MEMORADUM
STATUTE OF FRAUDS AND OPERATING AGREEMENTS

TO: Drafting Committee on the Harmonization of Business Entity Statutes
FROM: Daniel S. Kleinberger, Co-Reporter
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This memo has four sections:

- general background as to the relationship between operating agreements and the statute of frauds, with an appendix containing Re-ULLCA's detailed comment on the issue;
- specific background about recent relevant developments in Delaware case and statutory law;
- possible approaches for the uniform acts, including two different revisions that might be made (starting with HULLCA); and
- an appendix discussing some complex choice of law issues.

General Background

Since time out of mind (or "the mind of man [sic] runneth not to the contrary"), partnership law has accepted oral partnership agreements. The UPA did so; RUPA does so; so do ULPA (2001), ULLCA, and Re-ULLCA. However, since the 18th century, English and, subsequently, U.S. law, has included various statutes of frauds. (On the other hand, on information and belief, some years ago Parliament repealed the original statute of frauds.)

Whether statutes of fraud apply to partnership and operating agreements has been an open question. The Re-ULLCA Drafting Committee specifically chose to punt on this issue. The Comment to Section 101(13) ("operating agreement") acknowledges: "This Act states no rule as to whether the statute of frauds applies to an oral operating agreement." [1]

Delaware – Halvorsen

Three organs of the Delaware government have recently considered the question of whether the statute of frauds applies to a Delaware LLC agreement. The Chancery Court decided no, citing a learned treatise.[2] The Delaware Supreme Court affirmed.[3] The Delaware legislature promptly "reversed." The Delaware LLC Act now states: "A limited liability company agreement is not subject to any statute of frauds (including Section 2714 of this Title)."[4]

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[1] For the detailed discussion of the state of the law, see Appendix A (Re-ULLCA's comment).
[2] Olson v. Halvorsen, 982 A.2d 286, 289, 291 n. 15 (Del.Ch. 2008).
[3] Olson v. Halvorsen, 986 A2d 1150 (Del. 2009).
[4] 2010 Del Laws, ch. 287 (H.B. 372), § 1 (amending Del. Code Ann., tit. 6, § 18-101(7), the definition of "limited liability company agreement"). Section 2714 is captioned "Necessity of writing for contracts; definition of writing; evidence" and is a general statute of frauds, including real estate matters.

Change the Uniform Acts?

For those who abhor any statute of frauds, there is only one issue and its resolution is simple: uniform acts should buttress their authorization of oral partnership/operating agreements with an explicit and complete override of statutes of fraud. Other views are possible, however; it is worth considering why entity law warrants a departure from a state's general policy on statutes of fraud. More particularly, the Drafting Committee might take:

- a traditionalist approach, which leaves the law in place as is;
- a limited approach, which provides only that, to the extent that a statute of frauds:
  - applies to a provision in an operating agreement, and
  - has been satisfied initially through a signed writing,

  a person who subsequently becomes a member is subject to that provision, even if the member does not sign the writing.

Obviously, the traditionalist approach requires no revised language. Language for the two other approaches follows.

Complete Override

Add a new subsection to Section 110: "(h) An operating agreement is not subject to any statute of frauds, including a statute of frauds pertaining to the transfer of an interest in land."

Limited Approach

Revise Section 111(b) as follows:

(b) A person that becomes a member of a limited liability company is deemed to assent to the operating agreement. If a provision of an operating agreement is subject to a statute of frauds and that provision, when first adopted , was memorialized in a signed writing that satisfied that statute of frauds, a deemed assent under this subsection satisfies that statute of frauds.

