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IN THE SUPREME COURT OF THE STATE OF DELAWARE

SAADIA SQUARE LLC, Plaintiff Below-Appellant, v. SM LOGISTICS MEMBER LLC, Defendant Below-Appellee, and SM LOGISTICS HOLDCO LLC, Nominal Defendant Below-Appellee.	No. 396, 2021 APPEAL FROM THE COURT OF CHANCERY OF THE STATE OF DELAWARE, C.A. NO. 2021-0931-MTZ

APPELLANT'S OPENING BRIEF

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NATURE OF PROCEEDINGS

This action concerns the governance of SM Logistics Holdco LLC (the "Company"), a Delaware limited liability company formed by plaintiff below-appellant Saadia Square LLC ("Saadia" or "Plaintiff") and defendant below-appellee SM Logistics Member LLC ("SM" or "Defendant") to own and operate two commercial real estate properties. When Saadia and SM formed the Company, they implemented a capital structure that is commonly used in commercial real estate and treated each member differently, with differing levels of risk and return. SM was ensured repayment (with a guaranteed, set rate of interest) before Saadia would be paid a single dollar. In exchange for its $11.5 million investment, Saadia would receive 100% of the Company's upside after SM's investment was repaid. Like a debt holder, SM agreed to take on less risk (through a priority in repayment) but capped its return at a set amount. Like an equity holder, Saadia assumed a greater risk of losing its investment but is entitled to unlimited returns. SM was given an option to convert its interest to equity – and thereby position itself as an equally situated investor with Saadia, bearing the same risks and entitled to the same rewards – but never exercised it.

At the Company's inception, Saadia also agreed that SM would manage the Company. Naturally, since Saadia's and SM's economic incentives were not aligned unless and until SM converted its debt interest to equity, Saadia never intended to

give SM unfettered management authority. This is reflected in the Company's Operating Agreement, which neither prohibits SM's removal nor specifies the circumstances under and by which the Company's manager may be removed.

Since the Operating Agreement is silent on removing the manager – as is true for any subject not addressed by an LLC's governing contract – the Delaware Limited Liability Act, 6 *Del. C.* § 18-101 et seq. (the "LLC Act"), provides default statutory rules to define the parties' rights. *See Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del. 1999) ("The basic approach of the [LLC] Act is to provide members with broad discretion in drafting the Agreement and to furnish default provisions when the members' agreement is silent."); *Achaian, Inc. v. Leemon Family LLC*, 25 A.3d 800, 802 (Del. Ch. 2011) (recognizing the LLC Act as "an enabling statute whose primary function is to fill gaps, if any, in a limited liability company agreement"). One such default rule is provided in Section 18-402, which vests management of an LLC "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." 6 *Del. C.* § 18-402. The question presented here is whether, when the Operating Agreement does not articulate how or when the members may change the Company's manager, the LLC Act grants that right to members holding a majority interest in the Company's profits.

When SM chose not to exercise the option to convert its membership interest to equity before it expired, it ensured that Saadia would remain the Company's sole equity owner, entitled to 100% of profits and authorized by statute to remove and replace the manager at its discretion. Saadia exercised that right only after SM repeatedly abused its management authority to Saadia's extreme detriment. Among other things, SM surreptitiously sold one of the Company's real estate properties with the intent and effect of depriving Saadia of the valuable "right of first offer" to which the parties agreed Saadia would be entitled when SM intended to sell the properties. When SM's wrongdoing came to light, SM then refused to disclose to Saadia any information concerning the sale or account for the sale proceeds.

On October 19, 2021, Saadia took action by executing and delivering a written consent removing SM as the Company's manager and appointing Saadia to the same position. After SM disputed the validity of its removal, Saadia filed a complaint with the Court of Chancery on October 28, 2021, pursuant to 6 *Del. C.* § 18-110, to confirm that Saadia is the Company's rightful and duly authorized manager. *See* A25-A35.

By Order dated November 15, 2021, the Court of Chancery granted expedited proceedings. *See* A886-A888. SM answered the complaint on November 18, 2021 (A894-A907) and, on November 24, 2021, moved for judgment on the pleadings (A951-A994). In support of its motion, SM argued that the Operating Agreement's

absence of terms stating when and by whom the Company's manager could be removed reflected the parties' unambiguous agreement that SM would serve as manager indefinitely, without being subject to removal, unless Saadia and SM acted jointly to amend the Operating Agreement. *See* A988-A991. Under this interpretation, SM posited that Saadia was powerless to change the Company's manager and its written consent was invalid. *See id*. SM asked the Court of Chancery to dismiss Saadia's complaint, declare that SM remains the Company's manager, and void the actions Saadia took as manager following its appointment. *See* A993.

The parties briefed SM's motion and, on December 10, 2021, the Court of Chancery heard oral argument. *See* A1275-A1342. Following oral argument, the Court of Chancery issued a bench ruling granting judgment on the pleadings in SM's favor. A1343-A1356. In its ruling, the Court of Chancery held that, because the Operating Agreement identified SM as the "Managing Member" and did not contain express language permitting the Managing Member's removal, "[u]nder the plain text of the operating agreement and the LLC Act, Saadia could not remove SM as managing member by unilateral action." A1349. Instead, the Court of Chancery concluded, "the operating agreement provides, in so many words, that the manager shall cease to be a manager if the agreement is amended by mutual consent – or not at all." A1351. As a result, the Court of Chancery held that Saadia's action by

written consent to remove and replace SM was void and invalidated Saadia's prior acts as the Company's manager. A1352-A1355. The same day, the Court of Chancery entered an Order implementing its decision. A1271-A1273.

