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Obeid v. Hogan: Delaware Court of Chancery Addresses Authority to Delegate Under Section 18-407 of the Delaware Limited Liability Company Act

June 13, 2016

In *Obeid v. Hogan*, C.A. No. 11900-VCL (Del. Ch. June 10, 2016), the Delaware Court of Chancery held that the board of directors of a board-managed Delaware limited liability company and the managers of a manager-managed Delaware limited liability company did not have the authority under the respective limited liability company agreements to delegate to a non-manager the power to act as a special litigation committee. Based primarily on the language of the limited liability company agreements, the Court found that, on the factual record before it, the "core governance function" of controlling litigation on behalf of the companies could be discharged only by the board (or a committee) of the board-managed company and by the managers (or a subset of managers) of the manager-managed company, notwithstanding the provisions of Section 18-407 of the Delaware Limited Liability Company Act (the "Act") providing members and managers broad authority to delegate managerial powers.

The dispute in *Obeid* arose out of a series of internal disputes involving the members and managers of Gemini Equity Partners, LLC, the board-managed company (the "Corporate LLC"), and Gemini Real Estate Advisors, LLC, the manager-managed company (the "Manager LLC"). The Corporate LLC and the Manager LLC had the same three members, William T. Obeid, Christopher S. La Mack and Dante A. Massaro, each of whom initially served on the board of the Corporate LLC and as a manager of the Manager LLC. In 2014, La Mack and Massaro took action to remove Obeid from the board of the Corporate LLC and as "Operating Manager" (but not as a manager) of the Manager LLC. Shortly thereafter, Obeid filed claims against La Mack and Massaro, both directly and derivatively in the name of the companies, in the U.S. District Court for the Southern District of New York (the "NY Action"), alleging, among other things, usurpation of corporate opportunities and other breaches of fiduciary duty. In connection with the derivative claims, Obeid did not make a demand that the managers of the companies institute an action in the name of the companies, as he contended that, due to alleged conflicts of interest, demand would be futile. The Court found that the NY Action had proceeded beyond the stage at which La Mack and Massaro could contest Obeid's authority to assert such derivative claims.

In August 2015, La Mack and Massaro, each acting as "member-manager" of the two companies, executed an engagement letter with Michael R. Hogan, a retired federal judge, with the apparent intent of delegating to him the powers of a special litigation committee for purposes of asserting control over the derivative litigation. Judge Hogan was not a member of either company, he was not appointed as a manager of either company, and there were no formal resolutions of either company establishing a special litigation committee or appointing Judge Hogan to that role. After Obeid learned of Judge Hogan's engagement, he filed suit in the Court of Chancery, seeking a declaration that Judge Hogan could not act as a special litigation committee for either company. Obeid also sought an injunction preventing Judge Hogan from taking any action on behalf of either company, including exerting influence or control over the derivative claims.

In addressing whether Judge Hogan had been duly vested with the authority of a special litigation committee, the Court reviewed the provisions of the limited liability company agreement of each of the Corporate LLC and the Manager LLC. The Court found that the Corporate LLC's limited liability company agreement was designed to recreate the governance structure of a Delaware corporation. Specifically, it provided that the business and affairs of the Corporate LLC would be managed by or under the direction of its board, using the same basic language found in Section 141(a) of the Delaware General Corporation Law (the "DGCL"). Likewise, the Corporate LLC's limited liability company agreement, using language drawn primarily from Section 141(c) of the DGCL, provided that the board could delegate its powers to committees consisting solely of board members. The Court found that the presence of these provisions, among other features of the agreement embracing the governance structure of a Delaware corporation, counseled in favor of applying corporate-law analogies to guide the determination as to whether the Corporate LLC's board could validly delegate its powers to a non-director.

The Court noted that, in *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981), the Delaware Supreme Court held that a committee of a board of directors retained the power to dismiss derivative litigation, subject to an inquiry into the independence and good faith of the directors and the determination that the recommendation falls within a range of reasonable outcomes. According to the *Obeid* Court, central to the *Zapata* Court's holding was the observation that, under Section 141(c) of the DGCL, a committee could exercise the power of the board of directors with respect to the litigation asset. The *Obeid* Court found that delegating such power to an officer or non-director would constitute an improper abdication of the board's authority.

In an effort to overcome the argument that the authority to control derivative litigation could only be delegated to a committee of directors, the Corporate LLC pointed to Section 18-407 of the Act, which provides, in relevant part, that "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 . . . rights and powers to manage and control the business and affairs of the limited liability company." The Court rejected the Corporate LLC's argument, observing that the "general default provision" regarding delegation did not overcome the specific provisions of the Act vesting the power to bring derivative suits in "managers or members," and finding, in any event, that by embracing a governance structured modelled after Sections 141(a) and 141(c) of the DGCL, the Corporate LLC's limited liability company agreement "provided otherwise" for purposes of Section 18-407 of the Act–that is, the Corporate LLC's limited liability company agreement, by mirroring a corporate structure, imported the relevant principles of the DGCL restricting the delegation of the board's core governance functions to third parties.

While noting that similar reasoning may likewise apply to the Manager LLC, as its limited liability company agreement also evidenced the governance features of a Delaware corporation (albeit to a lesser degree), the Court did not need to reach that issue, as it found a separate basis on which Manager LLC's limited liability company agreement "provided otherwise" for purposes of Section 18-407 of the Act. The Court found that specific provisions of Manager LLC's limited liability company agreement evidenced a distinction between matters relating to the ordinary course of business of the LLC and more significant matters vested solely in the managers. Because such provisions demonstrated the apparent intent of the drafters of Manager LLC's limited liability company agreement to limit the delegation of core functions to managers, the Court found that the power to control litigation could not be delegated to non-manager Judge Hogan.

The Court's opinion in *Obeid* confirms that Delaware courts may review the provisions of limited liability company agreements to determine the governance structure the parties intended and, absent other factors, may view that as evidence of an intent to have aspects of the entity law of similarly-managed entities apply to the limited liability company. In drafting limited liability company agreements, transaction planners and their counsel should give careful consideration to the provisions authorizing or restricting the delegation of authority to various parties and whether the governance structure may impact the ability to delegate certain authority to third parties.

Related Files

- Read the Opinion: *Obeid v. Hogan*

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