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Re: Facchina v. Malley, et al.
C.A. No. 783-N
Date Submitted: July 12, 2006

Dear Counsel:

This post-trial letter opinion resolves the question of who is the managing member of Nominal Defendant Child Care of Irvine, LLC ("Child Care"), a Delaware limited liability company.

Peter Frey, Bruno Schmitter, Plaintiff Dante D. Facchina, and Defendants Ahmed N. Malley, Azeez N. Malley, and Jamal A. Abdelmuti formed Child Care of Irvine, Inc., a California corporation (the "California Corporation") in July 1994

and entered into a Shareholder's Agreement,[1] Article II, Section K(1) of which provided that "[a]ll major decisions regarding investments, capital distributions, capital contributions, loans, mergers, acquisitions, dissolutions, changes in corporate structure, and hiring and firing of key personnel will be made by majority consent."[2] The ownership interests in the California Corporation were as follows: Facchina 33-1/3%; Frey and Schmitter, collectively, 33-1/3%; Defendants, collectively, 33-1/3%.

The stockholders of the California Corporation had intended for it to be a Subchapter S corporation, but that status could not be achieved because one shareholder, Frey, was a foreign national. Accordingly, the stockholders converted the form of their business—the operation of a child care center in Orange County, California—to a limited liability company. On January 14, 1997, the California Corporation merged with Child Care of Irvine, LLC ("CCI"), a Delaware limited liability company, with CCI as the surviving entity. The members of CCI never

[1] JTX 20.
[2] The Shareholder's Agreement also allowed any one shareholder, at least on an interim basis, to frustrate the will of the majority. If any shareholder objected to a "major decision," the dispute would be submitted to arbitration.

executed an operating agreement.[3] Their percentage interests in CCI were the same as their interests in the California Corporation.

Facchina was CCI's initial managing member. In 1998, Facchina was removed by the other five members, and Ahmed Malley and Jamal Abdelmuti were designated interim managing members.

On June 4, 1999, Facchina, Frey, and Schmitter, collectively holders of a two-thirds interest in CCI, executed written consents removing Ahmed Malley and Jamal Abdelmuti as managing members and returning Facchina to the position of managing member.[4] On June 7, 1999, Facchina established another Delaware limited liability company—Irvine Child Care, LLC ("Irvine Child Care"), and Facchina, Frey, and Schmitter, using their two-thirds interest again, executed a written consent that merged CCI into Irvine Child Care, which was the surviving

[3] Facchina testified that the members did enter into an operating agreement. Tr. 21-22. No document was produced at trial. The better inference is that Facchina was simply wrong. The Agreement and Plan of Merger recites that the operating agreement would be the one "in effect immediately prior to the effective date." JTX 4. The Defendants testified that they intended, and that everyone understood, that the Shareholder's Agreement would serve as the operating agreement for CCI.

[4] JTX 8, 9.

entity and later became the nominal defendant in this action.[5] Irvine Child Care's name was changed to Child Care of Irvine, LLC (or "Child Care"). Finally, at that time, Facchina acquired the interests of Frey and Schmitter in Child Care.[6]

In the absence of a limited liability company agreement (*i.e.*, an operating agreement), the "decision of members owning more than 50 percent [is] controlling."[7] Frey, Schmitter, and Facchina, when they acted to remove Ahmed Malley and Jamal Abdelmuti and to install Facchina, owned more than 50% of CCI and, thus, had the authority to accomplish those objectives. It follows, because there was no limited liability company agreement, that in June 1999, Facchina became the managing member of CCI, to the exclusion of Ahmed Malley and Jamal Abdelmuti.[8]

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[5] JTX 10.
[6] *See* JTX 12.
[7] 6 *Del.C.* § 18-402.
[8] This analysis has not been burdened by the following concerns which the parties did not voice: by 6 *Del.C.* § 18-401, the designation of a manager is made "as provided in § 18-101(10) of [Title 6 of the Delaware Code]." That subsection provides in part that "'manager' means a person who is . . . designated as a manager of a limited liability company pursuant to . . . a limited liability company agreement . . . ." One could read this provision—materially unchanged since 1999 when the conduct in question occurred—as providing that a limited liability company without an operating agreement cannot have a "manager." Even if that were the case, Facchina, with either his majority interest or his interest coupled with the interests of Frey and Schmitter, was able to control the affairs of CCI since the time when Frey and Schmitter joined his cause.

The Defendants have not acquiesced in this analysis for the following reasons:

1. The Shareholder's Agreement should be viewed as the operating agreement of CCI and Child Care.

2. Under the Shareholder's Agreement:

(a) the proper vote is by "head count" and not by majority interest in the limited liability company, and

(b) the provision in the Shareholder's Agreement requiring unanimity on major decisions was violated and the Defendants were denied the opportunities to submit their claims to arbitration under that agreement.

