COURT OF CHANCERY
OF THE
STATE OF DELAWARE

DONALD F. PARSONS, JR.
VICE CHANCELLOR

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Wilmington, Delaware 19801-3734

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Re: *CAPROC Manager, Inc. and CAPROC L.L.C. v. The Policemen's & Firemen's Retirement System of the City of Pontiac and The General Employees' Retirement System of the City of Pontiac*, Civil Action No. 1059-N

Dear Counsel:

This case stems from a dispute between shareholders of the Delaware limited liability company CAPROC LLC ("CAPROC"). CAPROC is a real estate operating company formed to own, acquire, develop, operate, lease and manage real estate and mortgages. CAPROC is governed by its operating agreement, entitled the Second Amended and Restated Limited Liability Company Agreement (the "LLC Agreement" or "Agreement"). The Agreement specifically designates CAPROC Manager as CAPROC's Managing Shareholder. The Policemen's & Firemen's Retirement System of the City of Pontiac and The General Employees' Retirement System of the City of Pontiac (collectively "Defendants") together own over 50% of CAPROC's outstanding

shares.[1] Defendants seek to remove CAPROC Manager as the Managing Shareholder of CAPROC and purport to have done so by a majority shareholder vote.

In response to Defendants' actions, CAPROC Manager and CAPROC brought this suit for, among other things, entry of a status quo order and a declaration under 6 *Del. C.* § 18-110 that CAPROC Manager remains the Managing Shareholder of CAPROC. Subsequently, the parties stipulated to an order maintaining CAPROC Manager as Managing Shareholder and in charge of day-to-day operations, while barring it during the pendency of this dispute from taking any actions beyond routine operations conducted in the ordinary course of business (the "Status Quo Order"). The Court entered the Status Quo Order on February 23, 2005.

Defendants have filed a Motion to Dismiss in Favor of Arbitration.[2] They argue that the LLC Agreement's arbitration clause, § 12.7, is broad in scope and applies to any "dispute or controversy arising under" the Agreement. Defendants argue that CAPROC's claims arise under the LLC Agreement and therefore must be submitted to arbitration. CAPROC denies that this action is subject to the arbitration clause and contends that it falls within this Court's jurisdiction because CAPROC has no adequate remedy at law. For the reasons stated in this letter opinion, I conclude that Plaintiffs' claims are subject

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1 Defendants owned 64.77% of CAPROC's shares as of August 21, 2003. LLC Agreement Ex. A.

2 By its terms, the Status Quo Order applies "[p]ending the resolution by this Court or an arbitrator of the [removal] issue . . . until further order of the Court or a later appointed arbitrator."

to arbitration under the LLC Agreement. Thus, the Court will grant Defendants' Motion to Dismiss.

I. ANALYSIS

The Delaware Limited Liability Company Act (the "Delaware Act")[3] provides the statutory basis for Delaware LLCs. "The basic approach of the Delaware Act is to provide members with broad discretion in drafting the [LLC] Agreement and to furnish default provisions when the members' agreement is silent."[4] In fact, the statute itself states that "[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."[5]

The Court of Chancery does not have jurisdiction over claims that are properly committed to arbitration because the availability of arbitration provides an adequate legal remedy.[6] Delaware public policy favors resolution of disputes through arbitration and requires that any doubt regarding the arbitrability of a dispute be resolved in favor of arbitration.[7] If a potentially applicable arbitration provision exists, the court will only

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3 6 *Del. C.* § 18-101 et seq.

4 *Elf Atochem North Am. v. Jaffari*, 727 A.2d 286, 291 (Del. 1998).

5 6 *Del. C.* § 18-1101(b).

6 *IMO Indus., Inc. v. Sierra Int'l, Inc.*, 2001 WL 1192201, at *2 (Del. Ch. Oct. 1, 2001).