Saadia filed a Notice of Appeal from the Court of Chancery's Order on December 15, 2021. This Court granted Saadia's motion for an expedited schedule on December 21, 2021 and is set to hear oral argument *en banc* on February 23, 2022.

SUMMARY OF ARGUMENT

1. SM was entitled to judgment on the pleadings only if, viewing the factual allegations and inferences drawn therefrom in Saadia's favor, Saadia could not recover under any reasonably conceivable set of circumstances susceptible of proof. In this case, that required a finding that the language of the Operating Agreement unambiguously supported only a single interpretation under which Saadia had no legal right to remove and replace SM as the Company's Managing Member. If there is any other reasonable interpretation of the Operating Agreement, then the contract is ambiguous as a matter of law and judgment on the pleadings should have been denied.

2. While the Operating Agreement identifies SM as the Company's Managing Member, the contract contains no terms articulating when or under what circumstances the Managing Member ceases to hold that position. The Operating Agreement also does not address whether the Company's Members may change the Managing Member or describe a process for doing so. The Court of Chancery interpreted this omission as evidence that the parties intended for SM to serve as Managing Member indefinitely and could not be removed unless the Members unanimously amended the Operating Agreement. This interpretation, however, is not supported by the language of the Operating Agreement, read as a whole. It is equally (if not more) reasonable to conclude that the Operating Agreement's absence

of removal language vests the right to change the Managing Member in the Company's Members under the default provisions of the LLC Act.

3. Pursuant to Section 18-402 of the LLC Act, an LLC shall be governed by its members owning a majority of interest in the LLC's profits, unless provided otherwise in an operating agreement. When, as here, the operating agreement does not specify the circumstances under which a manager shall "cease" serving in that position, Section 18-402's default standard provides members the ability to change management should they deem it necessary. In this case, Saadia is the sole common equity owner of the Company and is entitled to 100% of the Company's profits; accordingly, Saadia is empowered by statute to remove and replace SM as Managing Member. Saadia validly exercised that power by written consent on October 19, 2021.

STATEMENT OF FACTS

A. The Parties' Respective Rights in the Company.

Saadia and SM formed the Company in August 2018 to own and operate commercial properties located in Mount Olive, New Jersey (the "New Jersey Property") and Rialto, California (the "California Property"). A26 (Compl. ¶ 1). The Company indirectly owned interests in the New Jersey Property and the California Property (together, the "Properties") through two wholly owned subsidiary entities, SM Logistics Mount Olive LLC ("New Jersey Property Owner") and SM Logistics Rialto LLC ("California Property Owner"), respectively. *Id.*

The Company's affairs are governed by an Operating Agreement, dated as of August 31, 2018 (cited as "Op. Agr."), to which Saadia and SM are parties. A26 (Compl. ¶ 4); A37-A121. While the Operating Agreement identifies Saadia and SM as "Members" (*see* A52 (definition of "Members")), their respective rights are materially different.

The Operating Agreement notes that both Saadia and SM "contributed the membership interest" in a separate entity, SM Logistics Owner LLC, "to the Company in exchange for an Interest in the Company." A42. The Operating Agreement does not define an "Interest in the Company" as a Member's "equity," but more generally as:

> [A]ll of the interest of that Member in the Company including, without limitation, such Member's (i) share of

> the Profits and Losses and the other allocations of the Company pursuant to this Agreement, (ii) share of the distributions of the Company, (iii) Capital Account, (iv) share of the capital of the Company, and (v) right to participate in the management of the business and affairs of the Company in accordance with the terms of this Agreement.

A48 (definition of "Company Interest"). Profits and Losses are defined as "for each Fiscal Year or other period, an amount equal to the Company's taxable income or loss for such Fiscal Year or period." A54 (definition of "Profits" and "Losses").

This is where any similarities between Saadia's and SM's respective "Company Interests" end. Section 5.1 of the Operating Agreement states in detail the Members' rights to distributions of the Company's cash. Those distributions are to be paid from "(a) the sum of all cash received by the Company from any source … minus (b) reserves set aside in the discretion of the Managing Member." A47 (definition of "Cash Available for Distribution"). Therefore, the cash available for distribution to Members is not tied to the Company's profits.

The priorities according to which available cash is to be distributed to Members are first determined by whether or not SM has exercised an "Equity Conversion" option. Under Section 5.5 of the Operating Agreement:

> At any time prior to the Outside Conversion Date, SM may by written notice (an "Equity Conversion Notice") to all Members, elect to cause an Equity Conversion and upon delivery of the Equity Conversion Notice, an "Equity Conversion" will be deemed to have occurred for all purposes hereunder. If SM fails to timely deliver an

> Equity Conversion Notice, the right to effect an Equity Conversion shall cease and be forfeited by SM.