3. Use of written consents to designate Facchina as the managing member, instead of a formally convened meeting, violated both the Shareholder's Agreement and controlling California law.

See 6 *Del.C.* § 402 ("Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members . . . ."). Thus, the precise question may not be the identity of the managing member (or manager) but, instead, it may be the identity of the person(s) entitled to manage the entity.

4. Facchina's prior-filed California action either deprives this Court of jurisdiction to act or should induce this Court to defer to that proceeding.

The Defendants also challenge events that occurred after the designation of Facchina as the managing member. Specifically, they challenge the transfer from Schmitter and Frey to Facchina of their interests in Child Care as inconsistent with the provisions governing the assignment of limited liability company interests. Also, they challenge whether the merger of CCI into Irvine Child Care could have been accomplished without a meeting.[9]

The Defendants maintain that that Shareholder's Agreement serves as a stand-in for CCI's operating agreement.[10] When the California Corporation

[9] The Court does not resolve these latter questions. If the subsequent transactions are void (or voidable), the parties are left with the management as duly constituted for CCI. If Facchina was the duly authorized managing member of a limited liability company that survived the various subsequent transactions, Facchina remains the managing member. In short, regardless of whether the subsequent transactions are valid, Facchina will be a managing member of whatever entity currently exists, unless the efforts of Frey, Schmitter, and Facchina to remove Ahmed Malley and Jamal Abdelmuti and to replace them with Facchina as the managing member were ineffective.

[10] The question of whether the Shareholder's Agreement continued in effect after the merger of the California Corporation with CCI is significant because of the potentially ambiguous nature of the terms of Article II, Section K(1) of the Shareholder's Agreement. As noted previously, Section K(1) provides, in part, that "[a]ll major decisions regarding investments, capital distributions, capital contributions, loans, mergers, acquisitions, dissolutions, changes in corporate structure, and hiring and firing of key personnel will be made by majority consent."

merged into CCI, however, that corporation ceased to exist; there was no longer any stock; there were no shareholders; and the agreement lapsed.[11] Thus, the Shareholder's Agreement did not take on the role of the operating agreement by force of law.

As members of the limited liability company, the owners of that entity could have agreed that their rights and obligations as members of CCI would be controlled by the Shareholder's Agreement.[12] The merger of the California Corporation into CCI, which all parties agree was valid, was accomplished through the "Action by Unanimous Written Consent of the Shareholders and Directors of

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The Defendants have argued that "majority consent" refers not to consent by a majority of equity, but instead to a majority of individual shareholders (*i.e.*, a "head-count"). The Shareholder's Agreement continues with another provision that deviates from the majoritarian norm: "However, if one Shareholder will object to a major decision which the other five (5) favor and feel is crucial to the development and growth of the [California Corporation], the five (5) Shareholders will have the right to appeal to a single arbitrator whose decision will be final and binding." As a consequence, if the Shareholder's Agreement is found to control CCI, it is at least arguable that later approvals by the consent of 66-2/3% of the equity were insufficient because they represented the consent of only three of the six individual equity-holders (*i.e.*, not a majority under the "head-count" approach).

[11] *See Shields v. Shields*, 498 A.2d 161, 168 (Del. Ch. 1985).

[12] The label appended to the agreement is not important. *See* 6 *Del.C.* § 18-101(7) ("'Limited liability company agreement' means any agreement (whether referred to as a limited liability company agreement, operating agreement or *otherwise*) . . . of the member or members as to the affairs of a limited liability company and the conduct of its business.") (emphasis added).

Child Care of Irvine, Inc." (the "Merger Consent"),[13] by which the Agreement and Plan of Merger (the "Merger Agreement")[14] was adopted.

Article III of the Merger Agreement provides:

> From and after the Effective Date, and until thereafter amended as provided by law, the Certificate of Formation and Limited Liability Company Agreement of CHILD CARE LLC as in effect immediately prior to the Effective Date shall be the Certificate of Formation and Limited Liability Company Agreement of the Surviving Entity.[15]

The Defendants argue that this provision incorporates the Shareholder's Agreement. CCI, the surviving entity, however, did not have an operating agreement. This provision simply establishes that the surviving entity's (*i.e.*, CCI's) operating agreement before the merger would be the operating agreement for the surviving entity (*i.e.*, CCI) after the merger and, accordingly, this provision cannot be read as an adoption of the California Corporation's Shareholder's Agreement as the operating agreement for CCI post-merger.[16]

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[13] JTX 3.
[14] JTX 4.
[15] *Id*. "Child Care LLC" is defined by the Merger Agreement to be Child Care of Irvine, L.L.C. (or "CCI").
[16] The Merger Agreement, thus, did not incorporate or carry forward the Shareholder's Agreement. Perhaps the drafter committed a scrivener's error (contrary to the intentions of the

