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The Increasing Role of Equity in Delaware LLC Litigation

By Jason C. Jowers and Meghan A. Adams

Both the case law and an amendment to the Delaware Limited Liability Company Act (the "LLC Act") in recent years demonstrate Delaware's rejection of a solely contractarian view of LLCs. In the area of fiduciary duties, the Delaware General Assembly amended 6 Del. C. § 18-1104 in 2013 to clarify that managers of Delaware LLCs owe default fiduciary duties in the absence of waiver or modification of such duties. Even before the amendment, the Delaware Court of Chancery, a court of equity, found that managers and managing members of LLCs owed such "equitable fiduciary duties." *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 661 (Del. Ch. 2012). Although it has been evident for several years that equity has a role to play in LLC litigation, it has been less clear where exactly equity's reach will end relative to the LLC Act's stated adherence to the freedom of contract and the LLC Act's limited gap-fillers, which apply in the absence of governing contract language. The recent decision of *In re Carlisle Etcetera LLC*, 114 A.3d 592 (Del. Ch. 2015) provides new lessons on the subject of equity's reach. Although the length of equity's powerful arm into the area of LLC litigation may surprise some practitioners, there is a consistent theme in the case law that may provide comfort: the Court of Chancery normally will exercise its equitable powers only when the parties have left gaps in their operating agreement.

Based on *Carlisle*, the Court of Chancery may use its equitable powers to dissolve a Delaware LLC even where neither the operating agreement nor the LLC Act expressly permits such dissolution. Allowing judicial dissolution of limited liability companies, 6 Del. C. § 18-802 provides that "[o]n application by or for a member or manager the Court of Chancery may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." By its terms, Section 18-802 limits the right to seek statutory dissolution to members and managers of an LLC. But what happens when a nonmember assignee, who has acted as a de facto member of an LLC, seeks dissolution of the LLC when it is not reasonably practicable to carry on the business and there is no exit procedure prescribed by the operating agreement? According to the *Carlisle* decision, "when equity demands," the right to petition for dissolution may extend to a nonmember assignee who lacks any dissolution rights under the Delaware LLC Act or under the parties' LLC agreement. As discussed in greater detail below, the court in *Carlisle* relied upon Section 18-1104 of the LLC Act, which states that "the rules of law and equity" shall govern in "any case not provided for in this chapter," as a basis for an equitable backstop when neither the LLC Act nor the LLC agreement provide for an exit mechanism and the parties are deadlocked.

This article will: (1) discuss the background facts of *Carlisle,* (2) compare the traditional contractarian view of LLCs with the evolving role of equity in LLC litigation, and (3) conclude with real-world advice for practitioners in light of the *Carlisle* opinion and equity's increasing role in LLC litigation.

Background Facts of *Carlisle*

In *Carlisle*, petitioner Well Union Capital Limited (WU Parent) and respondent Tom James Company (James) formed Carlisle Etcetera LLC (the "Company"). WU Parent and James each contributed approximately $11 million in capital to the Company in exchange for a 50 percent membership interest. WU Parent and James also executed a simple form of operating agreement (the "Initial LLC Agreement"), in which they

committed to work on a more detailed operating agreement. The parties never agreed to a replacement LLC agreement.

The Initial LLC Agreement created a four-member board to manage the Company, with each member appointing two of the board members, and designating one of James' appointees as Carlisle's CEO. In the court's view, the LLC was intended to be a joint venture between equal parties. However, because James controlled the CEO position, it also effectively gave James control over the Company in the event of a deadlock.

After the Company was formed, WU Parent transferred its member interest to a wholly-owned subsidiary called Well Union U.S. Holdings, Inc. (WU Sub). James was aware of the transfer, did not object, and treated WU Sub as a member from that point on. Within a few years, the parties' relationship soured. While the parties recognized that they could not manage the Company jointly and that a buyout would be necessary, they could not agree on a buyout procedure or a price.

WU Sub subsequently filed an action in the Court of Chancery to seek dissolution of the Company pursuant to 6 Del. C. § 18-802. James moved to dismiss on the grounds that WU Sub was an assignee, not a member, and that an assignee lacked standing to petition for dissolution.

