# UNITED STATES BANKRUPTCY COURT
# DISTRICT OF DELAWARE

JUDGE PETER J. WALSH

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October 31, 2011

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**Re: James R. Zazzali, et al. v. Wavetronix LLC, et al.**
**Adv. Proc. No. 10-55963**

Dear Counsel:

This is with respect to Individual Defendants' motion to dismiss the First Amended Complaint (Doc. # 63). For the reasons set forth below, I will deny the motion.

Individual Defendants' opening brief correctly states the legal standard for a motion to dismiss:

> Rule 12(b)(6) of the Federal Rules of Civil Procedure, made applicable to this adversary proceeding by Rule 7012(b) of the Federal Rules of Bankruptcy Procedure, governs a motion to dismiss for failure to state a claim upon which relief can be granted. "The purpose of a motion to dismiss is to test the sufficiency of a complaint, not to resolve disputed facts or decide the merits of the case." Paul v. Intel Corp., 496 F. Supp.2d 404, 407 (D. Del. 2007). The complaint "must contain either direct or inferential allegations respecting all the material elements necessary to sustain recovery under *some* viable legal theory." Twombly, 550 U.S. at 562 (quoting Car Carriers, Inc. v. Ford Motor Co., 745 F.2d 1101, 1106 (7th Cir. 1984) (emphasis in original)).
>
> In considering a motion to dismiss, the Court must accept as true all factual allegations in the complaint and draw all inferences from the facts alleged in the light most favorable to the plaintiff. Worldcom, Inc. v. Graphnet, Inc., 343 F.3d 651, 653 (3d Cir. 2003). The relevant record consists of the complaint and any "document integral to or explicitly relied on in the complaint." U.S. Express Lines, Ltd. v. Higgins, 281 F.3d 383, 388 (3d Cir. 2002).

(Doc. # 64, pp. 14-15.)

Notwithstanding that standard, Individual Defendants repeatedly challenge Plaintiffs' factual allegations and indeed offer their own version of a number of contested facts.

More importantly, the centerpiece of Individual Defendants' motion is Article 7.7 of the Operating Agreement which provides as follows:

> Board Members' Standard of Care. **A Board Member's (including Managers [sic]) duty of care in the discharge of the Board Member's duties to the Company and the other Members is limited to refraining from engaging in grossly**

> **negligent or reckless conduct,[intentional misconduct,][1] or a knowing violation of law.** In discharging its duties, a Board Member shall be fully protected in relying in good faith upon the records required to be maintained under Article IV and upon such information, opinions, reports, or statements by any of its other Members, or agents, or by any other Person, as to matters the Board Member reasonably believes are within such other Person's professional or expert competence and who has been selected with reasonable care by or on behalf of the Company, including information, opinions, reports, or statements as to the value and amount of the assets, liabilities, profits, or losses of the Company or any other facts pertinent to the existence and amount of assets from which distributions to members might properly be paid.[2]

Although I must confess that I am not very familiar with the Revised Uniform Limited Liability Company Act ("RULLCA") as adopted by the State of Idaho, my reading of what appears to be relevant portions of the Idaho statute lead me to conclude that Individual Defendants' reliance on Article 7.7 of the Operating Agreement is misplaced.

I start with Section 30-6-409 of the Idaho statute:

> (1) A member of a member-managed limited liability company owes to the company and, subject to section 30-6-90(2), Idaho Code, the other members the fiduciary duties of loyalty and care stated in subsections (2) and (3) of this section.

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[1] Individual Defendants' statement of this provision in their opening brief left out the term "intentional misconduct." (Doc. # 64, p. 16.)

[2] With respect to the first sentence of this provision, I note that there is no comma between the term "grossly negligent" and the term "reckless conduct." Thus, I read this to mean that grossly negligent and reckless conduct are intended to mean the same thing.
This is consistent with Black's definition of "gross negligence": "A conscious, voluntary act or omission in reckless disregard of a legal duty and of the consequences to another party, who may typically recover exemplary damages." (Black's Law Dictionary 1134 (9th ed. 2009).)

(2) The duty of loyalty of a member in a member-managed limited liability company includes the duties:

(a) To account to the company and to hold as trustee for it any property, profit or benefit derived by the member:

(i) In the conduct or winding up of the company's activities;

(ii) From a use by the member of the company's property; or

(iii) From the appropriation of a limited liability company opportunity;

(b) To refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a person having an interest adverse to the company; and

(c) To refrain from competing with the company in the conduct of the company's activities before the dissolution of the company.

(3) Subject to the business judgment rule, the duty of care of a member of a member-managed limited liability company in the conduct and winding up of the company's activities is to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company. In discharging this duty, a member may rely in good faith upon opinions, reports, statements or other information provided by another person that the member reasonably believes in a competent and reliable source for the information.

* * *

(7) In a manager-managed limited liability company, the following rules apply:

(a) Subsections (1), (2), (3) and (5) of this section apply to the manager or managers and not the members.(Emphasis added.)