The Defendants also argue that the owners of the enterprise agreed that the Shareholder's Agreement would govern the operation and management of CCI.[17] They emphasize that CCI, established only because the California Corporation could not qualify for Subchapter S status, was a continuation of the enterprise governed by the Shareholder's Agreement. Although an agreement to that effect might have made sense under the circumstances, the Defendants have not proved, even by a preponderance of the evidence, that any such agreement was ever reached. Neither of the Defendants who testified was able to state that an oral agreement to adopt the Shareholder's Agreement had been reached with all members of CCI. Ahmed Malley and Jamal Abdelmuti both "understood" that the Shareholder's Agreement would be accorded the status of an operating agreement.[18] This testimony only reveals what two members anticipated or understood would happen; it does not prove that an agreement was reached among

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parties) in referring to CCI's operating agreement instead of the Shareholder's Agreement. That, however, is not a conclusion that the Court can draw from the record before it.

[17] There was no written agreement adopting the Shareholder's Agreement as the operating agreement. Such an agreement could have been reached orally. *See* 6 *Del.C.* § 18-101(7).

[18] Tr. 105-06; 135-38.

the members.[19] An "understanding" is not a substitute for an agreement, especially where, as here, there is no evidence that this "understanding" was shared by or with the other contracting parties. In sum, the Defendants have failed to prove the existence of a limited liability company agreement, including the possibility that the Shareholder's Agreement served as a stand-in; the governance of CCI, accordingly, was under the default provisions of 6 *Del.C.* § 18-402.[20]

The Defendants argue that the efforts of Frey, Schmitter, and Facchina to install Facchina as the managing member were insufficient under California law because that act was purportedly accomplished without a meeting of the members, which they assert is a requirement of California law, and, instead, purportedly accomplished only by written consent. There is no dispute that, under Delaware law, the use of written consents, without a meeting of the members, was sufficient as a procedural matter. In short, the Defendants argue that California law controls the internal governance of a Delaware limited liability company with its principal

[19] A draft limited liability company agreement for CCI was prepared in December 1996. JTX 2. This is probably the agreement which Facchina believes was signed. As noted, there is no credible evidence that it was ever signed.

[20] I note, in passing, that the Defendants, in earlier litigation against Facchina in this forum, took the position that CCI had no operating agreement. *See* JTX 19.

(and, in this instance, only) place of business in California. Delaware law, however, governs the internal affairs of a Delaware limited liability company, regardless of its place of operations.[21] Thus, the designation of Facchina as CCI's managing member was, as a matter of Delaware law, effective. Accordingly, unless the affirmative defenses (or other contentions in the nature of an avoidance) presented by the Defendants are sufficient, the Court must confirm Facchina's status as Child Care's managing member.

The equitable defenses of waiver, estoppel, and acquiescence have been raised by the Defendants.[22] The assertion of these defenses is premised upon Facchina's delay in bringing and pursuing this action following his unsuccessful efforts to regain control, as managing member, of the limited liability company in 1999, when the written consents were executed. Facchina's explanation for delay—for example, the cost of litigation and that the defense costs were being

[21] *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1112-13 (Del. 2005). With that conclusion, I need not consider whether the Defendants' exposition of California law on this subject is correct.

[22] For a review of these doctrines, see DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY §§ 11-1, 11-2, & 11-3 (2006). The parties have not noted any material difference between California law and Delaware law on these topics.

paid by the limited liability company—is not particularly compelling. The Defendants point to potential prejudice if Facchina is determined to be the "rightful" managing member and thereafter seeks "back pay." The Defendants' arguments, however, would suggest that they are entitled to control the affairs of the limited liability company in perpetuity, even though they collectively hold only a one-third interest. Mere delay cannot sustain the result sought by the Defendants.[23] Accordingly, their reliance on equitable defenses is misplaced.

Finally, the Defendants argue that proceedings in California preclude Facchina from seeking and obtaining the relief he seeks in this forum. In 1999, Facchina sued the Defendants in California and claimed to be the rightful manager of Child Care.[24] That matter was referred to arbitration; the arbitrator ruled adversely to him and dismissed his action for failure to prosecute;[25] the arbitrator's order was set aside by the Superior Court; a squabble, however, arose over who would act as the arbitrator for future proceedings; appeal was taken to the Court of

[23] I am satisfied that there is no prejudice (or detrimental reliance). There may be some risk that Facchina will pursue a "back pay" claim, but the concerns advanced by the Defendants, if otherwise appropriate, can be advanced in that proceeding.
[24] JTX 21.
[25] JTX 24.

