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Form 5 LLC: A Modest Proposal for A Limited Liability Company Agreement Based on Form 5

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Chapter 13
FORM 5 LLC: A MODEST PROPOSAL FOR A
LIMITED LIABILITY COMPANY AGREEMENT
BASED ON FORM 5

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§ 13.01 Introduction¹

Long before there were limited liability companies (LLCs), there were mining joint ventures.² Although LLCs have generally become the dominant choice for the formation of privately held entities,³ the common law joint venture stubbornly persists as the preferred investment vehicle for mining companies.⁴ The practitioner faced with advising its mining clients regarding choice of business structure has a plethora of “Form 5” options previously published by the Rocky Mountain Mineral Law Foundation (Foundation): Form 5,⁵ Form 5A,⁶ or Form 5A LLC,⁷ each with its benefits and costs, virtues and shortcomings.

To provide even more confusion, the authors propose yet another version of Form 5, that the authors have dubbed the “Modest

¹The authors wish to thank Lauren King, a summer associate with Holme Roberts & Owen LLP, for her assistance, as well as the other colleagues whom we consulted in developing this chapter.

²The first limited liability company statute was adopted in Wyoming in 1977. See Susan Pace Hamill, “The Origins Behind the Limited Liability Company,” 59 *Ohio St. L.J.* 1459 (1998), for a history of the LLC. Mining joint ventures and joint operating agreements have been a staple of the proceedings of the Rocky Mountain Mineral Law Foundation since at least 1956. See, e.g., Dale H. Flagg, “Tax Treatment of Joint Operations,” 2 *Rocky Mt. Min. L. Inst.* 247 (1956). The history of the mining joint venture is summarized in John C. Lacy, “Alternate Ways of Paying the Piper: Dilution and Nonconsent Mechanisms in Mining Venture Agreements,” 31 *Rocky Mt. Min. L. Inst.* 7-1, §§ 7.02, 7.03[4] (1985).

³The total number of Delaware LLCs formed in 2005 exceeded the number of Delaware corporations formed in that same year. See Larry E. Ribstein & Robert R. Keatinge, Ribstein and Keatinge on Limited Liability Companies § 1:1 n.1 (2d ed. Supp. 2006) (citing the annual reports of the Delaware Secretary of State to the International Association of Corporate Administrators).

⁴See James F. Cress & Douglas P. Wall, “Domestic and International Uranium Ventures and LLCs,” *Uranium Exploration and Development* 10-1, 10-4 & 10-5 (Rocky Mt. Min. L. Fdn. 2006) [hereinafter Uranium JV Paper]. This chapter results from a comment in the Uranium JV Paper stating that “the Foundation could enhance the LLC options available for mining ventures without too much trouble . . . by publishing a limited liability company form based on Form 5.” *Id.* at 5. One of the authors now disavows the “without too much trouble” portion of that comment.

⁵*Model Form 5: Mining Venture Agreement* (Rocky Mt. Min. L. Fdn. 1984) [hereinafter Form 5].

⁶*Model Form 5A: Exploration, Development and Mine Operating Agreement* (Rocky Mt. Min. L. Fdn. 1996) [hereinafter Form 5A].

⁷*Model Form 5A LLC: Exploration, Development and Mining Limited Liability Company* (Rocky Mt. Min. L. Fdn. 1998) [hereinafter Form 5A LLC].

Form” in the vain hope that the project would thereby become more manageable. The Modest Form is intended as a less complex LLC agreement based primarily on Form 5, incorporating certain provisions from Form 5A and Form 5A LLC, as well as new provisions based on amendments to the Delaware Limited Liability Company Act (DLLCA)⁸ since the adoption of Form 5A LLC and other recent LLC legal developments. The authors have provided a first draft of the Modest Form for review and comment by users of the previous forms.⁹

Naturally, the terms of the Modest Form significantly drive the content of this chapter. Similar to the challenges faced by the authors who transformed Form 5A into Form 5A LLC,¹⁰ certain revisions to Form 5 were necessary in drafting the Modest Form to recognize the existence of an entity separate from its owners and to incorporate common conventions in the drafting of LLC agreements. Those changes include, for example, that title to property is held in the name of the LLC instead of its owners, and that owners have “Percentage Interests” in the entity rather than “Participating Interests” in the assets. This chapter, however, largely does not discuss those concepts because they are non-controversial and now familiar to many practitioners, and were covered comprehensively by the authors of Form 5A LLC.¹¹

Instead, we reconsider the structure of Form 5A and certain provisions of Form 5A LLC a decade after their publication and suggest some issues that may pose obstacles to their wider use. Departing to a limited extent from the original “Modest Proposal” of an LLC based solely on Form 5, we also consider certain provisions of Form 5A LLC that may be sufficiently beneficial in an LLC agreement to be included in the Modest Form, based on our admittedly untested assessment of their general acceptance or

⁸ Del. Code Ann. tit. 6, §§ 18-101 to -1109 (elec. 2007).

⁹ The draft Modest Form is not appended to this chapter due to space limitations in the Annual Institute *Proceedings*, but is available as a free download from the Foundation’s web site, <http://www.rmmlf.org>, or directly from the authors.

¹⁰ See Ronald K. Edquist & Randall E. Hubbard, “The New Form 5A LLC: Implementation of Form 5A in the LLC Context,” 44 *Rocky Mt. Min. L. Inst.* 13-1 (1998).

¹¹ See *id.*

usefulness.¹² We then discuss some “new” provisions proposed in the Modest Form based on recent legal developments. Before concluding, we briefly touch on a few dispute resolution matters and the tax exhibit that accompanies the Modest Form.

We begin with a summary of the various forms and their history, and the philosophy behind their construction, before launching into the substance of the Modest Form.

§ 13.02 Background

[1] Form 5 and the Joint Venture

Form 5 is a model joint venture agreement for a common law joint venture contemplating that “one party (described as “XCO”) owns a mineral property and is offering a 50% undivided interest in the property to a second party (described as “YCO”) in exchange for YCO’s agreement to fund a stated amount of exploration, development and/or mining costs.”¹³ As stated in the General Comments to Form 5, “[a]lthough it is certainly possible, and may be preferable in many situations, to create a state law partnership, mining venture agreements have traditionally avoided this approach and the Model Form follows this tradition.”¹⁴

A joint venture may be carried out through a variety of structures.¹⁵ Although many business associations that are not statutorily created entities will be deemed general partnerships,¹⁶ in

¹²For expediency in comparing the business terms of Form 5 to Form 5A and Form 5A LLC, whenever the terms of Form 5A and Form 5A LLC are the same, the authors will refer in this chapter only to Form 5A LLC.

¹³See Form 5, General Comments at 1.

¹⁴*Id.* General Comments art. IV, at 6-7.

¹⁵See, e.g., Joint Venture Task Force of the Negotiated Acquisitions Comm. of the Am. Bar Ass’n, *Model Joint Venture Agreement With Commentary* (2006) [hereinafter the ABA Model Joint Venture Agreement]. The ABA Model Joint Venture Agreement is actually a limited liability company agreement for a Delaware limited liability company. In the preface, committee Co-Chairs Thomas B. Hyman, Jr. and Alison J. Youngman state that the choice of a Delaware limited liability company “reflects first, the widespread use of limited liability companies and, second, the frequent use of Delaware as the jurisdiction of formation, even though the Delaware LLC statute is not based on the Uniform Limited Liability Company Act.”

¹⁶See Delaware Revised Uniform Partnership Act, Del. Code Ann. tit. 6, § 15-202(a) (elec. 2007) (“[T]he association of two or more persons (i) to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership. . .”).

numerous contexts, courts and commentators have recognized the existence of the common law joint venture,¹⁷ commonly described as “an enterprise undertaken by several persons jointly to engage in a common plan or project for their mutual benefit with a sharing of capital, skill and effort.”¹⁸ The primary disadvantage of a common law joint venture or partnership is that the parties are subject to unlimited liability for the joint venture’s obligations.¹⁹ The primary advantages of the common law joint venture business structure are the flexibility for constructing the contractual relationship, and the ability to avoid partnership tax treatment in the very limited circumstances where avoiding such tax treatment is desired.²⁰ Under Form 5, the joint venture is managed by a management committee, and the day-to-day operations are managed by a manager.²¹

[2] Interlude: Form 5A

Roughly a decade after its publication, Form 5 suffered the inevitable fate of revision with the publication of Form 5A in 1996. In his 1990 paper, David Johnson wrote that “[w]hile the status attained by Form 5 has to be deemed complimentary to the efforts of the [Foundation], the ensuing use of Form 5 is clearly inconsistent with the intent of its authors. Consequently, there is in practice an increasing clamor for revisions to Form 5 or a sequel to Form 5 designed to better accommodate the prevailing use of the document.”²² The “intent” referred to by Johnson was that Form 5 be used as a checklist and not as a form contract.²³ The problem, urged Johnson and the Form 5A Commentary, was that complex issues regarding development and production that were

¹⁷ See generally Stephen I. Glover & Craig M. Wasserman, *Partnerships, Joint Ventures & Strategic Alliances* § 5.03 (rev. ed. 2006).

¹⁸ *Pike v. Commodore Motor Corp.*, No. 940, 1985 WL 11564, at *3 (Del. Ch. May 10, 1985).

¹⁹ See Glover & Wasserman, *supra* note 17, § 6.02[2].

²⁰ John R. Maxfield, Davis O. O’Connor & Risa L. Wolf, “New Oil and Gas Exploration Investment Vehicle: The Limited Liability Company,” 38 *Rocky Mt. Min. L. Inst.* 17-1, §§ 17.01, 17.03[1][e][iii] (1992).

²¹ See Form 5, arts. VII, VIII.

²² David Stafford Johnson, “Form 5 Mining Venture Agreement: The Sequel?,” 36 *Rocky Mt. Min. L. Inst.* 10-1, 10-5 (1990).

