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IN THE SUPREME COURT OF THE STATE OF DELAWARE

SAADIA SQUARE LLC, Plaintiff Below-Appellant, v. SM LOGISTICS MEMBER LLC, Defendant Below, Appellee, and SM LOGISTICS HOLDCO LLC, Nominal Defendant Below - Appellee.	No. 396, 2021 On appeal from the Court of Chancery of the State of Delaware C.A. No. 2021-0931-MTZ

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NATURE OF PROCEEDINGS

In this litigation, Saadia Square LLC ("Saadia" or "Plaintiff"), the minority member of SM Logistics Holdco LLC (the "Company"), claims that it was entitled unilaterally to remove SM Logistics Member LLC ("SM") as Managing Member of the Company at any time and for any reason.[1] Yet, as the Court of Chancery found, Saadia's position is inconsistent with – and is, in fact, directly contradicted by – the plain language of the Company's Operating Agreement. The Operating Agreement expressly designates SM as the Managing Member. Under the Operating Agreement, such managerial authority cannot be altered absent an amendment approved by all Members (including SM). On these points, the Operating Agreement is clear and unambiguous. Accordingly, consistent with Delaware's policy of enforcing the plain language of limited liability company ("LLC") agreements, the Court of Chancery properly rejected Saadia's claim.

Saadia seeks to avoid the terms of its agreement by making a two-step argument, neither step of which is supported by the Operating Agreement nor Delaware law. First, Saadia argues that Section 18-402 of the Delaware Limited Liability Company Act (the "LLC Act") supersedes the plain language of the Operating Agreement and provides a "default" mechanism for the removal of SM as

[1] The Company and SM are referred to herein as the "SM Entities". Capitalized terms not defined herein shall have the meaning set forth in the Company's Operating Agreement.

the Managing Member. Second, Saadia contends that SM's Member interest should be construed as "debt," while Saadia's own Member interest should be considered the sole "equity" of the Company. On the basis of this contention, Saadia claims that it (as the purported sole equity holder) was entitled to remove SM as Managing Member under Section 18-402 of the LLC Act. Saadia is wrong on both points.

Pursuant to Section 18-402, *unless otherwise provided in the LLC agreement*, the management of an LLC is vested in the members in proportion to each member's then-current interests in the LLC's profits. Yet, as stated in the LLC Act itself, this default rule has no application where—as here—the LLC agreement expressly provides for a different management structure. Indeed, the Operating Agreement unambiguously provides that SM (not Saadia) ***shall*** be the Managing Member of the Company. Under the Operating Agreement, the only way appoint a different Managing Member is through an amendment to the Operating Agreement which requires the consent of ***all*** Members. Having explicitly agreed to this management structure in the Operating Agreement, Saadia cannot now insist that a purported statutory default standard should be applied to reach a contrary result. Rather, as Delaware courts have stressed on numerous occasions, in the context of LLCs, it is the parties' written agreement that must control.

This same principle also vitiates the second step of Saadia's argument—*i.e.*, that SM's interest in the Company is somehow debt, and Saadia holds 100% of the

Company's equity. This remarkable assertion finds no support in the language of the Operating Agreement, but is instead refuted by the text of that agreement. In addition, Saadia's attempt at classifying SM's interest as debt is contrary to well-established Delaware law providing that preference rights as between members or stockholders (such as those present here) merely create a preferred *equity* instrument, not a debt instrument. Because SM's interest is equity, Saadia's claim that it controls the vote under Section 18-402's default standard falls apart, as it is SM (not Saadia) that has the far greater interest in the Company. Indeed, SM has an 86% equity interest in the Company, further demonstrating the baselessness of Saadia's attempt to usurp SM's management authority.

For these and other reasons explained herein, the Court of Chancery correctly held that Saadia's attempt to remove SM as Managing Member and appoint itself to that role was void and invalid, and further correctly held that all actions purportedly taken by Saadia as Managing Member were null, void and unenforceable. The judgment of the Court of Chancery should be affirmed.

SUMMARY OF ARGUMENT

1. Denied. The Court of Chancery correctly held that the SM Entities were entitled to judgment on the pleadings because Saadia could not recover under any reasonably conceivable set of circumstances susceptible of proof. Specifically, the Court of Chancery found that the Operating Agreement supports a single reasonable interpretation under which Saadia had no right to remove and replace SM as the Company's Managing Member.

2. Denied. The Court of Chancery correctly interpreted the Operating Agreement, which expressly defines SM as the Managing Member of the Company and requires the consent of all Members to amend this grant of managerial authority. The Court of Chancery also properly concluded that because the Operating Agreement expressly provides for the management of the Company, Section 18-402 of the LLC Act has no application.

3. Denied. The Court of Chancery correctly held that Section 18-402 has no application here because the Operating Agreement expressly provides for management of the Company by SM as the Managing Member. Furthermore, SM was and remains an equity Member of the Company and, in fact, holds a greater interest in the Company's profits than Saadia. Accordingly, even if Section 18-402 did apply (which it does not), Saadia lacked authority to remove SM as Managing

Member. For these reasons, Saadia's written consent dated October 19, 2021 was void and invalid.

STATEMENT OF FACTS

I. The Company and SM's Role as Managing Member

The Company was formed in August 2018 to acquire, improve and operate two parcels of real property. A26 (Compl. ¶ 1). Through two wholly-owned subsidiaries, the Company acquired a facility located in Rialto, California (the "California Property") and a commercial property located in Mount Olive, New Jersey (the "New Jersey Property"). A0043, A0044, A0098-A0099, A0100-A0103 (Opr. Agr. §§ 1.7, 2.1 and Exs. B-1, B-2).

From the Company's inception, SM and Saadia were the only two Members of the Company, and that status has never changed. Indeed, the term "Members" is defined in the Operating Agreement as "collectively, SM and Saadia, and any person or Persons who … has been admitted as a successor Member or additional Member …." A0052.[2] Similarly, Section 1.8 provides that the Members are those entities identified in Schedule A, which lists SM and Saadia as the only two Members of the Company. A0044 (Opr. Agr. § 1.8). Schedule A also provides that SM made an "Initial Capital Contribution" of $51 million, whereas Saadia's Initial Capital Contribution was $11.5 million. A0044, A0057, A0097 (Opr. Agr. §§ 1.8, 3.1 and Ex. A). SM was further obligated to, and subsequently did, make an additional capital contribution of $17.5 million. A0057 (Opr. Agr. § 3.1).