The court held that WU Parent was not a member because it assigned its interest to WU Sub. Under the LLC Act, "[u]nless otherwise provided in a limited liability company agreement[,] . . . [a] member ceases to be a member . . . upon assignment of all the member's limited liability company interest." 6 Del. C. § 18-702(b)(3). Moreover, "[u]nless otherwise provided in a limited liability company agreement[,] . . . [a]n assignment of a limited liability company interest does not entitle the assignee . . . to exercise any rights or powers of a member." 6 Del. C. § 18-702(b)(1). The Initial LLC Agreement did not give assignees the right to seek statutory dissolution. Consequently, the court determined that neither WU Parent nor WU Sub had standing to seek statutory dissolution pursuant to Section 18-802 because neither were members.

Despite these findings, the court found that the LLC Act was not "the exclusive extra-contractual means of obtaining dissolution of an LLC" because WU Sub had standing to seek dissolution in equity.

The Contractarian View of LLCs

To understand how the court reached its decision in *Carlisle*, it is important to examine how the case law regarding the relationship between traditional notions of equity and LLCs has evolved. It is the policy of the LLC Act "to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." 6 Del. C. § 18-1101(b). The Court of Chancery has often enforced this policy by holding parties to the strict terms of their bargained for LLC agreements, even when the result might seem harsh. For example, in *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, the court held that the parties to an LLC agreement could waive by contract the right to seek statutory dissolution under Section 18-802. 2008 WL 3846318 (Del. Ch. Aug. 19, 2008). In so holding, the court emphasized that the freedom of contract was important to "[t]he allure of the limited liability company" along with the "legitimate business reasons why members of limited liability company may wish to waive their right to seek dissolution or the appointment of a receiver."

In the mid-2000s, some commentators from the bench, bar, and academia advocated what the *Carlisle* decision refers to as a "purely contractarian" view of interpreting LLC and limited partnership agreements. Under this view, for example, if an LLC agreement is silent as to fiduciary duties, out of respect for the freedom of contract, courts should not imply common law fiduciary duties. *See* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 4 (2007); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager after More than a Decade of Experimentation?*, 32 Del. J. Corp. L. 565, 569–70 (2007); and Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. Ill. L.Rev. 131, 146–162 (2009). Ultimately, the Delaware courts would later largely reject a contractarian view that would leave little to no role for equity.

The Existence of Default Equitable Fiduciary Duties

Although some scholarship advocated that equity should not be used to imply fiduciary duties given the LLC Act's policy of giving maximum effect to freedom of contract, Delaware courts found that silence in an LLC agreement left a gap in LLC governance for equity to fill. Some of the Court of Chancery's opinions on the subject cited to Section 18-1104, which provides that the "rules of law and equity" shall control "[i]n any case not provided for in" the LLC Act. In other words, silence is a drafting choice that invites Section 18-1104 to serve as a gap-filler to permit traditional equitable doctrines to govern the actions of LLC fiduciaries, much in the same way they govern corporate fiduciaries. Explaining Section 18-1104 in *CML V, LLC v. Bax*, the Delaware Supreme Court stated that the "General Assembly expressly acknowledged in the text of the LLC Act that common law equity principles supplement the Act's express provisions." 28 A.3d 1037, 1045 (Del. 2011). The court went on to explain that "what this means is that where the General Assembly has not defined a right, remedy, or obligation with respect to an LLC, courts should apply the common law." *CML*'s interpretation of Section 18-1104 further opened the door to traditional equitable doctrines governing LLC disputes when not preempted by the LLC Act or LLC agreement.

In *Auriga Capital Corporation v. Gatz Properties, LLC*, the court held that the default standard in the LLC context is that fiduciary duty principles will apply to managers of an LLC unless those duties are expressly and clearly limited or eliminated in an LLC agreement. 40 A.3d 839, 849–54 (Del. Ch. 2012). Relying on the equitable overlay of Section 18-1104, Chief Justice Strine, then writing as Chancellor, found that "unlike in the corporate context, the rules of equity apply in the LLC context by *statutory mandate*, creating an even stron-

ger justification for application of fiduciary duties grounded in equity to managers of LLCs to the extent that such duties have not been altered or eliminated under the relevant LLC agreement." The court determined that the parties to the LLC agreement at issue had not contracted around the default fiduciary duties, as nothing in the LLC agreement clearly modified or eliminated them, and awarded damages due to the manager's breach of his fiduciary duties. On appeal, the Delaware Supreme Court affirmed the award of damages, but found that it had been unnecessary to reach the issue of default fiduciary duties and specifically stated that it was "declin[ing] to express any view regarding whether default fiduciary duties apply as a matter of statutory construction," thus leaving open the issue of whether default fiduciary duties exist for LLC managers. *Gatz Props., LLC v. Auriga Cap. Corp.*, 59 A.3d 1206, 1218 (Del. 2012).

