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Re: *Lola Cars International Limited v. Krohn Racing, LLC*
C.A. No. 6520-VCN
Date Submitted: November 16, 2012

Dear Counsel:

This too-long running saga of a failed venture may be drawing to a close. Defendant/Counterclaim-Plaintiff Krohn Racing, LLC (“Krohn”), following trial, generally prevailed against Plaintiff/Counterclaim-Defendant Lola Cars International Limited (“Lola”), its fellow member party in Proto-Auto, LLC (“Proto-Auto” or the “Company”).¹ The Court, however, declined to shift the

¹ *Lola Cars Int’l Ltd. v. Krohn Racing, LLC*, 2010 WL 3314484 (Del Ch. Aug. 2, 2010). This matter involved actions bearing the designations C.A. No. 4479-VCN and C.A. No. 4886-VCN (the “Terminated Litigation”). No appeal was taken from the final judgment.

prevailing parties' legal fees to Lola under the bad faith exception to the American Rule, which generally requires each party to bear its own legal fees.²

* * *

Proto-Auto, following the strife between Lola and Krohn, not surprisingly, claimed to be short of funds. Indeed, Krohn alleges that the deficit according to Proto-Auto's balance sheet as of February 3, 2009, was \$2,140,834.³ The legal fees incurred for Proto-Auto and Jeffrey Hazell ("Hazell"), Proto-Auto's Chief Executive Officer and Krohn's representative on Proto-Auto's two-person governing board, have been paid by Krohn.⁴ Krohn now seeks, in effect, to require Lola to pay its proportionate share of these legal fees.⁵

² *Id.*, 2010 WL 3314484, at *22.

³ The parties' current dispute turns on what the 2010 balance sheet would reveal. As discussed later, neither that audited balance sheet nor, evidently, any subsequent audited balance sheet has been prepared. Krohn suggests that it is a reasonable inference that the burden of litigation and the relationship between Krohn and Lola demonstrates that Proto-Auto's financial state has not materially improved.

⁴ How the litigation expenses ended up being reflected on Proto-Auto's balance sheet is not all that obvious. It seems that they were inserted late in the sequence of events. Whether it was the result of a change of heart, a belated effort to find a way to shift a part of the fees to Lola, or just inadvertent or inevitable, but good faith, delay cannot not be ascertained as a matter of undisputed fact.

⁵ Krohn owns 49% of Proto-Auto; Lola owns 51% of Proto-Auto. Proto-Auto is organized under the laws of the State of Delaware.

Krohn relies upon Proto-Auto's Operating Agreement (the "Operating Agreement")⁶ which provides in pertinent part:

8.3 If the audited balance sheet of the Company for any financial year shows negative net assets for the Company (that is, the liabilities of the Company exceed the value of the assets), then the Member Parties agree to make loans to the Company . . . within seven days as follows: (a) Lola shall provide a loan equal to 51% of the amount of the negative net assets of the Company; (b) Krohn shall provide a loan equal to 49% of the amount of the negative net assets of the Company.

Lola has not paid (or loaned) its share of the deficit attributable to the legal fees incurred for Proto-Auto and Hazell. By Section 8.4 of the Operating Agreement,

If either of the Member Parties fails to make such loan as provided by clauses 8.2 and 8.3, then the other [party] . . . may itself lend the whole or part of the same to the Company. If the relevant Member Party makes such loan to the Company it shall be entitled to be paid a commercial rate of interest on the same until repaid, and may . . . recover the amount as a debt from the non-payer. . . .

Krohn recognizes that Proto-Auto does not have an "audited balance sheet" that meets the condition set by Section 8.3 of the Operating Agreement. It attributes that shortcoming to resistance and improper conduct by Lola. In other words, Krohn argues that Lola cannot avoid its obligation to pay by refusing to cooperate with the preparation of audited balance sheets.

⁶ The Operating Agreement appears, among other places, as Exhibit 3 to Krohn Racing LLC's Opening Brief in Support of its Motion for Judgment on the Pleadings.