7 *Id.* at 3; *see also Parfi Holding AB v. Mirror Image Internet, Inc.*, 817 A.2d 149, 155–56 (Del. 2002); *SBC Interactive, Inc. v. Corp. Media Partners*, 714 A.2d 758, 761 (Del. 1998).

conclude a dispute is not covered when the court finds either "an express provision excluding the dispute from the coverage of the arbitration clause or the most forceful evidence of purpose to exclude . . . ."[8]

When determining the arbitrability of a claim the court is faced with two issues:

> First, the court must determine whether the arbitration clause is broad or narrow in scope. Second, the court must apply the relevant scope of the provision to the asserted legal claim to determine whether the claim falls within the scope of the contractual provisions that require arbitration. . . . If the arbitration clause is broad in scope, the court will defer to arbitration on any issues that touch on contract rights or contract performance.[9]

In assessing arbitrability, the court may not determine the merits of the dispute.[10] Indeed, "[c]ourts may not consider any aspect of the merits of the claim sought to be arbitrated, no matter how frivolous they appear."[11]

A. Arbitrability

The LLC Agreement contains a broad arbitration provision. Section 12.7 states that "[a]ny dispute or controversy arising under this Agreement shall be submitted to

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8 *United Eng'rs & Constructors, Inc. v. IMO Indus., Inc.*, 1993 WL 43016, at *5 (Del. Ch. Feb. 16, 1993) (quoting *United Steelworkers of Am. v. Warrior & Gulf Nav. Co.*, 363 U.S. 574, 584–85 (1960)).

9 *Parfi Holding AB*, 817 A.2d at 155.

10 10 *Del. C.* § 5701; *see also United Eng'rs*, 1993 WL 43016, at *7.

11 *SBC Interactive, Inc.*, 714 A.2d at 761.

binding arbitration . . . ." Delaware courts have found arbitration provisions using similar "arising under" language to be broad in scope.[12]

Having concluded that the arbitration provision is broad, the Court now must apply it to Plaintiffs' asserted claim. According to Defendants, the question of whether CAPROC Manager remains the Managing Shareholder of CAPROC depends upon the interpretation of the parties' rights and obligations under the LLC Agreement, and is therefore arbitrable. CAPROC advances two primary arguments to the contrary.[13] First, CAPROC argues that the validity of the purported removal of the Managing Shareholder does not "arise under" the LLC Agreement because the Agreement does not contain a removal provision. Second, CAPROC contends that the LLC Agreement provides strong evidence of a purpose to exclude removal from arbitration.

1. Does removal "arise under" the LLC Agreement?

CAPROC argues that the provision of the LLC Agreement that names CAPROC Manager as Managing Shareholder without specifying any term limit or method of removal reflects an intent to make CAPROC Manager the permanent Managing

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[12] *Andarko Petroleum Corp. v. Panhandle Eastern Corp.*, 1987 WL 16508, at *2–3 (Del. Ch. Sept. 8, 1987).

[13] Plaintiffs' Complaint arguably raised a second issue that relates to whether Defendants voluntarily withdrew from CAPROC. Defendants contend this issue is also arbitrable, because it arises under the LLC Agreement. At argument, Plaintiffs' counsel stated that their only claim relates to the validity of the removal, and that they do not seek a declaration on whether Defendants voluntarily withdrew from CAPROC. Thus, the Court need not address the arbitrability of any issue relating to withdrawal.

Shareholder of CAPROC. Section 18-402 of the Delaware Act expressly provides that "a manager shall cease to be a manager as provided in a limited liability company agreement."[14] The LLC Agreement, however, does not contain any provision relating to removal of a manager. CAPROC contends that the only permissible method of removal under the LLC Agreement is through amendment of the Agreement, but any amendment would require "written consent of CAPROC Manager and Seventy-Five (75%) of the remaining Shareholders of the Company."[15] Because Defendants do not claim to have validly amended the LLC Agreement, CAPROC contends that they cannot claim to have

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[14] 6 *Del. C.* § 18-402. Section 18-402 states in relevant part:

> **§ 18-402. Management of limited liability company.**
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> Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling; provided however, that if a limited liability company agreement provides for the management, in whole or in part, of a limited liability company by a manager, the management of the limited liability company, to the extent so provided, shall be vested in the manager who shall be chosen in the manner provided in the limited liability company agreement. The manager shall also hold the offices and have the responsibilities accorded to the manager by or in the manner provided in a limited liability company agreement. Subject to § 18-602 of this title [Resignation of a Manager], a manager shall cease to be a manager as provided in a limited liability company agreement.

[15] LLC Agreement § 12.4.

used a method of removal that would "arise under" the Agreement and, therefore, be subject to arbitration.