A68 (Op. Agr. § 5.5). The "Outside Conversion Date" is September 1, 2020. A53 (definition of "Outside Equity Conversion Date").

Prior to an Equity Conversion, or if SM does not exercise the Equity Conversion option, SM (like a debt holder) is entitled to full repayment of its capital, plus interest, before Saadia receives any cash distributions. *See* A64 (Op. Agr. § 5.1(b)). Unless and until SM exercises the Equity Conversion, it receives all distributions until its Capital Contributions have been repaid in full, plus the higher of (i) a 12% Internal Rate of Return on SM's Capital Contributions, compounded quarterly, or (ii) 50% of SM's Capital Contributions. *See id*. (Op. Agr. § 5.1(b)(v)). Saadia thereafter receives 100% of distributions. *See id.* (Op. Agr. § 5.1(b)(vi)). Therefore, as a debt holder, SM enjoys a priority to the Company's cash, but its upside is capped. As the 100% equity holder, Saadia is entitled to unlimited upside on its investment after SM is repaid with interest.

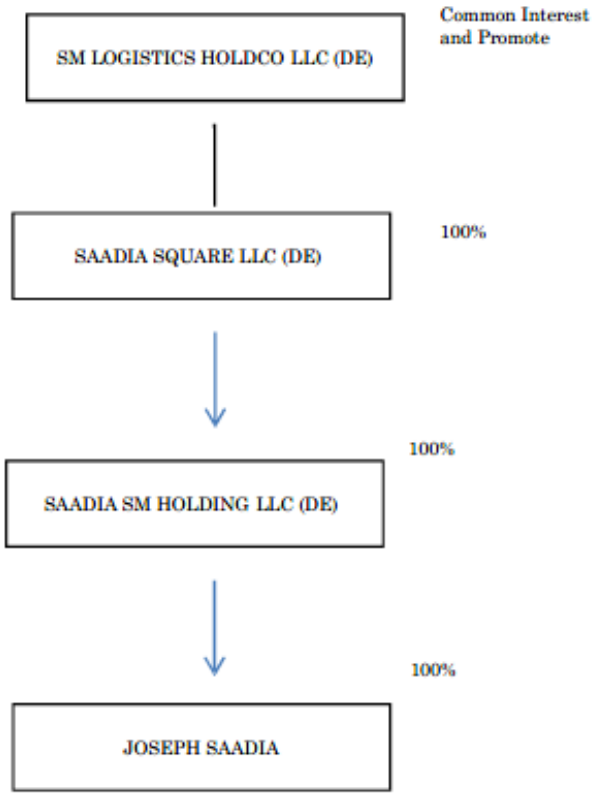
If SM exercised the Equity Conversion option, its distribution rights relative to Saadia would change materially. Following an Equity Conversion, SM's upside no longer would be capped and, as a co-equity Member with Saadia, it thereafter would share the Company's profits *pro rata* with Saadia. Under the post-Equity Conversion structure, SM no longer would hold a priority right to cash distributions; rather, cash would be distributed *pari passu* to SM and Saadia, as determined by

their respective "Percentage Interests," after payment of the Company's debt. *See* A65 (Op. Agr. § 5.1(c)(v)). Once SM received sufficient *pari passu* distributions to repay its Capital Contributions (plus an amount equal to the pre-Equity Conversion interest rate), Saadia then would be entitled to a 20% promote fee from future cash distributions, while the remaining 80% would continue to be shared by SM and Saadia on a *pari passu* basis. *See id.* (Op. Agr. § 5.1(c)(vi)). In this way, if SM converted its debt interest to equity, SM then would continue indefinitely to share the Company's upside with Saadia according to the Members' relative percentages of ownership. *See* A53 (defining the Members' "Percentage Interest" as a figure to be determined "as of the Conversion Date").[1]

The Members' distribution rights as articulated in Section 5.1 of the Operating Agreement show that, from the time the Company was formed until such time as SM opted to exercise its Equity Conversion option, the parties intended for SM's "membership interest" to consist of debt (with limited risk but limited upside) and Saadia's "membership interest" to consist of equity (with greater risk and unlimited upside). This also is true in the event of the Company's dissolution, where liquidated assets are to be distributed to SM and Saadia according to the priorities established

[1] By contrast, the "Funding Percentage" describes the Members' relative capital contributions *before* an Equity Conversion. *See* A49 (definition of "Funding Percentage"). Therefore, following an Equity Conversion, the "Percentage Interest" reflects the Members' equity holdings.

in Section 5.1 of the Operating Agreement. *See* A77 (Op. Agr. § 8.3(b)(iv)). The Members' disparate economic rights are further confirmed by Exhibit E to the Operating Agreement, which is a "Saadia Organization Chart":



A121. As this illustrates, Saadia holds a 100% "Common Interest" in the Company's equity.

SM was free to convert its membership interest to equity, and thereby obtain ownership of a "Percentage Interest" as determined under the Operating Agreement, at any time on or before September 1, 2020. Ultimately, however, SM opted not to exercise the Equity Conversion Option by that date and thus forfeited the right to do

so. A27 (Compl. ¶ 7). Therefore, Saadia remains – and always will remain – the Company's sole 100% equity Member.

