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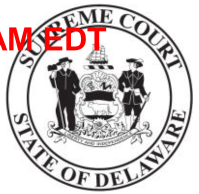

IN THE SUPREME COURT OF THE STATE OF DELAWARE

LAW OFFICE OF KRUG,	:	
	:	
Defendant Below,	:	
Appellant/Cross-Appellee,	:	
	:	
v.	:	C.A. No. 106,2019
	:	
A&J CAPITAL, INC.	:	Court Below – Court of Chancery
	:	of the State of Delaware,
Plaintiff Below,	:	C.A. No. 2018-0240-JRS
Appellee/Cross-Appellant.	:	

APPELLEE'S ANSWERING BRIEF ON APPEAL AND CROSS-APPELLANT'S OPENING BRIEF ON CROSS-APPEAL

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NATURE OF PROCEEDINGS

The central issue in this case is whether A&J Capital, Inc. (“A&J”) was properly removed as the Class B Manager (“Manager”) of LA Metropolis Condo I, LLC (“LAMC” or the “Company”) ***for cause***, as required by the Company’s Operating Agreement and a Management Agreement between the Company and A&J. “Cause” is defined in the Agreements as “gross negligence, intentional misconduct, fraud or deceit.”

After trial, the Court of Chancery held that “the ‘for cause’ removal provision was a protection for which A&J bargained and gave consideration,” that such provisions “are not aspirational, nor do they allow the principal to remove the agent on a whimsy and then manufacture ‘cause’ after-the-fact to justify the removal.”[1] The court further held that Appellant Law Office of Krug (“Krug”) was required to “establish that cause for removal existed, including [that] members knew the cause for removal at the time they cast their votes.”[2] Additionally, in order to violate any of the standards for removal, A&J’s conduct must have caused harm or been intended to cause harm to the Company or its Members.[3] The court ultimately concluded that it was “satisfied from the preponderance of the evidence that the[] members removed A&J without cause and then formulated after-the-fact explanations for removal that are neither credible nor adequate under the operative agreements to justify their actions.”[4]

In so ruling, the trial court determined that it was unnecessary to reach certain issues, including serious questions regarding whether signatures on certain of the removal ballots were forged. The court’s

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[1] Appellant’s Opening Brief (“OB”), Ex. A, Post-Trial Opinion (“PTO”), at 2.

[2] *Id.* 31.

[3] *Id.* 35.

[4] *Id.* 2.

language, however, leaves little room for doubt as to how it would have ruled if it had been necessary to do so.[5]

Krug's lead argument on this appeal is one he[6] never made below: that the trial court erred in placing the burden of proof on him to establish cause for removing A&J. This argument is waived. It is also contrary to law.

Krug also makes numerous other factual and legal points that were not properly raised below, and a number of assertions that either veer outside the record or are at odds with the trial court's factual findings.

But Krug's bottom-line position on this appeal is clear. He maintains that the Members could remove A&J for cause so long as cause existed at the time of removal, regardless of whether they knew what that cause was when they cast their ballots, without showing that A&J's conduct satisfied the elements of the common definitions of the standards for removal set forth in the operative agreements, and without establishing that A&J's conduct caused any harm or was intended to harm the Company or its Members. Essentially, Krug seeks to turn unambiguous provisions permitting removal only for cause into ones permitting removal without any cause at all. This would make the for-cause removal provisions merely "aspirational," in the Court of Chancery's words, and would not give A&J its bargained-for protections.

This Court should affirm the trial court's rulings.

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[5] *Id.* 27 n.115 ("A&J presented the testimony of a document authentication expert to raise questions regarding the authenticity of several of the Removal Ballots, some of which, on their face, appeared either to be altered or to contain signatures copied and pasted from other documents."). If the Court of Chancery's Final Order and Judgment is reversed, it will need to resolve the forgery issue and other issues on remand, as they could be dispositive of the outcome of the removal vote.

[6] Mr. Krug has argued that his law firm is merely a "dba." (March 26, 2019, Affidavit of Krug filed on March 27, 2019). This brief therefore refers to Krug as "he" or "him" rather than "it."

To the extent that the Court does not do so, however, it should nevertheless rule in A&J's favor on its cross-appeal, which seeks reversal of the lower court's ruling denying A&J's motion for summary judgment. That motion sought judgment in A&J's favor as a matter of law, based on longstanding corporate law precedent holding that a for-cause removal must be effectuated with certain procedural due process, including notice and an opportunity to respond to the allegations. It is undisputed that those procedures were not followed here. Once again, Krug's position would vitiate the requirement that A&J be removed only for cause.

SUMMARY OF ARGUMENTS

A&J's Answer to Krug's Summary of Arguments on Appeal

1. Denied. Krug did not preserve the argument below that the trial court improperly placed the burden of proof on him to demonstrate that there was cause to remove A&J as Manager. In any event, the trial court properly placed the burden of proof on Krug.

2. Denied. The trial court properly applied the standards set forth in the operative agreements. Krug was required to show that (i) A&J caused or intended to cause harm to the Company or the Members, and (ii) the Members knew the causes for removal at the time they cast their votes. Applying those standards, the Court of Chancery correctly determined that Krug had not proved that there was cause to remove A&J.

A&J'S Summary of Argument on Cross-Appeal

1. On cross-appeal, the trial court erroneously held that no notice or opportunity to respond were required in order to remove A&J for cause, resulting in an improper denial of summary judgment in A&J's favor. The Court need not reach this issue if it rules in A&J's favor on Krug's appeal.

STATEMENT OF FACTS[7]

The Parties

Plaintiff A&J Capital, Inc. is a financial services firm based in California. (PTO 3). A&J serves as the Company's Class B Manager and manages the Company's daily affairs as set forth in §5.3(d)(ii) of the Operating Agreement (*id*. 3, 11; A98-99) and in accordance with the Management Agreement. (A67-83). Frank Xu is A&J's founder and President, and Alex Verba is Senior Vice President and in charge of the Company's day-to-day operations. (PTO 3-4).

Defendant Law Office of Krug ("Krug") is a single-person law firm in California. (*Id*. 4). Krug claimed to have been appointed as the interim Class B Manager following A&J's purported removal by certain Members of the Company. (*Id.* 4).

Nominal Defendant LA Metropolis Condo I, LLC (the "Company") is a Delaware limited liability company with its principal place of business in California. (*Id*. 4, 14).

Non-party Henry Global Consulting Group ("Henry Global") is a well-known migration agent in China. (PTO 5). As migration agent, Henry Global solicits investments for EB-5 projects, in addition to providing other services to investors once the EB-5 investments are made. (*Id*. 5, 14). Henry Global is run by Mr. Xu's brother-in-law. (*Id*. 5).

The EB-5 Immigrant Investment Program and the Company

Congress created the EB-5 Immigrant Investor Program ("EB-5" Program") in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. (*Id*.). The U.S. Citizenship & Immigration Services ("USCIS") administers the EB-5 Program. (*Id*. 5-6). Under the EB-5

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[7] Except where otherwise noted, these facts are taken from the Court of Chancery's post-trial Memorandum Opinion ("Post-Trial Opinion" or "PTO"). The Opinion is attached as Exhibit A to Appellant Law Office of Krug's Opening Brief (the "Opening Brief" or "OB").

Program, foreign entrepreneurs (and their spouses and unmarried children under 21) are eligible to apply to become lawful permanent residents—*i.e.*, "green card" holders—if they:

- Make the necessary investment in a "new commercial enterprise" ("NCE") in the United States; and
- Plan to create or preserve 10 permanent full-time jobs for qualified U.S. workers.

(*Id*.).

To qualify, the immigrant investor must be actively engaged in the commercial enterprise; serving as either a limited partner of an enterprise that creates the requisite number of jobs, or as an investor in an NCE that makes a loan to an enterprise that creates the requisite number of jobs. (*Id*. 5). The investment must create 10 jobs per each foreign investor that last for at least two years, however the investment must also remain "at risk" during the pendency of the investor's residence application with USCIS, a process that can take as long as ten years. (*Id*. 5-6).

<u>The Company and the Project</u>

Mr. Xu was initially approached by a broker respecting potential EB-5 investment in a multi-phase real estate project in Los Angeles involving the construction of a condominium building (the "Project"). (*Id*. 4, 6). Mr. Xu contacted the Project's developer, Greenland LA Metropolis Development I, LLC (including its affiliates, collectively, "Greenland"), to discuss such an EB-5 investment and, when Greenland expressed interest, introduced Greenland to Henry Global. (*Id*.). The investment was ultimately structured as a $100 million construction loan from the Company to Greenland with an annual 2.2% rate of return and maturation in five years (the "Loan"). (*Id.* 8). The Loan was to be funded by a $500,000 investment by 200 Members who would invest in the Company in exchange for a projected 1.0% total return on the investment and permanent United States residency. (*Id*. 8-9).

The PPM

A Private Placement Memorandum ("PPM") was circulated to potential investors by Henry Global to explain and market the investment. (*Id*. 8). If the investors did not like the terms set forth in the PPM, there were numerous other EB-5 investment options from which to choose. (B255; B262).