Appendix A – Re-ULLCA's Comment on the Issue

The Comment to Section 101(13) ("operating agreement") states in pertinent part:

> This Act states no rule as to whether the statute of frauds applies to an oral operating agreement. Case law suggests that an oral agreement to form a partnership or joint venture with a term exceeding one year is within the statute. E.g. Abbott v. Hurst, 643 So.2d 589, 592 (Ala. 1994) ("Partnership agreements, like other contracts, are subject to the Statute of Frauds. A contract of partnership for a term exceeding one year is within the Statute of Frauds and is void unless it is in writing; however, a contract establishing a partnership terminable at the will of any partner is generally held to be capable of performance by its terms within one year of its making and, therefore, to be outside the Statute of Frauds.") (citations omitted); Pemberton v. Ladue Realty & Const. Co., 362 Mo. 768, 770-71, 244 S.W.2d 62, 64 (Mo. 1951) (rejecting plaintiff's contention that mere part performance sufficed to take the oral agreement outside the statute and holding that partnership was therefore at will); Ebker v. Tan Jay Int'l, Ltd., 739 F.2d 812, 827-28 (2d Cir.1984) (same analysis with regard to a joint venture). However, it is not possible to form an LLC without someone signing and delivering to the filing officer a certificate of organization in record form, Section 201(a), and the Act itself then establishes the LLC's duration. Subject to the operating agreement, that duration is perpetual. Section 104(c). An oral provision of an operating agreement calling for performance that extends beyond a year might be within the one-year provision – e.g., an oral agreement that a particular member will serve (and be permitted to serve) as manager for three years.
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> An oral provision of an operating agreement which involves the transfer of land, whether by or to the LLC, might come within the land provision of the statute of frauds. Froiseth v. Nowlin, 156 Wash. 314, 316, 287 P. 55. 56 (Wash. 1930) ("[The land provision] applies to an oral contract to transfer or convey partnership real property, and the interest of the other partners therein, to one partner as an individual, as well as to a parol contract by one of the parties to convey certain land owned by him individually to the partnership, or to another partner, or to put it into the partnership stock.") (quoting 27 CORPUS JURIS 220).").
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> In contrast, the fact that a limited liability company owns or deals in real property does not bring within the land provision agreements pertaining to the LLC's membership interests. Interests in a limited liability company are personal property and reflect no direct interest in the entity's assets. Re-ULLCA §§ 501 & 102(21). Thus, the real property issues pertaining to the LLC's ownership of land do not "flow through" to the members and membership interests. See, e.g.,

Wooten v. Marshall, 153 F. Supp. 759, 763-764 (S.D. N.Y. 1957) (involving an "oral agreement for a joint venture concerning the purchase, exploitation and eventual disposition of this 160 acre tract" and stating "[t]he real property acquired and dealt with by the venturers takes on the character of personal property as between the partners in the enterprise, and hence is not covered by [the Statute of Frauds]."

Appendix B – Choice of Laws Issues

The following discussion is from the forthcoming supplement to Bishop & Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW, 14.02[7][b][i] (Statute [of Frauds] Inapplicable to LLC Agreements [NEW]). Copyright 2010 – Carter G. Bishop & Daniel S. Kleinberger

[i] Statute Inapplicable to LLC Agreements [NEW]

The Delaware LLC statute expressly allows oral LLC agreements,[5] but before August, 2010, the statute did not specifically consider whether oral LLC agreements are subject to the statute of frauds. Effective August 2, 2010, the statute provides "A limited liability company agreement is not subject to any statute of frauds (including Section 2714 of this Title)."[6] This provision overturns a decision of the Delaware Supreme Court, which had affirmed the Chancery Court's determination that the statute of frauds did apply to LLC agreements.[7]

The new provision is clear and unequivocal but nonetheless raises choice of law questions, especially with regard to real estate located outside Delaware.

> **EXAMPLE:** XYZ, LLC is a Delaware LLC all of whose members are residents of Delaware. The LLC's operations are confined to Delaware.[8] XYZ files suit against one of its members, alleging that the member has breached an oral term of the operating agreement under which the member agreed to contribute a parcel of land to the LLC. The land is located in Delaware. The statute of frauds will not provide a defense to XYZ's claim.

