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Delaware Chancery Court Orders Venture Capital Firm To Increase Terminated LLC Member's Payout In Post-Trial Opinion

August 28, 2018

On August 13, 2018, Vice Chancellor Travis Laster of the Delaware Court of Chancery ordered Domain Associates, LLC ("Plaintiffs," "Domain," or the "Firm"), a venture capital firm, to pay its former member, Nimesh Shah ("Defendant" or "Shah"), the fair value of his 12.1% member interest as of the date he was forced to withdraw from the LLC, potentially worth millions of dollars. Domain had contended that Shah was entitled only to the amount of his capital account balance, or approximately $438,000. In his post-trial opinion, Vice Chancellor Laster also found the individual members of Domain jointly and severally liable for breaching the Domain LLC Agreement when they voted to force him to withdraw on April 18, 2016 but did not pay him his share of the fair value of the business. Significantly, after concluding that the LLC Agreement was silent as to the payout for a forced-out member, the Court looked not only to the Delaware Limited Liability Company Act (the "LLC Act") but also to the Delaware Revised Uniform Partnership Act (the "Partnership Act") for guidance because Domain operated in a manner akin to a general partnership, as distinct from other governance structures. The decision provides important guidance for drafting operating agreements governing Delaware entities, understanding the potential sources of law that may guide a court adjudicating intra-entity disputes, and in litigating disputes involving these agreements.

Background

Founded in 1985, Domain is a venture capital firm that at the relevant time focused on the biopharmaceutical, diagnostic, and medical device sectors, the last of which was Shah's area of expertise. The LLC Agreement permitted the members to force any other member to withdraw from the Company provided that the vote of the non-withdrawing members was unanimous. The LLC Agreement also addressed members who voluntarily retire or withdraw by operation of law due to insanity, bankruptcy, or death. In those instances, the LLC Agreement provided that such withdrawing member shall be paid "in exchange for his entire interest in the Company, an amount equal to . . . Member's capital account." The LLC Agreement was silent as to the amount to be paid following a *forced* withdrawal.

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Shortly after Shah became an equity member, Domain began to question its commitment to medical device investments. On January 19, 2016, Domain's founders asked Shah to leave and proceeded to engage Shah in several months of discussions regarding the economic terms of his departure. After Shah rejected Domain's terms and refused to withdraw voluntarily, the other members voted unanimously to force Shah to withdraw on April 18, 2016. Domain and its members took the position that, upon his forced withdrawal, Shah was only entitled to the value of his capital account in return for his member interest. According to Domain's records, Shah's capital account had a balance of $438,353.05, and Domain sent Shah a check for that amount. Shah returned the check and asserted that he was entitled to 12.1% of Domain's cash on hand on his withdrawal date, or $1,553,667, because he viewed that amount to be the fair value of his interest.

The Decision

After reviewing the terms of the LLC Agreement, examining the default rules of the LLC Act that apply where an LLC agreement is silent, and looking for guidance to analogous rules of the Partnership Act, Vice Chancellor Laster concluded that Domain and its members breached the LLC Agreement by failing to pay Shah the fair value of his member interest when they forcibly removed him from the Firm. The Court held that the LLC Agreement's provision regarding the payout due to a retiring member was inapplicable to a forcibly expelled member. The Court also awarded Shah pre- and post-judgment interest running from April 18, 2016. The Court ordered the parties to jointly calculate Shah's damages within 30 days pursuant to guidance provided in the decision.

Takeaways and Analysis

The Governance Structure Adopted By A Delaware Entity May Have Significant Implications For Interpretation Of The Entity's Operating Agreements

In its analysis of the LLC Agreement, the Court noted that the Agreement provided five ways by which a member's status could terminate: (i) retirement, (ii) death, (iii) insanity, (iv) bankruptcy, and (v) forced withdrawal by vote of the other members. The Court observed that, while the LLC Agreement provided for a clear compensation formula for retirement, death, insanity, and bankruptcy, the Agreement did not specify any payout mechanism for a forced withdrawal. Accordingly, the Court looked to the LLC Act, but concluded that no provision was relevant and, as a result, Section 18-1104 of the LLC Act directed that "the rules of law and equity . . . shall govern."

