

CONSIDER INDEMNIFICATION AND ADVANCEMENT OBLIGATIONS WHEN DRAFTING LIMITED LIABILITY COMPANY OPERATING AGREEMENTS

By Mark J. Tarallo

When parties are negotiating over the terms of a Delaware limited liability company operating agreement, the most heavily negotiated provisions typically involve things like capital contributions, allocations and distributions, and governance. However, a recent Delaware Chancery Court case serves as a reminder that all provisions of a limited liability company operating agreement must be given careful consideration, including the provisions relating to advancement and indemnification rights. In *Harrison v. Quivus Systems, C.A. 12084-VCMR*, the Delaware Chancery Court ruled on cross motions for summary judgment in a case where the plaintiff, the former CEO of the defendant, sought indemnification and advancement from the defendant corporation. The court ruled in favor of the plaintiff, and awarded not only the advancement and indemnification sought, but also “fees on fees” incurred by the plaintiff in bringing the action in Delaware.

John Harrison (the plaintiff in this action) had served as the CEO of Quivus Systems, LLC (the defendant), since its inception in 2007. In 2014, the controlling shareholder of Quivus removed Harrison as CEO, and in 2015 filed suit against Harrison in the Superior Court for the District of Columbia, alleging mismanagement and corporate malfeasance. In response to this lawsuit, Harrison made a demand for indemnification (including advancement of expenses), which was refused by Quivus. After this refusal, Harrison sued Quivus in the Delaware Chancery Court, leading to the ruling issued by Vice Chancellor Montgomery-Reeves on August 5, 2016.

The court considered the language of the Quivus operating agreement, and noted that while there had been several drafts exchanged and the document had been heavily negotiated, the indemnification language had not been revised at all. The language in the operating agreement provided, in part, “[s]ubject to any limitations set forth in the [Delaware LLC] Act, the company shall indemnify and advance expenses to each present and future member or manager of the company (and, in either case, his heirs, estate, personal representatives or administrators) to the full extent allowed by the laws of the state of Delaware, both as now in effect and as hereafter adopted.” The court noted that the “full extent of the law” provisions referred

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to Section 18-108 of the Delaware Limited Liability Company Act (which essentially provides that the language of the operating agreement governs) and not the more restrictive language of Section 145 of the Delaware General Corporation Law. As a result, the plain language of the Quivus operating agreement would control, and Harrison was entitled to advancement of his indemnification expenses.

Parties negotiating an operating agreement, especially one for an operating business that involves multiple shareholders or investors who are not involved in the operation of the business, should carefully consider the indemnification and advancement provisions of the operating agreement. Frequently, drafters will simply default to the catch-all “to the full extent of the law” language, which can lead to some unintended results. Parties may want to consider drafting language that tracks more closely the language of Section 145 of the Delaware General Corporation Law, which incorporates more restrictive provisions as to the granting of indemnification (imposing “good faith” obligations on claimants seeking indemnification, some requirement of success on the merits in claims made against the claimant). If the document does include indemnification language that is more consistent with the DGCL language, the parties should also confirm that the right set forth in the operating agreement is the sole and exclusive right to indemnification, to avoid a claim being made under the LLC Act. The parties may want to exclude indemnification for any breach of the operating agreement, any breach of the LLC Act, intentional misconduct and knowing violation of the law, and the parties may want to require that any indemnification for a matter in which the company is an adverse party to the person requesting the indemnification must be approved by the company.

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