> **EXAMPLE:** XYZ, LLC is a Delaware LLC all of whose members are residents of Florida. The LLC's operations are confined to Florida.[9] XYZ threatens suit against one of its members, alleging that the member has breached an oral term of the operating agreement under which the member agreed to contribute a parcel of land to the LLC.

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[5] Del. Stat. Ann. tit. 6, § 18-101(7) (defining "limited liability company agreement" as "written, oral or implied").

[6] 2010 Del Laws, ch. 287 (H.B. 372), §§ 1 (amending Del. Code Ann., tit. 6, § 18-101(7), the definition of "limited liability company agreement") and 31 (effective date). Section 2714 is captioned "Necessity of writing for contracts; definition of writing; evidence" and is a general statute of frauds, including real estate matters.

[7] Olson v. Halvorsen, 986 A2d 1150 (Del. 2009), affirming 982 A.2d 286, 289 (Del.Ch. 2008).

[8] The residence of the members and the location of the business are not necessarily relevant to the choice of law question, but are placed in Delaware to limit the complexity of the example.

[9] The residence of the members and the location of the business are not necessarily relevant to the choice of law question, but are placed in Florida to limit the complexity of the example.

> The land is located in Florida. The member brings a quiet title action in Florida,[10] denying any oral agreement and seeking a declaration that the alleged obligation is unenforceable under both the Florida statute of frauds and another statute which requires "the presence of two subscribing witnesses" to the signature of the vendee.[11] Most likely, the Florida court will apply Florida law in the quiet title action.

In the first example, there is no choice of law issue. Only Delaware law is implicated. In the second example, both Florida and Delaware have substantial interests in play.[12] Delaware's interests pertain to the internal affairs doctrine.[13] Florida's interests pertain to certainty in land title, and those interests are substantial.[14] Indeed, according to the Restatement (Second) of Conflict of Laws, those interests typically control the choice of law decision: "Whether a conveyance transfers an interest in land and the nature of the interest transferred are determined by the law that would be applied by the courts of the situs. These courts would usually apply their own local law in determining such questions."[15] A Comment notes: "To date, the courts of the situs have usually applied their own local law to determine the validity of a conveyance of an interest in land."[16] Another comment states, more specifically, "In the absence of statute, the courts of the situs would usually apply their own local law to determine questions involving the formalities necessary for the validity of a conveyance of an interest in land." Within the term "formalities," the comment specifically includes "such requirements as those of a writing ... [and] of witnesses."[17]

Florida law prefers its "land transaction" formalities requirements over the power-to-bind rules of even its <u>own</u> LLC statute.[18] In addition to the its general statute of frauds, Florida law further provides:

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[10] E.g., Katcher v. Sans Souci Co., 200 So.2d 826, 828 (DCA 3rd 1967) (quiet title action holding that a claimed oral easement was unenforceable per the statute of frauds).
[11] West's F.S.A. § 689.01, which is further discussed below.
[12] Restatement (Second) of Conflict of Laws, § 6(2)(c) (listing as a major factor in choice of law decisions "the relevant policies of other interested states [i.e., other than the forum state] and the relative interests of those states in the determination of the particular issue").
[13] For an explanation of this doctrine, See ¶6.07[1].
[14] In re Morris, 147 B.R. 929, 934 (Bkrtcy.S.D.Ill. 1992) ("Because of the unique nature of land and a state's interest in controlling the use and possession of its land, the validity and effect of a conveyance of land and the nature of the interest conveyed are generally determined by the situs court's own local law.").
[15] Restatement (Second) of Conflict of Laws, §223, Validity and Effect of Conveyance of Interest in Land (subsection numbering omitted).
[16] Restatement (Second) of Conflict of Laws, §223, Validity and Effect of Conveyance of Interest in Land, cmt b.
[17] Restatement (Second) of Conflict of Laws, §223, Validity and Effect of Conveyance of Interest in Land, cmt e.
[18] Skylake Ins. Agency, Inc. v. NMB Plaza, LLC, 23 So.3d 175 (DCA 3 2009).