B. Plaintiff Removes and Replaces Defendant as the Company's Managing Member.

The Operating Agreement vests management of the Company in a "Managing Member," which has "the right and duty to manage the business of the Company" and "the exclusive right to perform or cause to be performed all management of and operational functions relating to the day-to-day business of the Company." A69 (Op. Agr. § 6.3(a)-(b)). The Operating Agreement appoints SM as the Managing Member (A52 (definition of "Managing Member"); A68 (Op. Agr. § 6.1(a))), but neither states that SM holds that position exclusively nor prohibits Saadia from acting as Managing Member. The Operating Agreement also does not set forth a procedure for removing or replacing the Managing Member. A28 (Compl. ¶ 9).

While the Operating Agreement appointed SM as the Managing Member, Saadia retained the right to purchase the Properties if SM decided to sell them. This "right of first offer" is set forth in the Operating Agreement, which describes a procedure which requires SM to give Saadia notice of a proposed sale of a Property and an opportunity to purchase the Property at the same price. *See* A78-A82 (Op. Agr. §§ 10.1-10.5).

In March 2020, SM decided to lease the California Property to Rialto Distribution LLC (the "California Tenant"). A737. In connection with that lease,

unbeknownst to Saadia, SM granted an affiliate of the California Tenant an option to purchase the California Property for $123,353,000. *Id.* In doing so, SM completely disregarded the right of first offer procedure that the Operating Agreement obligated it to follow.

SM then rejected Saadia's attempts to enforce its right of first offer, forcing Saadia to commence litigation in California. A737-A738. During the pendency of that litigation, SM revealed that it caused the Company to sell the California Property, without notice to Saadia, notwithstanding that the California Property was subject to a notice of *lis pendens* filed by Saadia. A738-A739. A title search confirmed that the California Property was sold on August 3, 2021 for $123,353,000. A739. SM, however, refused Saadia's requests for an accounting of the sale proceeds. *Id.*

After learning that SM had duplicitously and unlawfully sold the California Property without honoring the right of first offer, Saadia decided to act. On October 19, 2021, Saadia, as the Member holding 100% of the Company's equity, and under the authority of Section 18-402 of the LLC Act, 6 *Del. C.* § 18-402, removed SM as the Company's Managing Member and appointed Saadia as SM's replacement. *See* A28-A29 (Compl. ¶ 11). Saadia took these actions by written consent, as permitted by Section 18-302(d) of the LLC Act, 6 *Del. C.* § 18-302(d). A123-A124.

The same day, Saadia delivered a copy of the written consent to SM and notified SM that it had been removed as the Company's Managing Member. A29 (Compl. ¶ 12). Saadia further notified that SM that, effective immediately, it was not authorized to take any actions for the Company, on the Company's behalf, or to bind the Company, including (but not limited to) selling, transferring, or leasing the Properties. *Id*. Saadia instructed SM to direct any communications from third parties concerning the Properties and the Company's affairs to Saadia as Managing Member, and to immediately provide Saadia full access to the Company's accounts, books, and records. *Id*.

Under its authority as the Company's newly appointed Managing Member, Saadia sought to satisfy the New Jersey Property Owner and the California Property Owner's debt obligations to their senior lender by requesting a payoff letter for a loan secured by the Properties. A29 (Compl. ¶ 13). Saadia also negotiated and closed on a sale of the New Jersey Property by the New Jersey Property Owner for $157 million in accordance with the terms of an offer previously sent by SM. *Id.*

Six days after Saadia executed and delivered the written consent, SM disputed the validity of Saadia's actions to remove SM as the Company's Managing Member and appoint Saadia to that position. A29-A30 (Compl. ¶ 14). Saadia then commenced this action pursuant to Section 18-110(a) of the LLC Act, 6 *Del. C.* § 18-110(a), to confirm its authority and resolve the controversy created by SM.

ARGUMENT

I. DEFENDANT WAS NOT ENTITLED TO JUDGMENT ON THE PLEADINGS.

A. Questions Presented.

Did SM prove, and did the Court of Chancery hold correctly, that there is only one reasonable interpretation of the Operating Agreement under which Saadia agreed unambiguously that it could not remove or replace the Company's Managing Member? A1084-A1092.

In the absence of language in the Operating Agreement stating how and under what circumstances the Company's Managing Member could be removed, did Saadia validly act pursuant to 6 *Del. C.* § 18-402 to remove SM from that position and appoint a replacement? A1093-A1099.

B. Scope of Review.

Appellate review of a trial court's ruling granting a motion for judgment on the pleadings presents a question of law which this Court reviews *de novo*. *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1204 (Del. 1993). To the extent the trial court's ruling involves the interpretation of a contract, this is a question of law that the Court reviews *de novo* for legal error. *AT&T Corp. v. Lillis*, 953 A.2d 241, 252 (Del. 2008). The Court also reviews *de novo* a trial court's interpretation of statutes. *In re Krafft-Murphy Co., Inc.*, 82 A.3d 696, 702 (Del. 2013).

