Milbank

Private Equity Group Client Alert

November 10, 2008

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DELAWARE COURT RULES LLC OPERATING AGREEMENTS ARE SUBJECT TO STATUTE OF FRAUDS

On October 22, 2008, Vice Chancellor Lamb of the Delaware Court of Chancery ruled in *Olson v. Halvorsen*[1] that notwithstanding the Delaware Limited Liability Company Act's express allowance of *oral* limited liability company operating agreements, the Delaware statute of frauds renders unenforceable provisions of oral operating agreements that could not possibly be performed within one year.

Background

The plaintiff, Brian Olson, was one of three founders of Viking Global, a hedge fund and investment management firm. At its inception, Viking Global was comprised of one Delaware limited partnership and three Delaware limited liability companies. Short-form limited partnership and operating agreements were drafted and signed for the limited partnership and two of the limited liability companies and more complete long-form agreements were drafted for all of the entities, but only one of those long-form agreements was ever signed.

Following a six-month sabbatical in 2005, Olson was notified by Andreas Halvorsen and David Ott, the other Viking founders, of their decision to remove Olson from his position at Viking. Upon resignation form Viking, Olson received the balance of his capital account and the remaining compensation owed to him for 2005. The unsigned operating agreement for one of the Viking limited liability companies contained an earnout provision providing that a retiring member was entitled to a percentage of that limited liability company's profits during the six-year period following retirement, which percentage was to be based on the retiring member's profit percentage at the time of retirement. The dispute arose when Olson tried to enforce that earnout provision.

[1] *Olson v. Halvorsen*, C.A. No. 1884-VCL, 2008 WL 4661831 (Del. Ch. Oct. 22, 2008).

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Court's Analysis

Vice Chancellor Lamb noted that while the Delaware Limited Liability Company Act expressly allows oral operating agreements, the Act does not expressly exclude application of the statute of frauds requirement that agreements that cannot be performed within one year must be in writing. Neither party was able to produce any case law either supporting or refuting the notion that the statute of frauds applies in the LLC context. The Court noted that commentators did not agree as to the applicability of the statute of frauds to oral operating agreement. While some commentators have argued that any exception to a statutorily-mandated principle of contract law must be explict, others have argued that the General Assembly implicitly excepted LLC from the statute of frauds by both (i) expressly permitting oral operating agreements and (ii) including language in Section 8-1101 of the Act that the policy of the Act is to give maximum effect to the principle of freedom of contract.

Turning to the statute of frauds, the Court stated that Delaware law has long held that "the statute of frauds does not apply to a contract which may, by any possibility, be performed within a year."[2] Based on this principle, the Court held that: "if an LLC agreement contains a provision or multiple provisions which cannot possibly be performed within one year, such provision or provisions are unenforceable. . . . However, in keeping with the legislature's expressed intent [in the Delaware Limited Liability Company Act] 'to give maximum effect . . . to the enforceability of [limited liability company agreements],' provisions of an oral LLC operating agreement that could possibly be performed within one year will not fall within the statute of frauds and will remain enforceable."[3]

The Court next examined whether the earnout provision in question could possibly be performed within one year. In arguing that the earnout could be performed within one year, Olson proffered case law where oral agreements providing for a future stream of payments over a multi-year period were not rendered unenforceable under statute of fraud principles. Distinguishing the case at hand, the Court observed that the earnout provision required more than simply an obligation to make payments in the future, citing attendant provisions requiring the remaining members to take actions to protect the departing member's economic interest and preventing one of the remaining members from withdrawing certain funds. The Court also noted that earnout payments in subsequent years could not be calculated until more than one year after the event triggering the payment obligation.[4]

The Court also examined whether the "multiple writings" exception to the statute of frauds applied to the earnout provision in dispute.[5] Olson provided a signed letter agreement that generically referenced a limited liability company agreement "as amended from time to time."[6] The Court noted that had the letter agreement contained a specific reference to the unsigned agreement rather than the generic reference it did contain, the Court may have found Olson's arguments more persuasive. Olson also cited financial statements and tax returns as evidencing the economic agreement of the parties, but the Court also dismissed these sources as they did not reference the terms of the unsigned operating agreement or the earnout itself.

Conclusion

The *Olson* holding should flash as a warning signal to managers of hedge funds and private equity funds who have delayed documenting upstream agreements evidencing manager profit participations, relying, instead, on "hand-shake" deals and roughly-outlined unsigned arrangements or draft agreements. Without proper signed documentation evidencing a profit participation, the rights of the managers to participate in the future profits of the fund enterprise are now in jeopardy.

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[2] *Olson, 3,* citing *Haveg Corp. v. Guyer,* 211 A.2d 910, 912 (Del. 1965).
[3] *Olson*, 3. To bolster its decision, the Court noted that most oral operating agreements are not likely to contain terms that cannot possibly be performed within a year, thus carving-out considerable space in the holding. We note that this tends not to be the case for operating agreements in the hedge fund and private equity fund context.
[4] We can infer from the Court's statements that a provision in an oral operating agreement containing no obligations left to be performed following the one-year statute of frauds period other than the payment of money would not be rendered unenforceable by the Delaware statute of frauds. However, it is difficult to imagine any true earnout or future profit participation in the hedge fund or private equity fund context that could avail itself of such an exception.
[5] To satisfy the statute of frauds, multiple writings must "(a) reasonably identify the subject matter of the contract, (b) indicate that a contract has been made between the parties or an offer extended by the signing party and (c) state with reasonable certainty the essential terms of the unperformed promises in the contract." Restatement (Second) of Contracts § 131.
[6] *Olson*, 5.

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