The PPM contained a number of pertinent disclosures. Among them, the PPM expressly disclosed that: "The Company will pay out of … **interest income** all ordinary administrative and operating expenses … **as well as payments to** Managers and **other third-party service providers for** servicing the Loan, **assisting with the Offering, and providing immigration services to the Company, Subscribers, and Class B Members**." (A161) (emphasis added). Thus, the PPM contemplated that payments to third party service providers assisting with the offering and immigration services—including agents such as Henry Global—would come from the Company's interest income, *i.e.,* the 2.2% per annum interest payments received from Greenland.

In addition to their $500,000 investment in the Company, the Members would also "incur an Administration Fee of $45,000." (A154). The PPM disclosed that the Administration Fee would, *inter alia*, be used to pay to "oversea/offshore finders and agents to seek potential investors in the Company (each a "**Program Locator**") and document processors to process immigration paperwork and assisting with their immigration paperwork for those investors (each, a "**Processor**")…." (*Id*.). The agent for these services was Henry Global. (B250).

As noted above, however, the PPM also expressly contemplated that the funds to pay third party service providers would come from the Administration Fee, and interest income. (A161). Importantly, these additional payments from income interest would come out of, and were thus "capped" by, the annual interest payments received by the Company, and would still be expected to yield the 1.0% return to the Members as disclosed. In other words, these payments would be entirely in keeping with the

economics of the deal as disclosed to the Members.

The PPM further stated that: "None of such fees [for Program Locators and Processors] shall be paid out of the Subscription Price or investment in the Membership Interests of the Company." (A154). The "Subscription Price" refers to the "the $500,000 per Class B Unit paid by each Subscriber." (A123). The court found that "Membership Interest" refers to a Member's interest in the Company. (PTO 42-46). Thus, as long as fees to Henry Global are paid from the Administrative Fee or interest income, they do not run afoul of the prohibitions against payment of such fees from the Subscription Price or investment in the Membership Interests of the Company. Krug never presented any evidence that Henry Global's fees were paid from one of these prohibited sources, and the court below found they were not. (PTO 46-7, 49).

The Operating Agreement

The Company is governed by the Operating Agreement, which was effective as of July 11, 2014. (PTO 11; A84-119). The Operating Agreement provides that the Company is to be Manager-managed.[8] (A95 §5.1). Such management is to be in good faith (A100 §5.6) and in compliance with all legal and policy requirements of the EB-5 program, as advised by the Regional Center. (A103 §5.14). The Operating Agreement only permits removal of the Class B Manager by a majority vote of the Members only for "gross negligence, intentional misconduct, fraud or deceit, all as more fully set forth in the Management Agreement." (A97 §5.3(c)(ii)).

The Management Agreement

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[8] The Operating Agreement contemplates that the Company will be managed by both Class A and Class B Managers. (A95 §5.1). The Class A Manager resigned in September 2017. (PTO 16-17).

The Management Agreement is the agreement by which A&J became the Company's Class B Manager and assumed the day-to-day operations of the Company. (A67-83). Each Member subsequently joined the Management Agreement by Joinder Agreements executed contemporaneously with the Member's subscription to the Project. (PTO 13 n.48).

The Management Agreement reinforces the rights and duties of the Class B Manager under the Operating Agreement. (A70 §2(b)). Consistent with the PPM, the Management Agreement also sets forth the compensation of the Class B Manager. Section 6(a) provides: "The Company shall pay to the Class B Manager an annual management fee equal to four-tenths percent (0.4%) of the outstanding Development Loan amount, calculated on an actual/360 year on a non-compounding basis." (A72). Thus, if there is no loan outstanding, there is no source of payment for A&J set forth in the Management Agreement.

Importantly, however, the Management Agreement also expressly contemplates that the Class B Manager's compensation may be modified by approval of the Members: "The Management Fee shall from time to time be reviewed and **modified as may be mutually agreed upon by the Company and the Class B Manage**r…." (*Id.*) (emphasis added).

As with the Operating Agreement, the Management Agreement provides that the Class B Manager may only be removed via majority vote of the Members and for "cause." The relevant provision in the Management Agreement states:

> For Cause. The Class B Manager may be removed by Majority Vote (as defined in the Operating Agreement) of the Class B Members for **gross negligence, intentional misconduct, fraud or deceit**; ….

(A76 §12(b) (emphasis added)).

The Distributor Service Agreement

Effective August 28, 2014, the Company executed a Distributor Service Agreement ("DSA") with a Henry Global entity. (A226-30).[9] The DSA provided that, in exchange for various services, including investor recruitment and serving as a liaison with the investors on immigration matters (*id*. §§1.1-1.3), Henry Global would be paid a portion of the Administration Fee and a percentage of the interest income earned on the Loan. (PTO 14). The services contemplated by the DSA included raising the entire $100 million in investments used by the Company to make the Loan to Greenland to finance the Project. (A226). Thus, it is fair to say that the Company and the Project owe their existence to Henry Global's fundraising efforts.

All of Henry Global's compensation from the Company for its services has been paid from the Administration Fees paid by the Members and the 2.2% interest income paid to the Company by Greenland, as expressly disclosed and contemplated by the PPM and the Operating Agreement. (PTO 50).

Operation of the Company

During the subscription process, the Loan with Greenland was negotiated and finally executed on August 28, 2014. (PTO 15). For the fiscal year 2014 through 2016, and in addition to its requirements under the Operating Agreement, A&J had an accounting firm prepare a review of the Company's unaudited financial statements, including notes reflecting payments to Henry Global, which A&J sent to Henry Global for dissemination to the Members. (PTO 15-16). For fiscal year 2017, A&J sent the financial review directly to the Members. (*Id*. 17). The payments or fees owed to Henry Global were disclosed in the financial statements, including in the notes. (*Id*. 16).

There was some evidence at trial that the two testifying Members did not receive the notes to the financial reflecting payments to Henry Global in the 2015-16 packages sent to them by Henry Global.

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[9] On November 9, 2015, the DSA was terminated and a new, substantially identical, DSA was executed with a different Henry Global entity (A231-36). (PTO 14 n.53).

(PTO 16 n.65). The court below, however, found that A&J provided the exact amounts owed to Henry Global each year to the Members via the financial statements and noted that one Member testified that her vote to remove A&J was motivated in part by those payments. (*Id*. 52 n.176).

<u>The Prepayment Plan</u>

Once the Project was substantially completed, money from the sale of the individual condominium units in the Project was transferred to an account in Greenland's name for the benefit of the Company (the "Pledge Account"). (*Id*. 18). A&J insisted on the Pledge Account to ensure that Greenland would not use the proceeds from the Project without A&J's approval and for purposes other than those in accordance with the Loan Agreement. (*Id.*).

Greenland, however, took the position that it should be able to use the funds since they consisted of funds that had not yet been paid back to the Company and on which Greenland was paying interest. (*Id*.). Through the maturity of the Loan in November 2021, Greenland was expected to pay approximately $9 million in interest on the Loan (*i.e.*, monies accumulating in the pledge account). (*Id.* 21).

Meanwhile, A&J was concerned that money was accumulating sufficiently quickly in the Pledge Account that it might soon reach the $100 million principal amount of the loan, which could cause the Members' investments to no longer be considered "at risk" for EB-5 purposes. (*Id.* 19). Greenland proposed a prepayment option that would achieve the result each were seeking, which was to prepay the Loan to the Company and redeploy the funds to another Greenland project.[10] (*Id*.).

Ultimately, Greenland and A&J agreed upon a prepayment plan. (PTO 19). The terms of the prepayment plan included a prepayment fee of $1 million, representing 1% of the total loan from the Company, $200,000 of which would go to the Company and increase the equity value of the investors'

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[10] The trial court's finding that Greenland proposed the prepayment is supported by the record. (PTO 19-20 and n.79-81). Krug nevertheless continues to insinuate, without basis, that A&J actually proposed the prepayment. (OB 9).

interests, and $800,000 of which would go to A&J to partially make up for fees it would lose as a result of the prepayment of the Loan –approximately $1.6 million– as well as past and future unanticipated work related to negotiations related to amending loan documents and other related work. (*Id*. 20-21). Importantly, the $1 million proposed prepayment fee would be paid exclusively by Greenland, not by the Company or the Members. (*Id*.).

A&J presented the proposed prepayment plan, including the prepayment fee, to the Members for approval, and issued a Prepayment Notice and Ballot in connection therewith. (*Id*.). The Notice listed some of the reasons for A&J's request that the Members approve a payment of $800,000 from the prepayment fee to A&J in connection with the plan, "including, without limitation":

- Continued oversight of the Company and investment management during the interim period between repayment of the loan; and
- Identifying opportunities for redeployment of capital.

(*Id*. 22). Because prepayment was not contemplated by the operative documents, there were no provisions for payment of the Class B Manager during the period between prepayment of the Loan and full redeployment of the capital. (*See* A67-83, A84-119). A&J believed these factors warranted a request to the Members to approve the $800,000 fee to A&J. (PTO 21).

A&J was also concerned about how quickly it would be able to obtain the necessary majority of votes for approval, given the Members were all Chinese residents. (*Id.* 22). The Operating Agreement is silent on the issue of how votes should be counted. (A84-119). Accordingly, A&J structured the vote so that abstentions should be counted as votes in favor of the prepayment plan. (PTO 22-23). The Members ultimately voted down the prepayment plan, so neither the plan nor the proposed fee occurred. (*Id*. 23).