Appeals; the Court of Appeals sent the matter back for hearing before a different arbitrator;[26] Facchina then dismissed the action with the intention that it be without prejudice.

The key question to be distilled from this mixture is: was Facchina's voluntary dismissal of the California action with prejudice or without prejudice?[27] Under § 581(b)(1) & (c) the California Code of Civil Procedure, a plaintiff has the absolute right to dismiss a proceeding without prejudice as long as the trial has not commenced.[28] The Defendants argue that the commencement of the trial-like proceedings before the arbitrator (which did occur) was "pragmatically" the same as the commencement of trial before a judge of the Superior Court and the right to dismiss without prejudice is limited.[29] If true, Facchina's dismissal would

[26] *See Child Care of Irvine v. Superior Ct. of Orange County*, 2006 WL 637127 (Cal. Ct. App. Mar. 15, 2006).

[27] This question, one governed by California law, is better answered by the California courts. The Defendants, on May 19, 2006, represented to the Court that they would promptly seek such an answer. As of July 12, 2006, the date of the last submittal to the Court, no such action had been taken. The Defendants report that they intend to take prompt action, but, in light of their previously unfulfilled promise, there is no reason for the Court to continue to await their action in California.

[28] *See also O'Dell v. Freightliner Corp.*, 12 Cal. Rptr. 2d 774, 781 (Cal. Ct. App. 1992).

[29] The above proposition is by no means clear from the case law cited to the Court by the parties. *See, e.g.*, *Young v. Ross-Loos Medical Group, Inc.*, 185 Cal. Rptr. 536, 537-38 (Cal. Ct. App. 1982) (holding that statute permitted appeal since dismissal of action by arbitrator was

presumably have necessarily been with prejudice—but for the vacation on appeal of the arbitrator's order. The Defendants' argument that the dismissal must be with prejudice therefore requires inquiry into the consequences of the Superior Court's decision to vacate the arbitration order. The vacation order "left the case at large and the parties . . . in the same position as if [the case] had never been tried . . . ."[30] It is "as though no trial had ever been had . . . ."[31] With this perspective, when Facchina dismissed his California action, the circumstances, following the vacation of the order from the arbitration effort, were "as if no trial had ever been had," and dismissal, at his choice, could have been without prejudice in accordance with California procedure.[32] Thus, because Facchina was able to

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"pragmatically an 'award'" and explaining that, although Section 583 does not apply "*directly*" to an arbitration proceeding, "'the concept and limits of [that section have been imported] into the test of reasonable diligence in bringing a claim to resolution by arbitration'" for purposes of determining arbitrator's award or sanction (alterations in original) (citations omitted)). It does appear, however, that, but for vacation of the arbitrator's decision on appeal, the entry of an adverse ruling by an arbitrator will limit a plaintiff's capacity to dismiss without prejudice under California Code of Civil Procedure § 581. *See, e.g.*, *Herbert Hawkins Realtors, Inc. v. Milheiser*, 189 Cal. Rptr. 450, 452-53 (Cal. Ct. App. 1983).

[30] *Guzman v. Superior Ct. of Los Angeles County*, 23 Cal. Rptr. 2d 585, 586 (Cal. Ct. App. 1993) (quoting *Sichterman v. R. M. Hollingshead Co.*, 4 P.2d 181 (Cal. Ct. App. 1931)).

[31] *Id*. (quoting *Riley v. Loma Vista Ranch Co.*, 89 P. 849, 850 (Cal. Ct. App. 1907)).

[32] *Cf. Harris v. Billings*, 20 Cal. Rptr. 2d 718, 721 (Cal. Ct. App. 1993) (explaining that voluntary dismissal without prejudice is permitted where, *inter alia*, plaintiff has not "suffered an adverse arbitration award").

dismiss (and did dismiss) the California action without prejudice, he becomes free—if he ever was not free—to pursue the relief he now seeks in this forum.[33]

Accordingly, the Court finds that Facchina is entitled to manage the affairs of Child Care, to the exclusion of those individuals who are currently purporting to perform that function. Counsel are requested to confer and submit a form of order to implement this letter opinion.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-NC

[33] One other aspect of the California proceedings must be addressed. In a response to interrogatories, Facchina, according to the Defendants, admitted that the Shareholder's Agreement governed management of Child Care. That argument fails. The interrogatory upon which the Defendants rely was ambiguous and, thus, Facchina's answer is necessarily ambiguous. With that conclusion, it is not necessary to consider Facchina's argument that his interrogatory response does not constitute a judicial admission or that the Defendants are precluded from relying upon the interrogatory response because they did not rely upon it in their primary post-trial briefing and because the interrogatory answer was admitted at trial for the limited purpose of impeachment and cannot be used as substantive evidence for the Court's findings of fact.