

Delaware LLC Agreements – Application of the Statute of Frauds

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The Delaware Court of Chancery recently addressed an issue of first impression before the Delaware courts, or apparently before a court in any other United States jurisdiction - whether the statute of frauds applies to limited liability company ("LLC") operating agreements.¹ The Court held that the statute of frauds² was applicable to LLC operating agreements governing LLCs formed under the Delaware Limited Liability Company Act (the "LLC Act"). This ruling, however surprising to Delaware practitioners, provides useful lessons for those that utilize LLCs in the operation of their business or in their practice.

The parties in *Olson* were hedge fund founders, who subsequently disagreed about a provision in an unsigned LLC operating agreement after one of the founders (the plaintiff) was removed from his position in the LLC by the remaining founders (the defendants). The unsigned agreement contained a provision which provided any founder, who voluntarily or involuntarily retired from their position, a multi-year earnout of their interest in the company based on a percentage of the remaining founders' income over the following six years. In addition to the payment obligation, the provision at issue included several obligations which the remaining founders had to comply with, including maintaining the retiring member's economic interest, preventing action which would reduce that interest, and preventing one specific founder from withdrawing a certain percentage of his funds unless he relinquished his veto rights. The Court found that the statute of frauds rendered this provision unenforceable, holding that because the LLC operating agreement which contained the provision had not been signed and the oral agreement to the terms of the provision could not be performed within one year, the provision at issue could not be enforced as against the parties.

The Court noted that the LLC Act expressly allows for oral operating agreements, but further noted that the LLC Act does not expressly address the applicability of the statute of frauds to such agreements. The Court further noted the view of some commentators that in the absence of an express, specific intent to override the statute of frauds, it should apply. Conversely, it was noted that others contend that the Delaware legislature's expressed intent to give maximum effect to the enforceability of LLC operating agreements should trump the applicability of the statute of frauds.

In the end, the Court relied on the policy for enactment of the statute of frauds -- to protect against unfounded or fraudulent claims that require performance over an extended period of time. While the Court noted that few oral LLC operating agreements are likely to contain provisions that cannot be performed in one year, if that is the case, then those provisions will be unenforceable.³

What does this decision mean for those utilizing the LLC form -- LLC operating agreements (and likely any other agreement governing alternative entities) should always be reduced to writing and executed. By executing operating agreements, the contracting parties ensure their intent is confirmed and that the provisions therein will not be subject to a claim of unenforceability by application of the statute of frauds.

¹ *Olson v. Halvorsen, et al.*, 2008 Del. Ch. LEXIS 156 (October 22, 2008).

² The Delaware statute of frauds provides, in relevant part, "that an agreement 'that is not to be performed within the space of one year from the making thereof' must be reduced to writing and signed by the party against which the agreement is to be enforced". *Olson* at *11 (quoting 6 *Del. C.* §2714(a)).

³ It is important to note that the Court suggests that if only payment were required after a one year period, and all other obligations could be satisfied within one year, such an oral agreement would not be subject to the statute of frauds. *Olson* at *10-12.