The Purported Termination of A&J

On March 14, 2018, A&J received a letter purporting to give A&J notice—after the fact—that A&J had been "terminated" as the Class B Manager for the Company, and that Krug had been appointed as

the Interim Class B Manager (the "Removal Notice"). (PTO 27). The Removal Notice asserted that "[a] majority of [the Company's] Class B Members have, in writing, voted to remove A&J Capital Investment, Inc. as the Class B Manager." (*Id*.). The Removal Notice did not identify a basis for removal. (*Id*.). Prior to receiving the Removal Notice, neither A&J nor the Company had received any notice of any alleged default, or of the intent to hold a vote by the Members to remove A&J. (B252-53).

In addition, no basis for termination of A&J was provided by the Members who allegedly voted to terminate A&J, either in the "Notice to Class B Members and Request for Vote" or in the "Notice of Election" (collectively, the "Ballot(s)") (PTO 26).

Krug did not present evidence at trial respecting what was communicated to the Members who voted. The Ballot was the only consistent communication made to the Members who allegedly voted for removal, but it did not state any basis for removal.[11] (*Id*.). Additionally, Krug did not communicate directly with the Members; instead all communications were through an intermediary, Liming Wang, who did not appear at trial.[12] (*Id*. 27 & n.114). The two Members who did appear at trial testified that Wang did not provide any reasons for removal of A&J and that they did not remember whether they forwarded the Ballot to other Members or discussed bases for removal with other Members. (PTO 30-31 n.125).

<u>This Action</u>

A&J filed its Verified Complaint for Injunctive Relief pursuant to Sections 18-110 and 18-111 of the Delaware Limited Liability Company Act on April 3, 2018, seeking a declaration that A&J was not

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[11] Krug suggests (for the first time on this appeal) that the evidence shows –and that A&J concedes– that the Members discussed the $800,000 Prepayment Fee in a series of "chat room" messages prior to the removal vote. In addition to coming too late, this is a mischaracterization of the evidence: on their faces, the messages discuss the Loan principal, not the Prepayment Fee. (*E.g.*, "[A&J] is fixed on getting that **$100 million**!" (OB 13 (citing A437 ¶21) (emphasis added)); "[A&J] is… so determined to… rob us blind of **our principal**" (*id*. (citing A436 ¶ 19))).

[12] During discovery there had been a suggestion that even Wang did not communicate with all the voting Members; however, Wang did not appear at trial to clarify this issue. (PTO 27 n.114).

properly removed as Manager of the Company. (A406-431). A&J also filed a Motion for Expedited Proceedings and a Motion for Order to Maintain Status Quo. (PTO 28). A status quo Order was entered by the court below on May 9, 2018, providing, *inter alia*, that A&J would continue acting as Manager during the pendency of the litigation. (*Id*.). On May 2, 2018, Krug filed his Answer and Counterclaims.

The Court of Chancery's Summary Judgment Opinion

On May 3, 2018, A&J moved for summary judgment, arguing that removal for cause requires certain procedural due process, including notice and an opportunity to be heard—even if not specified in the governing documents—based on sixty years of Delaware corporate common law precedent. (B23-26).

It is undisputed that the Operating and Management Agreements permitted removal of the Manager only for cause as defined therein. It is further undisputed that Krug and the Members who voted for removal did not give A&J advance notice of its purported removal or the opportunity to respond to the charges against it. Indeed, it is undisputed that Krug did not even purport to give A&J notice of what those charges were until well after the purported removal. Finally, Krug conceded that, if a corporate charter contained the identical removal-for-cause provisions that are contained in the Agreements, he would have been required to give A&J notice and an opportunity to respond as provided in the cases identified above. (B167-70).

Notwithstanding, the court below denied A&J's motion by Letter Opinion dated July 18, 2018, finding that corporate law does not apply in the alternative entity context in this particular case.[13] Invoking the LLC Act's policy of freedom of contract, the court below held that it would not imply terms such as a notice requirement for removal in the absence of an express term. (SJO 10-13).

[13] The Letter Opinion ("SJO") is attached hereto as Exhibit 1.

The court additionally stated that it is only appropriate to analogize to corporate law in the alternative entity context when the parties embrace corporate elements in their operating agreement. (*Id.* 13). It found that the Company here is expressly "uncorporate" in its structure, based on management by a single managing member rather than by a board of directors, and members having the right to approve or disapprove several operational decisions. (SJO 17-18).

While not in the court's summary judgment decision, the transcript of the argument reflects its view that a more appropriate analogy than corporate law in this context is employment/wrongful termination law. (B191, B233-34). At Krug's urging, the court relied on *Davenport Group MG, L.P. v. Strategic Inv. Ptnrs., Inc.*, 685 A.2d 715 (Del. Ch. 1996), which did not require notice and permitted the use of "after-acquired" evidence to bolster initial causes for removal. Nevertheless, the court stated that Krug would have to show at trial that the Members voted for removal for a reason and what that reason was. (B156; B191-92; B220-21; B233-34).

The Court further ruled that, if Krug wanted to keep the trial date, the depositions of certain Members should proceed so that A&J could inquire into the reasons that they voted to remove A&J as Manager. (B229-33).

The Court of Chancery's Post-Trial Opinion

The Court of Chancery held a two-day trial on August 6-7, 2018, during which it received over 400 trial exhibits and heard live testimony from six witnesses. The court issued its post-trial opinion on January 29, 2019, ruling "from the preponderance of the evidence that the [M]embers removed A&J without cause and then formulated after-the-fact explanations for removal that are neither credible nor adequate

under the operative agreements to justify their actions." (PTO 2). A Final Order and Judgment was entered in A&J's favor on February 8, 2019. (OB Ex. B).[14]

In reaching its conclusion, the trial court first determined that it did not need to reach certain issues. "A&J presented the testimony of a document authentication expert to raise questions regarding the authenticity of several of the Removal Ballots, some of which, on their face, appeared either to be altered or to contain signatures copied and pasted from other documents." (PTO 27 n.115). The court ruled that it "need not go down that craggy path to resolve this dispute," because "[i]f Krug cannot establish that cause for removal existed, including whether Members knew the cause for removal at the time they cast their votes, then the process by which removal occurred, and the question of whether the Ballots are authentic and valid, are irrelevant." (PTO 31-32).[15]

In framing the discussion of whether there was cause to remove A&J, the court referred back to its discussion of *Davenport* and after-acquired evidence during the summary judgment argument:

> At the conclusion of oral argument on A&J's motion for summary judgment, I explained that while Krug could supplement his for-cause basis for removal with additional evidence or causes for termination discovered after removal, he still was obliged to demonstrate that A&J had engaged in conduct, or failed to engage in conduct, at the time of removal that would satisfy the standards for removal as laid out in the operative agreements. … Stated differently, Krug cannot justify removal by searching for grounds after-the-fact. In *Davenport Group MG, L.P. v. Strategic Investment Partners, Inc.*, then-Vice Chancellor Steele held that post-termination evidence of cause for removal is not *per se* irrelevant in an action challenging the removal of a general partner. *Davenport*, 685 A.2d 715, 723 (Del. Ch. Jan. 23, 1996). ***Drawing from principles that have***

[14] The Final Order and Judgment included an award of costs to A&J as the prevailing party. (OB Ex. B ¶3). A&J subsequently submitted a Bill of Costs, which was granted by the court below. (B355-56). After Krug failed to pay the costs within the time provided, the Court entered the award as a separate judgment against Krug, which was transferred to the Prothonotary's Judgments Office. (B359-63). To date, Krug still has not paid the costs, and collection efforts are underway in California.

[15] To the extent that this Court reverses the trial court's Final Order and Judgment, this case should be remanded for the trial court to address these and other issues.

> ***emerged in our employment law in the context of wrongful termination, the court noted that an employer is not barred from introducing evidence it discovers post-termination when defending a claim of wrongful termination.*** *Id*. ***These cases do not hold, however, that the employer may escape liability for wrongful termination (in a for cause termination case) even though it did not possess cause at the time of termination and instead relies only upon after-acquired evidence to justify its actions.*** *…*

(PTO 31-32) (emphasis added).

As for the two Members who were deposed and ultimately testified at trial about their purported reasons for voting to remove A&J, the trial court found that "[n]either … proved to be credible trial witnesses, as revealed in their demeanor and the substance of their testimony," and that their testimony "fell far short of filling the[] information gaps" about "what, if anything, the Members were told about the bases for removal or even whether the Members were asked to remove A&J for cause." (*Id.* 24, 30).

The trial court held that the standards for removal set forth in the Operating and Management Agreements ("gross negligence, intentional misconduct, fraud or deceit") have their common-law meanings, including the required element of harm associated with each standard. (*Id.* 33-36).

Of the 35+ purported bases for removal identified by Krug in discovery, he went to trial on two of them:

- A&J's request for the prepayment fee as part of the prepayment of the loan coupled with the manner by which A&J structured the vote for approval of the prepayment plan (by stating that abstention would be deemed as approval) – which Krug repeatedly characterized at trial as "attempted theft"; and

- Payments authorized by A&J and made to Henry Global.

(*Id.* 36-37).

