COURT OF CHANCERY
OF THE
STATE OF DELAWARE

WILLIAM B. CHANDLER III
CHANCELLOR

COURT OF CHANCERY COURTHOUSE
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GEORGETOWN, DELAWARE 19947

Submitted: August 24, 2009
Decided: September 3, 2009

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Ms. Linda Merritt (**Via E-mail & U.S. Mail)**
699 West Glen Rose Road
Coatesville, PA 19320

Re: *R&R Capital, LLC v. Merritt*
Civil Action No. 3989-CC

Dear Counsel and Ms. Merritt:

I have concluded that oral argument is unnecessary. Thus, the argument scheduled for September 29, 2009, is cancelled. This is my decision on the pending motions.

This lawsuit arises out of a protracted dispute concerning the continued operation and management of nine Delaware limited liability companies: Buck & Doe Run Valley Farms, LLC, Grays Ferry Properties, LLC, Hope Land, LLC, Merritt Land, LLC, Unionville Land, LLC, Moore Street, LLC, PDF Properties, LLC, Pandora Farms, LLC, and Pandora Racing, LLC (collectively the "Entities;" Pandora Farms, LLC and Pandora Racing, LLC will be independently referred to as the "Pandora Entities"). Plaintiffs R&R Capital, LLC ("R&R") and FTP Capital, LLC ("FTP") seek summary judgment on Count I of their amended complaint, which seeks a declaration that defendant Linda Merritt was validly removed as manager and member of the Entities. Defendant Merritt has also moved for summary judgment. For the reasons set forth below, I grant plaintiffs' motion for summary judgment and deny defendant's motion, and appoint a receiver to wind up the business and affairs of the Entities.

I. BACKGROUND

Since their inception, Merritt has been a member and the manager of the Entities. Plaintiffs also are members of the Entities, and have certain contractual rights under the operating agreements of the Pandora Entities. Merritt is the only manager of the Pandora Entities; PDF Properties, LLC is the sole member.

From its rocky beginning, the parties' working relationship has completely deteriorated. In early 2007, Merritt allegedly told plaintiffs that she was selling real estate owned by Hope Land, LLC for approximately $300,000. Plaintiffs were told that they would receive approximately $130,000 from that sale, and that Merritt would be entitled to $149,984.50. Plaintiffs contested the distribution of the sale proceeds, but Merritt sold the property without plaintiffs' consent. Plaintiffs claim that no distribution was ever made to them. Merritt contends that the sale proceeds were used to pay LLC expenses, but she has failed to provide an accounting to prove this assertion.

In addition, the parties disagreed over the management of Grays Ferry Properties, LLC. Plaintiffs allege that they invested over $836,000 to purchase abandoned properties from the City of Philadelphia, refurbish them, and then sell them as affordable housing. Grays Ferry purchased twenty-one such properties. In April 2007, plaintiffs allege that Merritt intended to convey one of the properties to Peter Pelullo to satisfy a purported obligation Merritt owed to his construction company. Pelullo was a member of Grays Ferry. Plaintiffs objected to the transfer. Merritt then allegedly disclosed that the property was already titled in Pelullo's name, and that at least twelve properties owned by Grays Ferry were actually titled in the name of Peter Pelullo or his company. Plaintiffs allege that Merritt later sold several properties to Pelullo at below market value, violating section 4.2(b) of the Grays Ferry operating agreement.

Furthermore, plaintiffs have serious disagreements with Merritt over the management of the Pandora Entities. The Pandora Entities were formed to raise and breed race horses. Plaintiffs allege that while Merritt was authorized to maintain thirty-six horses on the premises, she actually maintained sixty-three horses on the premises. The extra horses amounted to a combined value of $1,300,000. Plaintiffs allege that Merritt was either maintaining the extra horses with common LLC resources, or buying extra horses for the Pandora Entities without authorization.

Additionally, on July 23, 2008, East Marlborough Township filed an action against Unionville Land, LLC claiming that Merritt allowed a building located in the heart of Unionville's Historic District to go into serious disrepair. Plaintiffs also allege that Merritt has not dissolved Moore Street, LLC according to its operating agreement, which provides that dissolution shall occur upon the sale of all or substantially all of the

LLC's assets. Plaintiffs allege that Moore Street sold its only asset and that Merritt has failed to take steps to wind up or dissolve the LLC.

