

Court of Appeals Upholds Contract Merger Clause



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In *Behler v. Kai-Shing Tao*, the New York Court of Appeals found that the merger clause contained in a limited liability company agreement governed by Delaware law superseded an alleged prior oral agreement between the parties, despite their history of conducting business through oral arrangements.

Facts:

In 2012, Kai-Shing Tao ("Tao"), the CEO and Chairman of Remark Holdings, Inc. ("Remark"), asked his "close friend" Albert Behler ("Behler") to invest in Digipac LLC ("Digipac"), a special purpose vehicle created by Tao to hold shares of Remark. Behler initially expressed concerns about the liquidity of such an investment, citing "the inherent difficulty in liquidating shares of a limited liability company". To address these concerns, the parties entered into an oral agreement whereby Behler invested \$3 million in Digipac, receiving a 24.14% stake in Digipac, and Tao promised Behler two exit strategies:

1. If Remark's stock price reached \$50 per share, Digipac would sell its shares of Remark, and Behler would receive his *pro rata* share of the proceeds; or
2. If Remark's stock price did not reach \$50 per share within five (5) years following Behler's investment, Tao would provide Behler with an opportunity to exit based on the value of Digipac's Remark holdings at the time.

At the time of the oral agreement and Behler's investment, Digipac was governed by its original LLC agreement with Tao as the "Sole Member" with exclusive authority to amend the LLC agreement.

In 2014, Tao unilaterally amended the LLC agreement. The amended LLC agreement addressed investment in Digipac, as well as the liquidation of assets and distributions to members, among other things, but did not include automatic exit options for its members. The amended LLC agreement also contained a standard merger clause stating that the amended LLC agreement "constitutes the sole and entire agreement of the parties to this Agreement with respect to the subject matter contained herein and therein, and supersedes all prior and contemporaneous understandings, agreements, representations and warranties, both written **and oral**, with respect to such subject matter, including the Original [LLC] Agreement."

Remark's stock price did not reach \$50 per share, and following the five (5) year anniversary, Tao failed to provide Behler with an exit opportunity as previously orally agreed.

Arguments:

Behler argued that the oral agreement and the amended LLC agreement were distinct in both form and substance, as the oral agreement was made between friends in a personal capacity, but Behler was only party to the amended LLC agreement in his membership capacity. He claimed that the oral agreement was a personal assurance between friends, not a business contract governed by Digipac's governing documents.

Decision:

Behler sued Tao for breach of contract and promissory estoppel, seeking an order directing Tao to purchase Behler's Digipac membership for its value on the five (5) year anniversary of his investment. The New York Supreme Court granted Tao's motion to dismiss, reasoning that the amended LLC agreement does not provide for automatic exit options and the merger clause supersedes any prior agreements between the parties. The First Department and the Court of Appeals affirmed.

The Court of Appeals rejected plaintiff's argument, finding that "[t]he consideration the plaintiff received from the oral agreement was, in part, a guaranteed exit from his Digipac investment, which implicates, and in fact assumes, plaintiff's role as a Digipac member." Behler's membership in Digipac and Tao's unilateral amendment authority under the original LLC amendment meant that Behler was contractually bound by the properly amended LLC agreement, including its merger clause.

The Court stated that the Delaware Limited Liability Company Act's (the "DLLCA") goal of providing clarity and certainty to its members would be upended by accepting the idea that the parties entered into the oral agreement in a different capacity that therefore shields the oral agreement, which covered the same subject matter as the amended LLC agreement, from the reach of the amended LLC agreement. The Court emphasized the DLLCA's policy of giving "maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements" which includes honoring merger clauses as final and exclusive integrations of agreements between parties.

The Court also noted that because the oral agreement and the amended LLC agreement both concerned investment in Digipac, liquidation of Digipac's assets and distribution of the proceeds, and the transfer of a Digipac membership interest, the two agreements covered the same subject matter and therefore the amended LLC agreement's merger clause unambiguously nullified the prior oral agreement.

The Court rejected the plaintiff's promissory estoppel claim because "[u]nder Delaware law, '[p]romissory estoppel does not apply . . . where a fully integrated, enforceable contract governs the promise at issue'" and even under New York law, the promissory estoppel claim would be dismissed as "duplicative of the breach of contract claim."

Dissent:

The dissent argued that the oral agreement and the amended LLC agreement did not concern the same subject matter, as the oral agreement was reached between two friends to induce one to invest in the other's company by "protecting his investment and affording him a way out following the occurrence of certain events" and the amended LLC agreement, Digipac's governing instrument, was intended to manage Digipac's internal affairs and direct the conduct of its business. Additionally, the two agreements involved different parties who were exercising different roles (friends and business associates vs. a member and the manager of Digipac, in addition to Digipac's entire body of members). Therefore, the dissent argued the plaintiff's arguments were sufficient to survive dismissal at an early procedural stage.

Takeaways:

This Court noted that while it may appear "harsh" to allow one party to a contract to unilaterally extinguish his contractual obligation, even after benefitting from the other party's performance, Delaware law prioritizes contractual clarity and "advises prospective investors in a closely held LLC . . . to scrutinize the existing LLC agreement" and take appropriate measures to ensure their contracted-for rights are provided for in a clear written agreement between the parties.

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