[2] No successor or additional members have ever been admitted.

With regard to the management of the Company, the definitions section of the Operating Agreement provides that "'***Managing Member' means SM.***" A0052 (emphasis added). SM's role as the Managing Member is reiterated in Section 6.1(a), which states that "***SM shall act as the Managing Member of the Company*** and shall have the powers of a 'manager' pursuant to the [LLC] Act, except as otherwise provided in this Agreement." A0068 (emphasis added). Section 6.3 further provides that the Managing Member has the "right and duty to manage the business of the Company in its sole and absolute discretion" and "the exclusive right to perform or cause to be performed all management and operational functions relating to the day-to-day business of the Company." A0069.

The Operating Agreement does not permit Saadia to modify unilaterally this express grant of authority to SM. Rather, subsection (c) of Section 6.1 (which sets forth the "Authority of Members") states that "any amendments to this Agreement … shall require the consent of all Members." A0068. Section 13.3, the general amendment section, repeats this standard, stating that "this Agreement may be amended or modified from time to time only by a written instrument executed and agreed to by all of the Members." A0089.

II. The Operating Agreement's Distributions Provision

Article 5 of the Operating Agreement addresses the manner in which "Cash Distributions" may be made to the Members of the Company. A0064-A0068. "Cash

Available for Distribution" is defined in the Operating Agreement as "(a) the sum of all cash received by the Company from any sources (other than Capital Contributions intended to be funded to a Subsidiary), minus (b) reserves set aside in the discretion of the Managing Member." A0047.

Article 5 contains two waterfall provisions for the payment of distributions. A0064-A0068. Section 5.1(b) (the "IRR Waterfall") provides that "[p]rior to an Equity Conversion, or if an Equity Conversion is not exercised, Cash Available for Distribution shall be distributed to the Members" as follows:

- first, to repay accrued and unpaid Short Term Company Loan Return on any Short Term Company Loan made by a Member;
- second, to repay any unpaid Short Term Company Loan;
- third, to repay accrued and unpaid Company Loan Return on any Company Loan made by a Member;
- fourth, to repay any unpaid Company Loan;
- fifth, 100% to SM until the aggregate of all Distributions paid to SM results in SM having received the greater of 12% Internal Rate of Return of and on its Capital Contributions, compounded quarterly or a 1.5x multiple on its Capital Contributions; and
- finally, 100% to Saadia.

A0064.

Section 5.1(c) (the "Pari Passu Waterfall") provides that "[f]rom and after an Equity Conversion," Cash Available for Distribution shall be distributed to the Members" as follows:

- first, to repay accrued and unpaid Short Term Company Loan Return on any Short Term Company Loan made by a Member;
- second, to repay any unpaid Short Term Company Loan;
- third, to repay accrued and unpaid Company Loan Return on any Company Loan made by a Member;
- fourth, to repay any unpaid Company Loan;
- fifth, to the Members pari passu in accordance with their respective Percentage Interests until the aggregate of all Distributions made to SM results in SM having received the greater of a 12% Internal Rate of Return on and of its Capital Contributions; compounded quarterly and a 1.5x multiple on its Capital Contributions;
- thereafter, 20% to Saadia and 80% to the Members pari passu in accordance with their respective Percentage Interests.

A0065.

Which of these waterfall provisions applies to cash distributions turns on whether an "Equity Conversion" has occurred. Section 5.5 of the Operating Agreement provides that "[a]t any time prior to the Outside Conversion Date [defined as September 1, 2020], SM may by written notice … to all Members, elect to cause an Equity Conversion." A0068. The only consequence of SM electing an Equity Conversion under the Operating Agreement is, after such election, any cash distributions to the Members shall be governed by the Pari Passu Waterfall instead of the IRR Waterfall. If SM did not elect to exercise the Equity Conversion option by September 1, 2020, SM would waive the ability to do so and its distribution rights would remain governed by the IRR Waterfall. Importantly, nowhere in Article 5, or

anywhere else in the Operating Agreement, does it state that unless and until SM exercises the Equity Conversion option, it is merely a lender with some kind of undefined debt interest. A0064-A0068. To the contrary, Article 5 expressly distinguishes between "Loans" and distributions to Members with respect to their ownership (*i.e.*, equity) interests. A0064-A0068. Accordingly, SM's right to distributions, regardless of the applicable waterfall provision, is a right related to its equity interest in the Company.

SM's status as an equity holder (not a mere debt holder) is further confirmed by Section 8.5 of the Operating Agreement, which provides:

> Claims of the Members. The Members shall look solely to the Company Property for the return of their Capital Contributions, and ***if the assets of the Company remaining after payment or discharge of the debts or liabilities of the Company are insufficient to return such Capital Contributions, the Members shall have no recourse against the Company***, any Officer, Authorized Representative, employee or agent of the Company or any Member or such Member's Affiliates.

A0078 (emphasis added). Thus, the interests of both Members (*i.e.*, SM and Saadia) are expressly subordinated to the Company's creditors and without recourse against the Company. These features are hallmarks of equity, not debt.

III. Saadia Wrongfully Usurps SM's Management Authority

On October 19, 2021, Saadia's counsel informed SM's counsel that Saadia, by unilateral written consent as the professed "100% member of the Company" executed that same day, had purportedly removed SM as Managing Member and had

itself assumed that role. A0028-A0029 (Compl. ¶¶ 11, 12). The apparent reason for this managerial coup was to put Saadia in a position to engage in self-dealing that attempted to strip the Company of its sole remaining asset.[3]

Indeed, the day after purporting to install itself as the Managing Member, Saadia executed a deed conveying the New Jersey Property to a Saadia affiliate. A0029 (Compl. ¶ 13). Saadia has asserted that this transfer was effectuated pursuant to the terms of a January 2021 sale proposal by the Company. *Id.* However, in litigation before the New Jersey Chancery Division (the "New Jersey Court"), that court had already held this offer was properly revoked and provided Saadia no right to acquire the New Jersey Property. A0148. Furthermore, after the purported conveyance of the New Jersey Property, Saadia's affiliate entered into a lease with yet another Saadia affiliate for the vacant portion of the New Jersey Property (and gave that affiliate an option to purchase as well).[4] A1106-A1107, A1125. In its purported role as Managing Member, Saadia also sent a letter to the Company's mortgage lender requesting a payoff letter and purporting to promise that the Company would promptly pay off the remaining balance of the loan (which was $52 million). A0029 (Compl. ¶ 13).

