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Be Careful What You Ask For: Court of Chancery Finds Corporate Law Governs LLC Based on Drafting of LLC Agreement

By [Jason C. Jowers](#)

It is the policy of the Delaware Limited Liability Company Act (LLC Act) “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.” Indeed, cases routinely refer to LLCs as “creatures of contract,” given that the LLC Act generally cedes governance of the entity to the terms of the LLC agreement, establishing few mandatory provisions and normally only providing “gap fillers” where an LLC agreement is silent. Consequently, members of an LLC “can ‘customize’ their company, largely free of externally imposed restrictions.” Robert L. Symonds, Jr. & Matthew J. O’Toole, *Delaware Limited Liability Companies* § 1.03[A][1][a], at 1-13(2015). But what happens when drafters of LLC agreements use their statutorily granted freedom to adopt a governance structure that is similar to that of a corporation? Does adopting a corporate-style structure also adopt the corporate case law interpreting that structure and imposing restrictions?

In the recent case of *Obeid v. Hogan*, 2016 WL 3356851 (Del. Ch. June 10, 2016), the Delaware Court of Chancery confirmed that a Delaware LLC may adopt a governance structure that looks more like a corporation than a traditional LLC, but it also explained that “[t]he choices that the drafters make have consequences.” By

adopting a corporate-style of governance, such as a board of directors, the Court of Chancery will to some extent turn by analogy to Delaware’s case law governing corporate boards of directors. If the LLC agreement drafters wish to adopt a board of directors structure but do not wish to import Delaware’s body of board governance case law by analogy, the drafters should specify rules in the LLC agreement to the extent they wish to deviate from the traditional corporate rules.

Background Facts

Gemini Equity Partners, LLC and Gemini Real Estate Advisors, LLC, both Delaware LLCs, managed over 1 billion of real estate assets, which included both commercial properties and hotels. Until the members had a falling out, William Obeid managed operations of the hotels and Christopher La Mack and Dante Massaro managed operations of the commercial properties. Rather than opting for a traditional member-managed or manager-managed structure, Gemini Equity Partners, LLC’s (corporate LLC) LLC agreement adopted governance by a board of directors, with Obeid, La Mack, and Massaro comprising the board. In contrast, Gemini Real Estate Advisors, LLC (manager-managed LLC) chose a manager-managed governance structure, with Obeid, La Mack, and Massaro each serving as managers.

In 2014, Obeid filed an action in the U.S. District Court for the Southern District of New York, alleging that La Mack and Massaro had formed competing companies with corporate LLC and manager-managed LLC assets, and La Mack and Massaro counterclaimed. Some of Obeid’s claims in the New York federal action were derivative in nature. Obeid alleged that demand was futile because of La Mack and Massaro’s conflicts of interest.

In July 2015, the corporate LLC and the manager-managed LLC retained the law firm of Brewer, Attorneys & Counselors. Obeid claimed that the Brewer firm was hired without his input. At a joint special meeting of the board of the corporate LLC and the managers of the manager-managed LLC, La Mack and Massaro proposed that a retired federal judge be hired to serve as a special litigation committee for both entities, which would then investigate the claims in the New York action and make a recommendation as to whether the corporate LLC and the manager-managed LLC should pursue such claims. Obeid voted against the idea, but he was outvoted by La Mack and Massaro.

The notice for the special meeting did not put consideration of a special litigation committee on the agenda and no formal resolutions were considered or adopted at the joint special meeting. Furthermore,

there was no vote on a particular candidate. Following the special meeting, the Brewer firm circulated the names of two candidates, and La Mack and Massaro signed an engagement letter with Judge Hogan, formerly of the U.S. District Court for the District of Oregon. For both the corporate LLC and the manager-managed LLC, La Mack and Massaro signed as a “member-manager.” Judge Hogan was not appointed as a director of the corporate LLC or as a manager of the manager-managed LLC.

Once retained, Judge Hogan advised the members of both entities that he intended to seek a stay of the New York action, in which discovery was nearly complete, so that he could investigate the claims. In response, Obeid filed an action in the Delaware Court of Chancery seeking, among other relief, a declaration that Judge Hogan could not serve as a special litigation committee for either entity and thus could not attempt to exert control over the derivative claims in New York.