²³ See Form 5A, Commentary art. I.B.

not addressed in Form 5 arose during negotiations, leading to inevitable disagreements.²⁴

Accordingly, Form 5A was born, revising Form 5 to (1) allocate and limit responsibility for preexisting environmental problems and provide for the funding of an environmental compliance fund; (2) require pre-feasibility, feasibility, and development programs and budgets before proceeding from the exploration to the development phase of a project; (3) provide that indirect transfers of interests trigger preemptive rights; (4) reflect a new approach to post-payout dilution; (5) obligate the participants to pledge and subordinate their interests in the context of project financing; (6) expand the duties imposed upon the manager; and (7) expand the rights and remedies of non-defaulting participants.²⁵

[3] Form 5A LLC and the Dawn of the Limited Liability Company

Form 5A LLC, the next and current iteration of Form 5, revised the entire relationship of the parties for the purpose of limiting the liability of the participants. Although the first LLC statute was adopted in Wyoming in 1977,²⁶ it wasn't until 1988, when the Internal Revenue Service (IRS) ruled that an LLC could be taxed as a partnership²⁷ that states widely began adopting LLC statutes.²⁸ After the IRS adopted its "check-the-box" regulations in 1996, eliminating the need to analyze whether certain corporate characteristics were absent for partnership tax treatment,²⁹ the LLC began its ascent as the entity of choice for private joint ventures generally.³⁰ Form 5A LLC was published in 1998, in recognition that the LLC had become an important entity choice for mining companies after the issuance of the check-the-box regula-

²⁴ See Form 5A, Commentary art. I.A; see also John F. Welborn & Sasha A. Karpov, "Addressing the Conflicting Concerns of Participants in a Mining Project," *Mining Agreements III* 7-1 (Rocky Mt. Min. L. Fdn. 1991).

²⁵ See Form 5A, Commentary art. II.

²⁶ See Hamill, *supra* note 2.

²⁷ Rev. Rul. 88-76, 1988-2 C.B. 360.

²⁸ Edquist & Hubbard, *supra* note 10, §§ 13.01, 13.02[2].

²⁹ Treas. Reg. § 301.7701-3 (elec. 2007).

³⁰ See *supra* notes 3, 15, and accompanying text.

tions.³¹ The intent of Form 5A LLC was to follow Form 5A as closely as possible,³² although Form 5A LLC was bifurcated into a Members' Agreement³³ and an Operating Agreement³⁴ for reasons discussed below.

§ 13.03 The Proposal: In Defense of the Modest Form

The Modest Form is offered to (1) posit that the less complex Form 5 is still widely used and may still be more accepted as a starting point for joint venture negotiation than Form 5A LLC; (2) contend that, notwithstanding Form 5's continuing popularity, the LLC offers significant advantages over the unincorporated joint venture; (3) assert that Form 5A LLC is underused despite the superiority of the LLC as a mining investment vehicle; and (4) prompt the Foundation to consider the formation of a committee to undertake the drafting of a completely new LLC agreement for mining ventures.

Admittedly, the perception that Form 5 is more widely used than Form 5A LLC is based entirely on the personal experience of the authors and a completely unscientific poll of other practitioners in the mining area. That perception also ignores the reality that many mining venture draftspersons likely borrow elements from both Form 5 and Form 5A LLC, as well as other venture agreement models; and that certain elements of Form 5A LLC contain highly desirable refinements to Form 5 that will be discussed in more detail below.

Assuming that the parties desire partnership tax treatment, because of the ability of the parties to limit their personal liability, the LLC is a superior investment vehicle to the joint venture. Consider, for example, that, of the four disadvantages of the LLC entity form listed by Edquist and Hubbard, i.e., (1) lack of familiarity, (2) lack of judicial precedent, (3) transaction costs, and (4) that the parties may not desire partnership tax treatment,³⁵

³¹ Edquist & Hubbard, *supra* note 10, § 13.01.

³² *See id.* § 13.03[2].

³³ Form 5A LLC, Part I, Members' Agreement [hereinafter Form 5A LLC Members' Agreement or Members' Agreement].

³⁴ Form 5A LLC, Part II, Operating Agreement [hereinafter Form 5A LLC Operating Agreement or Operating Agreement].

³⁵ Edquist & Hubbard, *supra* note 10, at § 13.07.

all but the fourth disadvantage have been solved with the passage of time. Regarding familiarity, although mining companies may be among the last to embrace the LLC structure, there is no shortage of practitioners who know much more about LLCs than the authors.³⁶ With respect to judicial precedent, as more LLCs have been formed, more cases have been tried and reported, and it has become increasingly clear that, faced with a case of first impression in the LLC context, the Delaware courts will look to Delaware corporate or limited partnership law to arrive at a practical answer.³⁷ As to transaction costs, those have decreased proportionately with the increase in the familiarity of practitioners with the LLC form of entity and judicial construction of the entity (ignoring corporate registered agent and filing fees that are usually nominal in relation to the cost of a mining venture).

Finally, notwithstanding that this chapter is accompanied by a full-blown draft form, the authors are not so reckless as to actually recommend that anyone use the Modest Form in practice. Much has been made in past papers³⁸ of the warning statement on the cover of Form 5 that it is “not intended to be taken from the shelf and executed as is.”³⁹ The warning statement on the cover page of the draft Modest Form goes a step further, recognizing that the Modest Form has not been subjected to peer review, and should be compared to actual forms previously published by the Foundation. Better yet, the Foundation should consider constituting a new committee to transform the draft Modest Form into an actual, peer-reviewed, Foundation-endorsed Form 5 LLC, taking the best from each of the prior forms, considering changes in the law governing LLCs, and utilizing the more advanced familiarity of practitioners with the LLC form of entity.

³⁶ See, e.g., Ribstein & Keatinge, *supra* note 3.

³⁷ See DLLCA, Del. Code Ann. Tit. 6, § 18-1104 (elec. 2007) (“In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern.”). See also Louis G. Hering & David A. Harris, “2006 Cumulative Survey of Delaware Case Law Relating to Alternative Entities,” § III, in *2006 ABA Annual Meeting* (2006) (noting that a number of significant cases involving LLCs have been decided by the Delaware courts and that many provisions of the DLLCA are based on comparable provisions of the Delaware Revised Uniform Limited Partnership Act).

³⁸ See, e.g., Johnson, *supra* note 22, § 10.01, at 10-3.

³⁹ Form 5, cover page.

§ 13.04 Reconsidering Form 5A LLC: “Ten Years Gone”

[1] The Philosophy of the Form

[a] The Myth of the 50/50 Deal

As noted above, Form 5, Form 5A, and Form 5A LLC are each intended as a starting point for a 50/50 deal.⁴⁰ Unfortunately, the 50/50 deal is the most complicated deal to draft. Many of the provisions added to Form 5 in Form 5A LLC and its predecessor Form 5A were to insure that each 50% venture partner, including the non-managing venture partner, has detailed and specific rights to oversee the operation of the venture.⁴¹ In a 50/50 deal, the significant investment of the non-managing venture partner likely justifies such complicated provisions.

In the experience of the authors, however, most deals are not 50/50 deals.⁴² YCO often has the right to earn a greater than 50% interest (sometimes by a series of options to earn a greater Participating Interest after completion of its Initial Contribution). One party or the other may have superior funding ability, technical expertise, and superior negotiating power in determining the terms of the governing documents. With greater control and greater negotiating power concentrated in one party comes greater simplicity, because the non-controlling owner is unable to negotiate complicated rights to manage, monitor, or block activities of the venture (and based on transaction economics, may not be entitled to such rights). The non-controlling owner must rely on the protection of risk allocation, i.e., that the majority owner has the greater financial interest at stake and thus the incentive to make management decisions that maximize the wealth of the venture as a whole.

⁴⁰ See Form 5, General Comments; Form 5A, Commentary art. I.D.; Edquist & Hubbard, *supra* note 10, § 13.03[2].

⁴¹ For example, Form 5A substantially expanded the provisions dealing with development, to include “Pre-Feasibility Studies,” “Feasibility Studies,” and a multi-staged approach to decision-making related to Development. See Form 5A, Commentary art. IX.

⁴² The ABA Model Joint Venture Agreement assumes a 60/40 deal, with “Large Member,” a \$1 billion company, owning 60%, and “Small Member,” a \$100 million company, owning 40%. See ABA Model Joint Venture Agreement at xvi.

The “myth” of the 50/50 deal masks the more complex majority/minority reality in many deals, which reality has remained an underlying tension in the development of the forms. The “intent” problem then becomes one of philosophy, i.e., whether a form document should be drafted like a statute to protect the interests of the party that has lesser negotiating power, or should be drafted like a restatement, to reflect what is agreed in the greatest number of transactions (or would be if all alternatives are available).

[b] The Hybrid Approach

The best answer may be a hybrid approach of providing a simple form with more complicated provisions attached as alternatives to be incorporated into the body of the form when appropriate. It may be easier for the practitioner and the mining company faced with the need to quickly document a new transaction to begin their drafting exercise with a simpler framework, and to incorporate desired provisions appropriate for the business deal, rather than to begin with difficult provisions that may overwhelm a reader who is less experienced or pressed for time, and thus less patient.

The Modest Form is intended to be a less complex alternative to Form 5A LLC for a mining venture, based on the Form 5 structure, with the philosophy that more complicated, controversial, or frequently negotiated provisions should be eliminated from the base form and attached as alternative provisions available for inclusion if desired. The authors have included only a few alternative provisions, but recommend that the Form 5 committee review as possible alternative provisions all of the Form 5A provisions and other concepts that frequently recur in mining venture negotiations, such as feasibility study options, carried interests, non-consent provisions, and separate project areas for large properties.

The following subsections describe three examples of such choices made in developing the Modest Form.

Example 1: Feasibility Studies and Development. As noted in the Uranium JV Paper, Form 5A LLC contains detailed provisions regarding “Pre-Feasibility Studies,” “Feasibility Studies,” “Development Budgets,” “Feasibility Contractors,” and “Approved Alternatives,” with at least five Management Committee decision

points in the process to determine whether to move into development.⁴³ These provisions were controversial and debated at length in the development of Form 5, in part because they may increase the potential for deadlock.⁴⁴ Those provisions have not been included in the Modest Form, and represent the most substantial example of provisions that may be more appropriate as alternate provisions in a hybrid approach. For example, pre-feasibility studies and feasibility studies are often funded by the grant of a second option to YCO to earn an additional interest in the project, and may contain requirements specific to the mining property or mineral that is the subject of the joint venture. Other transactions employ “carried interest” options to assist XCO in funding its share of development expenses, in return for which YCO might demand greater control over the content and timing of pre-feasibility, feasibility study, and development operations. Different feasibility study and development options would be valuable additions as alternate provisions in any new form.

Example 2: Defaults and Dilution. The default provisions in Form 5A LLC appear in sections 11.4 and 11.5 of the Operating Agreement. They are similar to those included in Form 5,⁴⁵ except that the dilution multiple, and in some cases whether the dilution is at all punitive, depends on whether payout has occurred and on the use of the funds subject to the applicable capital call. Form 5A LLC also contains a remedy that allows the non-defaulting member to purchase the interest of the defaulting member for a to-be-specified percentage of its fair market value (as determined pursuant to an appraisal procedure).⁴⁶ The added buyout right is in addition to a provision carried over substantially from section 6.4(b) of Form 5 that requires a defaulting member to relinquish, at the election of the non-defaulting member, its membership interest for an amount, payable out of net proceeds, equal to its previous capital contributions.⁴⁷ In other words, Form 5A LLC

⁴³ See Uranium JV Paper, *supra* note 4, at 10-8 & 10-9.