C. Merits of Argument.

The Court of Chancery's ruling in favor of SM turned on its interpretation of the Operating Agreement – namely, the court's conclusion that the Operating Agreement memorialized unambiguously the parties' intent that SM would serve as the Company's Managing Member indefinitely and Saadia had no right to change the identity of the Managing Member, regardless of the circumstances, without SM's consent. This intent, however, is not stated explicitly in the Operating Agreement; rather, the Court of Chancery's interpretation relied upon the *absence* of express language providing for the Managing Member's removal, which in the court's view reflected the parties' agreement to opt out of default governance rules provided by the LLC Act.

Under Delaware law, SM was not entitled to judgment as a matter of law unless the Court of Chancery's interpretation of the Operating Agreement was the *only* reasonable one supported by the contractual language. However, it is at least *equally* reasonable to view the Operating Agreement's silence on when and how the Company's Managing Member may be removed as an omission that Section 18-402 of the LLC Act is intended to address. Pursuant to that statute, Saadia was authorized to – and did – remove and replace SM as Managing Member. Accordingly, SM's motion for judgment on the pleadings should have been denied.

1. *Judgment on the Pleadings Must Be Denied If There Is More Than One Reasonable Interpretation of the Operating Agreement.*

When deciding a motion under Court of Chancery Rule 12(c) for judgment on the pleadings, the trial court must "view the facts pleaded and the inferences to be drawn from such facts in a light most favorable to the non-moving party." *Desert Equities, Inc.*, 624 A.2d at 1205. In additional to factual allegations, the trial court may consider "the unambiguous terms of exhibits attached to the pleadings, including those incorporated by reference." *OSI Sys., Inc. v. Instrumentarium Corp.*, 892 A.2d 1086, 1090 (Del. Ch. 2006). Judgment on the pleadings can be granted "only when no material issue of fact exists and the movant is entitled to judgment as a matter of law." *Desert Equities, Inc.*, 624 A.2d at 1205. When a defendant seeks to dismiss a claim under Rule 12(c), the motion should be denied "unless the non-moving party 'could not recover under any reasonably conceivable set of circumstances susceptible of proof.'" *MPT of Hoboken TRS, LLC v. HUMC Holdco, LLC*, 2014 WL 3611674, at *5 (Del. Ch. July 22, 2014) (quoting *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC*, 27 A.3d 531, 536 (Del. 2011)). *See also Wallace ex rel. Cencom Cable Income P'rs II, Inc., L.P. v. Wood*, 752 A.2d 1175, 1179-80 (Del. Ch. 1999) ("To award judgment on the pleadings in favor of the defendants, [the court] must find that plaintiffs have either utterly failed to plead facts supporting an element of the claim or under no reasonable interpretation of the

facts alleged in the Complaint (including reasonable inferences) could plaintiff state a claim for which relief might be granted.").

A motion for judgment on the pleadings may provide "a proper framework for enforcing unambiguous contracts because there is no need to resolve material disputes of fact." *Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co. LLC*, 166 A.3d 912, 925 (Del. 2017). Only "[w]hen the contract is clear and unambiguous," however, will the Court "give effect to the plain-meaning of the contract's terms and provisions." *Osborn ex rel. Osborn v. Kemp*, 991 A.2d 1153, 1159-60 (Del. 2010). Conversely, when the Court "may reasonably ascribe multiple and different interpretations to a contract, we will find that the contract is ambiguous." *Id.* at 1160. An unreasonable interpretation of a contract is one that "produces an absurd result or one that no reasonable person would have accepted when entering the contract." *Id.* If a contract is susceptible to two or more reasonable interpretations, and therefore is ambiguous, the trial court must consider extrinsic evidence to determine the parties' intent. *Sunline Com. Carriers, Inc. v. CITGO Petroleum Corp.*, 206 A.3d 836, 847 (Del. 2019); *Pellaton v. Bank of New York*, 592 A.2d 473, 478 (Del. 1991). Ambiguity in a contract presents a material issue of fact that precludes entry of judgment on the pleadings. *See, e.g.*, *LPPAS Representative, LLC v. ATH Holding Co., LLC*, 2020 WL 7706937, at *6 (Del. Ch. Dec. 29, 2020); *ITG Brands, LLC v. Reynolds American, Inc.*, 2019 WL 4593495,

at *9 (Del. Ch. Sept. 23, 2019); *Brandywood Civic Ass'n v. Freas*, 2018 WL 3210854, at *3 (Del. Ch. June 29, 2018).

Applying this analytical framework, judgment on the pleadings could be granted to SM only if the Operating Agreement *unambiguously* prohibits Saadia from removing the Company's Managing Member. In other words, if there is *any* reasonable interpretation of the Operating Agreement other than the interpretation adopted by the Court of Chancery, then the Operating Agreement is ambiguous, SM's motion should have been denied, and the trial court's order awarding judgment to SM should be reversed.