In connection with the claims relating to the proposed prepayment fee, the court rejected the "attempted theft" characterization as "litigation hyperbole" (*id.* 37-38) and found that "none of [A&J's] actions, whether considered independently or in total, provided cause for removal." (*Id.* 37-38). The court found that all material facts regarding the proposed prepayment plan and fee had been disclosed, including the voting structure, and that there was no evidence of harm or intent to harm or deceive the Members. (*Id.* 37-44).

In connection with the claims relating to the payments to Henry Global, the court found that "Krug did not prove that the payments to Henry Global were unauthorized, prohibitively excessive or improperly hidden from the Members. Nor did he prove that the payments diminished the Members' expected investment returns." (*Id.* 52).

The trial court's ultimate holding in this case can be summed up as the uncontroversial proposition that a for-cause removal must actually be "for cause":

> [T]he "for cause" removal provision was a protection for which A&J bargained and gave consideration. "For cause" removal provisions are not aspirational, nor do they allow the principal to remove the agent on a whimsy and then manufacture "cause" after-the-fact to justify the removal. Nevertheless, the majority of the members of [the Company], … guided by Krug, apparently viewed their removal rights differently. … I am satisfied from the preponderance of the evidence that these members removed A&J without cause and then formulated after-the-fact explanations for removal that are neither credible nor adequate under the operative agreements to justify their actions.

(*Id.* 2).

<u>This Appeal</u>

Krug initiated this appeal *pro se* on March 6, 2019. (B344-45). On the same day, Krug's trial counsel filed a Motion to Withdraw as Counsel, explaining that they were "unable" to continue to represent Krug on an appeal of this matter. (B348 ¶3; B352 ¶3). Krug filed a Notice of Amended Appeal

on March 22, 2019 (B357-58). After an exchange of letters, this Court permitted Krug to "continue to proceed *pro se* on appeal, subject to [A&J]'s right to raise the issue on appeal in its answering/opening brief." (B364). Krug's counsel in this appeal entered its appearance on May 13, 2019, the same day his Opening Brief was due.

A&J filed a Notice of Cross-Appeal on March 20, 2019.

ARGUMENT

A&J's Answering Argument on Appeal

I. KRUG'S ARGUMENT REGARDING THE BURDEN OF PROOF WAS NOT PRESERVED FOR APPEAL, AND IS IN ANY EVENT MERITLESS

A. Question Presented

Whether (i) Krug waived any argument that the trial court erred by placing the burden of proof on Krug, and (ii) the trial court properly placed the burden of proof on Krug. (Point (i) was not raised below. Point (ii) preserved at A785-86).

B. Scope of Review and Legal Standard

Where a question presented in an appeal was not preserved below, the trial court's decision may only be disturbed upon a finding of plain error. *Realty Enters., LLC v. Patterson-Woods & Assocs., LLC*, 11 A.3d 228 (Del. 2010) (TABLE).

C. Merits of Argument

1. Krug Waived Any Argument Regarding the Burden of Proof

Krug's leading argument on this appeal is one that he never made previously: that the trial court erred by requiring Krug to demonstrate by a preponderance of the evidence that cause existed to remove A&J as Manager. Krug asserts that this argument was preserved, citing to page A884 of his appendix. (OB 20). Not so. Krug's record citation is to a passage from his Answering Post-Trial Brief, which reads in its entirety as follows:

> A&J cannot carry its burden to rebut the presumption of validity that attaches to the Ballots bearing the signatures of Members of record. The Court should reject A&J's efforts to shift this burden to Krug.

Thus, the argument that Krug made below regarding the burden of proof pertained to A&J's arguments regarding the authenticity and admissibility of the removal ballots—an issue that the trial court did not reach and that is not before the Court on this appeal.

Accordingly, as a threshold matter, Krug waived his this argument by not raising it below. Under Supreme Court Rule 8, "Only questions fairly presented to the trial court may be presented for review." *See Russell v. State*, 5 A.3d 622, 627 (Del. 2010). Arguments concerning the burden of proof are subject to Rule 8. *Johnson v. Braxton*, 577 A.2d 753 (Del. 1990) (TABLE).

"In a commercial dispute like this that does not involve fundamental rights, like child custody or a criminal defendant's liberty, the interests of justice would be disserved, not furthered, by allowing [Appellant] to raise this issue for the first time on appeal." *RockTenn CP, LLC v. BE & K Engineering Co.*, LLC, 103 A.3d 512, 512 (Del. 2014).

Krug was aware at least as of the summary judgment hearing that the Vice Chancellor believed that Krug would "have to demonstrate now why [the Members] removed [A&J]." (B167-70). Krug never sought clarification as to which party ultimately bore the burden to prove the existence of cause for removal. Moreover, Krug himself recognized that he had the burden of proof in his post-trial briefing, where he asserted that he "***has proven*** that requisite cause existed to remove A&J as the … Manager." (A891).

Krug thus understood that, to prevail at trial, he would have to demonstrate to the Court that cause to remove A&J as Manager existed. Krug never objected to this burden of proof in any of his pre- or post-trial briefs, and therefore such objection is waived.

2. In Any Event, Krug's Argument Regarding the Burden of Proof is Meritless.

Assuming this Court considers the merits of Krug's argument regarding the burden of proof, the Court of Chancery properly placed the burden of proving the reasons for the removal vote—*i.e.*, "cause"—on Krug. This decision is consistent with Delaware law, and there was no plain error. In its Post-Trial Opinion, the trial court explained that Krug "was obliged to demonstrate that A&J had engaged in conduct, or failed to engage in conduct, at the time of removal, that would satisfy the standards for removal as laid out in the operative agreements." (PTO 31-32). In so holding, the court relied in part one of Krug's leading cases, *Davenport*, where the Court of Chancery "***[d]r[e]w[] from principles that have emerged in our employment law in the context of wrongful termination***" in resolving a for-cause removal case in the alternative entity context. (PTO 31-32) (emphasis added) (citing *Davenport*, 685 A.2d at 723).

Following the same analogy, in a wrongful-termination case, the "employer bears the burden of proving by a preponderance of the evidence that the employee was terminated for just cause." *Murphy & Landon, P.A. v. Pernic*, 121 A.3d 1215, 1222 (Del. 2015). Thus, it follows that Krug, as the party seeking to justify the removal of A&J as the incumbent Manager, must bear the burden of proving by a preponderance of the evidence that the removal was justified—here, that such removal was for cause.

The cases cited by Krug are inapposite because none of them address the necessity of proving (after the fact) that a manager of an LLC was removed ***for cause***. For example, in *Ensing v. Ensing*, 2017 WL 880884, *1 (Del. Ch. Mar. 6, 2017), the court found that the plaintiff "carried her burden of proving that [defendant] had no authority to remove [plaintiff] as manager" of the two Delaware LLCs at issue. But for-cause removal was not at issue in *Ensing* because the relevant removal provision provided that the manager of the company could be "removed at any time, ***with or without cause***, but only by the written consent of a Majority-in-Interest of the Members." 2017 WL 880884, at *10 (emphasis added). Rather, the dispositive issue was whether a majority of the members had in fact consented to the removal of the plaintiff as the manager.

Similarly, *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991) and *Gassis v. Corkey*, 2014 WL 2200319 (Del. Ch. May 28, 2014), each involved a challenge to the removal of directors of Delaware nonstock corporations, based on the validity of a previous election rather than whether the director had been properly removed for cause. *See Gassis*, 2014 WL 2200319, at *13 (emphasis added) ("As an elected director, Section 3.06 permits Bishop Gassis's removal ***with or without cause***.").

Accordingly, the cases cited by Krug do not stand for the proposition that a declaratory judgment plaintiff challenging its removal "for cause" as a manager of a Delaware LLC has the burden of establishing the non-existence of cause.

As a practical matter, the burden of proving that cause for removal existed could ***only*** have rested with Krug. As the Court of Chancery observed: "'For cause' removal provisions are not aspirational ….." (PTO at 2). A holding that A&J bore the burden of proving that no cause existed for its removal would indeed make the provision for which it bargained aspirational, which would effectively give the Members the right to remove A&J at will.

Finally, to the extent that the Court of Chancery (plainly) erred in requiring Krug to prove that cause for removal existed, such error was harmless, because the court also concluded that it was "satisfied from the preponderance of the evidence that these members removed A&J without cause and then formulated after-the-fact explanations for removal that are neither credible nor adequate under the operative agreements to justify their actions." (PTO 2). In other words, even if the burden had been placed on A&J to show that no cause existed, it satisfied that burden by a preponderance of the evidence.

II. THE TRIAL COURT CORRECTLY APPLIED THE STANDARDS FOR REMOVAL IN THE AGREEMENTS.

A. Question Presented

Whether the Court of Chancery correctly applied the standards for removal by requiring a showing that (i) A&J caused or intended to cause harm to the Company or the Members, and (ii) the Members knew the causes for removal at the time they cast their votes. (Preserved at (i) A789-96, A799-800, B305-06; and (ii) A785-88, B288-91, B305-11.)

B. Scope and Standard of Review

Whether the trial court correctly interpreted and applied the standards under the applicable agreements for the Members' removal of A&J is a question of law subject to *de novo* review. *Salamone v. Gorman*, 106 A.3d 354, 367-68 (Del. 2014).