Lola scoffs at Krohn's efforts to obtain reimbursement of part of the legal costs which it paid and has raised several arguments in support of its position. First, it notes that there is no advancement or indemnification provision for legal fees in the Operating Agreement that requires Lola to pay the litigation costs of Krohn, Proto-Auto, or Hazell. Second, it asserts that nothing would entitle Hazell to reimbursement of his attorneys' fees. Third, Lola observes that the obligation under Section 8.3 of the Operating Agreement to react to "negative assets" shown in the audited balance sheet fails because there is no audited balance sheet. Fourth, it argues that Krohn's claim is barred by *res judicata* and waiver. In short, according to Lola, the Court has already rejected Krohn's, Proto-Auto's, and Hazell's claims for an award of attorneys' fees and Krohn never adopted its current approach in the Terminated Litigation when it could have done so.

Both parties have moved for judgment on the pleadings.⁷

* * *

Under Court of Chancery Rule 12(c), judgment may be entered on the pleadings if there is no material fact in dispute and the moving party is entitled to

⁷ In essence, Lola seeks a judgment that it is not liable for any of the disputed fees. Krohn seeks a determination that Lola is liable for litigation expenses, although the amount is not yet at issue.

judgment as a matter of law. A court, in ruling on such a motion, must view the alleged facts in the light most favorable to the non-moving party and must draw all reasonable inferences in the favor of the non-moving party.⁸

* * *

Lola insists that any claim that it must pay defense costs for the prior litigation is barred by *res judicata* and waiver. If this case were strictly about an obligation to pay legal fees, Lola would be correct. The Order and Final Judgment resolving the Terminated Litigation provided:

4. Defendants claim that Lola should pay Defendants' litigation costs, including attorneys' fees, under the bad faith exception to the American Rule is denied.

The litigation costs referenced in the Order and Final Judgment involved those of Proto-Auto and Hazell, which are sought here. That, under principles of *res judicata*, would be the end of the debate. Moreover, even though fee shifting under the American Rule was sought in the Terminated Litigation, any other basis for seeking reimbursement of legal expenses should have been brought at the same time. If there is a right under the Operating Agreement to reimbursement of legal

⁸ *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, LP*, 624 A.2d 1199, 1205 (Del. 1993).

expenses—and it does not appear that there is, as such—then, that should have been addressed in the Terminated Litigation. Krohn’s failure to use any other path could be viewed as a waiver of any right to follow that course.⁹

This case, however, is not about the payment of litigation costs. It is about the consequences of a Proto-Auto balance sheet with “negative assets.” One understands why Lola contends that this case is about legal fees that Krohn paid in the Terminated Litigation. Krohn, no doubt, filed this action because of litigation expenses from the Terminated Litigation, but its claim is not for litigation expenses. Krohn’s claim is for the share of Proto-Auto’s “negative assets” that Lola may be required to pay (or loan) to Proto-Auto under the Operating Agreement.

* * *

The Court turns to the question of whether the litigation expenses were reasonably incurred by Proto-Auto. Proto-Auto was named a defendant in the Terminated Litigation by Lola. As a defendant, Proto-Auto was justified in

⁹ It may be true that Proto-Auto was unable to pay its legal fees, that Proto-Auto and Krohn understood that the cost of Proto-Auto’s defense in the interim would need to be paid by Krohn because there was no other practicable source, and, indeed, that Krohn should have made such payments timely in order to assist Proto-Auto’s (and, for that matter, Hazell’s) defense.

retaining counsel.¹⁰ Whether the expenses incurred were reasonable and necessary is something that cannot be determined from the pleadings.¹¹

As for legal fees incurred for Hazell's benefit, Lola points out that he had no right to mandatory indemnification.¹² That, however, does not necessarily answer the question of whether Proto-Auto could indemnify him. If there is no right to mandatory advancement or indemnification, the decision to provide an officer or a director with assistance in paying legal fees arising out of work-related matters is, as a matter of Delaware law, left to the governing board's business judgment.¹³ That the Operating Agreement could have provided for indemnification, but did

¹⁰ The potential for conflict arising out of representation of Proto-Auto by the same law firms representing Krohn was understood, and no one objected to it. Lola, at least for present purposes, must be deemed to have waived any objection to that potential conflict.

¹¹ Although it may be that Lola has an obligation with respect to the deficit on Proto-Auto's balance sheet, because the expenses leading to the deficit were incurred at the instance of Krohn representatives largely for the benefit of Krohn and its interests, Lola is not required to accept blindly the related bookkeeping entries.