Overall, plaintiffs allege that Merritt's conduct has been nothing but dilatory and self-serving. Plaintiffs further allege that (1) Merritt has failed to timely pay city, state and/or federal taxes related to the Entities, (2) there are outstanding judgments and/or liens against the Entities as a result of Merritt's conduct, and (3) many of the Entities have had their certificates of formation cancelled by the State of Delaware for failing to pay their required annual taxes or for failing to maintain a registered agent for service of process.

In turn, Merritt has alleged a litany of grievances concerning plaintiffs' conduct. Merritt alleges that she was consistently and fraudulently mislead by Ira Russack, the owner of R&R, because he concealed that he had pleaded guilty to filing a false income tax return. Merritt argues that Russack's felony conviction prevented the Pandora Entities from obtaining a racing license in New York, and hampered the operations of the Entities. Moreover, Merritt contends that plaintiffs consistently harassed and tampered with the effective operation of the Entities and prevented Merritt from successfully operating the Entities. As should be painfully obvious by this point, the working relationship of the Entities' members is completely dysfunctional and beyond repair or reconciliation.

On August 20, 2008, plaintiffs sent Merritt notice of her removal as manager of the Entities for "cause" pursuant to Section 4.5 of the Entities' operating agreements, and Section 3.5 of the Pandora Entities' operating agreements.

The Entities' operating agreements set forth the basis for a manager's removal for cause as follows:

> The Manager may be removed as Manager for "Cause" upon the written demand of [Plaintiffs]. Such written demand shall set forth with specificity the facts giving rise to such Cause. As used herein, a removal for "Cause" shall mean that the Manager to be removed shall have (a) engaged in fraud or embezzlement, (b) committed an act of dishonesty, gross negligence, willful misconduct, or malfeasance that has had a material adverse effect on the Company or any other Member, or (c) been convicted of any felony.[1]

[1] Compl., Ex. A. The defined terms in the operating agreements for the various entities differs slightly, but not materially. In addition, Section 4.5 of the operating agreements for the so-called Owned Entities is identical in all relevant respects to Section 3.5 of the Pandora Entities' operating agreements. *See id.* at Exs. A-I. Accordingly, I need not differentiate between Section 4.5 of the Owned Entities and Section 3.5 of the Pandora Entities.

The removal notice was based on Merritt's conduct that was subject to an action entitled *R&R Capital v. Merritt*, C.A. No. 06-1544, before Judge Mary McLaughlin of the United States District Court, Eastern District of Pennsylvania (the "Pennsylvania Action"). The Pennsylvania Action arose from a dispute between the parties concerning the purchase, possession and ownership of three thoroughbred "pinhooking" horses. R&R purchased the horses from Merritt's wholly-owned company, Mer-Lyn Farms, LLC. In the Pennsylvania Action, R&R sought to obtain possession of two of the pinhooking horses and sought to rescind the transaction whereby it purchased the third pinhooking horse, based on Merritt's misrepresentations regarding the health of the horses.

On April 17, 2009, Judge McLaughlin issued an Order finding in favor of R&R on its rescission and replevin claims and in favor of Merritt with regard to certain expenses associated with training and caring for the horses. Judge McLaughlin found that Merritt engaged in fraud in connection with the challenged transaction. In her written opinion, Judge McLaughlin specifically found that "R&R was induced to purchase [the horses] on the basis of statements by Pelullo and Merritt that were both fraudulent and material. . . . In these circumstances, the statement that [the horse] was one of the best horses available was a knowing misstatement not in accord with the facts and therefore fraudulent."[2]

II. ANALYSIS

A. Summary Judgment

Pursuant to Court of Chancery Rule 56, a motion for summary judgment shall not be granted unless "there is no genuine issue as to any material fact and . . . the moving party is entitled to a judgment as a matter of law."[3] The moving party has the burden of establishing that no genuine issue of material fact exists, and the court must draw all reasonable inferences in favor of the nonmoving party.[4]