C. Merits of Argument

1. The Court of Chancery Correctly Found That Harm is a Required Element of the Removal Standards

The plain language of the Operating and Management Agreements provides that the Class B Manager may only be removed for cause, defined as "gross negligence, intentional misconduct, fraud or deceit." (A97 §5.3(c)(ii); A76 §12(b)).[16] These are not defined terms under the Operating Agreement or the Management Agreement. The trial court was thus obligated to interpret and apply the contractual standards for removal according to their ordinary meanings. *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 16 A.2d 1192, 1195-96 (Del. 1992).

[16] The Management Agreement sets forth the same standards for removal for cause. (*See* A76 §12(b)).

The Court of Chancery properly applied the common-law meanings of the standards for removal under the Agreements—"gross negligence, intentional misconduct, fraud or deceit"—holding that all of them have a requisite element of harm (PTO 35), and found that the preponderance of the evidence did not support Krug's claim that A&J was removed for cause. (PTO 32).

Krug challenges this holding on the grounds that the Agreements do not expressly state that harm or an intent to harm is required. (OB 24-26). According to Krug, these standards for removal are standards of conduct that do not require any harm to warrant removal. (*Id.* 24, 27).

The trial court considered this argument below and correctly rejected it. Among other things, the trial court noted that Krug's position is inconsistent with the language of the Agreements themselves: "[T]he operative agreements do not state that the Class B Manager may be removed for grossly negligent or fraudulent ***conduct***; they state, instead, that removal will be justified, among other reasons, for 'gross negligence' or 'fraud.'" (*Id.*) (emphasis in original).

As the trial court further explained, concepts of harm are fundamentally embedded in the standards for removal set forth in the Operating Agreement:

> [T]he contractually imposed standards of conduct ***necessarily incorporate an appreciation that the proscribed conduct must either be harmful or cause harm to justify removal***. If there is no risk of harm to the Company as a result of the Manager's actions, then there can be no deviation from the standards of care or conduct contemplated by the definitions of gross negligence, intentional misconduct, fraud or deceit.

(*Id.*) (emphasis added). In so holding, the court cited *Ramsey v. Georgia Southern University Advanced Development Center*, 189 A.3d 1255 (Del. 2018), a recent decision of this Court which the trial court described as "holding that Delaware negligence law incorporates the notion of a foreseeable risk of harm directly into the determination of whether a defendant owed a duty (as a matter of law) to the plaintiff" (PTO 37 n.138). Krug criticizes the court below for citing a case addressing the ***ultimate liability*** of an

alleged tortfeasor, arguing that "[o]f course, harm is a required element of proving liability in a plenary tort claim but that is a far cry from the trial court's proposition that harm is a required precondition to remove A&J as the …Manager." (OB 29). Krug does not elaborate further on this distinction, begging the question of what the standards for removal really mean if no element of harm is required.

Additionally, the trial court observed that Krug "does not appear to disagree that the parties likely incorporated the elements of the standards as commonly known in our law." (PTO 36 & n.139) (citing admissions by Krug). The Court of Chancery recited the common law elements of the removal standards under Delaware law—all of which require harm/damage. (*Id.* 32-35).

Despite having made no argument against the use of the common law definitions of the standards for removal below, Krug now argues (for the first time) that the trial court should have applied the definition of gross negligence used in corporate law and analyzed whether A&J breached its duty of care. (OB 30-32). Putting aside the irony in Krug advocating reliance on analogous corporate law after opposing such reliance on summary judgment, and also putting aside that A&J owed no fiduciary duty (A100 §5.6), Krug fails to explain how applying corporate law concepts of gross negligence as a standard for removal would have yielded a different result.

As Krug states, "The duty of care requires that directors 'inform themselves, prior to making a decision, of all material information reasonably available to them." *In re Synutra Int'l, Inc. S'holder Litig.*, 2018 WL 705702, *5 (Del. Ch. Feb. 2, 2018) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1983)). Krug makes no argument, however, that A&J failed to inform itself of all material information reasonably available to it in connection with any matter at issue. Likewise, Krug identifies the "due care factors" as a "loose, sloppy deal process that strays far from what is standard and expected of an informed, well-functioning board." (OB 31 (citing *Dawson v. Pittco Capital Partners, L.P.*, 2012 WL 1564805 (Del. Ch. Apr. 30, 2012)). But Krug points to no evidence of a "loose, sloppy deal process"—nor does he even explain to

what deal process he might be referring. He also fails to explain how A&J's conduct "strays far from what is standard and expected of an informed, well-functioning board."

Thus, the state of play is the same now as it was after trial: "Krug has not cited any case in support his construction of the contractual removal standards that would justify divorcing the proscribed conduct from anticipated or actual harm caused by the conduct." (PTO 36). Krug's reliance on *R&R Capital, LLC v. Merritt*, 2009 WL 2937101 (Del. Ch. Sept. 3, 2009) is misplaced. There, the Court of Chancery confirmed the validity of the plaintiffs' removal of the manager of nine affiliated Delaware LLCs of which plaintiffs were members based on a fraud perpetrated by the manager on the **members**. The manager had argued that she should not be removed for cause unless the fraud had caused harm to the **companies**. (*Id*. at *4). The Court of Chancery disagreed, based on its construction of the operating agreements at issue. (*Id*. at *4-5). Thus, *R&R Capital* does not support a general proposition of separating "standards of conduct," as Krug would have it, from actual harm to the Company or its Members.

Krug's reliance on *Venhill Limited Partnership v. Hillman*, 2008 WL 2270488 (Del. Ch. Jun. 3, 2008) is misplaced and ironic. The case has nothing to do with the standards for removal of a manager (or general partner), because the general partner in that case had already been removed. Moreover, in arguing that harm should not be required to prove violation of a standard of conduct for removal, Krug is relying on a case in which the court found the removed general partner's actions caused harm, rendering him liable for damages. Specifically, the court found that the general partner had engaged in willful misconduct and acted in bad faith and with gross negligence when he "irrationally pursued his own agenda by imprudently investing tens of millions of dollars in an insolvent company with no rational plan for future success." *Id.* at *3. The Court observed that "it is obvious that [the general partner] acted in a grossly negligent manner. His decisions did not involve any rational consideration of the relevant factors." *Id.* at *30. Krug asserts, with no evidence or explanation: "A&J's conduct similarly was grossly negligent under

these standards and need not have risen to the type of conduct described by the trial court." (OB 33). The Court should reject this conclusory assertion made with no citation to any record evidence.

To the extent that the trial court erred in finding harm to be a requisite element of any of the standards for removal, however, such error was harmless, because the existence or non-existence of harm was not pivotal to the court's ultimate holdings. As the court stated: "[E]ven if harm (foreseeable or actual) were divorced from the contractual standards as Krug would have it, as explained below, the preponderance of the evidence does not support the contention that A&J violated any of the standards of conduct in connection with any of the alleged grounds for removal." (PTO 36).

Finally, the Court should reject Krug's half-hearted policy argument (made for the first time on appeal) that "it would be a mistake to require that the standards for removing managers of limited liability companies rise to a level of actually proving damages." Krug provides no explanation why it would be a mistake for courts to enforce removal-for-cause provisions contained in limited liability company agreements—or the common law definitions of the terms contained therein—as written. On the contrary, it would be a greater mistake for courts to allow members of LLCs to claim "cause" without having to satisfy any standards whatsoever. Interpreting the removal-for-cause provisions as Krug suggests would open the door to mischief by members of LLCs, who would be allowed to disrupt the settled expectations of managers and non-voting members of Delaware LLCs and inflict unnecessary costs on Delaware entities and courts by effecting a removal for "cause" based on nothing more than certain members' (or their sponsors') unhappiness with the decisions of the managers. As the Court of Chancery held: "the 'for cause' removal provision was a protection for which A&J bargained and gave consideration," and was "not aspirational." (PTO 2).

2. The Court of Chancery Correctly Concluded That the Members Were Required to Know the Purported Cause for Removal at the Time They Voted

Krug argues that the trial court erred by requiring Krug to prove that the Members had knowledge of cause for A&J's removal at the time they cast their votes. (OB 41). According to Krug, it suffices if cause existed at the time of removal, even if there is no evidence that all the voting Members knew what it was.

Krug first argues that the removal provisions in the Agreements "do not specifically provide" that the Members must have known of cause at the time they cast votes for removal. (*Id.*). This would, of course, render the "for cause" removal requirement illusory.

Krug further argues that, under *Davenport*, he may rely exclusively on "after-acquired" evidence to justify A&J's removal. (OB 41-42). (OB 41). The trial court disagreed, holding that Krug "cannot justify removal by searching for grounds after-the-fact." (PTO 32 n.128). In *Davenport*, as the trial court explained, "the court noted that an employer is not barred from ***introducing evidence*** it discovers post-termination when defending a claim of wrongful termination." (*Id.*) The court further explained, "These cases do not hold, however, that an employer may escape liability for wrongful termination (in a for cause termination case) even though it did not possess cause at the time of termination and instead relies only upon after-acquired evidence to justify its actions." (*Id.*) Nor do the cases cited by Krug support the conclusion that, as a matter of Delaware law, a "good faith basis alone is enough to justify a for cause removal." (*Id.*) If "a good faith basis" is truly the standard for establishing cause in a "for cause" removal, as Krug would have it, then removal "for cause" provisions are ultimately meaningless. The trial court recognized the ultimate absurdity of Krug's position:

> [A] holding that would allow removal for any reason unearthed after the fact of removal would circumvent the for-cause contractual predicate for which A&J bargained. And it would deny the Members of the ***opportunity meaningfully to participate in the removal process*** because, by definition, their removal votes would not have been informed by the after-acquired evidence.