> No estate or interest of freehold, or for a term of more than 1 year, or any uncertain interest of, in or out of any messuages, lands, tenements or hereditaments shall be created, made, granted, transferred or released in any other manner than by instrument in writing, signed in the presence of two subscribing witnesses by the party creating, making, granting, conveying, transferring or releasing such estate, interest, or term of more than 1 year...."[19]

In Skylake Ins. Agency, Inc. v. NMB Plaza, LLC, the court dealt with an LLC lessor that admitted having signed a 10-year lease in accordance both with the general statute of frauds and the Florida LLC statute but invoked the "two witnesses" requirement to repudiate the lease.[20] The trial court granted summary judgment on the lessee's claims for specific performance and damages. The court of appeals affirmed on the specific performance claim – i.e., on the issue pertaining to title – but, in light of the lessor's brazen conduct, remanded for trial on a damages claim.[21]

Given this background, a Florida court would most likely prefer its "land transaction" formalities requirements over the dictates of a foreign LLC statute.[22] Thus, it is uncertain whether Delaware's override of the statute of frauds will have extraterritorial reach.

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[19] West's F.S.A. § 689.01.

[20] Skylake Ins. Agency, Inc. v. NMB Plaza, LLC, 23 So.3d 175, 177-178 (DCA 3 2009).

[21] Skylake Ins. Agency, Inc. v. NMB Plaza, LLC, 23 So.3d 175, 178 -179 (DCA 3 2009). The statute has an exception to the "two witnesses" requirement for corporations, but the court declined to apply that exception to LLCs. Id.

[22] See Pint v. Breckner, No. 08-CV-5340(JMR/SRN), 2009 WL 4042905 at *3 (D. Minn. Nov.19, 2009) (declining to apply Minnesota law to the question of whether a mortgage granted by a Minnesota LLC was valid; "acknowledg [ing] Florida's statutory inability to regulate the internal affairs of an out-of-state LLC," but stating "this dispute does not go to the governance of the Minnesota LLC; it concerns the validity and rights accrued under a mortgage"). Although the court's analysis merely led it to enforce the parties' contractual choice of law provision, the result would likely have been the same without that provision. The case is especially noteworthy because the forum state is Minnesota, not Florida. Compare In re Morris, 147 B.R. 929 (Bkrtcy.S.D.Ill. 1992). The case concerned whether a person acting for a dissolved Iowa corporation had the capacity to transfer land owned by the corporation in Illinois. The court acknowledged that in general the law of the situs state controls questions of capacity but stated "in determining the capacity of a foreign corporation as transferor, the situs court might apply the local law of the state of incorporation because that state's interest in regulating the corporation's existence and powers is so great as to outweigh the values of certainty and convenience that would be served by application of its own law." Id. at 934. The choice of law mattered because Iowa law "differs from Illinois law in that it continues corporate existence indefinitely to convey a dissolved corporation's property, while Illinois case law holds that corporate property passes automatically to the shareholders at the end of the statutory winding up period." Id. at 935. For two reasons, the court decided that Iowa law should apply. "[A]ll corporations derive their life and right to transact business from the state in which they are incorporated. While the manner of doing business in a foreign jurisdiction may be controlled by the statutes of that jurisdiction, the corporation's organization, the manner of its dissolution, and its resulting obligations are subject to the control of the state which gave it birth. Thus, under the rule of comity existing between the

various states, the rights granted by the state creating the corporation will be recognized insofar as they deal with its corporate life and existence." Id. at 934-935. Moreover, and perhaps more importantly, applying Iowa law did nothing to undermine any important Illinois policies. "[T]he fact that Iowa provides a longer time for the corporation to dispose of assets following dissolution does not make its statute repugnant to the laws of Illinois, as both states' statutes serve to facilitate the transfer of title from the defunct corporation." Id. at 935. Thus, In re Morris resolves a choice of laws between the entity laws of two states, not between the entity law of a foreign state and the real property law of the forum state.