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CLIENT ALERT

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Can Nonmembers Seek Dissolution of Delaware LLCs? Sometimes

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A RECENT DELAWARE COURT OF CHANCERY OPINION DEMONSTRATES HOW PARTIES' FAILURE TO FORMALIZE THEIR RELATIONSHIP CAN HAVE A MATERIAL IMPACT ON THEIR LATER DEALINGS.

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Section 18-802 of the Delaware LLC Act provides that a member or a manager may petition the Court of Chancery for dissolution of a Delaware LLC "whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." But does a nonmember assignee have a right to seek to dissolve an LLC, despite being neither a member nor a manager? In a recent case, *In re Carlisle Etcetera LLC*, C.A. No. 10280-VCL (Del. Ch. April 30, 2015), the Delaware Court of Chancery answered that question in the affirmative, declaring that, "when equity demands," the right to petition for dissolution may be extended to a nonmember assignee who lacks any dissolution right under an LLC agreement or the LLC Act.

Background

Two companies, Well Union Capital Limited and Tom James Company, formed Carlisle Etcetera LLC in 2012. Each member contributed approximately $11 million in capital to the LLC in exchange for a 50 percent membership interest, and the court determined that they intended the LLC to be a joint venture between equal members. The members executed a simple operating agreement and committed to draft a more detailed replacement agreement. The LLC agreement created a four-member board to manage the company, with each member appointing two of the board members, and designated one of Tom James's appointees as Carlisle's CEO, giving Tom James effective control over the company in the event of a deadlock. Ultimately, business matters took priority over LLC formalities, and the replacement agreement was never finalized.

Shortly after the LLC's formation, Well Union transferred its member interest to a wholly owned subsidiary to serve as a "blocker" entity for tax purposes. Tom James was fully informed about the transfer and did not object, and both Tom James and the LLC treated the subsidiary as "an equal member of the company."

Within a few years, the parties' relationship soured, and they disagreed about how to manage the LLC. Based on the deadlock at the member and manager levels, the subsidiary (and later Well Union as co-petitioner) petitioned the Court of Chancery for dissolution.

An Equitable Basis for Dissolution

Vice Chancellor J. Travis Laster determined that, by virtue of the assignment of Well Union's membership interest to its subsidiary, it lacked standing to petition for judicial dissolution under Section 18-802 because it was no longer a member or a manager of the LLC. The subsidiary similarly lacked standing because the mere assignment of Well Union's interest, without acknowledgment by the operating agreement or affirmative vote

or written consent of all members, was insufficient to confer membership rights on a mere assignee. In support of the policy underlying denying such an assignee a membership interest, Vice Chancellor Laster opined that "it is far more tolerable to have to suffer a new passive co-investor one did not choose than to endure a new co-manager without consent."

Despite finding that Well Union and the subsidiary lacked standing to petition for judicial dissolution, the court found that the LLC Act was not "the exclusive extra-contractual means of obtaining dissolution of an LLC." Rather, as a court of equity, Chancery "has the power to order the dissolution of a solvent company and appoint a receiver to administer the winding up of those assets." Rejecting the purely contractarian view advocated by Tom James, the court determined that, "[f]or Section 18-802 to provide the exclusive method of dissolving an LLC, it would have to divest this court of a significant aspect of its traditional equitable jurisdiction."

Vice Chancellor Laster based his finding on nearly a century of equity jurisprudence and commentary, including Justice Story's *Commentaries on Equity Jurisprudence* and Pomeroy's *Equity Jurisprudence*, as well as on decades of Delaware precedent. Further buttressing Chancery's equitable jurisdiction to order dissolution, Vice Chancellor Laster noted that "the LLC Act elsewhere recognizes that equity backstops the LLC structure by providing generally that 'the rules of law and equity' shall govern in 'any case not provided for in this chapter.'" The court seemed particularly concerned with Tom James's use of the board deadlock to exert its will and control the company through its board member CEO, despite the parties' original intent that the LLC be a joint venture among equal members. Quoting from then-Vice Chancellor (now Chief Justice) Strine's opinion in *Haley v. Talcott*, 864 A.2d 86 (Del. Ch. 2004), he concluded that, in a two-member LLC, the mere "existence of an exit mechanism was not sufficient; it had to be a 'reasonable exit mechanism' that provided 'a fair opportunity for the dissenting member who disfavors the inertial status quo to exit.'"

Finally, the court noted that the state's role in authorizing the creation of LLCs was sufficient to reject the purely contractarian view and support the exercise of equitable dissolution, stating:

> To my mind, when a sovereign makes available an entity with attributes that contracting parties cannot grant themselves by agreement, the entity is not purely contractual. . . . Because an LLC takes advantage of benefits that the State of Delaware provides, and because dissolution is not an exclusively private matter, the State of Delaware retains an interest in having the Court of Chancery available, when equity demands, to hear a petition to dissolve an LLC.

Because the parties never intended for one member to be able to exercise absolute power over the company, and because Chancery is tasked with ensuring that parties' express expectations are fulfilled wherever possible, the court concluded that the subsidiary, as an assignee, should be afforded the power to seek dissolution of the LLC. Five days later, the court granted the petitioners' motion for summary judgment and appointed a custodian to effect the dissolution.

Practical Implications

In re Carlisle Etcetera is a textbook example of how parties' failure to formalize their relationship can have a material impact on their later dealings. No matter how pressing business matters may become, members in a LLC (or any entity) should always formalize their relationship and the rules that will govern that relationship. Had Well Union insisted on finalizing the more comprehensive LLC agreement, its subsidiary would have been afforded all benefits of membership in the LLC, and the road to dissolution would have been more direct. Although LLCs are generally regarded as "creatures of contract" whose operating agreements will govern the rights and obligations of their members, Well Union and its subsidiary were fortunate that the court determined to step in to fulfill the maxim that "equity regards as done that which in good conscience ought to be done." While the court ultimately granted the petitioners the relief they sought, the path to reach that end result was likely made more expensive and time-consuming than had the subsidiary been recognized as a member, rather than an assignee, of the LLC.