⁴⁴ This is the perception of one of the authors, who served on the editorial committee for Form 5A and reviewed several proposals that led to the final form of these provisions.

⁴⁵ See Form 5 § 6.4.

⁴⁶ Form 5A LLC, Operating Agreement § 11.5(c).

⁴⁷ See *id.* § 11.5(b)(ii).

contains two distinct buyout rights in the same default provision.⁴⁸ The contribution default provisions in Form 5A LLC may be appropriate for a particular agreement of the parties, but seem rather complicated for a form and may be another example of provisions that are more appropriate as alternate provisions.

Example 3: Confidential Information. Form 5A LLC contains numerous refinements in the protection of confidential information developed with the input of the Foundation’s Form 7 (Confidentiality and Nondisclosure Agreement) Committee.⁴⁹ Conceptually, the revisions differentiate between “Business Information” developed under the LLC Agreement and “Member Information” that a member develops independent of the LLC and voluntarily uses or discloses in connection with performance of its obligations under the LLC Agreement. The use, ownership, and disclosure of Business Information and Member Information are subject to different restrictions under Article XIII. In general, both members own and may freely use Business Information for any purpose (whether or not related to the Business), subject to certain confidentiality obligations. Member Information, however, is owned solely by the member that originally developed that information, and may only be used by the other member in the context of the Business. Generally, Member Information can only be disclosed by the non-owning member if compelled by law.

While useful for joint ventures where one party contributes proprietary technology, such as bioleaching, or in ventures between parties owning adjoining mines and mining facilities, the distinctions between “Member Information” and “Business Information” may be more complex than necessary for many ventures. Also, several of the provisions may be controversial. For example, any enhancements, improvements, or refinements of “Member Information” developed by either member in the context of the Business are not jointly owned, but would be owned by the member

⁴⁸The additional buyout right applies only if a member has covered the defaulted capital contribution. The obligation to relinquish a member’s interest applies whether or not a cover payment is made, but only in the case of contributions for a program and budget covering development or mining (i.e., excluding programs and budgets covering feasibility, pre-feasibility, and the like in which case the defaulting member’s interest may be reduced but not relinquished). *See id.* § 11.5.

⁴⁹These provisions are found in Form 5A LLC Operating Agreement art. XIII.

that originally developed the Member Information. Also, because it is jointly owned, either member may disclose confidential Business Information in connection with an independent business venture.

In light of the foregoing, the Modest Form adopts some of the confidentiality definitions, but would treat the more complex Form 5A LLC confidentiality concepts as alternative provisions.

[2] Form 5A LLC’s Two-Agreement Complexity

[a] The Concern: Claims by Third Parties

As noted above, Form 5A LLC is divided into a Members’ Agreement and an Operating Agreement with the stated purpose of maximizing the limited liability feature of the LLC entity.⁵⁰ As summarized by Edquist & Hubbard, the concern is that the LLC itself might enforce the contribution, indemnification, and continuing liability provisions against the members and, if the LLC could enforce those obligations, so might the creditors or a bankruptcy trustee of the LLC.⁵¹ Those concerns are bolstered by a section of the DLLCA providing that a creditor may enforce the obligation of a member to contribute capital to an LLC to the extent the creditor reasonably relied on the contribution obligation in extending the credit, and further provided that the LLC

⁵⁰ Edquist & Hubbard, *supra* note 10, §§ 13.04[1] & [2].

⁵¹ *Id.* §§ 13.03[2], 13.04. In addition to the liability issues discussed herein, Edquist & Hubbard accurately predicted, *see id.* § 13.06[5], that veil-piercing concepts would be applied to LLCs. *See e.g.*, Thomas v. Hobbs, No. 04C-02-010 RFS, 2006 WL 1653947 (Del. Super. Ct. Apr. 27, 2005). Traditional veil piercing involves an action by a creditor to impose personal liability on a member for obligations of the LLC. *See id.* at *3-4. The limitation of liability objectives that formed the basis for separating Form 5A LLC into two agreements are not implicated by traditional veil piercing because the Form 5A LLC Members’ Agreement concerns obligations of the members, not the LLC. The concept of reverse veil piercing, i.e., an action by a creditor to impose liability on a LLC for personal obligations of a member, has also been applied in the LLC context, notably where a member attempts to insulate assets to avoid creditors. *See, e.g.*, Great Neck Plaza, L.P. v. Le Peep Restaurants, LLC, 37 P.3d 485 (Colo. Ct. App. 2001). Reverse veil piercing could be a significant concern of one member with respect to the liabilities of the other member. *But see* DLLCA, Del. Code Ann. tit. 6, § 18-703(a), (d) (elec. 2007) (providing that a charging order granting rights to receive distributions to which a member would otherwise be entitled to a judgment creditor is the exclusive remedy by which the judgment creditor may satisfy a judgment out of the judgment debtor’s LLC interest). Notwithstanding the foregoing, there likely are situations involving extreme circumstances where a Delaware court might be willing to apply principles of reverse veil piercing to avoid such an exclusive remedy provision.

agreement reflected the contribution obligation at the time the credit was extended.⁵² The rationale of Form 5A LLC is that separating those obligations into a separate Members' Agreement removes the ability of the LLC and the LLC's creditors to enforce those obligations against the members.

[b] The Problem

The approach of separating Form 5A LLC into two agreements had an undesirable side effect. Users of Form 5 had grown accustomed to the organization of that document, which allowed for detailed review of more frequently negotiated provisions and more cursory review of "boilerplate." Form 5's familiar organization was somewhat revised in Form 5A, and had to be further disrupted in Form 5A LLC in order to segregate into the Members' Agreement the obligations that might be asserted against a member by the LLC, its creditors, or a bankruptcy trustee. Over time, this disruption has proven to be potentially off-putting to those familiar with Form 5 and to users who deal regularly with LLCs (or for that matter, mining joint ventures), who generally are accustomed to a single agreement incorporating all of the operative provisions in a more or less customary progression.

More importantly, time has shown that separating the governing documents into two agreements likely does not accomplish the objective of preventing the Members' Agreement from being enforced as an LLC agreement.⁵³ At the time Form 5A LLC was drafted, the DLLCA defined the "limited liability company agreement" in relevant part as "any agreement, written or oral, of the member or members as to the affairs of a limited liability company and the conduct of its business."⁵⁴ The current provision also provides that a "limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agree-

⁵² DLLCA, Del. Code Ann. tit. 6, § 18-502(b) (elec. 2007).

⁵³ The authors have great respect for the authors of Form 5A LLC and recognize that the approach of dividing Form 5A LLC was very innovative at the time and based on substantive concerns under the then-recently-overhauled DLLCA, for which there was little precedent. It is, of course, easier to critique an idea with the hindsight of additional law and experience than it is to generate the idea to address the concerns raised by a recently-amended and thinly-construed statute.

⁵⁴ Del. Code Ann. tit. 6, § 18-101(7) (1997) (amended 1999, 2001, 2004, 2005, 2007).

ment.”⁵⁵ By defining the LLC agreement as “any agreement,” the statute left unanswered (and continues to leave unanswered) the question as to whether “any” is used in the plural or singular to mean one single agreement or multiple agreements entered into among the members.⁵⁶ Agreements other than the document titled “Operating Agreement” or “Limited Liability Company Agreement” might also be held to constitute the LLC agreement, especially because it is clear that the company need not execute “any” such agreement.

Ribstein & Keatinge state that an LLC agreement could exist in more than one document, as some partnership cases have held.⁵⁷ In addition, the title of the agreement has been shown to be irrelevant to the statutory definition of “limited liability company.” The 2001 amendment (one of five such amendments to such definition since the statute’s enactment)⁵⁸ modified the definition to make clear that an LLC agreement may be referred to as “a limited liability company agreement, operating agreement or otherwise.”⁵⁹

Because an LLC agreement need not actually be referred to as an LLC Agreement (or in the case of Form 5A LLC, as an Operating Agreement), and because the Members’ Agreement and Operating Agreement both deal with the exploration and development of the same mining property, a court likely would conclude that the Members’ Agreement and the Operating Agreement should be

⁵⁵ DLLCA, Del. Code Ann. tit. 6, § 18-101(7) (elec. 2007).

⁵⁶ Webster’s defines the adjective “any” in part as “one, some, or all indiscriminately of whatever quantity.” *Webster’s Third New International Dictionary* (Merriam-Webster, Inc. 2002).

⁵⁷ See Ribstein & Keatinge, *supra* note 3, § 4.16 and the cases cited therein.

⁵⁸ See 72 Del. Laws ch. 129 (1999) (amending the definition to make clear that single-member LLC agreements are enforceable); 73 Del. Laws ch. 295 (2001) (discussed below); 74 Del. Laws ch. 275 (2004) (discussed below); 75 Del. Laws ch. 51 (2005) (amending the definition to clarify that members, managers, and assignees need not execute the LLC agreement in order to be bound by its terms); 76 Del. Laws ch. 105 (2006) (expanding the definition to include “implied” agreements in addition to written and oral agreements).

⁵⁹ 73 Del. Laws ch. 295 (2001). While casting doubt on the efficacy of the two-agreement approach, the amendment does make clear that the Form 5A LLC Operating Agreement (which took the title “Operating Agreement” from Form 5A instead of “Limited Liability Company Agreement,” as would be consistent with the DLLCA) is an LLC agreement under the DLLCA.

read together as one agreement governing the business and affairs of the LLC.

[c] The Solution to the Liability Problem: Putting the Pieces Back Together

A better method to insulate the members from the liability concerns underlying the two-agreement approach is to expressly allocate liability in the LLC agreement and expressly limit the ability of third parties to enforce those provisions of the LLC agreement, a method made possible by the flexibility of the DLLCA as amended. To further such an approach, the Modest Form includes the following language:

NOTWITHSTANDING ANYTHING IN THIS AGREEMENT TO THE CONTRARY, NO PERSON OR ENTITY OTHER THAN A MEMBER SHALL HAVE THE RIGHT TO ENFORCE ANY REPRESENTATION OR WARRANTY OF A MEMBER HEREUNDER, OR ANY OBLIGATION OF A MEMBER TO CONTRIBUTE CAPITAL HEREUNDER, TO FUND CONTINUING OBLIGATIONS, TO REIMBURSE OR INDEMNIFY ANY OTHER MEMBER HEREUNDER, AND SPECIFICALLY NEITHER THE COMPANY NOR ANY LENDER OR OTHER THIRD PARTY SHALL HAVE ANY SUCH RIGHTS, IT BEING EXPRESSLY UNDERSTOOD THAT THE REPRESENTATIONS AND WARRANTIES, AND THE CONTRIBUTION, REIMBURSEMENT AND INDEMNIFICATION OBLIGATIONS SET FORTH IN [SPECIFIC SECTIONS] SHALL BE ENFORCEABLE ONLY BY A MEMBER AGAINST ANOTHER MEMBER (WHICH, NOTWITHSTANDING ANYTHING TO THE CONTRARY IN THIS AGREEMENT, ARE IN ALL SUCH CASES FOR THE BENEFIT OF THE MEMBERS). FOR THE AVOIDANCE OF DOUBT, THE COMPANY SHALL BE BOUND BY [SPECIFIC SECTIONS], BUT SHALL HAVE NO RIGHT TO ENFORCE THOSE PROVISIONS AGAINST A MEMBER, SUCH RIGHTS BEING EXCLUSIVELY VESTED IN THE MEMBERS.^{59.1}

The approach of including specific language in the LLC Agreement to remove the ability of a creditor to reasonably rely on a contribution obligation in extending credit is a common practice, and is supported by the 2004 amendment to the definition of “limited liability company agreement” in the DLLCA, which provides that an LLC may provide rights to third parties, but only “to the extent set forth” in the LLC Agreement.⁶⁰

^{59.1} Modest Form § 4.9(d).