Defendants disagree and contend that there are at least two methods to remove CAPROC Manager other than by amendment, and that they accomplished removal under both those methods. First, Defendants suggest that removal may be accomplished by a simple majority vote because the parties intended the default rule of 6 *Del. C.* § 18-402 to apply. They rely on the portion of § 18-402 which states that "[u]nless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members . . . with the decision of members owning more than 50 percent of the . . . interests in the profits controlling." Thus, Defendants contend that they did not have to have enough votes to amend the LLC Agreement (75%). Second, Defendants contend that removal is a remedy implicitly available as a response to breach of contract and that removal therefore was proper in response to CAPROC Manager's alleged breaches of the LLC Agreement.

The validity of Defendants' purported removal of CAPROC Manager necessarily depends on interpretation of the parties' rights and obligations under the LLC Agreement. In its Complaint, CAPROC averred that "[a]s Managing Shareholder, CAPROC Manager derives its authority from Section 5.11 of the Agreement and the LLC Act,"[16] and "can cease to be a manager under the Agreement only by resignation or Amendment pursuant

[16] Amended Verified Complaint Under 6 *Del. C.* § 18-110 ("Compl.") ¶ 31.

to Section 12.4 of the Agreement."[17] The Complaint further alleges that Defendants' conduct in attempting to remove CAPROC Manager "violates the Agreement,"[18] strongly suggesting that Plaintiffs' claims do arise under the LLC Agreement.

In addition, the issues posed by Defendants' arguments arise under the LLC Agreement because they necessitate determination of the intent of the parties when they entered into the Agreement. In these circumstances, to resolve the issues raised by the Complaint, the Court would be forced to determine whether the parties intended to make removal impossible under the LLC Agreement, even in the face of material breaches of the Agreement by the Managing Shareholder. In determining the arbitrability of a claim, however, the Court may not consider the relative merits of that claim or the defenses to it "no matter how frivolous they appear."[19] Thus, the nature of the issues raised by Plaintiffs' claim supports subjecting it to arbitration.

In connection with its argument that the purported removal of CAPROC Manager is not subject to arbitration, CAPROC relies on *Nash v. Dayton Superior Corp.*[20] In *Nash*, the Court of Chancery held that to determine whether it has subject matter jurisdiction over a possibly arbitrable dispute, it must conduct two related inquiries. The

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17 *Id.* at ¶ 32.

18 *Id.* at ¶ 33.

19 *SBC Interactive, Inc.*, 714 A.2d at 761; *see also* 10 *Del C.* § 5701 ("the Court shall not consider whether the claim with respect to which arbitration is sought is tenable, or otherwise pass upon the merits of the dispute").

20 728 A.2d 59, 63 (Del. Ch. 1998).

first inquiry is whether the dispute is one which, on its face, is subject to arbitration under the governing contract; the second is "whether, realistically evaluating the complaint, a legal remedy is available and fully adequate."[21]

The *Nash* case involved a corporate acquisition. The dispute centered on a Closing Balance Sheet that the acquisition contract provided would form the basis for any post-closing adjustments of the consideration received by the selling shareholders. The court considered two separate claims asserted by plaintiffs. The first claim related to an attempt by one party to add certain new items, which the complaint did not identify with any specificity, to the Closing Balance Sheet in the early stages of a prescribed dispute resolution process that culminated with arbitration. The court held this claim had not been shown to fall within the contractual arbitration clause, stating:

> There is, at least potentially, a factual question as to whether the parties intended the arbitration process to permit Dayton Superior to revise the Closing Balance Sheet in response to objections raised by the Notice of Disagreement. For this reason, and in the present posture of the matter, I am unable to conclude that the New Items claim is clearly arbitrable.[22]

The court then evaluated the nature of the non-arbitrable claim and concluded that plaintiff had no adequate remedy at law. Therefore, the court denied the motion to dismiss as to that claim.

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[21] *Nash*, 728 A.2d at 63

[22] *Id.* at 63–64.