(PTO 32 n.128) (emphasis added). Krug makes no argument addressing the trial court's reasoning. This Court should adopt the trial court's interpretation of *Davenport* and find that after-acquired evidence of cause, without more, is not enough to support removal for cause.

Finally, as with so many other issues on this appeal, even if the trial court erred in its interpretation of *Davenport*, such error was harmless, because Krug cannot point to any matter discovered after the removal vote that would have constituted cause for removal, or to any matter that the trial court disregarded on the basis that it occurred after the removal. Both the prepayment proposal and the payments to Henry Global were matters that occurred and were disclosed to the Members prior to the removal vote.

3. The Court of Chancery Correctly Determined That Neither the Prepayment Proposal Nor the Payments to Henry Global Gave Rise to Cause to Remove A&J

Turning to the matters that Krug contends gave rise to cause for removal, as the trial court found: "Krug does not clearly tie these events to any one or more of the particular standards for removal as stated in the operative agreements but rather contends in general terms that the identified conduct violates all of the standards." (PTO 36-37). That remains the case on this appeal. Krug's arguments about (a) the prepayment proposal and (b) the payments to Henry Global are addressed below.

a. The Prepayment Proposal Did Not Constitute Cause for Removal

Krug's position that cause existed to remove A&J is largely based on the idea that A&J engaged in wrongdoing by requesting the Members' consent to a prepayment proposal with Greenland, pursuant to which Greenland would prepay the outstanding construction loan to the Company, together with a $1 million prepayment fee, which would be allocated as $800,000 to A&J as Manager and $200,000 as additional equity to the Company. In considering Krug's contentions, the Court should keep in mind these three salient points: that (1) the proposed fee was to be ***paid by Greenland***, (2) the proposed fee was

contained in a ***request for the Members' approval*** of the prepayment plan, and (3) the prepayment plan was rejected by the Members and thus ***the fee was never paid***.

(i) Krug Did not Engage in Gross Negligence or Bad Faith by Requesting a Prepayment Fee from a Third Party

According to Krug, "A&J's self-interested attempt to obtain for itself the majority of a prepayment fee to be paid by the borrower to the Company rises to a level of intentional misconduct, but at a minimum, constitutes gross negligence." (OB 34). Krug makes no effort to tie the request for the prepayment fee to the legal standards for intentional misconduct or gross negligence as defined by Delaware law. Instead, Krug contends that if a prepayment fee was proper, then the Company should have received the entire amount. This is nothing more than a dressed-up version of Krug's absurd claim of "theft" in the court below, which was properly and summarily rejected as "litigation hyperbole." (PTO 37). Although Krug no longer uses the word "theft," he clings to his baseless argument that requesting the Members' approval to receive $800,00 of the prepayment fee demonstrates intent to misappropriate Company funds. (*See* OB 34 ("The $800,000 could have offset the Company's payment of Loan expenses (or increased the Members' return on investment.")). None of Krug's proposed alternative uses for the money changes the fact that the prepayment fee was, as the trial court found, "to come directly from Greenland (who had consented to the fee)," or that A&J had to receive the approval of the Members to receive the prepayment fee in the first place. (PTO 37 n.143).

Krug cites no case law or provision in the applicable agreements establishing that the Company had a ***legal*** entitlement to receive any portion of a fee which would be paid in connection with the prepayment of the Loan. In fact, the initial Loan Documents themselves prohibited prepayment of the Loan. Similarly, Krug's contention that the proposed prepayment fee also risked financial harm to the Company by risking "diversion of Company assets to the Class B Manager" is without merit. (OB 28-29).

Additionally, where prepayment was not contemplated by the applicable agreements, A&J had no duty to agree to the prepayment without compensation and thereby forego the $1.6 million in management fees it expected to receive in the absence of prepayment, particularly where it would be required to provide additional, uncontemplated services in the form of redeploying the capital. (A115 § 11.15 (requiring Manager approval where an amendment to the Operating Agreement increases duties or limits right to reimbursement); *see also Bird v. Lida, Inc.*, 681 A.2d 399, 406 (Del. Ch. 1996) ("[A] corporate officer or director who has made a contract with the corporation that is valid and binding at the time of the contract is under no equitable duty to forego a contracted[-]for return at a future time should changes in market conditions make his contract especially advantageous.").

Krug next argues that A&J's attempt "to obtain a significant payday without disclosing to the Members the real reason for this payment…is gross negligence and intentional misconduct." (OB 34). Again, Krug's argument is stated in general terms, without any attempt to tie the specifics of A&J's alleged misconduct to the elements of the standards of conduct under Delaware law. Krug conflates gross negligence or intentional misconduct with the fiduciary duty of loyalty. It is the duty of ***loyalty***, not care, that prevents a corporate fiduciary from engaging in self-interested transactions, and even then, the bar to self-interested transactions is far from absolute. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), (recognizing that company insiders breach no duty by requesting that the equity owners approve a transaction in which the insider has an interest, so long as the interest is disclosed). Although Krug complains at length about the disclosures in the Prepayment Notice and Ballot, he does not (because he cannot) dispute that the Prepayment Notice stated that A&J would receive $800,000 from Greenland if the Members approved the prepayment fee.

Krug also ignores that the Operating Agreement itself permits transactions between the Company and the Manager. (A102-03 §5.12). Likewise, the Management Agreement permits A&J to request an increase in its compensation for managing the Company. (A72 §6(a)) ("The Management Fee shall from

time to time be reviewed and ***modified as may be mutually agreed upon*** by the Company and the Class B Members.") (emphasis added).

Krug further argues that the form of the prepayment proposal put the Members at risk of harm. Krug claims that linking the prepayment proposal to the prepayment fee jeopardized the immigration status of the Members by "forcing the Members to accept or reject a fix that was tied to a hot button issue (paying $800,000 to A&J for little to no consideration)." (OB 28). But Krug cites no evidence to support this claim. Moreover, had the Members so desired, they could have requested a vote on the prepayment plan without a prepayment fee attached. (PTO 43). That the Members ultimately voted down the plan—apparently without any adverse immigration consequences—demonstrates that the Members were never forced to do anything.

Finally, Krug argues, for the first time on this appeal and without any evidentiary support, that "A&J's behavior eroded the trust of a majority of the Members." (OB 29). Even if the Court considers this argument, there is no Delaware law supporting the proposition that "eroded trust" with the Members is a "risk of harm" warranting removal for cause.

(ii) The Prepayment Notice Was Not Misleading or Deceitful

Krug also resurrects his baseless claim that the Prepayment Notice was "deceitful because it inaccurately stated that the $800,000 prepayment fee to be received by A&J 'shall be payable' as compensation 'for services rendered in connection with the Prepayment.'" Krug construes the "shall be payable" language as "indicating [that] the fee was required." (OB 35). But, as noted in A&J's post-trial briefs, this is a facially absurd construction of the Prepayment Notice. (B298). On its face, the Notice is titled "Notice to Class B Members and ***Request*** for Consent to Prepayment," and it states that the purpose of the Notice is to inform the Members that Greenland requested permission from the Company to prepay the outstanding amount on the Loan and to "***request*** that the Class B Members consent to and authorize

the Company to agree to the Prepayment and enter into the Fourth Loan Amendment." (A240) (emphasis added). As A&J explained previously, the "shall be payable" language simply describes what will occur between Greenland, the Company, and A&J in the event the Members consent to the prepayment proposal. (B299). Krug's argument that "A&J never requested an increase in compensation from the Members" because it "simply informed the Members that $800,000 was required to be paid to it for the prepayment" is simply wrong. (OB 35 n.6).

Krug also appears to contend that the disclosures in the Prepayment Notice and Ballot were misleading because they did not disclose that the reason for the prepayment was to "recoup revenue it would lose from the prepayment." (OB 35). The Prepayment Notice, however, expressly disclosed that, among the reasons for the prepayment were to compensate A&J for "[c]ontinued oversight of the Company and investment management during the interim period between repayment of the loan"–during which time A&J would not otherwise be compensated–and "[i]dentifying opportunities for redeployment of capital." (PTO 22).

Nor, as the Court of Chancery recognized, do the eight justifications for the prepayment fee set forth in the Prepayment Notice and Ballot constitute fraud or deceit, let alone gross negligence or intentional misconduct. Krug claims that the justifications for the fee set forth in the Prepayment Notice were "misleading because (i) A&J already was obligated to perform certain services, even if related to prepayment and (ii) certain of the services already were performed and/or were unrelated to prepayment." (OB 36). But the court below properly found that "an intent to deceive or harm cannot be drawn directly from the trial record because there is no evidence of either (despite extensive discovery)." (PTO 40). The court also rejected Krug's claim that the court could infer deceit from the descriptions of the reasons for the prepayment fee in the Prepayment Notice:

> [T]he inference of ***deceit*** or intent to harm cannot be drawn circumstantially when it is clear that A&J unabashedly disclosed the

> reasons for the prepayment, the fact that it was seeking a prepayment fee and the reasons why it believed the fee was justified, and then made clear that it was up to the Members to decide whether to approve the prepayment proposal. The fact…that the Members ultimately voted to reject the prepayment proposal, further undermines the contention that A&J ***acted to deceive*** or harm the Members.