⁶⁰ 74 Del. Laws ch. 275 (2004).

Whether such an approach might also be respected with respect to removing the ability of the LLC itself to enforce those contribution obligations (and other obligations of the members) has not been settled; but the authors believe, for several reasons, that appropriate language would be enforced by the Delaware courts. For example, the DLLCA provides that “[e]xcept as provided in a limited liability company agreement, a member is obligated to a limited liability company to perform any promise to contribute cash or property or to perform services.”⁶¹ Further, it is a stated policy of the DLLCA to “give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”⁶²

[3] Environmental Liabilities, Representations, and Warranties

Form 5A LLC includes detailed environmental provisions and a new scheme for allocating environmental liabilities between the members that were first introduced in Form 5A. The Commentary to Form 5A describes the addition of those environmental provisions as follows:

Given the significance that environmental concerns have acquired during the last decade, Form 5A contains provisions placing environmental compliance within the purpose of the Agreement (Section 2.3(f)); incorporates warranties and representations regarding environmental conditions (Section 3.2(g)); allocates and limits responsibility for pre-existing environmental problems (Section 3.7(a)); and provides for establishing and funding an environmental compliance fund (Exhibit B, Paragraph 2.14).^{62.1}

Form 5 contains little detail about the allocation of risk for environmental liabilities. Consistent with the philosophy of basing the Modest Form primarily on Form 5, the approach taken in the Modest Form is to include the Form 5A provisions relating to environmental compliance and funding of environmental obligations (generally regarded as accepted and non-controversial), but excluding the Form 5A environmental representations and warranties, liability allocation and related indemnities (which the au-

⁶¹ Del. Code Ann. tit. 6, § 18-502(a) (elec. 2007) (emphasis added).

⁶² *Id.* § 18-1101(b).

^{62.1} Form 5A Commentary § II(A)(1), at ii.

thors viewed as more commonly subject to the negotiation of the parties and the circumstances of the particular transaction).

The most significant additions to the representations and warranties from Form 5 to Form 5A involve environmental liabilities, including the addition of detailed representations and warranties relating to preexisting environmental conditions in section 3.2(g) of the Form 5A LLC Members' Agreement. Because representations and warranties generally are highly negotiated and tailored based on the due diligence of the parties, consistent with the "hybrid philosophy" of forms employed in the Modest Form, such provisions should be considered more as example provisions rather than model provisions. Similarly, the cap on XCO's environmental indemnity in section 3.6(a) of the Form 5A LLC Members' Agreement and the limited right of YCO under section 3.2(b) of the Form 5A LLC Operating Agreement to resign and limit its environmental exposure are provisions that would usually be subject to substantial negotiation. The authors recognize that Form 5's treatment of these important issues, frankly, is inadequate for modern mining practice. While the comprehensive treatment of the subject in Form 5A LLC is admirable, the highly negotiable nature of these provisions led to a retreat to the original "Modest Form paradigm" of simplicity and the suggestion that these provisions form the core of a set of alternate environmental provisions.

From the perspective of developing a form LLC agreement, the allocation of risk for pre-existing environmental problems may be better suited to a separate agreement: not a "Members' Agreement," but an agreement akin to a purchase agreement, perhaps titled a "Contribution Agreement." In fact, the committee drafting the next generation of Form 5 should consider relocating all representations and warranties, including existing representations regarding title and those that could be added regarding the status of the parties under applicable securities laws, to a separate contribution agreement. Although it may seem hypocritical to advocate in one portion of the chapter to unify two agreements into one, then advocate in another portion of the chapter to strip out certain provisions, arguably representations and warranties do not relate to the ongoing "affairs of a limited liability company

and the conduct of its business.”⁶³ Rather, representations and warranties are made as of a point in time, usually prior to or contemporaneous with the execution of the LLC agreement, but certainly prior to the commencement of the joint venture operations.

[4] Security Interests

Section 4.3(b) of the Form 5A LLC Members’ Agreement includes a grant by each member of a security interest in its entire membership interest to secure “every obligation or liability of the Member granting such lien or security interest” under both the Members’ Agreement and the Operating Agreement. The security interest granted in Form 5 secures only the obligation of a defaulting member to repay a non-defaulting member that has made a loan to the defaulting member to cover its capital contributions.⁶⁴ The Modest Form includes the broader security interest contemplated by Form 5A LLC because of the significant capital contribution obligations, continuing obligations, and indemnification obligations, in addition to the manager’s obligations with respect to operations.^{64.1} The security interest provisions in the Modest Form, however, have been modified to reflect changes in the law under revised article 9 of the Uniform Commercial Code.⁶⁵ Under revised Article 9, a secured party is permitted to file a financing statement covering the applicable collateral if the debtor authorizes the filing in an authenticated record (i.e., an executed document) or becomes bound to a security agreement with respect to such collateral.⁶⁶ The Modest Form also includes a provision specifically providing for the admission of the transferee as a member in the LLC (not just an assignee of the economic inter-

⁶³ DLLCA, Del. Code Ann. tit. 6, § 18-101(7) (elec. 2007).

⁶⁴ Form 5 § 6.4(a).

^{64.1} Modest Form § 6.7.

⁶⁵ U.C.C. §§ 9-101 to 9-709. The stated purpose in the Form 5A Commentary for including the attorney-in-fact language was to allow a secured member to foreclose and take the entire interest, not just an economic interest.

⁶⁶ *Id.* § 9-509(a), (b). Although the LLC agreement constitutes a security agreement under the Uniform Commercial Code, *see generally* U.C.C. § 9-102(a)(73), it is customary to expressly include the relevant authorization.

est) upon the foreclosure or similar exercise of remedies by the non-defaulting member.⁶⁷

[5] Transfers

[a] Non-Recognition of Transfers

Consistent with Form 5, Form 5A LLC provides that the transferee of an interest in the LLC must provide notice and agree to be bound by the LLC agreement to have the rights of a member.⁶⁸ Under the DLLCA, a person may be an assignee of an economic interest without being admitted to the LLC as a member.⁶⁹ Although the assignee of an economic interest continues to have rights to distributions and allocations of profit and loss, the economic interest is free of voting and other member rights.⁷⁰ Consistent with more common recent practice, the Modest Form provides that the LLC need not recognize the transfer itself if the assignee has not agreed to be bound by the LLC agreement.⁷¹

[b] Beneficial Interests

Form 5A LLC prohibits transfers of “any beneficial interest” in the Company except in connection with the transfer of some or all of a member’s ownership interest.⁷² The presumed intent behind this provision is to limit transfers of rights that somehow constitute less than the entire bundle of rights that make up a membership interest (similar to the Form 5A restriction on transfer of any interest in the property separate from the obligations of the joint venture agreement). The term “beneficial interest” is defined dif-

⁶⁷ Modest Form § 6.7. Form 5A LLC provides for the appointment of the other member as its attorney-in-fact for the purpose of consenting to the transfer of the management rights—not just the economic interest—associated with the membership interest. See Form 5A Commentary § 6.6. Note that the consent rights of the defaulting member are likely eliminated upon the foreclosure because the defaulting member ceases to be a member in the LLC. See DLLCA, Del. Code Ann. tit. 6, § 18-702(b)(3) (elec. 2007). However, in a two-member LLC, the non-defaulting member would thereafter own 100% of the voting interests (i.e., excluding the interests that were foreclosed), and could simply admit itself as a member with respect to the interest that was foreclosed.

⁶⁸ Form 5A LLC Operating Agreement § 7.2(b).

⁶⁹ See Del. Code Ann. tit. 6, § 18-702(b) (elec. 2007).

⁷⁰ *Id.*

⁷¹ Modest Form § 15.2(a). DLLCA, Del. Code Ann. tit. 6, § 18-702(a) (elec. 2007) permits restrictions on transfer in the LLC agreement.

⁷² Form 5A LLC Operating Agreement §§ 7.1, 7.2(a).

ferently in different circumstances, and could be interpreted to preclude certain indirect transfers that the parties may wish to permit.⁷³ To clarify, the Modest Form defines “Transfer” to include indirect transfers that result in a change of control, but not other indirect transfers.^{73.1}

[c] Actions as a Group

Under Form 5A LLC, if a member transfers an interest, the transferring member and the transferee member must thereafter act as a group by collectively designating an agent to act for the group and providing notice of the designation.⁷⁴ In order to avoid a conflict, the Modest Form does not require the designation of an agent; instead, it simply provides that the member with the largest percentage interest has control of the voting rights of the group.^{74.1}

[d] Pledges

Form 5A LLC contains detailed provisions that require the recipient of a pledge of a member’s interest in the LLC to enter into an agreement with the non-pledging member stating that the recipient has no right to foreclose and limiting its remedy to selling the interest to the non-pledging member.⁷⁵ Section 9-408 of the Uniform Commercial Code provides that restrictions on the pledge of personal property are unenforceable.⁷⁶ Since Form 5A LLC was released, however, the DLLCA was amended to add section 18-1101(g), which specifically provides that section 9-408 shall have no application to interests in LLCs.⁷⁷ As an alternative

⁷³ For example, “beneficial ownership” can have a number of meanings when used in the context of a security. *See* SEC Rule 13d-3(a), 17 C.F.R. § 240.13d-3(a) (elec. 2007) (“For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.”).

^{73.1} Modest Form § 1.32.

⁷⁴ Form 5A LLC Operating Agreement § 7.2(f).

^{74.1} Modest Form § 15.2(e).

⁷⁵ Form 5A LLC Operating Agreement § 7.2(g).

⁷⁶ U.C.C. § 9-408.