If LLCs Adopt Governance Structures of Other Types of Entities, The Case Law Interpreting Those Structures from Other Entities Will Follow

Because of the broad freedom of contract under the Delaware LLC Act, the Court of Chancery explained that “the parties have broad discretion to use an LLC agreement to define the character of the company and the rights and obligations of its members.” However, emphasizing that there are consequences to the choices of the drafters, the court stated:

Using the contractual freedom that the LLC Act bestows, the drafters of an LLC agreement can create an LLC with bespoke governance features or design an LLC that mimics the governance features of another familiar type of entity. *The choices that the drafters make have consequences.* If the drafters have embraced the statutory default rule of a member-managed governance arrangement, which has strong functional and historical ties to the general partnership (albeit with limited liabil-

ity for the members), then the parties should expect a court to draw on analogies to partnership law. If the drafters have opted for a single managing member with other generally passive, non-managing members, a structure closely resembling and often used as an alternative to a limited partnership, then the parties should expect a court to draw on analogies to limited partnership law. *If the drafters have opted for a manager-managed entity, created a board of directors, and adopted other corporate features, then the parties to the agreement should expect a court to draw on analogies to corporate law.* (Emphases added.)

Analyzing the corporate LLC’s governance structure, the *Obeid* court found that the LLC agreement established a manager-managed LLC with a board of directors serving as the manager. Additionally, Section 9(f) of the LLC agreement adopted a provision that largely tracked Section 141(c) of the Delaware General Corporation Law (DGCL), which addresses the delegation of board authority to committees. Based on these provisions, the court concluded: “The presence of these corporate traits in the Corporate LLC Agreement calls for applying corporate precedents to derivative claims involving the entity. For present purposes, corporate law analogies should guide whether the Corporate Board can empower a special litigation committee comprising a single non-director.”

Special Litigation Committee of LLC with Corporate Governance Structure Must Comply with Rules for Corporate Special Litigation Committee

Turning to the dispute over whether Judge Hogan could serve as a member of a one-person special litigation committee to determine whether the derivative claims on behalf of the corporate LLC should continue, the court examined the corporate law decision of *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981). In *Zapata*, the Delaware Supreme Court found that the work of a special committee has to be

“twice tested”—once to determine if the act is legally permissible and a second time under equitable rules. The Delaware Supreme Court determined that, pursuant to Section 141(a) of the DGCL, the directors are empowered to manage and direct a corporation. Although a stockholder may displace director control in derivative actions by showing that demand is excused, that does not strip the board of its authority under Section 141(a). According to the Delaware Supreme Court, “[t]he problem is one of member disqualification, not the absence of power in the board.” Because Section 141(c) allows a committee of directors formed to exercise the full power of the board to the extent permitted by the board resolution forming the committee, an independent litigation committee of directors could decide whether a claim on behalf of the corporation should continue even if a majority of the full board remained interested in the deal and/or lacked independence. Having identified the legal authority for the special litigation committee, the *Zapata* court then developed an equitable test for judicial review of the special litigation committee’s actions.

In *Obeid*, Judge Hogan was not a *director* of the corporate LLC. The Court of Chancery explained that “[t]he leading treatises do not identify, and the parties have not cited, a single occasion in which a Delaware court has approved the use of a special litigation committee staffed by a non-director, or even intimated that such a committee would pass muster.” As the court explained, deciding whether to maintain a derivative action, which is normally against directors or officers of the company, is “not an ordinary-course-of-business affair that a board can delegate to whomever it chooses.” Furthermore, Section 141(c) (and Section 9(f) of the corporate LLC agreement that tracks it) speaks of committees of *directors*. Accordingly, the court found *Zapata* applied fully to the corporate LLC given its corporate governance structure, and Judge Hogan was disqualified from serving on the special litigation committee.

The defendants attempted to avoid this conclusion by pointing to Section 18-407

of the LLC Act, which permits delegation of a member's or manager's powers to non-members and non-managers. Specifically, Section 18-407 provides:

Unless otherwise provided in the limited liability company agreement, a member or manager of a limited liability company has the power and authority to delegate to 1 or more other persons the member's or manager's, as the case may be, rights and powers to manage and control the business and affairs of the limited liability company, including to delegate to agents, officers and employees of a member or manager of the limited liability company, and to delegate by a management agreement or another agreement with, or otherwise to, other persons. (Emphasis added.)