(PTO 40) (emphasis added).

Nor, as Krug argues, do the disclosures in the Prepayment Notice support an inference of "intentional misconduct or a reckless indifference to the Members' interests, i.e., grossly negligent." (OB 38). Krug also argues (as he did below) that the disclosures in the Prepayment Notice were misleading because most of the listed services in the Prepayment Notice were not associated with the prepayment proposal. (OB 38). But Krug testified at trial that it was "obvious" that most of the listed services were not associated with the negotiation of the prepayment. (A973-74, A977). Accordingly, the disclosures could not have misled anyone. (PTO 42). *E.g.*, *Berger v. Cushman & Wakefield of Pa., Inc.*, 2014 WL 2892408, *7 (E.D. Pa. Jun. 26, 2014) (stating that a party is unjustified in its reliance if it "knows [the representation is] false or if its falsity is obvious.") (citation omitted).

Furthermore, at trial, Class B Member Zhu Wang did not deny that she had enough information to cast a vote by the time she voted to deny the request for prepayment. (*See* B258). That is all that is required under the law. *Weingarden v. Meenan Oil Co.,* 1985 WL 44705, *2 (Del. Ch. Jan. 2, 1985) ("[T]he settled standard is whether there has been full and complete disclosure of all facts which a reasonable stockholder would consider important in deciding how to vote.") (citing *Lynch v. Vickers Energy Corp.,* 383 A.2d 278 (Del. 1977)).

Krug failed to prove at trial that the Prepayment Notice misled the Members. Accordingly, this Court should affirm the trial court's decision.

b. The Payments to Henry Global Did Not Constitute Cause for Removal

Krug argues that A&J "failed to demonstrate that its payment of millions of dollars from the Company to its familial partner, Henry Global, was not gross negligence or intentional misconduct warranting removal." (OB 39). Ignoring Krug's mischaracterization of who had the burden of proof, the trial court properly found that the payments to Henry Global did not provide cause for removal under the Agreements. The trial court first observed: "There can be no question that A&J was authorized to pay Henry Global for its services." (PTO 46). Section 5.3(d)(ii)(10) of the Operating Agreement authorizes the Class B Manager to "[e]nter into any agreement which the Managers may reasonably deem appropriate for any purpose beneficial to the Company…." (A98 §5.3.(d)(ii)(10)). The court found that "Krug has not pointed to any evidence suggesting that A&J considered the payments to Henry Global to be unreasonable and yet continued to make them. To the contrary, the ***credible*** evidence reveals that the payments to Henry Global are reasonable and that A&J believed them to be so." (PTO 46) (emphasis added). Krug cites no additional evidence and makes no argument which would justify overturning the trial court's findings of fact or law.

In a single sentence, Krug also repeats his argument below that "the Distributor Services Agreement violated the PPM by requiring the Company to pay Henry Global using the Members' investment income rather than the Administration Fee." (OB 39). The trial court correctly held that the provisions of the PPM and the Operating Agreement "make clear . . . that Henry Global's fee cannot be paid from the Members' financial contributions to the Company, but the fees can be paid from 'interest income,' i.e., the interest on the loan comprised of the Members' investment in the Company." (PTO 49). The court also correctly found that Krug did not "prove that the payments diminished Members' expected returns." (*Id*. 52).

Krug further argues that that A&J's approval of the Distributor Services Agreement with Henry Global without first seeking the consent of the Members is "inexcusable" and thus supports removal. (OB 39). But, as noted above and as found by the trial court (PTO 46), the Operating Agreement expressly authorizes A&J to enter into agreements which the "Managers may reasonably deem appropriate for any purpose beneficial to the Company." (A98 §5.3(d)(ii)(10)).

Krug's "double-dipping" argument is likewise without merit. Krug questions the trial court's conclusion that A&J was not aware of potential "double-dipping" by Henry Global, without pointing to any evidence in the record that A&J knew that individual Members also entered into separate agreements with Henry Global. (OB 51). Krug suggests that A&J's presumed lack of knowledge about Henry Global's "double dipping" is itself sufficient to establish gross negligence. (*Id.*). Not only is this an entirely new argument on appeal, but Krug never connects the dots to explain why or how A&J should have known of the alleged separate agreements between the Members and Henry Global (which, as the immigration agent, had the primary contact with the Members), nor why it would be wrongful for such separate agreements to exist. The trial court found that "there is no contractual prohibition against Henry Global receiving revenue from multiple sources." (PTO 51).

The trial court also rejected Krug's claim that "A&J intentionally concealed the payments to Henry Global from the Members." (PTO 51). Although Krug complains that A&J "concealed the Distributor Services Agreement from the Members" and "never provided the necessary Mandarin translation of the Financial Statements disclosing the payments to the Members," he does not point to evidence in the record to support reversing the trial court's conclusion here—such as evidence that anyone ever complained about the Financial Statements being in English. (OB 40). His general statement that this is "reckless indifference to the Members" is unsupported by facts or law.

A&J's Argument on Cross-Appeal

I. THE COURT OF CHANCERY ERRONEOUSLY FAILED TO GRANT SUMMARY JUDGEMENT IN A&J'S FAVOR

A. Question Presented

Whether the trial court erred by finding that removal for cause under the Operating and Management Agreements did not require procedural due process. (Preserved at B23-28; B137-145).[17]

B. Scope of Review

The Court's review of the trial court's denial of summary judgment is *de novo*. *Bathla v. 913 Market, LLC*, 200 A.3d 754, 759 (Del. 2018).

C. Merits of Argument

1. Delaware Common Law Requires Observance of Procedural Due Process for For-Cause Removals of Corporate Directors

For over sixty years, Delaware common law has provided that a vote to remove a corporate director for cause may not occur before the director has been given adequate notice of the charges that constitute cause and been afforded an opportunity to be heard.

In *Campbell v. Loew's, Inc.*, 134 A.2d 852 (Del. Ch. 1957), the Court of Chancery, prior to the adoption of Section 141(k) of the Delaware General Corporation Law, held that "it is certainly true that when the shareholders attempt to remove a director for cause, '* * * there must be the service of specific charges, adequate notice and full opportunity of meeting the accusation * * *.'" *Id.* at 859 (citation omitted). The Court further stated that "an opportunity to defend the charges *before the stockholders voted* …. had to be afforded as a matter of law …." *Id.* at 860 (emphasis added). The Court explained the importance of these issues being resolved prior to a vote in practical terms:

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[17] To the extent that the Court affirms the trial court's Final Order and Judgment, it need not reach this question.

> [W]here the procedure adopted to remove a director for cause is invalid on its face, a stockholder can attack such matters before the meeting. This conclusion is dictated both by the desirability of avoiding unnecessary and expensive action and by the importance of settling internal disputes, where reasonably possible, at the earliest moment. Otherwise a director could be removed and his successor could be appointed and participate in important board action before the illegality of the removal was judicially established. This seems undesirable where the illegality is clear on the face of the proceedings.

Id. at 859.

Campbell has withstood the test of time as good law in Delaware. Nearly 30 years later, in *Bossier v. Connell*, 1986 WL 12785 (Del. Ch. Nov. 12, 1986), the Court of Chancery noted that *Campbell* "was decided in 1957 before the statutory amendments which now permit the removal of directors by stockholder consents for cause or without cause," rendering the rule set forth in that case—"that if there is a removal by the stockholders of a director for cause, there must be the giving of specific charges, adequate notice, and full opportunity of meeting the accusation"—"for the most part moot." *Id.* at *6. Nevertheless, the Court was "compel[led]" to follow *Campbell*, "because the purported removal of Mr. Bossier was for cause and defendants do not argue otherwise." *Id.* The Court concluded: "I believe that the ruling in *Campbell v. Loews* is binding on this Court in the present circumstances, and the procedures for removal for cause set forth therein were not followed. I therefore must hold that the purported removal of Mr. Bossier as a director on September 16, 1986 was ineffective and void." Importantly, *Bossier* involved an attempted removal of a director for cause by written consent, like the purported removal here.

More than 15 years later, the Court of Chancery had occasion to revisit this issue in *Superwire.com, Inc. v. Hampton*, 805 A.2d 904 (Del. Ch. 2002), where, relying on *Campbell* and *Bossier*, the court held:

> Directors of Delaware corporations can be removed "for cause" or, where permitted by the governing documents and the law, "without cause." But

> there are additional requirements that must be observed when doing so "for cause." A "for cause" removal of a director requires that the individual be given (i) specific charges for his removal, (ii) adequate notice, and (iii) a full opportunity to meet the accusation. The same is true whether the action is taken at a meeting of stockholders or by written consent.