⁷⁷ Del. Code Ann. tit. 6, § 18-1101(g) (elec. 2007).

to limiting the effects of a pledge and working through the relevant language, the parties could simply agree that pledges are impermissible without the consent of the other party (which may be the most appropriate default rule for a form). The Modest Form attempts to strike a balance, permitting the pledge but providing that upon a foreclosure the lender obtains only the rights of an assignee, i.e., no rights to vote or manage the LLC.^{77.1} The Modest Form also makes clear that a transfer to such a lender upon default or foreclosure is subject to the preemptive right contained in the various forms.⁷⁸

[e] Preemptive Right

The “preemptive right” present in the various forms⁷⁹ has been renamed in the Modest Form as an “acquisition right,” consistent with more common recent usage. A preemptive right would typically apply to interests to be issued by the LLC itself.

[6] Other Matters

[a] Distributions In Kind

Taking production in kind is an important concept in Form 5,⁸⁰ but the drafters of Form 5A LLC removed the provision for taking in kind because the tax reasons for it do not exist in the LLC context.⁸¹ The authors believe that some parties may want to require distribution of mineral products in kind for business reasons and thus have retained this provision. DLLCA § 18-605 states that, except as provided in an LLC agreement, a member has no right

^{77.1} Modest Form § 15.2(f).

⁷⁸ *Id.* See Form 5 § 15.3.

⁷⁹ Form 5 § 15.3.

⁸⁰ *Id.* art. XI. Under section 761(a) of the Internal Revenue Code, participants in a mining joint venture are generally taxed as a partnership, but have the right to elect not to be taxed as a partnership if the terms of the joint venture meet certain requirements, including granting the parties the right to take their shares of production in kind. The taking-in-kind provision may have been included in Form 5 to enable the parties to elect not to be taxed as a partnership. See Form 5A Commentary § 4.2. The absence of joint marketing of products in Form 5 may also be intended to defeat a claim that the joint venture is a partnership or mining partnership. Avoidance of partnership or mining partnership liability should not be a concern in the LLC context.

⁸¹ Edquist & Hubbard, *supra* note 10, § 13.03[2][g][iii]. An LLC is taxed as a partnership in all events (unless it elects to be taxed as a corporation), and therefore does not have the flexibility to elect not to be taxed as a partnership. As a result, the taking-in-kind provision is unnecessary for tax reasons.

to demand a distribution in kind, but may be compelled to take in kind. Consistent with Form 5, the Modest Form makes clear that a member may be compelled to take in kind, but also makes clear, consistent with the DLLCA, that a member may not demand an in kind distribution.^{81.1} The parties are free to negotiate the provision, including whether taking in kind will be mandatory unless unanimously agreed otherwise, or at the discretion of the manager.

[b] Supplemental Business Arrangements

Form 5A LLC contains a provision permitting the members of the management committee to segregate the area of interest covered by the agreement into one or more separate business arrangements through unanimous agreement.⁸² Such a provision is unnecessary at the outset because, if the parties can unanimously agree to a supplemental business arrangement, they could always agree to an amendment to the LLC agreement, an amendment that would likely be required in any case if the parties agree on such a supplemental business arrangement. In joint ventures covering a large area of interest, such as uranium exploration ventures, the parties may want to provide for the division of the area of interest into “project areas” under separate agreements to avoid dilution in the entire area when the parties have different exploration priorities, and the parties may desire non-consent exploration or development rights, back-in rights, and other provisions best left to custom drafting.⁸³ Such provisions may be suitable for development as alternative provisions to the Modest Form.

[c] Timing of Initial Contributions; Title Considerations

Consideration should be given to the timing of the Initial Contributions by the Members, both of the properties and cash contributions. Form 5 and Form 5A reflect an “earn in” paradigm whereby an interest in the properties may be “earned” by or vested in YCO only after expenditure of its agreed Initial Contribution on Operations for the benefit of the Properties, although the

^{81.1} Modest Form § 11.2.

⁸² Form 5A LLC Operating Agreement § 10.13.

⁸³ See, e.g., Harold S. Bloomenthal, “The Evolution of the Uranium Joint Venture,” *Uranium Exploration and Development* 8-1 (Rocky Mt. Min. L. Fdn. 1976).

details of holding title prior to and after completion of YCO's Initial Contribution and the amount and timing of expenditures for Operations are left to individual negotiation. The Modest Form provides that title to the Properties will be held by the LLC, and YCO's entire cash Initial Contribution could theoretically be made to the LLC immediately upon signing the LLC agreement and subsequently expended by the LLC for operations. Parties desiring the "earn in" approach of Forms 5 and 5A should consider specifying the timing of the Initial Contributions of the parties in section 6.1 of the Modest Form and its affect on voting and other rights arising from the parties' membership interests in the LLC. If YCO's contributions are made immediately and held by the LLC pending expenditure on approved Programs and Budgets, the parties should consider the impact of this arrangement on any desired right of YCO to withdraw from the LLC without liability for the balance of its Initial Contribution, particularly in light of section 5.4 of the Modest Form limiting the return of capital contributions.

As stated in section 2.4 of the Modest Form, title to the Properties will be held by the LLC and will need to be conveyed to the LLC by appropriate deeds and assignments. When using Form 5 and Form 5A, parties contributing property have sometimes been reluctant to part with title to their property prior to YCO's completion of all expenditures required to earn its interest, sometimes retaining title until completion of YCO's Initial Contribution or using a lease, exploration agreement, escrow, or other arrangement.⁸⁴ Despite those rational concerns, immediate conveyance to the LLC may offer superior bankruptcy protection for both parties, and should be considered.⁸⁵

The DLLCA affords significant protections to the non-bankrupt members in the event of the bankruptcy of a member. For example, under DLLCA § 18-304, a person ceases to be a member of an

⁸⁴ See, e.g., Edquist & Hubbard, *supra* note 10, § 13.03[2][c]. Some of the issues raised by joint holding of title in Form 5 and Form 5A are discussed in Form 5A, Commentary § 3.4.

⁸⁵ See Uranium JV Paper, *supra* note 4, at 10-7 ("Holding the property in the limited liability company may offer protection against the bankruptcy of one of the members . . . , and YCO will probably prefer immediate conveyance to the LLC to obtain this protection.").

LLC upon its bankruptcy or an assignment for the benefit of its creditors. Similarly, under DLLCA § 18-702, an assignee of an LLC interest has economic rights to distributions and allocations of profits and losses, but no right to participate in the management of the business and affairs of the LLC.

The provisions of the DLLCA, however, potentially conflict with the rights of the bankruptcy estate under the U.S. Bankruptcy Code. Under the Bankruptcy Code, upon the bankruptcy of a member, at a minimum the economic rights of the member to distributions and to allocations of profits and losses pass to the bankruptcy estate, despite contractual provisions or state law purporting to modify or terminate the bankrupt member's interest in property upon the occurrence of the bankruptcy (sometimes referred to as “ipso facto” provisions).⁸⁶ Under another provision of the Bankruptcy Code, however, if the LLC agreement is an “executory contract,” the foregoing DLLCA provisions may effectively prevent the bankrupt member or bankruptcy trustee from exercising the bankrupt member's voting and other rights associated with its interest in the LLC.⁸⁷ The law is unsettled as to

⁸⁶ See 11 U.S.C. § 541(c)(1) (elec. 2007):

[A]n interest of the debtor in property becomes property of the [bankruptcy] estate . . . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law—(A) that restricts or conditions transfer of such interest by the debtor; or (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a [bankruptcy] case . . . or on the appointment of or taking possession by a trustee in a [bankruptcy] case . . . and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

⁸⁷ See 11 U.S.C. § 365(e) (elec. 2007):

(1) Notwithstanding a provision in an executory contract . . . , or in applicable law, an executory contract . . . may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract or lease that is conditioned on [bankruptcy, insolvency, or the appointment of a receiver] . . . (2) Paragraph (1) of this subsection does not apply to an executory contract . . . of the debtor, whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties, if . . . applicable law excuses a party, other than the debtor, to such contract . . . from accepting performance from or rendering performance to the trustee or to an assignee of such contract . . . , whether or not such contract . . . prohibits or restricts assignment of rights or delegation of duties; and . . . such party does not consent to such assumption or assignment; or . . . such contract is a contract to make a loan, or extend other debt financing or

which Bankruptcy Code provision is controlling in analyzing an LLC agreement and whether the Bankruptcy Code preempts the DLLCA to the extent the DLLCA provides for the extinguishment of the member’s non-economic management rights.⁸⁸ Despite any uncertainty arising from the foregoing considerations, the LLC almost certainly offers superior bankruptcy protection to a joint venture where title to property is held jointly by the venture partners.

[d] Additional Audit Rights

In addition to the right of either member to request an audit of independent public accountants, under section 11.6(b) of the Form 5A LLC Operating Agreement, either member may request additional audits with the costs paid by the requesting member. This additional audit to address any “issues raised by the requesting member” must also be an “independent” audit. An additional right of the minority member to raise “issues” and select its own “independent” auditor should be re-examined given the increased regulatory and other scrutiny imposed on public accountants since Enron. Such a provision is a tempting right that, if exercised, could unintentionally undermine the critical trust necessary in a joint venture relationship.

financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

⁸⁸ Compare *In re Ehmman*, 319 B.R. 200 (Bankr. D. Ariz. 2005) (holding that the non-managing member’s entire interest as a member passed to the bankruptcy estate (but basing its holding in part on the fact that the non-managing member had no management rights so the LLC agreement could not be considered an executory contract as to the member)) with *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738 (Del. Ch. 2004) (concluding that the LLC agreement was preempted to the extent it stripped the debtor of its economic rights, but was enforceable to the extent of sections 18-304 and -702 of the DLLCA, which state that the debtor ceases to be a member upon bankruptcy, but that the bankruptcy estate retains its status as an economic interest holder as an assignee); *In re Albright*, 291 B.R. 538 (Bankr. D. Colo. 2003) (substituting a trustee as a member in a single-member LLC but noting that with respect to a multi-member LLC, a non-debtor member could probably block admission except in the case of hindering, delaying, or defrauding creditors). As the court in *Milford Power* remarked, “[a] law professor could fruitfully spend the next year or so examining the implications that the Bankruptcy Code has on ipso facto clauses in alternative entity agreements.” *Milford Power*, 866 A.2d at 756.

§ 13.05 What’s “New” in the Modest Form?