Citing then-Vice Chancellor Leo Strine's decision in *Hillman v. Hillman* in addressing a limited partnership agreement dispute,[1] Vice Chancellor Laster looked for guidance to Section 15-701 of the Partnership Act, which as described in *Hillman*:

> "[E]xplicitly recognizes that after the expulsion of a partner, . . . the remaining partners may continue to operate the partnership business provided that a buyout payment is made to the expelled partner in an amount 'equal to the fair value of such partner's economic interest as of the date of dissociation based upon such partner's right to share in distributions from the partnership' as required by § 15-701."[2]

The *Domain* Court observed that "applying this rule of law" here "is all the more apt because the Company was a member-managed entity whose governance structures resembled a partnership." The Court stated that "[t]he choices that the drafters make have consequences," and if "the drafters have embraced the statutory default rule of a member-managed governance arrangement, which has strong functional and historical ties to the general partnership (albeit with limited liability for the members), then the parties should expect a court to draw on analogies to partnership law." The Court distinguished a member-managed entity from, for example, an entity with a single managing member and passive non-managing members (for which parties to the agreement should expect a court to look to limited partnership law by way of analogy) and a manager-managed entity with corporate features (for which the parties to the agreement should expect a court to look to corporate law).

Therefore, it is not enough for drafters of operating agreements to assess only the default statutory law applicable to that organizational form (*i.e.*, here, the LLC Act). Because the "choices that the drafters make have consequences," an organization's governance system may lead a court to look by way of analogy to laws and related decisions applicable to other organizational forms, as Vice Chancellor Laster in this case relied on general partnership law to interpret the LLC Agreement. That most likely would only be the case, however, where both the relevant agreement and statute are silent as to the issue in question, as was the case in *Domain*.

Delaware Courts Do Not Favor Contract Interpretations That Result In Forfeitures

The Court observed that allowing Shah to recover the fair value of his membership interest comports with another important Delaware law precept: "Delaware law does not favor interpretations that result in forfeitures."[3] If the Court followed Domain's interpretation of the LLC

[1] 910 A.2d 262, 271-78 (Del. Ch. 2006).

[2] *Hillman*, 910 A.2d at 276 (quoting 6 *Del. C.* § 15-701(b)).

[3] *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738, 762 (Del. Ch. 2004).

Agreement, it would result in Shah's forfeiture of the difference between the fair value of his 12.1% membership interest and the value of his capital account balance. The Court quoted prior Chancery Court precedent, writing, "the[] provisions [of the LLC Act] do not provide for the forfeiture of economic rights, requiring instead that the persons whose interests are eliminated are entitled to receive fair value therefor."

The Extent Of LLC Members' Participation In The Conduct Giving Rise To A Contractual Breach May Determine Whether Each Is Individually Held Jointly And Severally Liable

The Court held that Domain's members individually breached the LLC Agreement by forcing Shah to withdraw without paying him the fair value of his membership interest, entitling Shah to monetary damages for which the members were jointly and severally liable. The Court rejected the defendants' argument that only Domain, and not the members, were liable to Shah for breach of the LLC Agreement. In its analysis, the Court found it significant that "the LLC Agreement does not create an obligation on the part of the Company to pay Shah." Instead, the Court found, "[t]he LLC Agreement is silent, and the breach arises under the default provisions of the LLC Act." The Court also took account of equitable reasons supporting this outcome, including that "the remaining members were not passive actors or so uninvolved in the Company's management such that holding them liable for breach of contract is unwarranted." According to the Court, "[if] the Company had a true managing member that had made all of the decisions regarding Shah's forced withdrawal while the remaining members remained passive spectators, then again their argument would be stronger." The Court added that the remaining members "benefitted proportionately from the elimination of [Shah's] interest."

Again, careful drafting is essential. The Domain LLC Agreement was silent as to who was responsible for a breach of the contract. In that event, the Court found that a rational reading of the contract as well as equitable considerations supported joint and several liability on the part of individual members. If LLC members wish to protect against this outcome, the LLC Agreement should clearly preclude it.