The court noted that some jurisdictions have LLC acts that specifically provide for special litigation committees made up of non-directors. However, the Delaware LLC Act contains no such provision. The court concluded that Section 18-407 is a delegation of "ordinary-course-of-business" authority and that "Section 18-407 does not trump the specific provisions of the LLC Act that address derivative actions." Section 18-1001 of the LLC Act provides that a member or assignee of an LLC may bring a derivative action "if managers or members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed." (Emphases added.) The court interpreted this to mean that only the managers of a manager-managed LLC are the authorized decision makers when it comes to derivative actions. "This in turn implies that in a manager-managed LLC, control over derivative litigation must rest with the managers (or a subset of them)." Furthermore, the court found that by creating a corporate governance structure and adopting language that mimicked Section 141(c) of the DGCL, the corporate LLC agreement had "otherwise provided," which displaced Section 18-407's default provision. Therefore, Section

18-407 did not permit Judge Hogan to serve on the special litigation committee.

Court Interprets Manager-Managed LLC as a "Corporate-Style Division Between Members and Managers"

The court next examined whether Judge Hogan could serve as a special litigation committee of the manager-managed LLC even though he was not a manager. The court strongly suggested that the decision to structure the entity as manager-managed LLC with passive members, rather than as a member-managed LLC, was itself evidence of intent to adopt a corporate-style governance structure that should be interpreted by at least some corporate governance case law by analogy. The court specifically noted that the LLC agreement provided that "the business and affairs of the Company shall be managed by, one or more Managers," which recalls similar language in Section 141(a) of the DGCL." The vice chancellor then stated: "In my view, the resulting structure is sufficient to cause the reasoning that governed the Corporate LLC to apply equally to the Manager-Managed LLC."

However, the court determined it could decide the issue without holding that a manager-managed LLC structure would necessarily lead to adoption of *Zapata*. Deciding the issue based on the text of the manager-managed LLC agreement, the court concluded that specific provisions limited delegation of managers' "core governance functions" to only other managers. Turning back to Section 18-407, the court held that the LLC agreement "provides otherwise" than the default rule on delegation. Therefore Judge Hogan could not serve as a member of the special litigation committee because he was not a manager of the manager-managed LLC.

Conclusion

Consistent with the Court of Chancery's other decisions in the LLC context, *Obeid* continues to put a premium on careful, precise, and thorough drafting of LLC agreements. There is of course nothing wrong with an LLC adopting a corporate-style structure and intentionally importing rules from cor-

porate law. In fact, the founders of an LLC may wish to have the predictability of the corporate law governing the LLC by analogy. However, drafters should adopt a corporate structure knowing the consequences and recognize that if they parrot language from the DGCL the courts will likely rely on corporate case law interpreting such language. If at formation the drafters wish to borrow from the corporate structure or even borrow language directly from the DGCL, but wish for different rules to govern the LLC than would govern a similar provision in the DGCL, *Obeid* teaches that those variations need to be spelled out lest the court be given the opportunity to turn to the familiar corporate case law interpreting similar provisions.

With that said, neither drafters nor litigators should overreact to *Obeid*. The Court of Chancery recognizes there are limits to the use of analogies to the corporate law where the LLC Act or an LLC agreement and the DGCL are in conflict. Indeed, in *Obeid*, the court stated that "[i]t is important not to embrace analogies to other entities or legal structures too broadly or without close analysis. . . ." An LLC agreement may create a hybrid entity that mimics a corporation in some respects and a partnership in others, which requires looking to different law depending on the provision at issue. There may also be portions of the LLC Act and the DGCL that are in conflict and prevent the importation of a corporate law principle. The *Obeid* court noted, for example, that Section 202 of the DGCL establishes a default rule of alienability with a transferee obtaining stockholder status, while Section 18-702 of the LLC Act establishes a default rule of assignability with the assignee not automatically becoming a member or being able to participate in the management of the LLC except as provided in a limited liability company agreement.

Finally, both litigators and drafters should continue to monitor developments in this area to determine the consequences of at least this vice chancellor's belief that a manager-managed structure with passive members is a "corporate-style division" of authority akin to directors and stockholders. Given that LLC agreements vary in how

much power is given to managers even in a manager-managed form, the importation of corporate case law may very well depend on the circumstances of the dispute and how close a particular LLC's structure comes to a corporate structure.

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