[1] Fiduciary Duties and Operator Exculpation

[a] DLLCA Amendments and Developing Judicial Doctrines

Much has been established about fiduciary duties in LLCs since the publication of Form 5A LLC. As of the drafting of Form 5A LLC, the DLLCA simply provided with respect to fiduciary duties of members and managers that, to the extent such duties (including fiduciary duties) existed at law or in equity (i.e., implied duties), the members and managers would not be liable for their good faith reliance on the provisions of the LLC agreement; and such duties and liabilities could be expanded or restricted by provisions in the LLC Agreement.⁸⁹ In 2004, those provisions were amended to permit the elimination of those duties by the LLC Agreement, subject to the qualification that the implied contractual covenant of good faith and fair dealing could not be eliminated.⁹⁰ Other provisions were added by the 2004 amendment to permit the LLC agreement to limit or eliminate *liability* for breach of duties (including fiduciary duties) *and* for breach of contract, again other than the implied contractual covenant of good faith and fair dealing.⁹¹

The amendments to the DLLCA, however, left to the courts whether members and managers of an LLC were subject to implied fiduciary duties.⁹² The Delaware courts have not only settled that such implied duties exist,⁹³ but that corporate doctrines such as the entire fairness standard in the merger context,⁹⁴ and

⁸⁹ Del. Code Ann. tit. 6, § 18-1101(c) (1997) (amended 2004).

⁹⁰ 74 Del. Laws ch. 275 (2004). *See also* Del. Code Ann. tit. 6, § 18-1101(c) (elec. 2007).

⁹¹ *See* Del. Code Ann. tit. 6, § 18-1101(d) & (e) (elec. 2007).

⁹² *See* Edquist & Hubbard, *supra* note 10, § 13.06[4] (“Whether or not fiduciary duties are explicitly included in the applicable state statute is probably not the end of the story.”).

⁹³ *See* VGS, Inc. v. Castiel, No. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000), *aff’d*, 781 A.2d 696 (Del. 2001).

⁹⁴ *See* Solar Cells, Inc. v. True N. Partners, LLC, No. 19477, 2002 WL 749163 (Del. Ch. Apr. 25, 2002).

the application of the *Revlon* doctrine in a change of control transaction,⁹⁵ are also applicable to LLCs.

Because it bears repeating, the amendments to the statute make clear that *all* such duties, other than the implied contractual covenant of good faith and fair dealing, and any liability for breach of such duties or breach of contract, may be eliminated in the LLC agreement.⁹⁶ The contractual covenant of good faith and fair dealing, the duty referred to in the DLLCA that may not be eliminated, likely is not a fiduciary duty at all. The existence and scope of an implied fiduciary duty of good faith in Delaware has been the subject of much discussion recently among corporate practitioners,⁹⁷ but such esoteric considerations may be academic for the LLC practitioner since any implied fiduciary duties can be disclaimed under the DLLCA. Whether or not an implied fiduciary duty of good faith actually exists in Delaware, because an LLC, like a partnership, is a creature of contract, the parties to such agreement will remain subject to the contractual covenant of good faith and fair dealing implied in every contract.⁹⁸

[b] “Holy Grail” or Too Much of a Good Thing?

Since the dawn of the mining venture, mining practitioners (and Forms 5, 5A, and 5A LLC) have attempted to define the duties between the parties in the contract and to limit or eliminate implied duties, including fiduciary duties, between joint venturers. All the while, serious doubts have persisted whether these provisions were enforceable or whether applicable law, including the law of partnership, would impose a fiduciary standard.⁹⁹ Sim-

⁹⁵ See *Blackmore Partners, L.P. v. Link Energy LLC*, No. 454-N, 2004 WL 2580497 (Del. Ch. Nov. 10, 2004).

⁹⁶ DLLCA, Del. Code Ann. tit. 6, § 18-1101(c), (e) (elec. 2007).

⁹⁷ See *Brehm v. Eisner* (*In re Walt Disney Co. Derivative Litig.*), 906 A.2d 27, 67 n.112 (Del. 2006) (“[W]e do not reach or otherwise address the issue of whether the fiduciary duty to act in good faith is a duty that, like the duties of care and loyalty, can serve as an independent basis for imposing liability upon corporate officers and directors.”).

⁹⁸ *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1054 (Del. Ch. 1984); see also *RJ Assocs. v. Health Payors’ Org. Ltd. Pshp.*, No. 16873, 1999 WL 550350, at *30 (Del. Ch. July 16, 1999) (applying the implied covenant of good faith and fair dealing in the partnership setting).

⁹⁹ See, e.g., *Welborn & Karpov*, *supra* note 24; Ernest E. Smith, “Duties and Obligations Owed by an Operator to Nonoperators, Investors, and Other Interest Owners,” 32

ilarly, parties have often sought to define by contract the operator’s liability for assuming the risk-laden conduct of mineral exploration and development and to limit the operator’s liability to its venture partners to violation of a gross negligence/willful misconduct standard. The amended DLLCA provisions discussed above may be the “Holy Grail” for eliminating implied duties inconsistent with these goals.

The Modest Form assumes that the parties are sophisticated and therefore desire, to the extent possible, to negotiate and set forth in the LLC agreement the standard of care and specific duties that apply to the parties (as opposed to implied duties being imposed on the parties by the courts). The following language has been inserted into the indicated sections of the Modest Form to take advantage of the ability of the parties to contract around the default rules in the DLLCA, and to negate any implied fiduciary duties of the manager and the members (other than the contractual duty of good faith and fair dealing):

To the fullest extent permitted by the Act, this Agreement shall control as to any conflict between this Agreement and the Act or as to any matter¹⁰⁰ provided for in this Agreement that is also provided for in the Act.

There are no implied covenants contained in this Agreement other than those of the contractual covenant of good faith and fair dealing. No Manager shall have any fiduciary or other duties to the Company except as specifically provided by this Agreement, and the Manager’s and Members’ duties and liabilities otherwise existing at law or in equity are restricted and eliminated by the provisions of this Agreement to those duties and liabilities specifically set forth in this Agreement.¹⁰¹

Rocky Mt. Min. L. Inst. 12-2 (1986); Christopher Lane & Catherine J. Boggs, “Duties of Operator or Manager to Its Joint Venturers,” 29 *Rocky Mt. Min. L. Inst.* 199 (1983); Howard L. Boigon & Christine L. Murphy, “Liabilities of Nonoperating Interest Owners,” *Mining Agreements* 1-1 (Rocky Mt. Min. L. Fdn. 1979). These provisions continue to spawn litigation to this day. *See, e.g.*, *NovaGold Resources Inc. v. Barrick Gold Corp.*, No. 3:06-cv-00199TMB 7-11 (D. Alaska July 17, 2007) (dismissing claim of breach of fiduciary duty under joint venture agreement containing disclaimer of fiduciary duties and “gross negligence/willful misconduct” standard identical to Form 5).

¹⁰⁰ Modest Form § 3.1.

¹⁰¹ *Id.* § 4.8. The standard of conduct of the members and manager “specifically set forth” in the Modest Form, in addition to the contractual covenant of good faith and fair dealing, is the gross negligence/willful misconduct standard. *Id.* §§ 4.9(c)(iii), 8.3.

Form 5 and each of its successors contain virtually identical standards of care and exculpation of liability standards applicable to the operator or manager.¹⁰² With respect to Form 5 and Form 5A, because a joint venture is no more than a creature of contract, those stated standards were intended to be the only standards to which the manager was subject. Form 5A LLC, however, is an LLC and the members and manager are subject to the implied fiduciary and other duties that have been recognized by the courts. As such, those implied duties and liabilities *must* be eliminated or restricted for the “bargain” to be the same as intended in the original joint venture context.

The “Holy Grail” of limited duties may be too much of a good thing for some joint venture relationships. The Modest Form provides that the duties of the members and Manager are limited to those specified in the agreement and further provides that good faith reliance on the agreement is a defense to a claim of breach by the LLC or the other member.^{102.1} Ambiguities in the LLC agreement may therefore inadvertently shield the members from liability to each other, if there exists more than one good faith interpretation of a disputed provision. Parties holding a minority membership interest, those less experienced in mining activities, or parties that have bargained for a joint venture with an experienced mine operator may desire a higher standard of conduct by the other party. In such cases, the amended DLLCA permits the duties of the parties to be tailored to the circumstances.

[2] Continuing Obligations

Sections 4.1 and 4.2 of the Form 5A LLC Members’ Agreement include provisions regarding Continuing Obligations originally contained in sections 6.6 and 12.4 of Form 5. Form 5A LLC defines Continuing Obligations as “obligations or responsibilities that are reasonably expected to continue or arise after Operations on a particular area of the Properties have ceased or are suspended, such as future monitoring, stabilization, or Environmental Compliance.”¹⁰³ The Continuing Obligations provisions in Form 5 and Form 5A LLC generally provide that a member continues to

¹⁰² See Form 5 § 8.3; Form 5A LLC Operating Agreement § 9.3.

^{102.1} Modest Form § 4.8.

¹⁰³ Form 5A LLC Operating Agreement, Exhibit D.

be liable for its share of liabilities of the LLC after its resignation or deemed resignation from the LLC, the termination of the LLC, or the adjustment of its interest.

The Form 5A LLC Members' Agreement contains a detailed indemnification provision stating that each member shall indemnify the other member for breaches of representations or covenants contained in the Members' Agreement or the LLC Agreement.¹⁰⁴

The concept that one member should be personally liable to the other and should indemnify the other for its proportionate share of liabilities relating to the venture makes perfect sense in the case of a common law joint venture or a general partnership where each partner is personally liable for the obligations of the venture; however, such a concept must be considered carefully when the starting point is that the members are not personally liable for the obligations of the LLC so as not to negate that basic proposition.¹⁰⁵ The Modest Form combines and refines the two separate sections relating to Continuing Obligations into one section 6.6, and makes clear that such obligations are limited to reimbursement and are not intended to make a member personally liable for the obligations of the LLC.

[3] Indemnification

If a member or manager were found to be personally liable for obligations relating to the LLC, it normally would request indemnification by the LLC to the extent of the LLC's assets. If the LLC's assets were insufficient to cover those losses, it may be appropriate for one member to look to the other member for its proportionate share of the loss, to the extent that the loss was not the fault of the member seeking indemnification. The indemnification by the LLC of the members in the Form 5A LLC Operating Agreement provides that the Company may, and has the power to, indemnify the members and managers, but does not require

¹⁰⁴ Form 5A LLC Members' Agreement § 3.6.