There Can Be Multiple, "Rational" Interpretations Of A Contract, Including One That Leads To A Higher Payout For A Forced-Out Member Than A Member That Voluntarily Retires

Arguments that an adversary's contractual interpretation is irrational are no substitute for careful drafting. The Court rejected Domain's contention that awarding Shah an amount more than his capital account would lead to an irrational result by giving him greater compensation than members who voluntarily withdraw or leave for more "sympathetic" reasons. Drawing attention to the importance of drafting and the parties' freedom of contract, the Court stated that "[i]t is rational for sophisticated individuals to be worried about disputes and to want protection [in the form of being

paid for the fair value of their membership interests] against being forced out following a legitimate disagreement over performance or due to a power struggle or personality conflict." The Court further observed, "[i]f the forced-out member would receive only the value of her capital account, rather than the greater value of a proportionate share of the entity as a going concern, then the other members would gain by ganging up on a disfavored member." In light of this concern, the Court deemed the exclusion of the forced-withdrawal scenario from the payout formula "rational." The Court found that the parties could have addressed the forced withdrawal situation in the LLC Agreement but chose not to, and "that omission does not make [the Agreement's] terms irrational." The Court also hypothesized possible reasons for a choice to limit voluntarily withdrawing members to their capital accounts, including that members leaving on good terms may reach agreed-upon severance packages or that "[i]n the case of sad events like death, insanity, or bankruptcy, the remaining members might well be expected to provide compassionate support to their former colleague."

Delaware Courts Continues To Place Far More Probative Value On Contemporaneous Documentation And Conduct Over Litigation Positions

Noting the absence of contemporaneous documents, the Court found that there were no documents whatsoever support Domain's position that Shah was entitled to only the value of his capital account. "There are no contemporaneous documents to support this position, and until the events giving rise to this litigation, Domain never asserted that a withdrawing member was only entitled to the value of his or her capital account." Similarly, the Court found contemporaneous documents contradicted, and therefore the Court appeared not to credit, Shah's testimony at trial that he wished to remain a member of Domain and that he had asked for a written set of terms for his severance package for a record of their final offer rather than to use in negotiations with prospective employers. Similarly, while observing that it could not consider extrinsic evidence in interpreting the LLC Agreement given that the scope of the relevant provision was "plain and unambiguous," it observed that "the most persuasive extrinsic evidence" would have been Domain's course of dealing:

> The Company has never limited a departing member to his or her capital account. The Company instead has paid every member who left the Company millions more than their capital account. Admittedly, these departures were consensual, but there is no indication that during any of the discussions or negotiations, anyone ever mentioned the concept of forcing a member to withdraw and limiting them to their capital account.

The Court's reliance upon contemporaneous conduct and documents, or lack thereof, over post-litigation positions, is just the latest of many decisions emphasizing the importance of contemporaneous, pre-litigation evidence. *See, e.g.*, *Fox v. CDX Holdings Inc.*, C.A. No. 8031-VCL

(Del. Ch. July 28, 2015); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, Slip. Op. June 30, 2015, C.A. No. 8094-VCP (Del. Ch. June 30, 2015).

Management Projections Prepared In The Ordinary Course Of Business Are Deemed Generally Reliable

For the purposes of calculating the fair value of Shah's membership interest, the Court selected the model used by Domain's expert since it used management's cash flow projections that were prepared yearly, in the ordinary course of business, and not for the "purposes of litigation, in anticipation of a pending transaction, or under other circumstances that could undermine [the projections'] reliability." According to the Court, "Delaware law clearly prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations." The Court further noted, "[w]hen management projections are made in the ordinary course of business, they are generally deemed reliable." Shah's expert, in contrast, made major alterations to Domain's management projections without persuasive justification. Thus, *Domain* is consistent with other Delaware decisions in a variety of contexts (previously discussed here and here), including appraisal proceedings and breach of fiduciary duty claims arising out of mergers, affirming reliance on management projections prepared in the ordinary course for valuation purposes.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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