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Delaware Expands Rights Of Nonmembers Of Delaware LLCs

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The plain language of Section 18-802 of the Delaware LLC Act provides that "member[s] and manager[s]" have statutory authority to petition for dissolution of a Delaware limited liability company "whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement." However, in In re Carlisle Etcetera LLC, C.A. 10280-VCL (April 30, 2015), the Delaware Court of Chancery held that the right to petition for dissolution may, "when equity demands," be extended to a non-member assignee of an LLC membership interest. This holding was reached despite the nonmember assignee having no such right under either the LLC agreement or the LLC Act, placing considerable emphasis on the equitable principles that underlie the court of chancery's jurisdiction over Delaware alternative entities.

Facts

Two companies, Well Union Capital Limited (Member A) and Tom James Company (Member B) formed Carlisle Etcetera LLC. Each member contributed approximately $11 million in capital to the LLC in return for a 50 percent membership interest and, in the court's view, the LLC was intended to be a joint venture between equal parties. Both members executed a simple form of operating agreement in which they committed to work promptly on a more detailed operating agreement. Although the members drafted a replacement agreement, an initially amicable start to their relationship allowed business matters to take precedence over finalizing the agreement — an all too common mistake — and when that relationship soured, the replacement operating agreement was never finalized.

The LLC was structured to have a four member board to manage the company, with each member appointing two board members. However, one of Member B's board members was appointed CEO of the LLC and, in the case of impasses on the board, took operational control over the LLC.

After the LLC was formed, Member A transferred its member interest to a wholly owned subsidiary in order to create a "blocker" entity for tax purposes. Member B was fully informed about the transfer, did not object and treated the subsidiary as a member of the LLC.

Within a few years of forming the LLC, the relationship of the parties began to sour and the subsidiary (and later Member A as co-petitioner) petitioned the court of chancery to dissolve the LLC because of deadlock at the member and manager levels.

Court's Analysis

The Delaware LLC Act 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 practical to carry on the business in conformity with a limited liability company agreement." 6 *Del. C.* § 18-802. By the express terms of the statute, only members and managers of an LLC have the right to seek statutory dissolution. However, the threshold issue in this case was whether Member A or the subsidiary could be deemed "members" of the LLC. The court said no and reasoned the following:

1. Member A was not a member because it assigned its interest to the subsidiary. The Delaware LLC Act provides in relevant part that "a member ceases to be a member ... upon assignment of all of the member's limited liability company interest." 6 *Del. C.* § 18-702(b)(3). As such, Member A ceased to be a member of the LLC.

2. The subsidiary did not become a member, but rather was only a mere assignee of Member A's membership interest. As provided in the Delaware LLC Act "an 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 Court noted that in order for an assignee to become a member, in situations where the LLC agreement does not address the issue, there must be formal company action — the affirmative vote or written consent of all of the members of the LLC — and, following this "permitted admission," the records of the LLC reflecting this admission. The court found this standard was not met here. As the court emphasized in explaining the policy behind the statute — "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 neither Member A nor the subsidiary had statutory standing to petition for dissolution, the court found that the LLC Act was *not* the "exclusive extra-contractual means of obtaining dissolution of an LLC." Instead, the Court of Chancery is a court of equity, with equitable authority not only constitutionally vested, but also expressly recognized in the LLC Act as being the gap-filler for "any case not provided for" in the LLC Act. Thus, the Court of Chancery held that it retained the equitable power to dissolve an LLC in certain circumstances not contemplated by the LLC Act, and that the subsidiary had equitable standing to petition for dissolution. (Even though members of an LLC may waive the right to seek statutory dissolution, in the court's view, "the ability to waive dissolution under Section 18-802 does not extend to a party's standing to seek dissolution in equity.") Of particular concern to the court was Member B's use of the deadlock on the board to take control of management, despite the original

intent for the LLC to be an equal joint venture. Quoting a decision by then Vice Chancellor (now Chief Justice) Leo Strine, the court noted that a contractual exit mechanism in a two-member operating agreement must provide "a fair opportunity for the dissenting member who disfavors the inertial status quo to exit."

Key Takeaways

Carlisle reminds us that care should be taken in any assignment of membership interests to avoid an inadvertent transfer of de facto control of the LLC. Another lesson from Carlisle is that parties to a joint venture should spend the time at the beginning of the relationship to carefully draft the governing document rather than defer key issues to a later date. Given the LLC Act's intent to give "maximum effect" to freedom of contract, such careful drafting is always advisable.

Of note in Carlisle, however, is the court's rejection of Member B's "purely contractarian view" of the LLC Act. Noting that the LLC Act allows LLCs to take on attributes that only the state can authorize (ex., separate legal existence, potentially perpetual life, and limited liability for its members), the court reasoned that LLCs are not "purely contractual," and therefore "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." As was the case in Carlisle — where neither the LLC agreement nor the LLC Act provide standing to file for dissolution — the court may, "when equity demands," look to the "real relationship between the parties." Carlisle thus reminds us that the equitable authority of the Court of Chancery serves as the invisible backdrop to Delaware alternative entity disputes.

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