The second claim asserted in *Nash* challenged the propriety of the establishment of a product liability reserve on the Closing Balance Sheet. Plaintiffs argued that claim presented a legal question distinct from the concededly arbitrable question of the appropriate size of the reserve. The court found that the claim, on its face, fell within the scope of the arbitration clause. Certain language of the contract at least indirectly supported that conclusion. Having determined that the claim was arbitrable and that arbitration constituted an adequate remedy at law, the court dismissed the second claim for lack of subject matter jurisdiction.

The holding in *Nash* is not inconsistent with this Court's conclusion that the validity of Defendants' purported removal of CAPROC Manager is subject to arbitration. The arbitration provision in *Nash* was relatively narrow and related specifically to resolving disputes regarding the Closing Balance Sheet. The arbitration clause in this case is broad. In addition, unlike the situation in *Nash*, the "factual questions" CAPROC contends exist here as to whether the parties intended the arbitration provision to apply to removal are inextricably intertwined with its underlying claim on the merits. CAPROC's position rests on the premise that the LLC Agreement does not provide for any removal of the Managing Shareholder. To evaluate that premise for purposes of determining arbitrability, the Court necessarily would have to address factual and legal questions that involve contract interpretation and go squarely to the merits of the parties' dispute. Both the Delaware courts and the United States Supreme Court have made clear that when a

contract includes a broad arbitration clause, as the LLC Agreement does, the role of the court in determining arbitrability

> is confined to ascertaining whether the party seeking arbitration is making a claim which on its face is governed by the contract. Whether the moving party is right or wrong is a question of contract interpretation for the arbitrator ... The courts, therefore, have no business weighing the merits of the grievance, considering whether there is equity in a particular claim, or determining whether there is particular language in the written instrument which will support the claim.[23]

Moreover, the court in *United Engineers* also noted that "if an entire contract is submitted to arbitration, the submission includes all issues of law or fact, including the interpretation of the terms of the contract."[24]

Therefore, the Court concludes that CAPROC's claim for a determination of whether CAPROC Manager remains the Managing Shareholder does arise under the LLC Agreement and that the claim is subject to arbitration on its face. Furthermore, CAPROC does not seriously challenge the adequacy of arbitration as a remedy at law.[25]

2. Does the LLC Agreement exhibit a purpose to exclude removal from arbitration?

Because CAPROC's claim regarding removal of CAPROC Manager arises under the LLC Agreement, arbitration is an available remedy unless there is either an "express

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[23] *United Eng'rs*, 1993 WL 43016, at *5 (quoting *United Steelworkers*, 363 U.S. at 568).

[24] *Id.* (quoting 5 Am. Jur. 2d *Arbitration and Award* § 15).

[25] *See* note 34 *infra* regarding CAPROC's request that the Court limit the scope of any arbitration to the validity of the removal.

provision" excluding it or "the most forceful evidence of a purpose to exclude."[26] Regarding the latter exception, courts must be wary of becoming entangled in the construction of the substantive provisions of the agreement, because any attempt to infer a purpose to exclude an issue from arbitration may encompass the merits of that issue.[27]

The LLC Agreement does not contain any provision expressly excluding any issue from arbitration. CAPROC argues, however, that the parties intended to exclude removal because they intended CAPROC Manager to be the permanent Managing Shareholder.[28] According to CAPROC, a number of aspects of the LLC Agreement, collectively, exhibit strong evidence of a purpose to exclude from arbitration. First, the LLC Agreement specifically names CAPROC Manager as the Managing Shareholder of CAPROC and does not contain a removal provision. Second, the lack of a removal provision is especially important, according to CAPROC, because the Delaware Act (1) expressly provides that "a manager shall cease to be a manager as provided in a limited liability company agreement" and (2) contains no default removal provision.[29] Third, CAPROC emphasizes that it is structured such that CAPROC Manager is essentially a pass-through entity, with all of its shares owned by CAPROC's shareholders in the same proportions

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[26] *United Eng'rs*, 1993 WL 43016, at *5 (quoting *United Steelworkers*, 363 U.S. at 584–85).

[27] *See United Steelworkers*, 363 U.S. at 584–85; *see also United Eng'rs*, 1993 WL 43016, at *6–7.

[28] Tr. at 23–24.

