

Chancery Addresses Limitations of the Power to Delegate Authority to Third Parties in a Delaware LLC

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In a recent Memorandum Opinion in *Obeid v. Hogan*, C.A. No. 11900-VCL, the Delaware Court of Chancery addressed the delegation of litigation authority by limited liability company (“LLC”) managers. Christopher S. La Mack, Dante A. Massaro, and the plaintiff, William T. Obeid, were the members/managers of two LLCs, including Gemini Equity Partners, LLC (the “Company”). Their relationship soured and led to various lawsuits, including a case filed by Obeid in the U.S. District Court for the Southern District of New York against La Mack and Massaro that included derivative claims on behalf of the Company. La Mack and Massaro appointed Michael G. Hogan, a retired federal judge, as a one-person special litigation committee, and Obeid sued in the Court of Chancery seeking to invalidate the special litigation committee because Judge Hogan was not a director of the Company.

The Court of Chancery began its analysis by reiterating the contractarian nature of Delaware LLCs and that under the Delaware LLC Act, 6 *Del. C.* § 18-101 *et seq.*, parties have the “statutory freedom . . . to shape, by contract their own approach to common business relationship problems.” The court explained, however, that where the structure of an LLC resembles another type of business entity, such as a partnership or corporation, the LLC will likely be subject, by analogy, to legal principles applicable to that other type of entity. Because the Company had various corporate characteristics (including a board of directors and a provision permitting the board to delegate authority to committees that mimicked Section 141(c) of the Delaware General Corporation Law (the “DGCL”)), the court found that “corporate law analogies should guide whether the Corporate Board can empower a special litigation committee comprising a single non-director.”

Under Section 141 of the DGCL, a board of directors has the authority to make litigation decisions for its corporation. In a derivative suit, the stockholder “displaces” this authority and obtains the right to litigate on behalf of the corporation, generally because the board has refused a demand to litigate or the stockholder has established the futility of such a demand. In *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981), the Supreme Court of Delaware held that after a stockholder has obtained the right to sue derivatively, the board can reassert and delegate its litigation authority to a special litigation committee of independent

directors. In *Obeid*, the Court of Chancery opined that a “critical” fact underlying *Zapata* is that Section 141(c) of the DGCL permits “a committee [to] exercise all of the authority of the board . . .” because “the decision over the litigation must be final and not reviewable by the conflicted directors.” Thus, “[f]or the *Zapata* procedure to function, the recipient of the delegation ha[s] to be able to wield the full authority of the board with respect to the litigation asset.”

This conclusion was fatal to the special litigation committee created by La Mack and Massaro. While boards commonly (and permissibly) delegate “ordinary course of business” functions to officers and non-directors, such delegation is impermissible in a *Zapata* situation because “[o]fficers and other non-directors . . . cannot exercise the full power of the board of directors.” Thus, because Judge Hogan was not a director, he could not exercise the necessary power, and the special litigation committee was deficient.

While Section 18-407 of Delaware’s LLC Act states that “a member or manager of a limited liability company has the power and authority to delegate to 1 or more persons the member’s or manager’s . . . rights and powers to manage and control the business and affairs of the limited liability company,” this provision did not change the court’s conclusion. “Section 18-407,” the court explained, “validates the vast array of ordinary-course-of-business delegations that are part of the operation of an entity. Just as a corporate board of directors can rely on and delegate tasks and responsibilities to officers, employees, advisors, and other persons, so too can the members in a member-managed LLC or the managers in a manager-managed LLC.” “Section 18–407 does not validate every theoretically possible delegation, and it does not extend to the conflict-laden delegation of authority involved in the creation of a special litigation committee.” Moreover, the language of Sections 18-1001 and 18-1003 of the LLC Act indicates “that in a manager-managed LLC, control over derivative litigation must rest with the manager (or a subset of them).”

Obeid is significant for a variety of reasons. It is a reminder of the flexibility provided by Delaware’s LLC statute, which, by and large, permits parties to tailor and order their business relationships in any manner they please. To the extent the resulting LLC resembles another type of business entity, however, parties and drafters must be aware that non-LLC law may be applied by analogy. Corporate directors and managers of corporate-like LLCs must also be aware that special litigation committees cannot be staffed by non-directors or non-managers, and to the extent they are, their decisions are not likely to be upheld.

*This case has been appealed.