Thus, the fiduciary duty imposed on the managing members has two elements: a duty of loyalty and a duty of care. Article 7.7 of the Operating Agreement addresses only the latter. The relevant portions of the First Amended Complaint contain numerous references to fiduciary duty of both loyalty and of care.

Furthermore, the Idaho statute contains what I consider as an overarching provision that has bearing here:

> (4) A member in a member-managed limited liability company or a manager-managed limited liability company shall discharge the duties under this chapter or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.

(Section 30-6-409(4).)

I note Section 30-6-110 of the Idaho statute that, in relevant part, provides as follows:

> (3) An operating agreement may not:
>
> * * *
>
> (d) Subject to subsections (4) through (7) of this section, eliminate the duty of loyalty, the duty of care, or any other fiduciary duty;
>
> (e) Subject to subsections (4) through (7) of this section, eliminate the contractual obligation of good faith and fair dealing under section 30-6-409(4), Idaho Code.
>
> (f) Unreasonably restrict the duties and rights stated in section 30-6-410, Idaho Code.
>
> * * *
>
> (4) If not manifestly unreasonable, the operating agreement may:

(a) Restrict or eliminate the duty:

(i) As required in sections 30-6-409(2)(a) and (7), Idaho Code, to account to the limited liability company and to hold as trustee for it any property, profit or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of a limited liability company opportunity;

(ii) As required in sections 30-6-409(2)(b) and (7), Idaho Code, to refrain from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and

(iii) As required by sections 30-6-409(2)(c) and (7), Idaho Code, to refrain from competing with the company in the conduct of the company's business before the dissolution of the company;

(b) Identify specific types of categories of activities that do not violate the duty of loyalty;

(c) Alter the duty of care, except to authorize intentional misconduct or knowing violation of law:

(d) Alter any other fiduciary duty, including eliminating particular aspects of that duty; and

(e) Prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under section 30-6-409(4), Idaho Code.

* * *

(7) The operating agreement may alter or eliminate the indemnification for a member or manager provided by section 30-6-408(1), Idaho Code, and may eliminate or limit a member or manager's liability to the limited liability company and members for money damages, except for:

(a) Breach of the duty of loyalty.

These subsections of the Idaho statute are relevant to two issues here: (1) whether the limitation on the duty of care set forth in Article 7.7 of the Operating Agreement is, pursuant to subsection (4), "not manifestly unreasonable," and (2) whether the Article 7.7 of the Operating Agreement runs afoul of subsection (7) that precludes a member or manager from having a limitation of liability for money damages for breach of the duty of loyalty. I do not believe that these two issues can be effectively addressed in context of a Rule 12(b)(6) motion to dismiss. I believe these issues cannot be addressed short of an evidentiary record.

Under the prior Idaho Limited Liability Company Act Section 53-622, the duty of care was limited:

> Unless otherwise provided in an operating agreement:
>
> > (1) A member or manager shall not be liable, responsible or accountable in damages or otherwise to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes gross negligence or willful misconduct.

Of course, Article 7.7 of the Operating Agreement otherwise provided. But the prior version of the Idaho Limited Liability Company Act no longer controls, and Idaho's newly adopted version of the Act clearly departs from a gross negligence standard.

Given the fact that the drafters of Idaho's new Act replaced the gross negligence standard of care from prior Section

53-622 to the Section 30-6-409(3) rule, (see Larry E. Ribstein, An Analysis of the Revised Uniform Limited Liability Company Act, 3 Va. L. & Bus. Rev. 35, 63 (2008)), I believe that one can reasonably argue that Article 7.7 of the Operating Agreement does not simply alter the duty of care, it eliminates the duty of care, contrary to the existent Idaho statute.

Accordingly, I will deny the motion to dismiss.

Very truly yours,

Peter J. Walsh

PJW:ipm

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

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|---|---|---|
| In re: | ) | Chapter 11 |
| | ) | |
| DBSI, INC., et al. | ) | Case No. 08-12687(PJW) |
| | ) | |
| Debtors. | ) | Jointly Administered |
| _____ | ) | |
| | ) | |
| JAMES R. ZAZZALI, as Trustee of the DBSI Estate Litigation Trust created by operation of the Second Amended Joint Chapter 11 Plan of Liquidation; and CONRAD MYERS, as Trustee of the DBSI Liquidating Trust created by operation of the Second Amended Joint Chapter 11 Plan of Liquidation, | ) | |
| | ) | |
| Plaintiffs, | ) | |
| | ) | |
| v. | ) | Adv. Proc. No. 10-55963 (PJW) |
| | ) | |
| WAVETRONIX LLC, DAVID V. ARNOLD, LINDA S. ARNOLD, MICHAEL JENSEN, JOHN DOES 1-50, and ABC ENTITIES 1-50, | ) | |
| | ) | |
| Defendants. | ) | |

**ORDER**

For the reasons set forth in the Court's letter ruling of this date, Individual Defendants' motion to dismiss the First Amended Complaint (Doc. # 63)is **denied.**

Peter J. Walsh
United States Bankruptcy Judge

Dated: October 31, 2011