Id. at 912. The court additionally stated that the procedural safeguards required in connection with "for cause" removals are designed to preserve the equities inherent in removal for cause, which can have significant reputational consequences:

> In many cases, there are substantial collateral affects [sic] of being removed "for cause" that do not attend a removal "without cause." These can include differences in the treatment of rights flowing from contracts or other terms of employment. There are also likely to be significant reputational affects flowing from a "for cause" removal. These consequences alone might justify the conclusion that one choosing to act "for cause" must follow the prescribed procedures.

Id.

Significantly, none of the cases discussed above involved a corporation in which the charter or bylaws only permitted a director to be removed for cause, nor did any of the charters or bylaws specify the procedures that needed to be undertaken for a for-cause removal. Rather, it appears that the governing documents said nothing about removal for cause one way or the other, and the stockholders of the corporations took it upon themselves to remove the respective directors for cause. Thus, *Campbell, Bossier and Superwire.com* stand for a common law rule that the removal of a director for cause requires observance of certain procedural due process even in the absence of express provisions in the corporation's governing documents.

In other words, notice and an opportunity to respond are inherent in the concept of removal for cause in the corporate context.

It is undisputed that the Operating and Management Agreements permitted removal of the Manager only for cause, and that A&J was given no notice of the grounds upon which Krug purported to conduct the removal vote and was never afforded the opportunity to respond to Krug's charges before the vote occurred. Moreover, in the proceedings below, Krug admitted that a corporate charter containing the same removal-for-cause provisions as those here would have required notice and an opportunity to respond.

Thus, the question on this cross-appeal is whether the trial court properly declined to follow Delaware common law precedent for for-cause removals on the grounds that the entity involved is an LLC instead of a corporation. The court below concluded that it should not follow such precedent based on (a) the policy of freedom of contract set forth in the LLC Act, and (b) what it concluded was the "uncorporate" structure of the Company. These issues are addressed below.

2. Delaware's Policy of Freedom of Contract Does Not Mandate a Departure from Common Law Precedent

The trial court concluded that LLCs are "creatures of contract," and therefore, under the policy of freedom of contract set forth in Section 18-1101(b) of the LLC Act, Delaware common law cannot be grafted onto the Agreements, and a manager of an LLC is not entitled to procedural due process in a for-cause removal unless such protections are expressly provided in the operating agreement. (SJO 10-17). Based on a sample of two decisions, the court below further found that non-corporate business entities "typically" will expressly provide for procedural protections from removal when the parties intend for them to apply. (SJO 10-11 & n.23).

In so holding, the Court of Chancery brushed aside pronouncements of both the General Assembly and this Court. Specifically, "the General Assembly in 2013 adopted an amendment to the LLC Act

inconsistent with the purely contractarian view." *In re Carlisle Etcetera LLC,* 114 A.3d 592, 605 (Del. Ch. 2015) (citing H.B. 126, 147th Gen. Assemb. (Del. 2013) (amending 6 *Del. C.* § 18–1104 to provide that "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.")).

Even prior to the 2013 amendment to Section 18-1104, this Court recognized that, under the then-operative version of the statute, "the General Assembly expressly acknowledged in the text of the LLC Act that common law equity principles supplement the Act's express provisions. … [T]his means … that where the General Assembly has not defined a right, remedy, or obligation with respect to an LLC, courts should apply the *common law*." *CML V LLC v. Bax,* 28 A.3d 1037, 1045 (Del. 2011) (citation omitted; emphasis added). Indeed, "[t]he LLC Act is more explicit than the DGCL in making the equitable overlay mandatory." *Auriga Capital Corp. v. Gatz Properties, LLC,* 40 A.3d 839, 849-50 (Del.Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

Removal of a manager for cause is a matter "not provided for in this chapter" within the meaning of Section 18-1104. Thus, this Court should apply Delaware common law in interpreting the for-cause removal provisions. Where the common law does not even require a provision for for-cause removals in the governing documents to trigger the procedural requirements of notice and an opportunity to be heard, an operating agreement expressly stating that removal may only be for cause should be read to provide at least equal due process rights to the manager of an LLC.

3. The Company's Structure is Sufficiently Similar to a Corporate Structure to Apply Corporate Common Law Precedent

It is also appropriate to apply Delaware common law for for-cause removals applicable to corporations here because the Company is a manager-managed LLC (A95 §5.1), which has been analogized by this Court to a corporation where the manager is properly considered as a board of directors and the members as stockholders. *Kelly v. Blum*, 2010 WL 629850, *11 n.73 (Del. Ch. Feb. 24, 2010). In

the case of a manager-managed LLC with passive members, as here, it is appropriate for the Court to analogize corporate law when interpreting the LLC agreement. *Obeid v. Hogan*, 2016 WL 3356851, *6 & n.5 (Del. Ch. June. 10, 2016).

The reputational considerations underlying the procedural protections inherent in a for-cause removal, as explicated in the *Superwire.com* decision, are no different in the LLC context than in the corporate context. Nor did Krug ever dispute that A&J would suffer reputational consequences from a "for cause" removal that would reverberate through the applicable communities and affect its relationships not only in connection with this Company but with the nine other similar companies that it manages. (B25). In fact, Krug's baseless allegations against A&J garnered the attention of the USCIS, further damaging A&J's reputation and potentially having profound consequences for it and the Company's Members. (B121-23). Accordingly, the lower court should have applied the same common law procedural protections here as it would in the corporate context.

The court concluded otherwise, finding that the Company "is a prime example of an LLC that is expressly 'uncorporate' in its governance structure," because "[t]he Agreements provide for management by a single managing member rather than by a board of managers, and Class B Members, unlike stockholders in a corporation, have reserved for themselves the 'sole and exclusive right to approve or disapprove' several operational decisions, ranging from the incurrence of obligations, to the approval of additional capital contributions that are not made by all of the members on a pro rata basis, to the admission of additional Class B Members." (SJO 17-18) (footnotes omitted).

The examples recited by the Court of Chancery fail to distinguish the Company's structure from that of a corporation in any meaningful way. Single-member corporate boards of directors are no more

unusual than single-manager LLCs, particularly in the context of privately-held entities.[18] Additionally, corporate stockholders also have the right to approve or disapprove certain transactions, including *inter alia* mergers,[19] sales of all or substantially all assets,[20] and any amendments to certificates of incorporation that would increase or decrease the aggregate number of authorized shares of a class of stock.[21] None of those rights turns corporate stockholders into anything other than passive investors, like the Members here.

In deciding that it should not rely on corporate law precedent, the Court of Chancery further relied on *Brinckerhoff v. Enbridge Energy Co., Inc.*, 159 A.3d 242, 247, 252–253 (Del. 2017), where this Court "concluded that, in the alternative entity context, it was appropriate to measure good faith against a more traditional 'contractual good faith standard of care,' rather than against 'common law standards of care and fiduciary duties.'" (SJO 17). This distinction made sense in *Brinckerhoff* precisely because there are both contractual and fiduciary concepts of "good faith," which are not exactly the same, requiring a choice of one or the other in the case of alternative entities –which have both contractual and corporate characteristics. There is not, however, a contractual concept of for-cause removals that requires a similar choice to be made in this case, and it is entirely appropriate to follow the corporate common law precedent relating to for-cause removals.

While not in the court's summary judgment decision, the transcript of the argument and Post-Trial Opinion reflects its view that a more appropriate analogy than corporate law in this alternative entity

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18 8 *Del. C.* § 141(b) ("The board of directors of a corporation shall consist of 1 or more members …."); *see also, e.g.*, *In re AETEA Information Tech., Inc.*, 2015 WL 535868 (Del. Ch. Jan. 29, 2015) (identifying Petitioner as the company's only director).

19 8 *Del. C.* § 251(c).

20 8 *Del. C.* § 271(a).

21 8 *Del. C.* § 242(b)(2).

context is employment law. (B191; B233-34; PTO 32 n.128). Respectfully, the employment law analogy fails. The relationship here between A&J and the Members is far more akin to a corporate relationship with the A&J as director and the Members as stockholders than it is to an employment relationship with the Members as employer and A&J as the employee. A&J manages the Company. (A68-81). Moreover, as Krug has argued elsewhere (A815), the Members were not involved in the initial selection of A&J as the Manager nor in the negotiation of the terms of the Management and Operating Agreements pursuant to which A&J serves as Manager. They had the choice to invest or not invest in the structure that had been negotiated by the entities involved in the creation of the Company and the Project, and if they chose to invest, they were required to execute a form approving of the selection of A&J as Manager. (PTO 12 n.48, B255; B262). Nor do the Members actively oversee A&J's services as Manager; they are simply entitled to receive certain reports, much like stockholders would. (A93-95 §§4.5-4.6, 4.8, 5.1). In short, the Members are no more directly involved in the management of the Company than the stockholders of any corporation in which management and ownership are separated.

CONCLUSION

For the foregoing reasons, the Court of Chancery's Post Trial Opinion and Final Order and Judgment should be affirmed. In the alternative, the Court of Chancery's Summary Judgment Opinion should be reversed.

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CERTIFICATE OF SERVICE

Kurt M. Heyman, Esquire, hereby certifies that, on June 12, 2019, the foregoing Appellee's Answering Brief on Appeal and Cross-Appellant's Opening Brief on Cross-Appeal was served electronically upon the following counsel:

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