2. *The Operating Agreement Does Not Prohibit Plaintiff from Removing the Company's Managing Member.*

"Delaware courts interpret LLC agreements like other contracts – objectively, giving 'priority to the parties' intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions.'" *Mehra v. Teller*, 2021 WL 300352, at *16 (Del. Ch. Jan. 29, 2021) (quoting *Salamone v. Gorman*, 106 A.3d 354, 368 (Del. 2014)). "Under standard rules of contract interpretation, a court must determine the intent of the parties from the language of the contract." *Twin City Fire Ins. Co. v. Delaware Racing Ass'n*, 840 A.2d 624, 628 (Del. 2003). Applying those rules here, the language of the Operating Agreement does not support the Court of Chancery's interpretation that the absence of removal language reflects an intent that SM *alone* would serve as the

Company's Managing Member, indefinitely, without affording the Members any right to change the Managing Member. It is at least equally reasonable to conclude that Saadia and SM intended that the Managing Member could be changed without needing to amend the Operating Agreement. At a minimum, the existence of an alternative reasonable interpretation renders the Operating Agreement ambiguous and precludes judgment on the pleadings.

The Operating Agreement identifies SM as the Company's Managing Member with the powers of a "manager" as defined by the LLC Act. A68 (Op. Agr. § 6.1(a)). At the same time, however, the Operating Agreement states that the "Managing Member" – not SM specifically – "shall have the right and duty to manage the business of the Company in its sole and absolute discretion" and "shall have the exclusive right to perform or cause to be performed all management and operational functions relating to the day-to-day business of the Company." A69 (Op. Agr. § 6.3(a)-(b)). The Operating Agreement repeatedly describes the rights, duties, and obligations of the *Managing Member* as distinguished from *SM*'s rights, duties, and obligations. *Compare, e.g.*, A68 (Op. Agr. § 6.1(b), which eliminates fiduciary duties "that the Managing Member or any of its Affiliates might otherwise have to the Company"), *and* A69 (Op. Agr. § 6.4, stating that "[t]he Managing Member may retain one or more asset managers"), *with* A78-A82 (Op. Agr. §§ 10.1-10.5, articulating SM's obligations with respect to Saadia's right of first offer). The

Operating Agreement's consistent references to the "Managing Member," rather than to "SM," reflects an understanding that parties *other than SM* may serve in that capacity.

This understanding is buttressed by the Operating Agreement's provisions permitting the transfer of Members' interests and the admission of substituted Members following such a transfer or a Member's dissolution. *See* A73 (Op. Agr. § 7.2(a)); A74-A75 (Op. Agr. § 7.4(a)-(b)); A76 (Op. Agr. § 7.6(a)). If the parties contemplated that SM's transferee or successor could be admitted as a Member to replace SM, then they necessarily contemplated a scenario where SM did not serve as Managing Member. To conclude otherwise would violate the maxim that "a court must construe the agreement as a whole, giving effect to all provisions therein." *E.I. du Pont de Nemours & Co., Inc. v. Shell Oil Co.*, 498 A.2d 1108, 1113 (Del. 1985).

The Operating Agreement also does not state that the Managing Member shall serve for a set period of time or identify the circumstances under which the Managing Member's service may be terminated, for cause or otherwise. Nor does the Operating Agreement specify who may act to remove and replace the Managing Member or state that removal requires a vote surpassing a specific numerical threshold. The Operating Agreement does not explicitly prohibit the Managing Member's removal or state that SM exclusively shall serve as the Managing Member.

In short, the Operating Agreement says nothing about whether and how the Managing Member can be removed and replaced. While "it is axiomatic that courts cannot rewrite contracts or supply omitted provisions," *Murfey v. WHC Ventures, LLC*, 236 A.3d 337, 355 (Del. 2020), inferring from the *absence* of removal language that the parties to the Operating Agreement intended for SM to serve as Managing Member in perpetuity does just that. Instead, as this Court has recognized, the LLC Act is intended to "furnish default provisions when the members' agreement is silent" with respect to a specific matter. *Elf Atochem N. Am., Inc.*, 727 A.2d at 291.

Here, the applicable default provision is Section 18-402 of the LLC Act, which states in relevant part:

> 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. … Subject to § 18-602 of this title, a manager shall cease to be a manager as provided in a limited liability company agreement.

6 *Del. C.* § 18-402. This statute "by default grants control of a limited liability company to its members in proportion to their respective equity interests, with a controlling authority inuring to those members owning a majority of such interests, unless … otherwise stated in the operating agreement." *Lola Cars Int'l Ltd. v. Krohn Racing, LLC*, 2009 WL 4052681, at *3 (Del. Ch. Nov. 12, 2009).

Notably, the Company's Operating Agreement does not identify a "manner" in which the Managing Member "shall be chosen," nor does it state when or for what reasons the Managing Member "shall cease" to serve in that capacity. In similar circumstances, where an LLC's operating agreement did not "provide a standard for determining when the members have taken action" to remove a director, the Court of Chancery has applied Section 18-402, holding that "[t]he default rule in the LLC Act is that 'the decision of members owning more than 50 percent of the said percentage or other interest in the profits [is] controlling.'" *Obeid v. Hogan*, 2016 WL 3356851, at *18-19 (Del. Ch. June 10, 2016) (quoting 6 *Del. C.* § 18-402). The same reasoning applies here.