B. Removal

Pursuant to Section 4.5 of the Entities' operating agreements, a manager "may be removed as Manager for "Cause" upon the written demand of [Plaintiffs]" if the demand is given "with specificity" as to "the facts giving rise" to the fact that the manager "engaged in fraud" or that the manager engaged in dishonesty that "had a material adverse effect on the Company *or any other Member*."[5] On August 20, 2008, plaintiffs

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[2] *R&R Capital, LLC v. Merritt*, No. 06-1554, McLaughlin, J. (E.D. Pa. Apr. 17, 2009).
[3] Ct. Ch. R. 56(c).
[4] *Estate of Carpenter v. Dinneen*, 2007 WL 1114082, at *4 (Del. Ch. Apr. 11, 2007).
[5] *See* note 1, *supra*.

provided Merritt with specific notice that she was being removed as manager for cause. The "cause" listed in the notice was Merritt's fraudulent and material misrepresentations regarding the pinhooking horses.

Merritt argues that plaintiffs are estopped by the doctrine of *res judicata* from bringing their removal claim before this Court based on the pinhooking transaction because that issue was already litigated and decided in New York. I disagree. The elements of *res judicata* are well established. A party claiming that *res judicata* bars a claim in a subsequent action must demonstrate that: "(1) the court making the prior adjudication had jurisdiction; (2) the parties in the present action are either the same parties or in privity with the parties from the prior adjudication; (3) the prior adjudication was final; (4) the causes of action were the same in both cases or the issues decided in the prior action were the same as those raised in the present case; and (5) the issues in the prior action were decided adversely to the party's contention in the instant case."[6]

The third element, whether the earlier adjudication was final, is dispositive in this case. While the pinhooking transaction was alleged by plaintiffs in their New York complaint, Justice Ramos did not make a final adjudication with regard to the pinhooking transaction as it related to the removal action. Merritt alleges that Justice Ramos dismissed plaintiffs' amended complaint, including the pinhooking transaction. Justice Ramos, however, only demanded that the issues be held over for a trial on the merits. He did not specifically dismiss the claims based on the pinhooking transaction. In fact, Justice Ramos did not even mention the claims based on the pinhooking transaction in his analysis. I am hard-pressed to find anything in the New York record concerning the pinhooking transaction. Indeed, I am not alone in this futility. Judge McLaughlin in the Pennsylvania Action also failed to find that Justice Ramos specifically ruled on the pinhooking transaction. Judge McLaughlin wrote:

> Merritt's interpretation of Justice Ramos' ruling is unsupportable. Nothing in the transcript of the December 10, 2007, proceedings before Justice Ramos suggests that he intended to encompass the pinhooking horses in his ruling. . . . Nowhere in the December 10 hearing transcript does Justice Ramos, or any counsel or witness, refer to the pinhooking horses, either directly or indirectly, nor is any evidence presented to the court concerning those horses.[7]

Since I cannot find that Justice Ramos disposed of the issues surrounding the pinhooking transaction in a final adjudication, I reject Merritt's assertion that this Court is barred from hearing, or that plaintiffs are barred from bringing claims seeking removal of Merritt as manager of the Entities on account of the fraud related to the pinhooking

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[6] *Julian v. E. States Constr. Serv., Inc.*, 2009 WL 1211642, at *5 (Del. Ch. May 5, 2009).
[7] *See* note 2, *supra*.

transaction. In addition, and for the same reason that the pinhooking issue has not been finally adjudicated on the merits, I find no basis for Merritt's collateral estoppel or judicial estoppel defenses. Those defenses are similarly rejected.

Merritt also argues that plaintiffs have misinterpreted Section 4.5 of the Entities' operating agreements. Merritt insists that even if she perpetrated a fraud against plaintiffs, as long as the Entities did not suffer a "material adverse effect" as a result of the fraudulent behavior she cannot be removed as manager for cause. This is an incorrect interpretation of Section 4.5.

In a dispute requiring contract interpretation, summary judgment is appropriate only where the contract is unambiguous.[8] "Ambiguity exists 'when the provisions in controversy are reasonably or fairly susceptible of different interpretations or may have two or more different meanings.'"[9] I find no ambiguity here. In fact, the plain language of Section 4.5 of the Entities' operating agreement gives rise to only one reasonable meaning. According to Section 4.5(a), if a party committed fraud it could be removed as manager for cause. There is no qualification under Section 4.5(a) that demands the fraud result in "material adverse effect" to the Entities. The "material adverse effect" language falls only under Section 4.5(b). The more straightforward and grammatical reading of Section 4.5 leads to the correct interpretation—once it has been established that a member has committed fraud, the other members can remove that member as manager of the Entities for cause.