¹⁰⁵ See DLLCA, Del. Code Ann. tit. 6, § 18-303(b) (elec. 2007) ("Notwithstanding the provisions of subsection (a) of this section, under a limited liability company agreement or under another agreement, a member or manager may agree to be obligated personally for any or all of the debts, obligations and liabilities of the limited liability company.").

such indemnification.¹⁰⁶ The footnote to that section cites DLLCA § 18-108, stating that such indemnification is not required, but is permissive.¹⁰⁷ Form 5A LLC, however, never resolves the question of who decides when indemnification is appropriate, leaving that to the negotiation of the parties after the loss has already occurred. At that point, under the Form 5A LLC liability regime, the member subject to the loss could look to the other member under the Continuing Obligations and member indemnification provisions. To the extent, however, that the other member is insolvent, the member could have to absorb more than its proportionate share of the loss, even if the LLC has sufficient assets to cover the entire loss. The authors believe that all managers and members are entitled to indemnification from the LLC to the extent that such members or managers have not violated the relevant standard of care. The authors further believe that most parties would require an indemnification provision at the time the contract is drafted to avoid a dispute over indemnification after the occurrence of the loss.

The Modest Form includes a new section 4.9 that attempts to reconcile the various inconsistencies regarding the allocation of risk scheme in Form 5, Form 5A, and Form 5A LLC with the authors' perceptions about the intended allocation of risk. It begins with a general statement that members and managers are not liable for the obligations of the LLC to set the stage for the indemnifications.¹⁰⁸ New section 4.9 then continues with an indemnification of the members and managers by the LLC for third-party claims. In order not to negate the contractual duty provisions, indemnification by the LLC of a member or manager is restricted to the extent that the loss arises from the willful misconduct or gross negligence of the party seeking indemnification, i.e., the standard of care contained in each of Form 5, Form 5A, and Form 5A

¹⁰⁶ See Form 5A LLC Operating Agreement § 5.12.

¹⁰⁷ *Id.* at n.5.

¹⁰⁸ Form 5A LLC Members' Agreement § 3.5 also contains a limitation of liability provision. Although not uncommon, the provision is really no more than a recitation of DLLCA § 18-303.

LLC.¹⁰⁹ The indemnification by the LLC also covers the reimbursement obligation of the members for Continuing Liabilities discussed above, and clarifies that indemnification by the LLC is limited to the assets of the LLC and members are not personally liable for the indemnity.

New section 4.9 then provides for an indemnification by each member of the other member(s) and the LLC for actions taken without authority, breaches of representations and warranties, and breaches of covenants. Consistent with the indemnification from the LLC, the indemnification by one member of the other member for breaches of covenants (but not for breaches of representations and actions without authority) is only required to the extent that the breach constitutes willful misconduct or gross negligence. Note also that if the intent of such indemnity is to protect one member from the actions of the other member, the entire economic interest in the LLC of the member to be protected remains at risk unless the LLC also is a beneficiary of the indemnity. As such, the Modest Form includes the LLC as a party to the member indemnity. The practitioner, however, should consider carefully such an inclusion. The parties might be willing to sacrifice their investment so long as they are protected in those instances of personal liability to the members for obligations of or relating to the LLC.

[4] Dissolution, Resignation, and Liquidation

[a] Dissolution

The dissolution provision in section 12.1 of the Modest Form substantially follows section 12.1 of Form 5, incorporating section 12.2 of Form 5 to provide for dissolution of the LLC (instead of termination of the agreement, as provided in Form 5) if the Management Committee fails to adopt a program and budget. Form 5A LLC also requires the dissolution of the Company upon the resignation of a member or upon the bankruptcy, insolvency, dissolution, or assignment for the benefit of creditors of a member, “or as otherwise provided by the Act.”^{109.1} The DLLCA does

¹⁰⁹ Indemnification for actions without authority is contained in § 4.1 of Form 5 and in § 5.1 of Form 5A LLC. It was relocated to § 4.9 of the Modest Form to put all of the indemnifications in one location in the agreement.

^{109.1} 5A LLC Operating Agreement § 14.1.

not require the dissolution of an LLC upon the resignation of a member or upon an involuntary transfer of a member's LLC interest. In fact, DLLCA § 18-801(b) states the opposite, i.e., that

[u]nless otherwise provided in a limited liability company agreement, the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, ^{109.2} the limited liability company shall be continued without dissolution.

It is unlikely that a remaining member would desire for the LLC to dissolve upon the resignation or bankruptcy of the other member, as the remaining member has the discretion under the DLLCA to decide whether to continue. Upon the bankruptcy of a member, the bankruptcy estate probably only acquires rights in the LLC as an assignee.¹¹⁰ Instead of dissolution, the DLLCA provides that a person ceases to be a member upon the occurrence of a bankruptcy event with respect to such person.¹¹¹ Although the assignee of an LLC interest is entitled to the economic rights to which the assignor was entitled, the assignee may not exercise any rights or powers of a member (such as the right to vote on the designation of the manager or on Management Committee matters, or to designate a Management Committee member).¹¹² The remaining member therefore will be entitled to 100% of the voting rights after the resignation, bankruptcy, or dissolution of the other member, and should have the sole vote as to whether to dissolve the Company.

As a final note on dissolution, section 18-802 of the DLLCA provides that the Court of Chancery may upon application of a member or manager decree the judicial dissolution of an LLC. If the parties desire to prohibit a member from making such an application, the LLC agreement should make the prohibition explicit and

^{109.2} Del. Code Ann. tit. 6, § 18-801(b) (elec. 2007).

¹¹⁰ See *supra* § 13.04[6][c].

¹¹¹ DLLCA, Del. Code Ann. tit. 6, § 18-304 (elec. 2007).

¹¹² See *id.* § 18-702(b).

could even provide for liquidated damages for making such an application with the Court of Chancery.¹¹³

[b] Resignation and Deemed Resignation

In addition to requiring dissolution upon the resignation of a member, Form 5A LLC's resignation provision characterizes the member's resignation as a transfer of that member's interest to the non-resigning member.^{113.1} As noted above, the Modest Form does not require dissolution upon the resignation of a member, as the other member may desire for the LLC to continue. Also, to attempt to avoid claims against the non-resigning member for actions of the resigning member, the Modest Form characterizes the resignation as a cancellation of the interest, instead of as a transfer.¹¹⁴

Deemed resignation occurs in two other places in the Modest Form, consistent with Form 5. Section 6.4(b)(ii) of the Modest Form contains the remedy for failure to make an agreed contribution to the Company, and permits the non-defaulting member to treat the failure as the deemed resignation of the defaulting member and cancellation of the defaulting member's membership interest. Section 6.5 of the Modest Form provides that reduction of a member's percentage interest to 10% constitutes a deemed resignation and cancellation of the minority interest. Sections 18-306(2) and 18-502(c) of the DLLCA permit an LLC agreement to provide that the interest of any member that fails to make any contribution that the member is obligated to make will be subject to the consequences specified in the LLC agreement, including the reduction, elimination, or "forfeiture" of the member's entire membership interest in the LLC. The revisions in these sections of the Modest Form are intended to take advantage of this flexible remedy afforded by the DLLCA, which may help address concerns

¹¹³ *But see* *Sivsa Entertainment v. World Int'l Network*, No. B164377, 2004 WL 1895080 (Cal. Ct. App. Aug. 25, 2004) (holding that the California LLC statute does not permit members to modify or waive the right to judicial dissolution).

^{113.1} 5A LLC Operating Agreement § 14.2.

¹¹⁴ Modest Form § 12.2. *See* DLLCA, Del. Code Ann. tit. 6, § 18-702(e) (elec. 2007) (providing that an LLC may acquire an LLC interest by redemption or otherwise and once acquired the interest shall be deemed cancelled).

that the analogous provisions of Form 5 may have been an unenforceable forfeiture or penalty.¹¹⁵

[c] Liquidation

The provisions of Form 5 regarding liquidation of the assets of the venture (after dissolution in the case of an LLC) have been significantly revised in the Modest Form. Consistent with Form 5A LLC, the manager controls the liquidation, but the Modest Form provides for the appointment by the manager of a liquidator (which may be the manager),^{115.1} to allow for the flexibility that may be desired by the manager, especially if the LLC is in the zone of insolvency and the manager is concerned about fiduciary duties to creditors of the LLC.¹¹⁶

The liquidator in the Modest Form has been given broad authority, including the authority to determine whether to distribute cash or to distribute assets in kind upon liquidation. Because dissolution may be precipitated by a variety of factors involving antagonized venture partners, often the members have difficulty reaching agreement during the dissolution and winding up of the company. Granting a liquidator broad authority to make decisions during winding up may relieve conflict and therefore maximize distributions. Usually the interests of the members are aligned to maximize their distributions. The exception arises when the manager or liquidator desires to maximize reserves because of concerns regarding contingent liabilities and the lack of sufficient assets of the LLC to indemnify the manager for those liabilities. Those concerns are alleviated to some extent in the context of the

¹¹⁵ See, e.g., Lacy, *supra* note 2, at § 7.05[3]. Moreover, as discussed by Lacy, the forfeiture cases often involve threatened forfeiture of real property interests. Since forfeiture of real property rights is not implicated when the LLC owns the mining property, these cases should have less relevance to an LLC agreement. The member owns only its membership interest (not the LLC's real property) and, as noted in the text, the DLLCA expressly sanctions penalties up to and including "forfeiture" of the membership interest.

^{115.1} Modest Form § 12.3.

¹¹⁶ DLLCA, Del. Code Ann. tit. 6, § 18-804(b) (elec. 2007) provides that a liquidating trustee who has complied with the reserve and liquidation requirements in that section of the DLLCA is not personally liable to claimants, although compliance with that section requires a significant amount of judgment subject to various reasonableness standards.

Modest Form because of the obligation of each member to reimburse the manager and other member for continuing liabilities.

Finally, consistent with Form 5A LLC, the Modest Form eliminates the concept in Form 5 of requiring the parties to restore a capital account deficit upon liquidation.¹¹⁷ The deficit restoration obligation, which may have been included in Form 5A for tax reasons, generally is not consistent with the terms of the business deal so long as the member with the deficit capital account balance has made the capital contributions such member is obligated to make and has received the distributions and allocations of profits and losses specified by the LLC agreement. Further, an obligation to make up a capital account deficit generally is not necessary to achieve the desired tax treatment. The deficit restoration obligation requirement similarly was eliminated from Form 5A LLC.¹¹⁸ Nonetheless, practitioners should carefully consider whether a deficit restoration obligation is appropriate for a particular transaction in light of the specific tax and business considerations.

§ 13.06 Other Matters

[1] Authority to Bind the LLC

As indicated in the footnote to article VIII of the Form 5A LLC Agreement, the DLLCA does not reserve any special powers or matters to the members.¹¹⁹ Section 18-402 of the DLLCA, however, may grant members certain authority that was unintended in Form 5 or its reiterations, stating: “Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.” To avoid the argument that a person other than the manager has the power to bind the LLC, the Modest Form includes language making clear that members of the management committee are not

¹¹⁷ Form 5 § 12.5.

¹¹⁸ Form 5A is silent on this issue. Form 5A LLC Operating Agreement § 5.11 specifically negates any contribution obligation. See the discussion in Form 5A, Commentary to Exhibit C.