Later in 2012, citing its decision in *Gatz*, the Court of Chancery in *Feeley v. NHAOCG, LLC* held that the manager owed default fiduciary duties as the managing member of the LLC, finding *Gatz's* reasoning to be persuasive, even if not precedential. 62 A.3d 649 (Del. Ch. 2012).

The debate regarding whether a Delaware LLC should be viewed as a purely contractual entity to which principles of equity (including fiduciary duties) do not apply was resolved in 2013 when the Delaware General Assembly adopted an amendment to 6 Del. C. § 18-1104, which states: "In any case not provided for in this chapter, the rules of law and equity, *including the rules of law and equity relating to fiduciary duties* and the law merchant, shall govern." (Emphasis added to new language.)

Equity's Role in the Dissolution of Delaware LLCs

In addition to the default fiduciary duty decisions, equity has played a role in LLC litigation involving dissolution. In the 2004 opinion of *Haley v. Talcott*, the Court of Chancery held that the plaintiff was not limited to the contractual exit mechanism in the LLC agreement as it was not a reasonable alternative. 864 A.2d 86 (Del. Ch. 2004). Notably, the *Haley* court recognized that one of the attractions to the LLC form of entity was the statutory freedom of contract, and the "presence of a reasonable [contractual] exit mechanism bears on the propriety of ordering [judicial] dissolution under 6 Del. C. § 18-802." When the LLC agreement "provides a fair opportunity to the dissenting member who disfavors the inertial status quo to exit and receive the fair market value of her interest," arguably the LLC may proceed to operate because the charter provides an equitable way to break the impasse. Although the LLC agreement permitted voluntary withdrawal, the plaintiff had signed as a guarantor on the mortgage, which exceeded the value of the land. Therefore, even if he withdrew, plaintiff would remain personally liable for the mortgage debt of the LLC that he would no longer control. Since the exit mechanism did not address the guarantee and truly divorce the plaintiff from the business, the court held that it was "not equitable to force [the plaintiff] to use the exit mechanism" and ordered dissolution.

In 2013, the Court of Chancery was faced with the question of whether the members of an LLC had waived their right to seek statutory dissolution under Section 18-802. *Huatuco v. Satellite Healthcare*, 2013 WL 6460898, at *5 (Del. Ch. Dec. 9, 2013), *aff'd*, 93 A.3d 654 (Del. 2014). The court, citing its prior decision in *R&R Capital*, dismissed the action, holding that the LLC agreement "specifically considered, and addressed, dissolution and dissolution rights." Under the LLC agreement, the parties rejected all default rights under the LLC Act unless explicitly provided for in the LLC agreement or otherwise required by law. Echoing arguments that succeeded in *Haley*, the plaintiff argued that it was inequitable to leave the plaintiff with no exit mechanism. Rejecting this argument, the court found there was an exit mechanism: the plaintiff could surrender his interest for no consideration. Holding plaintiff to the benefit of the bargain, the court determined that an exit mechanism existed even if it was likely not "palatable" to the plaintiff. Unlike in *Haley*, the plaintiff could obtain a clean (though costly) break from the LLC. Significantly, suggesting that parties might not be able to contractually eliminate all routes to judicial dissolution, the court questioned "[w]hether the parties may, by contract, divest this Court of its authority to order a dissolution in *all* circumstances, even where it appears manifest that equity so requires – leaving, for instance, irreconcilable members locked away together forever like some alternative entity version of Sartre's *Huis Clos*. . . ."