Even if I believed that the "material adverse effect" language found in Section 4.5(b) applied to Section 4.5 in its entirety, Merritt would still not receive the outcome that she desires. In such a scenario, the full language of Section 4.5 would then be interpreted to read that the fraudulent act must have "had a material adverse effect on the Company *or any other Member*." Merritt's fraudulent conduct, however, was directed toward the plaintiffs—other members of the Entities. Clearly this action falls under the plain meaning of the "material adverse effect" language in that members of the Entities were materially harmed by Merritt's fraudulent acts. Accordingly, given that Judge McLaughlin in the Pennsylvania Action found that Merritt had committed fraud against plaintiffs, I find that Merritt's actions in connection with the pinhooking transaction establish that "cause" existed under Section 4.5 and conclude that such fraudulent acts provide plaintiffs with the right to remove Merritt as manager of the Entities for cause.

Finally, as a last ditch effort, Merritt claims that the August 2008 notice was not immediately effective because there was never a judicial finding of "cause" when the notice was sent to her and that such a finding is inappropriate under the procedural

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[8] *In re Nextmedia Investors, LLC*, 2009 WL 1228665, at *3 (Del. Ch. May 6, 2009).
[9] *Id.* (quoting *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992)).

posture of summary judgment. In August 2008, however, when the notice was given, Merritt was not immediately removed as manager but rather remained in office pending a finding of "cause" by this Court. When plaintiffs issued the notice, they appropriately pointed to what they reasonably believed were Merritt's fraudulent actions. Plaintiffs believed that these actions constituted fraud and enabled them to dismiss Merritt for cause as contemplated in the Entities' operating agreements. Indeed, Judge McLaughlin decided this issue in favor of plaintiffs and against Merritt in the Pennsylvania Action. Thus, I conclude that the August 2008 removal notice was proper and effective. Accordingly, Merritt has been removed as manager for cause. This conclusion also means that Merritt's summary judgment motion on the same issue is denied.

C. Appointment of Receiver

The removal of Merritt as *manager* of the Entities will not end this matter. Merritt apparently is still a member of the Entities and it is obvious that resentment, disagreements and suspicions exist between the parties. Moreover, the parties' working relationship as managers and members of the Entities is, to put it mildly, dysfunctional. Plaintiffs, in their June 2, 2008 petition, sought dissolution, or in the alternative, the appointment of a receiver for the winding up of the Entities. In accordance with that original request, and in the interests of justice for all the parties involved, I am directing the parties to submit, within seven (7) days of today, the name of a potential receiver to manage the business and affairs of the Entities until such time as they can be effectively wound up. The parties should attempt to agree upon a receiver and inform this Court within seven (7) days of today. If the parties cannot agree, I will appoint a receiver within ten (10) days from this date.

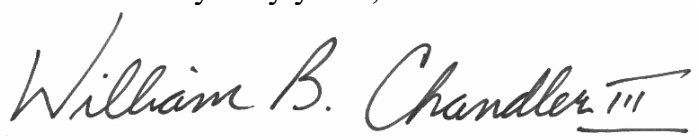
III. CONCLUSION

By this decision, I order the following relief: (1) the stay earlier imposed in this case is vacated; (2) summary judgment on Count I of the amended complaint is entered in favor of plaintiffs and against defendant Merritt; (3) defendant Merritt was validly removed as manager of the entities as of August 20, 2008; (4) Merritt shall take no further action in her capacity as manager of the entities, except that she may take all necessary steps to transfer control of the entities and their assets to the independent receiver; (5) the receiver shall take all steps necessary to conduct an accounting, pay all appropriate expenses and debts of the entities, and pay the balance of any capital account owed to Merritt and other members, and legally dissolve the entities; (6) a receiver will be appointed in accordance with this Court's instructions.

Plaintiffs shall submit an appropriate implementing order no later than noon, Tuesday, September 8, 2009.

IT IS SO ORDERED.

Very truly yours,



William B. Chandler III

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