While the Court of Chancery cited Robert L. Symonds, Jr. & Matthew J. O'Toole, *Symonds and O'Toole on Delaware Limited Liability Companies* (2d ed. & Supp. 2022), in support of its holding (A1351), this authority is neither controlling nor definitive. The authors of that treatise, finding a lack of clear case law on the issue, merely suggested that "[i]f the limited liability company agreement omits clear

provisions regarding removal, *it may be argued that a manager cannot be removed*." *Id.* § 9.05[C] (emphasis added).[2] The authors also did not reject the statutory power of members to remove a manager under Section 18-402 of the LLC Act, writing:

> This argument finds support in the plain language of the statute, which provides that, subject to a manager's right or power to resign, "a manager shall cease to be a manager as provided in a limited liability company agreement." The DLLC Act *does not make clear whether this language, by implication, establishes exclusive means by which a person may cease to be a manager*; the statute, for example, does not offer an explicit answer to the question whether Section 18-402's default rule of majority member management (if applicable) authorizes removal of a manager by action to that effect taken by a controlling member or bloc of members ….

Id. (emphasis added, footnotes omitted).

Ultimately, assuming that a manager can never be removed unless the operating agreement provides an explicit mechanism for doing so runs contrary to public policy as embodied in Delaware law. In the corporate context, this Court has recognized that "the stockholder franchise is the 'ideological underpinning upon which the legitimacy of the directors' managerial power rests." *Coster v. UIP Cos.*,

[2] The Court of Chancery previously quoted this language in *Llamas v. Titus*, 2019 WL 2505374, at *20 (Del. Ch. June 18, 2019), but did not consider the ability of members under Section 18-402 of the LLC Act to remove a manager; rather, the opinion addressed whether "a power of appointment in an LLC agreement implied a power of removal." *Id.* In any event, the *Llamas* Court's citation to the treatise was *dicta*, since "the analysis never reache[d] the question of whether such a power existed because [defendant] never tried to exercise it." *Id.*

Inc., 255 A.2d 952, 960 (Del. 2021) (quoting *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1126 (Del. 2003)) (internal quotations omitted). While the LLC Act is intended to "give the maximum effect to the principle of freedom of contract" (6 *Del. C.* § 18-1101(b)), members should not be deemed to have waived the fundamental right to select a manager without express language agreeing to do so. This is true with respect to default fiduciary duties, which may be eliminated under the LLC Act but only if the operating agreement does so clearly and explicitly. *See Auriga Capital Corp. v. Gatz Properties*, 40 A.3d 839, 850-51, 856 (Del. Ch.), *aff'd*, 59 A.3d 1206 (Del. 2012).

At the same time, the LLC Act prohibits an operating agreement from "eliminat[ing] the implied contractual covenant of good faith and fair dealing" (6 *Del. C.* § 18-1101(c)), which applies when a contracting party "has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected." *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010). Under the Court of Chancery's ruling, a manager could (as SM has done here) act in bad faith, with impunity, and face no risk that the holders of a majority of an LLC's equity interests, as a consequence of the manager's misconduct, would select a new manager to protect their reasonable expectations as investors. Applying Section 18-402 of the LLC Act as a default rule when an operating agreement says nothing about removal prevents just such an inequitable result.

3. *Plaintiff Acted Validly Pursuant to the LLC Act to Remove and Replace Defendant as the Company's Managing Member.*

In the absence of language in the Operating Agreement governing how and when the Managing Member may be removed, Section 18-402 gives the power to change the Managing Member to the Company's "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." 6 *Del. C.* § 18-402. Since SM allowed the Equity Conversion option to expire without exercising it, Saadia is the Member holding 100% of the Company's equity and retains the discretion to appoint the Managing Member. Saadia validly and effectively exercised this power on October 19, 2021, when it acted by written consent to remove SM as Managing Member and appoint Saadia as SM's replacement.[3]

While SM has offered an alternative interpretation of the Operating Agreement under which it is a "Majority Member" with sufficient ownership to maintain control over the Company indefinitely, this finds no support in logic or the

[3] In the proceeding below, SM did not dispute Saadia's right to act by written consent or the efficacy of the written consent itself; therefore, the only issue before the Court is whether Saadia had the requisite ownership of the Company needed to act under Section 18-402.

contract itself. Nowhere does the Operating Agreement use the terms "Majority Member" or "Minority Member" or apply them to Saadia or SM. Moreover, identifying Saadia and SM as "Members" is not dispositive – neither the Operating Agreement nor the LLC Act grants members equity ownership in the Company merely because they are named "members." Indeed, parties nominally identified as "members" may hold interests other than equity under the terms of an LLC's operating agreement. *See JAKKS PACIFIC, Inc. v. THQ/JAKKS PACIFIC, LLC*, 2009 WL 1228706, at *2 (Del. Ch. May 6, 2009) (stating that "[plaintiff]'s economic interest in the joint venture, though it is technically a member of the LLC, is less that of an equity owner and more akin to a licensor with rights to royalties based on sales").

