THE
NATIONAL LAW REVIEW

For Cause Removal Must Be For Cause

Monday, February 18, 2019

In A&J Capital, Inc. v. Law Office of Krug, Civil Action No. 2018-0240-JRS (Del. Ch. January 29, 2019), the Delaware Court of Chancery granted an LLC manager a final declaratory judgment that the manager had been improperly removed, and the Court ordered immediate reinstatement of the manager. In short, if a Delaware LLC's operating documents only allow "for cause" removal of the manager, then the manager cannot be removed "on a whimsy" by the members who then manufacture cause after-the-fact to justify the removal.

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Plaintiff A&J Capital, Inc. ("A&J") was selected as the manager of LA Metropolis Condo I, LLC, a Delaware limited liability company (the "Company"). The Company was organized to raise $100 million from 200 Chinese nationals so they could become United States lawful permanent residents through the EB-5 program. The capital was invested in a construction loan for the development of real estate in downtown Los Angeles, and the loan was extended to Greenland LA Metropolis Development I, LLC ("Greenland").

When the real estate project was substantially completed, funds from the sale of the condominium units were released to a pledge account in Greenland's name for the benefit of the Company. Greenland approached A&J with an offer to repay the loan before its maturity date in order to free up capital to redeploy for other projects. Also, the amount in the pledge account could foreseeably exceed the principal of the loan, potentially violating the members' EB-5 requirements. Greenland and A&J negotiated a prepayment plan and a $1 million prepayment fee for A&J, in exchange for A&J foregoing $1.6 million in management fees that it would otherwise receive at maturity of the loan.

A&J notified the members of the prepayment plan and the prepayment fee and requested the members' approval. Any member's abstention from voting was counted as a vote in favor of the plan. The members ultimately rejected the plan, as Greenland had a change of heart and became concerned that A&J would not commit the redeployed funds to Greenland on favorable terms.

Pursuant to the Management Agreement between A&J, the Company, and its members, the manager may be removed only by a majority vote of the members for gross negligence, intentional misconduct, fraud, or deceit. Other documents such as the Private Placement Memorandum support this standard.

James Krug, attorney for some of the members and defendant in this case, sent a removal ballot to the members, asking them to vote for (1) removal of A&J as manager and (2) election of Mr. Krug as the new manager. Importantly, the removal ballot did not state the basis for removal. Out of 200 members, 105 members voted to remove A&J; however, the authenticity of the ballots was questionable. A&J brought this suit to request that it be reinstated as manager.

Mr. Krug made two arguments that A&J violated the required standard of conduct. First, he argued that A&J's request for a prepayment fee plus the structure of the first vote revealed fraudulent intent. The Court rejected this argument because A&J unabashedly disclosed to the members the reasons for the prepayment plan and fee and made clear that it was up to the members to decide whether to approve the proposal. Ultimately, the members voted to reject the proposal.

Second, Mr. Krug argued that A&J made improper payments to its strategic partner, Henry Global. The Court quoted language from the Operating Agreement allowing the manager to enter into agreements it reasonably

deems appropriate for any purpose beneficial to the Company. The Court found that Henry Global provided significant services to the Company, including organizing conferences with potential investors, translating loan documents, assisting investors with their immigration applications, traveling with investors outside of China to open escrow accounts, and assisting with currency transfers. The Court emphasized that Henry Global was not paid out of the members' initial $100 million investments, rather out of the interest income, and that the members themselves were not able to receive a high amount of interest due to the structured purpose of the EB-5 investment program. Finally, the Court noted that A&J ordered an independent accounting firm to review the Company's financial statements, including payments to Henry Global, and A&J later distributed such statements to the members.

The Court held that a "for cause" removal was not warranted and therefore reinstated A&J as manager of the company. One footnote explains, "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."

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