[3] The Company sold the California Property in August 2021. A0739. Thus, by this time, the Company's sole remaining asset was the New Jersey Property.

[4] Saadia hid the lease and option from the courts and SM, which SM only discovered when it performed a title search.

IV. The Court of Chancery Proceedings

On October 28, 2021, Saadia filed its Verified Complaint for Declaratory Judgment in the Court of Chancery action (the "Complaint"), seeking a declaration validating the written consent and Saadia's actions thereafter. A0025-A0034. It was only through the filing of the Complaint that SM learned of Saadia's purported conveyance of the New Jersey Property to its affiliate.

Because Saadia failed to seek expedition of the litigation, on November 2, 2021, the SM Entities filed a motion to expedite, which explained the critical issues then facing the Company and the severe disruption caused by Saadia's improper actions. A0130-A0135. The Court of Chancery granted expedition and indicated that a status quo order should be entered to stabilize the Company. A0893, A0886-888, A1180-A1232. Because the Court of Chancery found that Saadia had been acting as the Managing Member since its October 19, 2021 written consent, the Court concluded that Saadia should be considered the "incumbent" and designated the provisional manager in the status quo order. A1062, A1055-A1061, A1238-A1270. However, the Court of Chancery adopted a form of status quo order largely based on the SM Entities' proposal, which contained significant limitations on Saadia's authority until such time as the Court of Chancery could consider the claim. A1062, A1055-A1061, A1238-A1270.

In an effort promptly to resolve the matter, the SM Entities moved for judgment on the pleadings on the grounds that Saadia's actions were contrary to the plain terms of the Operating Agreement. A0951-A0954, A0955-A0994. On December 10, 2021, the Court of Chancery heard oral argument on the SM Entities' motion for judgment on the pleadings. A1274, A1275-A1357. In a bench ruling (the "Ruling") that same day, the Court of Chancery granted the SM Entities' motion. A1343-1357, *see also* A1271-A1273.

The Court of Chancery held that "[t]he plain and unambiguous language of the operating agreement provides that SM is a member and, in fact, is the [M]anaging [M]ember." A1347 (Ruling at 73). In support of this holding, the Court of Chancery noted that the very term "Managing Member" is defined to mean "SM" in the Operating Agreement, and Section 6.1(a) of the Operating Agreement provides that SM "shall" act as the Managing Member. A1348 (Ruling at 74). The Court of Chancery further explained that "[u]nder the plain text of the [O]perating [A]greement and the LLC Act, Saadia could not remove SM as [M]anaging [M]ember." A1349 (Ruling at 75). This conclusion was mandated because the Operating Agreement contains no removal provision and because neither Section 18-402 nor any other provision of the LLC Act provides a default term for removal of a designated manager. *Id.* Accordingly, based on the plain language of the Operating Agreement, the Court of Chancery concluded that the parties agreed that

SM "shall cease to be a manager if the agreement is amended by mutual consent—or not at all." A1351 (Ruling at 77).

Given the plain language of the Operating Agreement, the Court of Chancery found that it was not necessary to follow Saadia down the path of applying Section 18-402. A1350 (Ruling at 76). Nonetheless, the Court of Chancery noted that "[t]o the extent Saadia may be claiming that SM's stake is anything less than membership, I want to make clear that even if SM's stake resembles debt more than equity, it is still valid membership." A1352 (Ruling at 78). As the Court of Chancery explained, under Section 18-301 of the LLC Act, even a party that provides no capital contribution whatsoever may be admitted as a member of an LLC and will have such rights as granted to such member under the operating agreement. A1353 (Ruling at 79).

For these and other reasons, the Court declared Saadia's actions to remove and replace SM as Managing Member of the Company to be void and invalid and declared all actions taken by Saadia since October 19, 2021 null and void, invalid and unenforceable. A1271-A1273.

On December 15, Saadia filed a notice of appeal with this Court. The following day Saadia moved the Court of Chancery to stay the judgment and reinstate a status quo order. On January 10, 2022, the Court of Chancery denied the motion for a stay pending appeal and request for a new status quo order. Thereafter,

Saadia moved this Court to review the Court of Chancery's denial of the motion to stay the judgment. The Supreme Court denied the motion on January 28.

ARGUMENT

I. THE TRIAL COURT CORRECTLY HELD THAT SAADIA'S PURPORTED REMOVAL AND REPLACEMENT OF SM AS THE MANAGING MEMBER WAS CONTRARY TO THE TERMS OF THE OPERATING AGREEMENT.

A. Questions Presented

Whether this Court should affirm the Court of Chancery's holding that Saadia's actions to remove and replace SM as Managing Member of the Company were contrary to the express terms of the Operating Agreement. A1343-1357, A1271-A1273.

B. Scope of Review

Review of the Court of Chancery's ruling granting a motion for judgment on the pleadings presents a question of law which this Court reviews *de novo*. *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*, 624 A.2d 1199, 1204 (Del. 1993). This Court also reviews questions of contract interpretation *de novo*. *Monzo v. Nationwide Prop. & Cas. Ins. Co.*, 249 A.3d 106, 117 (Del. 2021). Questions of statutory interpretation are reviewed *de novo* as well. *Wild Meadows MHC, LLC v. Weidman*, 250 A.3d 751, 756 (Del. 2021).

C. Merits of Argument

1. The Operating Agreement Expressly Provides That SM Shall Serve As The Managing Member.

Delaware is "a freedom of contract state, with a policy of enforcing the voluntary agreements of sophisticated parties in commerce." *Pers. Decisions, Inc.*

v. Bus Planning Sys., Inc., 2008 WL 1932404, at *6 (Del. Ch. May 5, 2008), *aff'd*, 970 A.2d 256 (Del. 2009) (TABLE). This principle applies fully to LLC operating agreements. *See* 6 *Del. C.* § 18–1101(b) (setting forth the policy of the Delaware LLC Act to "give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements").