[29] 6 *Del. C.* § 18-402.

they own CAPROC shares and with special provisions relating to the composition of the Board of Directors of CAPROC Manager. CAPROC contends this structure was specifically designed to protect minority shareholders and that removal of CAPROC Manager other than by amendment of the LLC Agreement would frustrate that purpose.[30]

The Court does not find the absence of a removal provision in the LLC Agreement to be strong evidence that the parties intended to exclude issues regarding an attempted removal of CAPROC Manager from arbitration. As discussed above, a determination that the parties intended CAPROC Manager to be the permanent Managing Shareholder, not subject to removal and not subject to arbitration on those issues, would necessitate a determination of aspects of the merits of this case. In addition, even if the parties had expressly prohibited CAPROC Manager's removal, which they did not, that would not necessarily exclude such removal from the scope of a broad arbitration clause.[31]

In *United Engineers*, the contract in question included a broad arbitration provision and a limitation of liability clause that specifically excluded consequential damages. A defendant demanded arbitration of a claim that arguably sought consequential damages. Plaintiff subsequently brought suit requesting a declaratory judgment that, among other things, liquidated damages were the exclusive remedy available under the contract. The court held that even though the contract arguably

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30 CAPROC's Answering Brief at 9–10.

31 *United Eng'rs*, 1993 WL 43016, at *7 (issues expressly excluded from the contract were not expressly excluded from arbitration).

precluded defendants' consequential damages claim, the exclusion did not restrict the arbitrator's authority to decide all claims, disputes and other matters arising out of the contract.[32] The court held that plaintiff's argument that consequential damages were excluded from the contract and thus not arbitrable, "goes to the merits of its dispute with . . . defendants and this Court is expressly prohibited by statute from entertaining such an argument in the face of a valid agreement to arbitrate."[33] The court therefore dismissed plaintiff's claims in favor of arbitration.

CAPROC's argument is even weaker than plaintiff's unsuccessful argument in *United Engineers*. There, the court held that even an *express* exclusion from the contract did not show a purpose to exclude from arbitration. *A fortiori*, CAPROC's reliance on an *implied* prohibition of removal as providing forceful evidence of an intent to exclude must fail.

I therefore find that the LLC Agreement does not exhibit "forceful evidence of a purpose to exclude" from arbitration disputes regarding the purported removal of a Managing Shareholder. Thus, in the circumstances of this case, CAPROC has failed to rebut the strong presumption in favor of arbitration.

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[32] *Id.*

[33] *Id.* (citing 10 *Del. C.* § 5701).

II. CONCLUSION

For the foregoing reasons, I conclude that CAPROC's claims are arbitrable and that arbitration offers CAPROC an adequate and complete remedy at law.[34] I therefore grant Defendants' Motion to Dismiss. The Status Quo Order will remain in effect until further order of this Court or the arbitrator.

IT IS SO ORDERED.

Sincerely,

/s/Donald F. Parsons, Jr.

Vice Chancellor

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[34] In addition to the relief requested in its Complaint, CAPROC requests in its Answering Brief that if the Court finds the dispute arbitrable, the scope of the arbitration proceeding be limited to only the issue of the validity of the vote to remove CAPROC Manager. This request apparently stems from a concern that Defendants intend to include a multitude of issues in the arbitration and to hamstring CAPROC and CAPROC Manager during the course of a lengthy and involved proceeding by means of the existing Status Quo Order, to the detriment of the business and its shareholders. Based on the limited record available in this case, it appears CAPROC may have legitimate cause for such concern. CAPROC has cited no authority, however, that suggests this Court has the jurisdiction to determine the scope of an arbitration, especially at this preliminary stage of the litigation. Moreover, CAPROC's request is contrary to Delaware precedent that the scope of arbitration is ordinarily determined by the arbitrator and not the court. *James Julian, Inc. v. Raytheon Serv. Co.*, 424 A.2d 665, 667 (Del. Ch. 1980); *see also United Eng'rs*, 1993 WL 43016, at *5–6 (declining to follow *Farkar Co. v. R.A. Hanson DISC, Ltd.*, 583 F.2d 68 (2d Cir. 1978), in which the court limited the scope of arbitration). For those reasons and because CAPROC presumably can petition the arbitrator for preliminary relief, a bifurcated proceeding or other measures it considers appropriate to prevent the injury it fears, I decline to limit the scope of the anticipated arbitration.