new complaint

factors laid out in *Fisk Ventures, LLC v. Segal*[3]: "1) whether the members' vote is deadlocked at the Board level; 2) whether there exists a mechanism within the operating agreement to resolve this deadlock; and 3) whether there is still a business to operate based on the company's financial condition." The Court also noted that "none of these factors is individually conclusive, nor must each be found for a court to order dissolution."

The Court determined that all three *Fisk* factors were at issue in the dispute between Lola and Krohn, as witnessed by the facts that the board members were "allegedly deadlocked over whether to replace Hazell as chief executive officer," and the only mechanism contained in the operating agreement to resolve the deadlock was "entirely voluntary." As for the practical difficulties in continuing to operate the business, the Court cited the fact that Proto-Auto continued to be dependent on the members for "significant additional working capital", as well as "Lola's allegations of mismanagement, coupled with Proto-Auto's poor performance and Hazell's apparent entrenchment as chief executive officer." "In fact," the Court went so far as to remark, "it is difficult to imagine how any company can attain commercial success with, as alleged here, a careless and disloyal chief executive." On this basis, the Court determined that "Lola's allegations can satisfy two of *Fisk*'s three criterion," necessitating a decision not to dismiss Lola's claim for dissolution of the venture.

In addition, the Court was not sympathetic to defendants' argument that because judicial dissolution was not specifically listed in the LLC operating agreement as one of the circumstances in which the joint venture could be terminated, such a remedy was precluded. Rather, the Court found that, even "[a]ssuming for current purposes that Section 18-802 may be precluded contractually," "the fact that this particular Operating Agreement merely contains several self-termination options and does not expressly provide for judicial dissolution does not make that statutory remedy unavailable. … It simply cannot be true that a number of nonexclusive, permissive termination clauses in the Operating Agreement can preclude judicial dissolution as provided for in the Act."

Breach of Fiduciary Duties

The Court also rejected defendants' motion to dismiss Lola's fiduciary duties claims against Hazell, which the Court characterized as "plainly derivative," on the ground that Lola failed to plead demand futility with particularity. Section 18-1003 of the Act requires that, in any derivative action, the complaint must state with particularity the plaintiff's attempt to either compel the LLC's management to initiate the suit or explain why such an effort was not made. For reasons that seem obvious, Lola made no such demand upon the two-member Proto-Auto board.

Citing *Aronson v. Lewis*,[4] the Court explained that demand will be considered futile, and thus excused, "when the particularized factual allegations contained in the complaint create a reason to doubt that 1) the directors are disinterested and independent [or that] 2) the challenged transaction was otherwise the product of a valid exercise of business judgment." Focusing on the first prong of the *Aronson* test, the Court stated that

[3] *See Fisk Ventures, LLC v. Segal (Fisk I)*, 2009 WL 73957. For a discussion of the *Fisk* decision, *see* our previous Client Alert entitled "Delaware Court of Chancery Refuses to Dismiss Claims Brought Against LLC's Managing Member and the Individual who Controlled the Managing Member" (May 14, 2009).
[4] *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984).

"[a] director may be considered interested in the litigation … if such litigation threatens a materially detrimental effect upon the director but not the company or its shareholders." Because Lola had pleaded with particularity facts indicating why Hazell faced a substantial risk of liability from the litigation initiated by Lola, including the profits Proto-Auto allegedly lost as a result of the breaches by Hazell, the Court, noting that the Proto-Auto board "consists of only two directors with equal voting power," found that Hazell "may be considered interested, and thus Lola has satisfied the demand excusal standard."

Implied Covenant of Good Faith and Fair Dealing

Finally, the Court rejected defendants' motion to dismiss Lola's claim that Krohn had breached its implied covenant of good faith and fair dealing in connection with Lola's desire to remove and replace Hazell as Proto-Auto's chief executive officer. According to the Court, the "covenant restrains a contracting party from engaging in arbitrary or unreasonable conduct that has the effect of frustrating the contract's overarching purpose and denying the other party the benefit of its bargain." However, the Court would not permit itself to "substitute its own notions of fairness for the terms of the agreement reached by the parties, and will therefore only invoke the implied covenant when … the contract is silent to the disputed topic, and where 'it is clear from the contract that the parties would have agreed to that term had they though to negotiate the matter.'"

Applying these principles to the dispute before it, the Court agreed with Krohn that "the implied covenant may not apply to matters covered by the contract," but found that "Krohn mischaracterizes Lola's implied covenant claim, which rests upon Krohn's failure even to consider Hazell's termination or attend board meetings to that end and not upon Krohn's obligation (or lack thereof) to assent to Lola's demands." Therefore, in the framework of the motion to dismiss, the Court determined that even though Krohn may not have been under any obligation to agree with Lola's assessment that Hazell should be removed as chief executive officer, it could "draw a reasonable inference that Krohn acted inappropriately and in bad faith by failing to consider Lola's request to have Hazell removed." In support of this inference, the Court again pointed to the specific allegations of mismanagement on the part of Hazell, "which in turn has allegedly frustrated Lola's purpose for entering into the Operating Agreement."

Conclusion

There are several noteworthy aspects to the *Lola Cars* decision. First, the Court was willing to allow Lola's effort to dissolve the deadlocked venture to proceed, despite the fact that the LLC operating agreement provided for other remedies to an unhappy party, but not a judicially-ordered dissolution. Second, it reiterated the principle that if an LLC only has two members and one member fails the test for independence or disinterestedness, then the demand requirement in connection with a derivative action for breach of fiduciary duty is excused. And, finally, although Delaware courts will generally not provide an "addendum" to contract terms negotiated between sophisticated parties by invoking the implied covenant of good faith and fair dealing, the courts may allow such a claim to survive a motion to dismiss if sufficient facts are alleged to support an inference that one party acted "inappropriately and in bad faith."

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