As the Delaware courts have frequently observed, Delaware LLCs are creatures of contract. *See, e.g.*, *TravelCenters of Am., LLC v. Brog*, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008). Accordingly, "[i]n governance disputes among constituencies in an LLC, the starting (and end) point almost always is the parties' bargained-for operating agreement, and the court's role in these disputes is to 'interpret [the] contract [and] effectuate the parties' intent.'" *A & J Cap., Inc. v. L. Office of Krug*, 2018 WL 3471562, at *5 (Del. Ch. July 18, 2018) (quoting *GRT, Inc. v. Marathon GTF Tech., Ltd.*, 2012 WL 2356489, at *7 (Del. Ch. June 21, 2012) (internal quotations omitted)). "The presumption that the parties are bound by the language of the agreement they negotiated applies with even greater force when the parties are sophisticated entities that have engaged in arms-length negotiations." *W. Willow-Bay Ct., LLC v. Robino-Bay Ct. Plaza, LLC*, 2007 WL 3317551, at *9 (Del. Ch. Nov. 2, 2007), *aff'd*, 985 A.2d 931 (Del. 2009) (TABLE).

When interpreting a contract governed by Delaware law, "the role of a court is to effectuate the parties' intent. Unless there is ambiguity, Delaware courts

interpret contract terms according to their plain, ordinary meaning." *White v. Curo Tex. Hldgs., LLC,* 2016 WL 6091692, at *21 (Del. Ch. Sept. 9, 2016) (internal citations omitted). Delaware adheres to the objective theory of contracts, giving effect to the plain meaning of a contract and reading the contract as a whole. *See Kuhn Constr., Inc. v. Diamond State Port Corp.*, 990 A.2d 393, 396-97 (Del. 2010) ("We will read a contract as a whole and we will give each provision and term effect, so as not to render any part of the contract mere surplusage"); *Citadel Hldg. Corp. v. Roven*, 603 A.2d 818, 822 (Del. 1992) ("It is an elementary canon of contract construction that the intent of the parties must be ascertained from the language of the contract."); *Rainbow Navigation, Inc. v. Yonge*, 1989 WL 40805, at *2 (Del. Ch. Apr. 24, 1989) ("… it is the 'objective' meaning of the words used and not a subjective understanding that, absent ambiguity, is controlling.") (citation omitted).

In accordance with these principles, "ambiguity only occurs when the provision in dispute is 'susceptible to two *reasonable* interpretations.'" *Multi-Fineline Electronix, Inc. v. WBL Corp.*, 2007 WL 431050, at *6 (Del. Ch. Feb. 2, 2007); *see also Alliant Techsys., Inc. v. MidOcean Bushnell Hldgs., L.P.*, 2015 WL 1897659, at *6 (Del. Ch. Apr. 27, 2015) ("That the parties dispute how to interpret the Agreement does not render it ambiguous."). Thus, "[i]f the contract's meaning is unambiguous, the court must grant judgment on the pleadings in favor of the moving party." *Lillis v. AT&T Corp.*, 904 A.2d 325, 330 (Del. Ch. 2006). Here, as

the Court of Chancery determined, the Operating Agreement is unambiguous and mandates the conclusion that Saadia's attempt to remove and replace SM as the Managing Member was unauthorized and improper.

There is no question that the parties agreed that SM—and only SM—would be the Company's Managing Member. In fact, the Operating Agreement expressly defines the term "Managing Member" to mean SM. A0052 (Op. Agr. at 11 (stating "'Managing Member' means SM.")). This grant of authority is reiterated in Section 6.1 of the Operating Agreement, which provides that "SM shall act as the Managing Member of the Company." A0068. There is no ambiguity in this language. Nor is there any ambiguity with respect to the powers of the Managing Member. The Operating Agreement states that "[e]xcept as expressly limited by or otherwise provided in the provisions of this Agreement, the Managing Member shall have the right and duty to manage the business of the Company in its sole and absolute discretion." A0069 (Op. Agr. § 6.3(a)).

These clear and express contractual provisions leave no doubt that the parties' intent was that SM would be the Managing Member of the Company with all attendant authority. The fact that the Operating Agreement does not provide for a means to remove SM as Managing Member is not an oversight. As between the two Members, SM contributed six times more capital to the Company and agreed to be the sole guarantor of the Company's substantial debt. A0057, A0097 (Op. Agr. §

3.1, Ex. A). In these circumstances, it was entirely reasonable for the parties to agree that SM would serve as Managing Member for the term of the Company or until the parties jointly agreed to amend the Operating Agreement pursuant to the amendment provision. A0068 (Op. Agr. § 6.1(c)); A0089 (Op. Agr. § 13.3 (providing that "this Agreement may be amended or modified from time to time only by a written instrument executed and agreed to by all of the Members")). Indeed, the parties' decision to reiterate the amendment standard as part of Section 6.1 (entitled "Authority of Members"), instead of solely relying on the general amendment provision found in Section 13.3, demonstrates their agreement that the authority provision would continue to apply until and unless the Operating Agreement was amended by "consent of all Members." A0068 (Op. Agr. § 6.1(c)).

The notion that Saadia could unilaterally remove SM as Managing Member appoint itself as new Managing Member, and thereby assume control over the business—at any time and for any reason—is nowhere found in the Operating Agreement. Rather, Saadia's claim to this authority is contrary to the plain language of the Operating Agreement. For example, Saadia's contention that it is now the Managing Member of the Company contradicts the express definition of the term "Managing Member" (which "***means SM***") and reverses the clear language of Section 6.1(a) (which says "***SM shall act as the Managing Member***"). A0052, A0068 (Op. Agr. at 11, § 6.1(a)) (emphasis added). Such changes in the parties'

written agreement could only be made pursuant to an amendment agreed to by all Members, and Saadia concedes, as it must, that SM is a Member. *See* Appellant's Opening Brief ("OB") at 8. Saadia cannot simply declare—as it has purported to do here—that its unilateral action modified these material provisions of the parties' negotiated governance structure.

Saadia seeks to avoid the effect of these clear contract terms by arguing that the Operating Agreement is ambiguous. In particular, Saadia contends that because certain provisions of the Operating Agreement refer to the rights and obligations of the "Managing Member" and other provisions refer to the rights and obligations of "SM," that it must mean other Members could potentially serve as the Managing Member. *See* OB at 21-22. However, as explained above, the Operating Agreement defines the term "Managing Member" to mean "SM." Accordingly, for purposes of the Operating Agreement, these terms are entirely synonymous. The only way that "Managing Member" could mean something other than "SM" is through an amendment of the Operating Agreement.