¹¹⁹ See Del. Code Ann. tit. 6, § 18-407 (elec. 2007) (providing that managers and members have the right to delegate rights and powers to manage and control the business and affairs of the LLC).

managers under the DLLCA, and that no members or members of the management committee have the power to bind the LLC.^{119.1}

[2] Action By Less Than Unanimous Written Consent

Form 5 does not provide for actions of the Management Committee by written consent. Form 5A LLC provides for action by unanimous written consent.¹²⁰ Circumstances may arise when the expediency of important transactions does not allow sufficient time to hold a meeting or opportunity to obtain the written consent of all of the members. For this reason, the Modest Form includes a written consent provision permitted under DLLCA § 18-302(d) that allows action by less than unanimous written consent, but also provides that notice of any such action should be provided to the member holding the minority interest.^{120.1} This provision, although permitted by the DLLCA, may be substantially inconsistent with the business understanding of a mining joint venture, where significant decisions such as approval of annual programs and budgets are often taken after one or more meetings and opportunity for discussion, even when one party has a majority voting interest. As such, the practitioner may consider it more suitable as an alternative provision.

§ 13.07 Dispute Resolution Considerations

As stated in the commentary to Form 5, Form 5 does not recommend any particular method for resolving disputes, but it does include sample language regarding arbitration.¹²¹ Form 5A LLC includes a governing law provision and no more.¹²² Although the Modest Form does not take on the difficult task of crafting an arbitration provision, one should be provided as an alternate provision to a new form of LLC agreement.

Any form provisions regarding disputes should consider important provisions of the DLLCA and case law thereunder which may implicate the resolution of disputes. For example, a party that desires to litigate a dispute should consider whether claims

^{119.1} Modest Form § 7.1.

¹²⁰ Form 5A LLC Operating Agreement § 8.4.

^{120.1} Modest Form § 7.4.

¹²¹ See Form 5 Commentary, art. XVI.

¹²² See Form 5A LLC Operating Agreement, art. XV.

are required to be brought as derivative claims under sections 18-1001 through -1004 of the DLLCA or as direct claims.¹²³ If the wrong approach is taken by a litigator, the pleading party could risk dismissal.¹²⁴ A derivative action may be brought only if managers or members with authority to do so have refused to bring the action (i.e., demand has been made), or making such a demand would be futile.¹²⁵ If the LLC agreement contemplates that disputes will be litigated instead of arbitrated, the parties may consider attempting to waive in the LLC agreement any requirement to bring claims as derivative claims or to make a demand on the members or managers with authority. Whether such a provision would be respected by the Delaware Court of Chancery is unclear.

If the parties desire arbitration, it is clear that the parties may agree to arbitrate some, if not all, disputes regarding a Delaware LLC in those cases involving broadly drafted arbitration clauses.¹²⁶ If the parties desire arbitration, to avoid lengthy and expensive court proceedings the parties also should make clear in the LLC Agreement whether the Delaware Court of Chancery or the arbitrators decide issues of arbitrability.¹²⁷

§ 13.08 Exhibit C: Tax Matters

The appropriate starting point for the tax provisions in Exhibit C of the Modest Form is the corresponding set of tax provisions in Exhibit C to Form 5A LLC. The Form 5A LLC tax provisions re-

¹²³ See *VGS, Inc. v. Castiel*, No. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000) (claims for waste, mismanagement, and self-dealing are derivative in nature and not direct claims).

¹²⁴ See *id.* See generally Daniel S. Kleinberger, Direct vs. Derivative Claims in the Closely Held LLC (outline of speech), ABA Sec. of Bus. L. Comm. Forum 2005 Spring Meeting).

¹²⁵ *VGS, Inc.*, 2000 WL 1277372. See also DLLCA, Del. Code Ann. tit. 6, § 18-1001 (elec. 2007).

¹²⁶ See *CAPROC Manager, Inc. v. Policemen's & Firemen's Ret. Sys.*, No. 1059-N, 2005 WL 937613 (Del. Ch. Apr. 18, 2005) (holding that, although removal of the manager was not covered by the LLC agreement, an arbitration provision requiring any dispute or controversy under the LLC agreement to be arbitrated nevertheless applied because of the broad arbitration clause and because the issue required interpretation of the LLC agreement).

¹²⁷ See, e.g., *Willie Gary LLC v. James & Jackson LLC*, No. 1781, 2006 WL 75309 (Del. Ch. Jan. 10, 2006), *aff'd*, 906 A.2d 76 (Del. 2006).

reflect the use of the LLC format and were updated in 1998 to reflect changes in applicable regulations through the date of Form 5A LLC's publication. While the tax provisions included in Form 5 and Form 5A preserved the theoretical possibility that the participants could elect not to be taxed as a partnership,¹²⁸ that possibility is eliminated by use of the LLC entity form.

In the spirit of making minimal changes to the prior forms, the Modest Form continues the approach, adopted by Form 5 and continued in Form 5A and Form 5A LLC, of including the tax provisions as a separate exhibit, rather than integrating them in the LLC Agreement. The separate exhibit containing the tax provisions is a vestige of the joint venture format and its predecessor mineral development agreements, that purposely preserved the parties' flexibility to elect not to be taxed as a partnership. In those circumstances in which the tax provisions did not apply, the exhibit could easily be removed. In the LLC entity context, however, the tax provisions will always apply. While the Modest Form preserves the approach taken by Form 5A LLC, the committee should consider integrating the tax provisions into the LLC Agreement consistent with more common convention for LLC practitioners.

The tax provisions in Exhibit C to the Modest Form do not incorporate significant changes from Exhibit C to Form 5A LLC. As discussed above, the Modest Form eliminates the obligation to restore capital account deficits on liquidation.¹²⁹ The deficit restoration obligation generally is not required in order to give effect to the desired allocation of income and losses, at least to the extent that the allocation and distribution provisions do not cause a Member to have a capital account deficit.¹³⁰ Based upon the business arrangement, it is unlikely that a Member will have a deficit capital account balance.¹³¹ Further, to the extent that the lack of a deficit restoration obligation would prevent a Member from be-

¹²⁸ Based upon the business transaction posited by the forms, the opportunity to elect not to be taxed as a partnership was of little practical consequence because, absent the addition of a payout provision, the partnership format was necessary for YCO to be able to deduct all of the deductible expenses attributable to its cash contributions.

¹²⁹ See the discussion *supra* § 13.05[4][e] accompanying notes 117-118.

¹³⁰ Treas. Reg. § 1.704-1(b)(2)(ii)(d) (elec. 2007).

¹³¹ See the discussion in Form 5A, Commentary to Exhibit C.

ing allocated tax deductions in a given year, the Member may be able to make other arrangements at the time of liquidation in order to preserve the tax deductions.

Exhibit C to the Modest Form continues to reflect a compromise between the Members' business deal and their tax objectives. In most circumstances, the parties' business intent is probably that liquidating distributions be made in accordance with percentage interests. However, the "safe harbor rules" under Internal Revenue Code § 704(b) require that liquidating distributions be made in accordance with capital account balances, which might not always be in proportion to percentage interests. Consistent with Form 5A LLC, section 4.2 of Exhibit C to the Modest Form provides that distributions on liquidation of the LLC will be made in accordance with the Members' capital account balances. However, Exhibit C to the Modest Form also includes additional allocation provisions intended to minimize the risk that capital account balances will not be in accordance with the Members' percentage interests. Practitioners should consider whether to provide for liquidating distributions in accordance with percentage interests (consistent with the business deal), rather than in accordance with capital account balances, recognizing that doing so may have implications for whether allocations of expenses will be respected for tax purposes under the "substantial economic effect" rules.¹³²

Exhibit C to the Modest Form also does not change the approach to revaluing the LLC's assets and adjusting capital account balances on contributions of cash to the LLC, or upon distributions of assets by the LLC. Consistent with Exhibit C to Form 5A LLC, the Modest Form reserves this issue to the agreement of the Members.¹³³

To the extent the committee chooses to incorporate alternative provisions in an LLC form, it may be desirable to provide alternatives for the provisions relating to liquidating distributions and revaluing assets, as discussed above. In addition, although the 50/50 deal contemplated by the Modest Form contemplates two corporate members and does not anticipate the use of employee incentives, the committee might wish to consider alternative pro-

¹³²I.R.C. § 704(b) (elec. 2007); Treas. Reg. § 1.704-1 (elec. 2007).

¹³³Modest Form Exhibit C § 4.1(h).

visions permitting the grant of equity incentives in the form of profits interests.

§ 13.09 Conclusion: Back to the Future?

At the time Form 5A LLC was drafted, it was creative and innovative and based on the best information available at the time. The authors worked within a mandate to comply as closely as possible with the terms of Form 5A, a form with little history of acceptance at the time Form 5A LLC was drafted. In addition, the authors of Form 5A LLC were constrained by a lack of judicial precedent regarding LLCs generally, and the recently-overhauled DLLCA in particular, and by a lack of common conventions for LLC agreement drafting.

The law and the experience of practitioners have progressed significantly in the last decade. The Modest Form is truly intended as a modest proposal, an incremental step towards the future of mining joint ventures, meant to initiate discussion about the desirability of a broader use of the LLC entity form by cloaking the new entity in the widely-recognized mining joint venture custom and usage embodied in Form 5. The next and more challenging step is for the Foundation to form a committee to begin the process again.

The Modest Form may be a good starting point for the next generation of Form 5, but it may be unnecessarily limited to concepts developed when the common law joint venture was the primary vehicle for joint mining operations. Based on the authors' experience, the mandate of sticking closely to prior forms will not necessarily result in a form that is durable and reflective of current practice. Perhaps the next Foundation mining joint venture form should not slavishly adhere to the language of the past, no matter how time-tested and widely-accepted, but should also consider other form models and use the appropriate entity law to the maximum advantage of the parties.

As such, a new form of LLC agreement could begin with a single-agreement, standard form of LLC agreement, organized in a customary manner, not with a mining joint venture agreement. The most used and accepted business terms from Form 5 and Form 5A can be incorporated into the new form in a manner that takes close account of the fiduciary duty and allocation of liability

rules applicable to LLCs. The committee should avoid including provisions that protect the interest of one party or the other, unless such protections are widely accepted as the norm. In the case in which such protections are sometimes but not consistently used, such protections should be included as alternate provisions that accompany the form. Such a structure would be consistent with the original vision of Form 5 as a “checklist” and starting point for a customized agreement.

To assist in getting this effort underway, the Modest Form is posted and downloadable for free from the Foundation’s website at www.rmmlf.org or available by e-mailing the authors at jim.cress@hro.com. The authors will receive any comments on the form and forward them to the Form 5 committee once it is formed.