It is a bedrock principle of Delaware law that LLCs "are creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.'" *R & R Cap., LLC v. Buck & Doe Run Valley Farms, LLC*, 2008 WL 3846318, at *4 (Del. Ch. Aug. 19, 2008) (internal citations omitted). As such, the LLC Act "leaves to the members … the task of 'arrang[ing] a manager/investor governance relationship'" as they see fit. *Id.* (quoting Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 5 (2007) (concluding that courts should not "superimpos[e] their view ex post on how that relationship should be

structured and scrutinized")). Therefore, investors in an LLC have unlimited freedom to structure their respective interests as debt or equity, with the economic rights attendant to either. *See, e.g.*, *Elf Atochem N. Am., Inc.*, 727 A.2d at 291 (noting that the LLC Act gives members "the broadest possible discretion in drafting their [LLC] agreements"); *Haley v. Talcott*, 864 A.2d 86, 88 (Del. Ch. 2004) ("[A] principle attraction of the LLC form of entity is the statutory freedom granted to members to shape, by contract, their own approach to common business 'relationship' problems.").

This is precisely what occurred here, where the Operating Agreement structures SM's investment as debt – which is repaid with a set rate of return, and no more – and Saadia's investment as equity – entitling Saadia to unlimited upside after SM is repaid. Under this agreed-upon structure, Saadia receives 100% of the Company's profits unless and until SM exercises its right to convert its interest to equity on par with Saadia, after which the Members split profits *pro rata* according to their respective ownership percentages. The structure used by Saadia and SM is common in commercial real estate investments. *See, e.g.*, Jon S. Robins, et al., *Mezzanine Finance and Preferred Equity Investment in Commercial Real Estate: Security, Collateral & Control*, 1 Mich. J. Private Equity & Venture Cap. L. 93, 103 (2012) (noting that "a preferred member will sacrifice a greater return at exit in exchange for more certainty during the life of the project, which leads us to the more

debt-like end of the spectrum," at which such preferred instruments "tend to be treated as economic equivalents to mezzanine loans by market participants").[4]

The Court of Chancery's opinion in *JAKKS PACIFIC, Inc.* is instructive. There, as here, the two members of an LLC agreed to materially different distribution rights. Like SM, the plaintiff ("JAKKS") was entitled to a "Preferred Return" on distributions ahead of the defendant ("THQ"). While "income of the joint venture was to be allocated first to JAKKS, up to the amount of the Preferred Return," the Court of Chancery noted "that is JAKKS's only claim on the income of the firm." 2009 WL 1228706, at *2. As is true for Saadia absent an Equity Conversion by SM, "[a]ll income above the Preferred Return belongs entirely to THQ, and THQ bears all of the risk of loss." *Id.* For this reason, the Court of Chancery found that "JAKKS's economic interest in the joint venture, though it is technically a member of the LLC, is less that of an equity owner and more akin to a licensor with rights to royalties based on sales." *Id.* Saadia and SM similarly agreed to a capital structure

[4] By analogy, in the corporate context, "Delaware courts [have] emphasized the contractual nature of preferred stock, thus treating preferred stock more like debt than common stock." Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 Minn. L. Rev. 1951, 1970 (2018). *See also* Richard A. Booth, *Financing the Corporation* § 3:5 (Dec. 2020 Update) ("[P]referred stock may be used as a close substitute for debt. Indeed, it is possible to construct classes of preferred stock that are virtually indistinguishable from debt. Accordingly, tax law and accounting rules may treat preferred stock as if it is debt in such cases.").

for the Company where SM, while named a "Member," holds debt with rights materially different than the equity held by Saadia, the other "Member."

Giving SM rights to appoint the Company's Managing Member on par with Saadia's, notwithstanding SM's non-equity economic interest, would be unreasonable because it "produces an absurd result or one that no reasonable person would have accepted when entering the contract." *Osborn*, 991 A.2d at 1160. According to SM, from the Company's inception it has always held a controlling equity stake and Saadia can never change the Managing Member – regardless of whether SM opts to exercise the Equity Conversion. A996-A997. SM never explains why Saadia would have agreed to entrust control of its investment, in perpetuity, to a party who bears less risk than Saadia. The answer, of course, is that no reasonable contracting party would surrender its right, as an equity owner, to change the Managing Member without recourse or assurances that the manager's economic returns are aligned with its own.

If, however, SM chose to exercise its Equity Conversion option, giving it economic rights on par with Saadia's, then it would be sensible for SM to expect voting rights commensurate with its relative percentage ownership of equity. This is the only interpretation of the Operating Agreement under which SM's Equity Conversion option has any value; otherwise, if SM holds a controlling majority stake in the Company whether it exercises the Equity Conversion option or not, then SM

would have no incentive to ever exercise it. An interpretation that makes the Equity Conversion option irrelevant would contravene the rule that "[u]nder general principles of contract law, a contract should be interpreted in such a way as to not render any of its provisions illusory or meaningless." *Sonitrol Holding Co. v. Marceau Investissements*, 607 A.2d 1177, 1183 (Del. 1992). In summary, when the Operating Agreement is considered as a whole, Saadia's economic rights as the 100% equity Member give it the lawful authority, pursuant to Section 18-402 of the LLC Act, to remove and replace SM as the Company's Managing Member.

CONCLUSION

For the foregoing reasons, Saadia respectfully requests that the Court reverse the ruling below and remand this action to the Court of Chancery for further proceedings and trial on the merits.

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Dated: January 7, 2022

CERTIFICATE OF SERVICE

I, Thad J. Bracegirdle, hereby certify that on the 7th day of January, 2022, true and correct copies of the foregoing were served upon the following counsel of record via File & ServeXpress:

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