Similarly, that the Operating Agreement permits, in certain circumstances, the transfer of the Members' interests or the admission of a "Substitute Member" upon the dissolution of a Member does not help Saadia. *See* OB at 22. In these circumstances, Saadia contends that it would make no sense for SM to retain its position as "Managing Member" and, thus, the parties must have contemplated that

other parties could potentially serve as the Managing Member. *Id.* However, this argument ignores that if SM were to transfer or otherwise lose its Member interest, then the remaining Members (*currently only Saadia*) could easily amend the Operating Agreement to designate a new Managing Member.

2. The Provisions of Section 18-402 Have No Application Where, As Here, The Operating Agreement Expressly Provides For The Management Of The Company.

Where, as here, the parties' operating agreement expressly establishes a management structure that departs from the member management standard set forth in Section 18-402, such default standard has no applicability. This conclusion is obvious from the text of the statute itself, as well as the entire structure of the LLC Act as a broad enabling statute with minimal mandatory provisions. *See* 6 *Del. C.* § 18-402 (stating "[u]nless otherwise provided in a limited liability company agreement …"); *Achaian, Inc. v. Leemon Family LLC*, 25 A.3d 800, 803 n.11 (Del. Ch. Aug. 9, 2011) ("Each default rule [in the LLC Act] is a statutory provision that governs *only in the absence of an agreement among the members covering the particular point*") (emphasis in original) (quoting Symonds & O'Toole § 1.03[A][2] at 1-15). Nonetheless, Saadia urges the Court to apply Section 18-402's default standard in this case. Saadia's argument must be rejected for the following reasons.

First, as illustrated above, Saadia's argument seeks to modify the express terms of the parties' agreement. This is not the role of Section 18-402, which

explicitly defers to the management structure contained in the parties' Operating Agreement. As the Court of Chancery found, there is simply no silence or gap that needs to be filled by a statutory default term in this case. The parties agreed that SM shall be the Managing Member in terms that make SM synonymous with the term "Managing Member" and, absent an amendment, provide no means by which SM could be removed as Managing Member. In this context, adopting Saadia's position would have the effect of amending the parties' written agreement to include a concept (*i.e.*, removal of the Managing Member) to which the parties never agreed and that is contrary to the agreement's actual terms.[5]

Second, Saadia's argument that the absence of language in the Operating Agreement concerning the removal of SM as Managing Member creates a gap that must be filled by a statutory default rule assumes that parties are required to include removal provisions in LLC agreements. But no such requirement exists. To the contrary, in the context of LLCs, the Delaware courts have recognized that "[v]irtually any management structure may be implemented through the company's governing instrument." *Domaine Assocs., L.L.C. v. Shah*, 2018 WL 3853531, at *14 (Del. Ch. Aug. 13, 2018) (citation omitted). Furthermore, as the Court of Chancery

[5] Such a conclusion would further be inconsistent with Section 1.1(a) of the Operating Agreement, which provides that "the provisions of this Agreement shall override the provisions of the [LLC] Act in the event of any inconsistency or contradiction between them." A0042 (Op. Agr. § 1.1(a)).

noted below, the LLC Act "does not provide any default rules in regard to the removal of a manager." A1349 (Ruling at 75). Section 18-402 provides a default standard for the *management* of an LLC only when such issue is not addressed in the LLC's operating agreement. Nothing in Section 18-402 purports to provide a default rule for the *removal* of a manager designated as such in an LLC operating agreement. To the contrary, on this issue, Section 18-402 expressly states that "[s]ubject to § 18-602 of this title, ***a manager shall cease to be a manager as provided in a limited liability company agreement***."[6] 6 *Del. C.* § 18-402 (emphasis added). Accordingly, the LLC Act defers entirely to the operating agreement on the issue of removal of a designated manager.

For these reasons, the Court of Chancery found where, as here, an operating agreement designates a particular manager and does not include any provision for removal of that manager, there is no default removal provision to be supplied by the LLC Act. *See* A1351 (Ruling at 77). Rather, consistent with the parties' agreement, such a manager is not subject to removal. *See id.* (citing *Llamas v. Titas*, 2019 WL 2505374, at *20 (Del. Ch. June 18, 2019) and noting that this position is supported by *Symonds & O'Toole*).[7] This is particularly true where the parties to the operating

[6] Section 18-602 concerns the resignation of a manager and is not relevant here.

[7] *See* Robert L. Symonds, Jr. & Matthew J. O'Toole, *Symonds & O'Toole on Delaware Limited Liability Companies* § 9.05[C], at 9-53 (2019). These learned commentators state:

agreement are sophisticated, as is the case here. Indeed, there is nothing prohibiting sophisticated parties from agreeing in an operating agreement to the designation of a specific manager and providing no means for removal of that manager other than an amendment. *See* A351-A1352 (Ruling at 77-78) (finding that "[t]he parties agreed to a specific managing member that can only be removed by amending the operating agreement, which requires mutual consent under Sections 6.1(c) and 13.3").[8]

Finally, Saadia's assertion that other opinions of the Court of Chancery support its position is wrong. Saadia is unable to cite to any opinion in which Section 18-402 has been applied by default when the LLC operating agreement is silent on the issue of removal of a manager. In *Obeid v. Hogan*, 2016 WL 3356851 (Del. Ch. June 10, 2016), the principal case on which Saadia relies, the parties' operating

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> If the limited liability company agreement omits clear provisions regarding removal, it may be argued that a manager cannot be removed. This argument finds support in the plain language of the statute, which provides that, subject to a manager's right or power to resign, "a manager shall cease to be a manager as provided in a limited liability company agreement."

Id. While these authors recognized that alternative arguments could be made at the time of their writing, the Court of Chancery has now endorsed the foregoing position in both *Llamas* and this action.