By Section 5.4 of the Operating Agreement, Hazell was constrained by budgetary considerations and a \$10,000 limit on any single item. The necessary budget was not prepared and duly approved, but the reasons for that failure are not entirely clear. Thus, although this provision may ultimately preclude consideration of Proto-Auto and Hazell's litigation expenses as a cause for Proto-Auto's negative net assets, the facts are not so free from doubt as to allow for judgment on the pleadings.

¹² Lola also posits that Krohn is responsible for Hazell's acts and omissions because of Section 4.1 of the Operating Agreement and, thus, it should have no responsibility for Hazell's expenses. That is not the same, however, as being obligated for Hazell's legal fees resulting from his involvement with Proto-Auto. Whether that bars a claim resulting from the impact of those fees on Proto-Auto's balance sheet is, at best, ambiguous.

¹³ See *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 573, 580 (Del. Ch. 2006).

not, does not preclude Proto-Auto's board from making such an award. The necessity for the specific legal services for Hazell's benefit and the reasonableness of their cost, as with the fees incurred for Proto-Auto, cannot be resolved on the pleadings.

* * *

Krohn, as other grounds for recovery of litigation expenses it paid for the benefit of Proto-Auto and Hazell, invokes the doctrines of equitable contribution¹⁴ and corporate benefit.¹⁵ Besides open factual questions, Section 8.1 of the Operating Agreement provides that the members are neither guarantors nor sureties for the Company, and the benefit conferred on Proto-Auto is difficult to define since the "real" party to the Terminated Litigation was essentially Krohn.

¹⁴ *E.g., Massachusetts Mut. Life Ins. Co. v. Certain Underwriters at Lloyd's of London*, 2010 WL 3724745, at *3 (Del. Ch. Sept. 24, 2000).

¹⁵ *E.g., Frank v. Elgamel*, 2011 WL 3300344, at *2 (Del. Ch. July 28, 2011).

* * *

The duty of a member of Proto-Auto to put money into the Company was predicated upon an “audited balance sheet” that showed “negative net assets.”¹⁶ It is undisputed here that there is no relevant (i.e., 2010 or later) audited balance sheet. Krohn attempts to overlook this inconvenience by blaming Lola. Specifically, it contends that Lola, acting through Stephen Charsley, interfered with Hazell’s efforts to have an independent auditor perform the necessary audit of Proto-Auto’s financial records. Krohn asserts that Lola did not want any audit because that would have triggered Lola’s obligations to spend yet more money on the Proto-Auto venture. It claims that Lola frustrated the efforts to obtain an audit and, with its vote, caused deadlock on the issue.

On the pleadings, the Court cannot conclude as a matter of undisputed fact, that Lola bears the responsibility for having improperly precluded an audit. Perhaps that will prove to be the case. If Lola, in fact, unjustifiably interfered with

¹⁶ Operating Agreement § 8.3. The most recent audited balance sheet was prepared in 2009 and revealed a significant balance in the negative net asset category. *See* text accompanying note 3, *supra*. There is no reason to believe that Proto-Auto has ever achieved a state of positive net assets. If the question were simply whether Proto-Auto’s balance sheet had improved since the audited balance sheet of 2009, the only reasonable inference would seem to be that it had not. Lola’s duty, however, to contribute funds to Proto-Auto is not triggered by the net asset count; instead, its duty arises from an audited balance sheet confirming the financial condition.

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the effort to obtain an audit, it would seem that Lola should not be able to benefit from the lack of an audit and avoid what otherwise would be an obligation to provide additional funding to the Company. In short, the absence of an audited balance sheet, which perhaps may not be Krohn's fault, presents a disputed issue of material fact and precludes the grant of the judgment on the pleadings sought by Krohn.

* * *

For the foregoing reasons, both pending motions for judgment on the pleadings are denied.¹⁷

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K

¹⁷ Combined for consideration with the cross-motions for judgment on the pleadings was Krohn's motion to reduce to judgment the Court's ruling of July 18, 2011 that Lola had successfully withdrawn its Deadlock Resolution notice. Alternatively, Krohn sought an extension of time to seek leave to pursue an interlocutory appeal. It had previously attempted to appeal the Court's July 18, 2011 decision as if it had been a final decision. On August 16, 2011, the Court expressed its views that piecemeal appellate review would be inefficient and that there was no just reason for immediate appellate review. Nothing in Krohn's papers has persuaded the Court that its previous conclusions were wrong, and, thus, Krohn's application is denied.