The *Carlisle* Court Finds Assignee May Seek Equitable Dissolution

After finding that neither WU Sub nor WU Parent were members of the Company, the court in *Carlisle* held that neither had statutory standing under Section 18-802 to seek dissolution, as that section limits the right to members and managers of an LLC. However, the court rejected the argument that statutory judicial dissolution was the sole form of judicial dissolution available. As the court noted, "Section 18-802 does not state that it establishes an exclusive means to obtain dissolution, nor does it contain language overriding this court's equitable authority." Moreover, the court found that accepting the position that Section18-802 provided the exclusive method of dissolving the LLC would mean divesting the Court of Chancery of a "significant aspect of its traditional equitable jurisdiction." As the *Carlisle* court observed, based on Article IV, Section 10 of the Delaware Constitution, the Court of Chancery's equitable jurisdiction is measured by "the general equity jurisdiction of the High Court of Chancery of Great Britain as it existed prior to the separation of the colonies," except "where a sufficient remedy exists at law." *DuPont v. DuPont*, 85 A.2d 724, 727 (Del. 1951). According to the court, if Section 18-802 could be interpreted to be the exclusive method of judicial dissolution, it would likely violate the Delaware Constitution.

After finding that a textual analysis of Section 18-802 did not preclude equitable judicial dissolution, the court turned to the question of whether it had the inherent

power to order equitable dissolution in the absence of permission from the LLC Act. Although LLCs of course did not exist at the time of the nation's founding, the Delaware Supreme Court has recognized that equity jurisdiction is not inflexible and that it "has taken its shape and its substance from the perceived inadequacies of the common law and the changing demands of a developing nation." *Schoon v. Smith*, 953 A.2d 196, 204 (Del. 2008) (internal quotations omitted). Relying on venerable equitable treatises from the early and mid-twentieth century by Joseph Story and John Pomeroy, the *Carlisle* court explained that courts of equity have traditionally had the power to dissolve partnerships. The court also cited the prior decisions in *Haley* and *Huatuco* as support for its right to dissolve an LLC if equity so requires.

Finally, distinguishing *R&R Capital*, the court concluded that the ability to waive judicial dissolution under Section 18-802 did not extend to a party's standing to seek judicial dissolution in equity. The court also noted that *R&R Capital* relied heavily on the purely contractarian view of LLCs, which was inconsistent with the amendment to Section 18-1104 in 2013. In rejecting the purely contractarian view, the vice chancellor also noted that an LLC is a contractual relationship not just between or among its members, but also with the sovereign that established it. "[T]he purely contractarian view discounts core attributes of the LLC that only the sovereign can authorize, such as its separate legal existence, potentially perpetual life, and limited liability for its members." Furthermore, the court explained that the sovereign state that created an artificial entity such as an LLC retains the power for its courts to end it.

Although the opinion only decided a motion to dismiss, after finding it had the power to use its inherent equitable powers to dissolve the Company, the court went on to suggest it should dissolve the entity. While the LLC was "technically" functioning, that operation was "purely a residual inertial status quo that just happen[ed] to exclusively benefit one of the 50% members." The board was hopelessly deadlocked. Additionally, the court noted that the parties never intended either party to be a passive investor. Therefore, the court held that WU Sub had standing in equity, as an assignee, to seek dissolution of the Company. A few days later, the court ordered dissolution of the Company and appointed a custodian. James then sold his interest to WU Sub, and the court vacated its order of dissolution of the entity since WU Sub's purchase of James' interest resolved the dispute.

Conclusion

Although one could read *Carlisle* as a rejection of the LLC Act's policy to give maximum effect to the freedom to contract, the authors of this article respectfully suggest that would be the wrong takeaway. Cases like *Carlisle* and *Feeley* make careful drafting in LLC agreements so as to eliminate gaps more, not less, important. In the case of default fiduciary duties, equity only has a role to play if drafters fail to address by contract the duties that shall govern the managers or managing members. Similarly, in *Carlisle*, the court chose to exercise its inherent equitable powers to dissolve the entity largely because there was no exit mechanism for WSU Sub. Although there can be little doubt that equity has played an increasing role in LLC litigation, consistently and predictably, the Court of Chancery exercises its equitable powers in cases where the LLC agreements were, for practical purposes, incomplete. Where parties expressly waive fiduciary duties or provide for a true exit mechanism, the court is far less likely to use equity to interfere with the parties' bargain. Although silence on certain issues may make it easier to get to "yes" at the negotiation table at the time of an entity's formation, parties risk the application of traditional equitable fiduciary duties and equitable judicial dissolution when they fail to address fiduciary duties and exit mechanisms in the LLC agreement.

Jason C. Jowers is a partner and Meghan A. Adams is an associate at Morris James LLP in Wilmington, Delaware, where they practice in the areas of corporate, alternative entity, and complex commercial litigation.