[8] *See also Llamas v. Titas*, 2019 WL 2505374, at *16 (Del. Ch. June 18, 2019) (recognizing that amendment of an LLC operating agreement may be an effective means of removing a manager) (citing *Symonds & O'Toole* § 9.05[C], at 9-53 to -54).

agreement expressly stated that the directors (who were the managers) "may be removed or expelled, with or without cause, at any time by the Members." *See* 2016 WL 3356851, at *18. But because the operating agreement did not state what vote of the members was necessary for this action, the Court of Chancery in *Obeid* held that the default standard contained in Section 18-402 would apply the missing vote standard. *See id.* at *19. The Court reached this conclusion both because there was an obvious gap in the agreement and because such default rule was consistent with the rule applicable to corporations, and the LLC at issue had adopted a corporate management structure. *See id.* Neither of these considerations apply here. In this case, the Operating Agreement does not in any way contemplate the removal of SM as Managing Member nor does it adopt a corporate board management structure.[9]

3. Public Policy Supports Applying LLC Agreements According To Their Terms, Not Implying Terms To Which The Parties Never Agreed.

Saadia also contends that construing Section 18-402 as providing a means for removal of SM as Managing Member is consistent with "public policy as embodied in Delaware law." OB at 25. As support, Saadia cites cases from the *corporate*

[9] Other cases cited by Saadia also do not address the circumstances present here. For example, in *Lola Cars Int'l Ltd. v. Krohn Racing, LLC*, 2009 WL 4052681 (Del. Ch. Nov. 12, 2009), while describing the plaintiff's claim, the Court of Chancery merely noted in passing that Section 18-402 provides a statutory default rule "unless of course otherwise stated in the operating agreement." *Id.* at *3. The Court in *Lola Cars* did not actually apply or even analyze Section 18-402, but rather dismissed plaintiff's claim on other grounds. *See id.* at *9-10.

context in which this Court has recognized that "the stockholder franchise is the 'ideological underpinning upon which the legitimacy of the directors' managerial power rests.'" *Id.* (citing *Coster v. UIP Cos., Inc.*, 255 A.3d 952, 960 (Del. 2021)). However, this authority does not address LLCs. Instead, the stated policy of the LLC Act is to "give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." 6 *Del. C.* § 18-1101(b); *see also CML V, LLC v. Bax*, 28 A.3d 1037, 1043 (Del. 2011) (recognizing that the LLC Act "allow[s] interested parties to define the contours of their relationships with each other to the maximum extent possible"). Saadia's claim—which seeks to imply a term contrary to the plain language of the Operating Agreement—violates this public policy.

Saadia's arguments based on the implied covenant of good faith and fair dealing also miss the mark. *See* OB at 26. As an initial matter, the implied covenant has no application where (as here) the parties' agreement contains express terms governing the issue. *See, e.g.*, A0052 (Op. Agr. at 11) (providing that "'Managing Member' means SM"). Moreover, Saadia's complaint in this action does not even plead an implied covenant claim. Therefore, Saadia's invocation of the implied covenant in its brief is a red herring and not properly before the Court.

Even were the Court to consider Saadia's implied covenant argument, it lacks merit. Saadia asserts that the implied covenant's objective of enforcing the

contracting parties' "reasonable expectations" somehow supports a finding that Section 18-402 supplies a mechanism for the removal SM as the Managing Member. *See* OB at 26. However, parties cannot have reasonable expectations that are directly contrary to the plain language of their contract. Having entered into an Operating Agreement that provides that Managing Member "means SM" and SM "shall" be the Managing Member until and unless the agreement is amended with the consent of all Members, Saadia cannot now contend that it reasonably believed it had the power unilaterally to remove SM from this role.

Finally, Saadia's public policy argument that adopting its construction of Section 18-402 will prevent SM from being able to "act in bad faith, with impunity, and face no risk [of removal]" is also flawed. *Id.* First, Saadia's complaint contains no allegations of bad faith conduct by SM and, thus, the argument is irrelevant to this appeal. Second, it is not uncommon that an entity's manager may not be removed without such manager's consent.[10] Saadia cites no authority for the notion that such situations are contrary to Delaware's public policy. Moreover, where a manager acts in bad faith, Delaware law provides a myriad of potential remedies, including, among other things, suit for breach of contract or breach of fiduciary duty. But Saadia does not seek any of these forms of relief in this case. Instead, Saadia is

[10] Indeed, any time an entity has a "controller," it is typical that such controller or the managers that it appoints cannot be removed without the controller's consent.

asking the Court to find that Section 18-402 injects into the Operating Agreement terms that are contrary to the parties' bargained for agreement. It is this request that is contrary to Delaware's public policy in the context of LLCs and should be rejected.

4. Saadia is Not (And Has Never Been) the Company's 100% Equity Member.

Even were one to assume that Section 18-402 applied here (it does not), Saadia's claim that it is the "sole equity" Member of the Company, and thus unilaterally can assume management of the Company, lacks merit. SM's membership interest has at all times been based on its equity investment (in fact, the majority equity investment) in the Company. Saadia's argument to the contrary is based solely on the fact that SM, having provided the lion's share of the Company's capital, bargained for the right to receive priority distributions, if and when the Company earned sufficient profits to make distributions to the Members. Under the IRR Waterfall, only after SM receives its priority distribution will Saadia be entitled to receive additional funds available for distribution. According to Saadia, this distribution structure treats SM's interest "like a debt holder" and Saadia's interest "like an equity holder"; therefore, SM must be a debt holder and Saadia must be the 100% equity Member. This analysis suffers from several flaws.

First, Saadia's argument is based upon a distinction that is found nowhere in the Operating Agreement itself. The Operating Agreement never uses the terms

"equity Member" or "equity Interest." And even though the Operating Agreement discusses Members potentially providing loans to the Company, it never characterizes SM's initial Member interest as a "loan" or a "debt". To the contrary, the Operating Agreement expressly distinguishes between the interests of "creditors" and "Members," which latter term includes ***both*** SM and Saadia. For example, pursuant to Section 8.3(c), upon dissolution of the Company, the Company's assets shall be distributed (i) first to creditors, (ii) second to pay the expenses of dissolution, (iii) third to establish reserves for contingencies and potential liabilities, and (iv) finally, to the Members—including both SM and Saadia. *See* A0077 (Op. Agr. § 8.3(c)). Nothing in the Operating Agreement suggests that SM would be entitled to payment as a creditor rather than a Member under this provision.

