

Chancery Rulings Highlight Flexibility of Equitable Relief Available

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COMMENTARY

This is the first in a series of short columns that will touch on topics that I hope will be of interest to Delaware lawyers. Within the limited space allotted for this short article, I will attempt to summarize two recent Court of Chancery decisions that demonstrate the flexibility of the equitable relief available from the Chancery Court.

The two cases are *Eureka VIII LLC v. Niagra Falls Holdings LLC* and *McGovern v. General Holding Inc.* The slip opinions for both decisions issued in June 2006 are 42 pages and 54 pages in length, respectively. By necessity, I will only have an opportunity here to highlight key aspects of those decisions with a focus on the relief granted.

The court removed from a decisionmaking role, in the *Eureka* case, one of two 50 percent owners of a limited liability company and in the *McGovern* matter, a 90 percent owner of a limited partnership. Noteworthy may not quite convey the import of a court decision that results in the removal from power of someone with such a large percentage of ownership in an entity. The somewhat egregious nature of the facts, detailed at great length

by the court in its opinions, supports the unusual results.

In the *Eureka* case, two members of an LLC, each owning 50 percent, presented competing claims about each other's breaches of the operating agreement. The court found that the breaches by *Niagra* created exactly the problematic situation that the operating agreement was designed to avoid. The remedy ordered by the court included divesting *Niagra* of its status as a member, thereby leaving the remaining party as the sole member of the LLC. *Niagra* would be left with the rights of an assignee under Section 18-1002 of the Delaware LLC Act, which, in essence, means that despite not having the "benefits of membership," *Niagra* would retain its economic interest in profits, losses and distribution rights. Without voting rights, for example, the breaching member, *Niagra*, was left with an assignable interest in the LLC for dividend distributions and future sales proceeds.

The breach of the agreement by *Niagra* occurred when *Niagra* allowed a creditor to take control of it. Thus, the remaining LLC member, *Eureka*, now found itself with a *de facto* partner that it never agreed to do business with and who had a very different objective, i.e., to cash-out its interests as fast as possible - - contrary to the long-term

investment goal originally envisioned by the LLC founders.

The court denied a counterclaim of *Niagra* for dissolution of the LLC based on allegations of incompatibility of two members owning 50 percent of an LLC, because the remedy left the LLC with only one member.

Niagra also tried to assert a breach claim itself against *Eureka* but the court found that *Niagra* materially breached prior to any alleged breach by *Eureka*, thereby barring *Niagra's* counterclaim for specific performance. (Laches also barred the *Niagra* claims because it waited too long to assert them.)

This case is a good illustration of the wide range of authority and flexibility that the Chancery Court has to customize equitable relief that fits the unique or special factual circumstances of each case that comes before it, in business litigation or otherwise.

In *McGovern*, the minority owners argued for the substitution of a "professional manager" to run the company, after removal of the general partner who owned 90 percent, due to the rather egregious violation of duties alleged by the minority. The company's greatest asset was valuable patents and intellectual property. The court describes in great

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detail how the 90 percent owner abused the rights of the two minority owners.

However, the court found that sale of the company was more appropriate because the parties would never be able to “get along” and it was not practical to force a 90 percent owner to be an eternal outsider. Moreover, due to the breaches of duty, the court allowed that the company needed to pay the attorney fees for the two minority members, but the 90 percent owner was required to repay the company for all the attorney fees that he caused the company to pay himself in the case. The court also restricted

the role of the 90 percent owner in the sale of the company in order to avoid his ability to interfere with the sale in a manner that virtually stripped the 90 percent owner of the role that he would otherwise play.

In support of the “capacious remedial discretion” of the Chancery Court in fashioning relief, Vice Chancellor Leo Strine cited to several Delaware Supreme Court decisions, including *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 175 (Del. 2002).

There are many more salient details in the 54-page decision of the court that cannot be summarized in this short space, but download it from the court’s Web site (or my blog, www.delawarelitigation.com)

and read the whole thing. It’s better than any novel I have read recently. •



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