Similarly, pursuant to Section 5.1, whether prior to or after a potential Equity Conversion, distributions must first be used to repay any "Company Loans"—a term that does not include SM's Member interest. Only to the extent funds remain, shall distributions be made to the Members, including SM. A0064-A0066. The status of both Members as equity holders is further made clear by Section 8.5, which expressly provides that Member interests are subordinated to the Company's creditors. A0078 (stating that "if the assets of the Company remaining after payment or discharge of the debts or liabilities of the Company are insufficient to return

[Members'] Capital Contributions, the Members shall have no recourse against the Company").

These and other provisions of the Operating Agreement show that Saadia's characterization of SM's interest as "debt" and its own interest as the sole "equity" has no basis in the Operating Agreement. Instead, Saadia has concocted this purported distinction between the Members in an after-the-fact attempt to justify its impermissible actions.[11]

Second, as the Court of Chancery explained below, the distinction that Saadia attempts to fabricate between "equity" members and some other type of membership is without legal import. *See* Ruling at 78-79. Section 18-402, even where applicable, provides that all members may participate in management in accordance with their current interests in the company's profits. An equity investment (*i.e.*, a capital contribution) is not a prerequisite to either membership in an LLC or participation

[11] Unable to find any support for its position in the body of the Operating Agreement, Saadia relies upon a "Saadia Organizational Chart," which was attached as Exhibit E to the Operating Agreement. *See* OB at 12. Saadia contends that this chart illustrates that it "holds a 100% 'Common Interest' in the Company's equity." *Id.* But this is untrue. The chart merely depicts Saadia's ownership structure—not the Company's. Section 11.1(a) says, "[a]ttached as Exhibit E is a structure chart reflecting all of the direct and indirect owners of equity in Saadia, which structure chart is true, correct and complete as of the date hereof." That Saadia holds a "Common Interest and Promote" says nothing about SM's Member interest, including whether such interest is also a common interest or a preferred equity interest. And the chart certainly does not imply that SM's majority capital contribution was merely a loan.

in its profits. Parties are free to admit any members they choose and to allocate profits among members as they deem appropriate. *See* 6 *Del. C.* § 18-301(d). Thus, Saadia's entire discussion of whether SM's contribution to the Company should be characterized as debt or equity is irrelevant.

Third, Saadia's assertion that SM's interest is debt simply because it is entitled to priority distributions *as between the Members* ignores well-established law concerning the distinction between debt and equity. Delaware courts have long held that even though preferred stock may enjoy priority rights with regard to other stockholders, such stock is nonetheless equity because it is junior to the corporation's creditors. *See, e.g.*, *Harbinger Cap. P'rs Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218, 230 (Del. Ch. 2006) (noting "preferred [stock]holders enjoy priority only with respect to the funds available to stockholders, whose interests as a class are junior to the corporation's secured creditors in the context of liquidation") (alteration in original) (quoting *In re Color Tile, Inc.*, 2000 WL 152129, at *5 (D. Del. Feb. 9, 2000)). As the Court of Chancery further explained in *Frederick Hsu Living Trust v. ODN Hldg. Corp.*,

> Delaware courts have held consistently that preferred stock is equity, not debt. "The fundamental reason that … preferred shares are equity is that they provide no guaranteed right of payment." "[T]he holder of preferred stock is not a creditor of the corporation. Such a holder has no legal right to annual payments of interest, as long term creditors will have, and most importantly has no maturity date with its prospect of capital repayment or remedies for default."

2017 WL 1437308, at *12 (Del. Ch. Apr. 24, 2017) (alterations in original) (footnotes omitted) (quoting *HB Korenvaes Invs. L.P. v. Marriott Corp.*, 1993 WL 205040, at *5) (Del. Ch. June 9, 1993)). Conversely, the Delaware courts have recognized that the "fundamental characteristic" of debt is "that there be a reasonable expectation of being repaid irrespective of the fortunes of the company." *Lasker v. McDonnell & Co.*, 1975 WL 1950, at *10 (Del. Ch. July 9, 1975).

Considering these factors, SM's interest is equity, not debt. SM has no enforceable obligation to repayment of its Capital Contribution, or interest thereon, at any set time. *See* A0059 (Op. Agr. § 3.4) (providing that "no Member shall have the right to withdraw, reduce or demand the return of its Capital Contribution"); *see also id.* (providing that Members are not entitled to interest on their Capital Contributions).[12] Instead, SM's ability to recover its investment, and any return thereon, is entirely dependent upon the fortunes of the Company and the Company's ability to make distributions to the Members at some unspecified date in the future.

[12] Saadia's characterization of SM's entitlement in certain circumstances to an "Internal Rate of Return" as an interest rate is false. Section 5.1(c) of the Operating Agreement provides that cash distributions to SM will include a 12% Internal Rate of Return, which is effectively a preferred return. SM will only be entitled to this preferred return when—and if—cash distributions are made to Members by the Company. SM has no contractual entitlement to demand payment of any sum whatsoever and no guarantee that it will receive any portion of its Internal Rate of Return, as would be the case if it were a lender with the right to receive repayment of principal and accrued interest.

A0064 (Op. Agr. § 5.1(b)). Moreover, SM's interest is expressly subordinated to general creditors. A0077, A0078 (Op. Agr. §§ 8.3(c), 8.5). Other fundamental attributes of debt that are *not* enjoyed by SM's interest include any claim upon "collateral" and the ability to accelerate payment of principal and interest upon default. *See Lasker*, 1975 WL 1950, at *10 (noting that "[a] fixed rate, a fixed maturity date, the ability to accelerate upon default and the use of collateral are the usual means of affording protection to a creditor"); *see also In re SubMicron Sys. Corp.*, 291 B.R. 314, 325 (D. Del. 2003), *aff'd*, 432 F.3d 448 (3d Cir. 2006) (noting lack of collateral suggests contribution was in exchange for equity not debt).[13] Finally, as explained above, SM is designated Managing Member of the Company, which implies an equity not debt interest. *See Harbinger*, 906 A.2d at 231 & n.56 ("[T]he right to vote is necessarily a characteristic right of equity[.]").

The only Delaware authority cited by Saadia that purportedly supports characterizing SM's interest as debt is *JAKKS PACIFIC, Inc. v. THQ/JAKKS PACIFIC*, LLC, 2009 WL 1228706 (Del. Ch. May 6, 2009), *aff'd*, 979 A.2d 1111 (Del. 2009) (TABLE). However, *JAKKS* was a books and records case in which the

[13] In fact, SM's interest in the Company lacks all the fundamental attributes of debt, including: (i) an unqualified obligation to pay a certain sum; (ii) a fixed maturity date; (iii) fixed percentage of interest payable regardless of debtor's income or lack thereof; (iv) ability to accelerate upon default; (v) use of collateral; and (vi) reasonable expectation of being repaid irrespective of the fortunes of the company. *See, e.g., In re Color Tile*, 2000 WL 152129, at *4-5 (D. Del. Feb. 9, 2000).

Court of Chancery recognized that *JAKKS* was a "member" even though its economic interest in the LLC was similar to that of a licensor with royalties. *See id.* at *1. It was this membership interest that entitled *JAKKS* to demand books and records from the company. The Court merely found that *JAKKS* lacked a proper purpose for its demand because the value of its economic interest was a matter under consideration in a then-pending arbitration and no production of additional records from the company could provide insight into what the arbitrator would decide. *See id.* at *5-6. *JAKKS* does not support Saadia's position because the Court did not base its ruling on whether JAKKS's interest constituted debt or equity for Delaware law purposes. To the extent *JAKKS* is at all relevant, the Court of Chancery properly found that it actually supports SM's position because the Court recognized JAKKS as a member with attendant rights, despite its unique economic interest. A1353-A1354 (Ruling at 79-80).

Fourth, Saadia's contention that any construction of the Operating Agreement that would result in SM holding management control both before and after an exercise of the Equity Conversion option is "absurd" lacks merit. *See* OB at 31. Indeed, it is undisputed that SM served as Managing Member for more than three years from the Company's inception and until Saadia's improper written consent. SM served as Managing Member for two years *before* any deadline for the exercise of the Equity Conversion option. When SM elected not to exercise the Equity

Conversion by the September 1, 2020 deadline (thereby retaining its existing IRR distribution rights), there is no basis to believe that such election would work some change to SM's managerial rights. To the contrary, SM contributed more than 80% of the Company's capital and personally guaranteed the Company's mortgage debt.[14] In these circumstances, it was entirely reasonable for the parties to vest management control solely in SM, regardless of whether SM at some point exercised the Equity Conversion option.[15] In fact, based on the plain language of the Operating Agreement, this is the *only* reasonable interpretation of the parties' agreement.

For all these reasons, the priority rights that SM's Member interest has over Saadia's Member interest merely reflect a preferred form of equity. That SM elected not to exercise its right to a different distribution structure (*i.e.*, the Equity Conversion) merely means that it chose to retain its preferred equity instead of

[14] In its Opening Brief, Saadia contends that it "bears more risk" on the investment than SM and, thus, it would be reasonable that Saadia exercised ultimate managerial control. OB at 1, 11, 31. This assertion is patently false given that SM contributed many times more capital to the Company than Saadia.

[15] It is a matter of public record that Jack Saadia (the controller of Saadia) was convicted of various felonies in connection with a $700 million scheme to smuggle counterfeit high-end clothing into the country. *See* Judgment in a Criminal Case, *United States v. Saadia*, No. 07-cr-0663-BMC (E.D.N.Y. Jan. 6, 2010), ECF No. 448; Final Order of Forfeiture, *United States v. Saadia*, No. 07-cr-0663-BMC (E.D.N.Y. Jan. 7, 2010), ECF No. 450. This history was further reason to ensure that Saadia would have no role in managing the entity, as commercial lenders are unlikely to deal with an entity helmed by Saadia.

converting to a different form of equity. This election does not mean that SM's equity interest somehow transformed into debt.

5. Even if Section 18-402 Applied, Saadia Is Merely a Minority Member.

However, even were the Court to find that the procedures outlined in Section 18-402 of the LLC Act governed the removal/replacement of the Company's Managing Member (which it should not), Saadia's written consent, which purported to remove SM as the Managing Member and appoint Saadia as SM's replacement, was ineffective.

As discussed in detail above, Saadia is not "the 100% equity member of the Company" (A0028-A0029 (Compl. ¶ 11)), nor is Saadia even the majority equity member of the Company. *See supra* I, C, 4. Rather, pursuant to the unambiguous, plain language of the Operating Agreement, SM is the majority equity member of the Company, as SM contributed the overwhelming majority of the capital to the Company. *See id.*; *see also* A0057, A0095 (Op. Agr. § 3.1 and Schedule A). Moreover, SM—not Saadia—has the current right to receive distributions of the Company's profits under Article 5, as SM did not exercise the Equity Conversion option. In fact, Saadia has no current right to receive any of the Company's profits; and will receive profit distributions from the Company, if at all, only after SM has, pursuant to the Operating Agreement, received profit distributions from the

Company sufficient to return its capital contributions together with the accrued "Internal Rate of Return" thereon. A0064 (Op. Agr. § 5.1(b)).

Moreover, as the Court of Chancery noted, Saadia admitted in a pleading filed in California in 2021 that Saadia was the "minority member" of the Company. *See* A1348 (Ruling at 74). Specifically, Saadia's California complaint, when describing the Company, states that "[Saadia] is a minority member pursuant to a written operating agreement." A0964, A1000. By definition, if Saadia is the "minority member," SM is the "majority member" of the Company.

For these reasons, Saadia's October 19th written consent would be ineffective even were Section 18-402 applicable (which it is not) because Saadia has never owned "more than 50 percent of the said percentage or other interest in the profits controlling[]" as required to take action under Section 18-402. 6 *Del. C*. § 18–402 ("the decision of members owning more than 50 percent of the said percentage or other interest in the profits [is] controlling."). *See Obeid*, 2016 WL 3356851, at *18–19 (plaintiff's removal from three-person board justified by Section 18-402 because two of the members holding two-thirds profits interest voted therefor). In sum, the purported removal of SM was not valid, and SM remains the Managing Member of the Company.

For all these reasons, Saadia's actions cannot find any support in the unambiguous terms of the Operating Agreement to which the Court must first look in ascertaining the parties' rights, nor in the LLC Act.

CONCLUSION

For the foregoing reasons, the SM Entities respectfully request that the Court affirm the judgment below.

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Dated: January 28, 2022

CERTIFICATE OF SERVICE

I hereby certify that, on January 28, 2022, true and correct copies of Appellees' Answering Brief were caused to be served by File & Serve*Xpress* on the following counsel of record:

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