

Governance Issues in LLCs

presented to
**Department of Energy
Contractor Attorneys' Association 2014
Spring Conference
May 29, 2014
Washington, DC**

Kenneth B. Weckstein
Brown Rudnick LLP

Tyler Przybylek
Wilton Road, LLC

Rob Humphries
Bechtel National, Inc.

Bob Cochran
CBI Federal Services, Inc.



Overview/Discussion Questions

1. What are the biggest problems in LLC governance from the perspectives of the Government and the Contractor?
2. As a practical matter, how does reach-back work in a multi-member LLC?
3. How should corporate governance be funded?

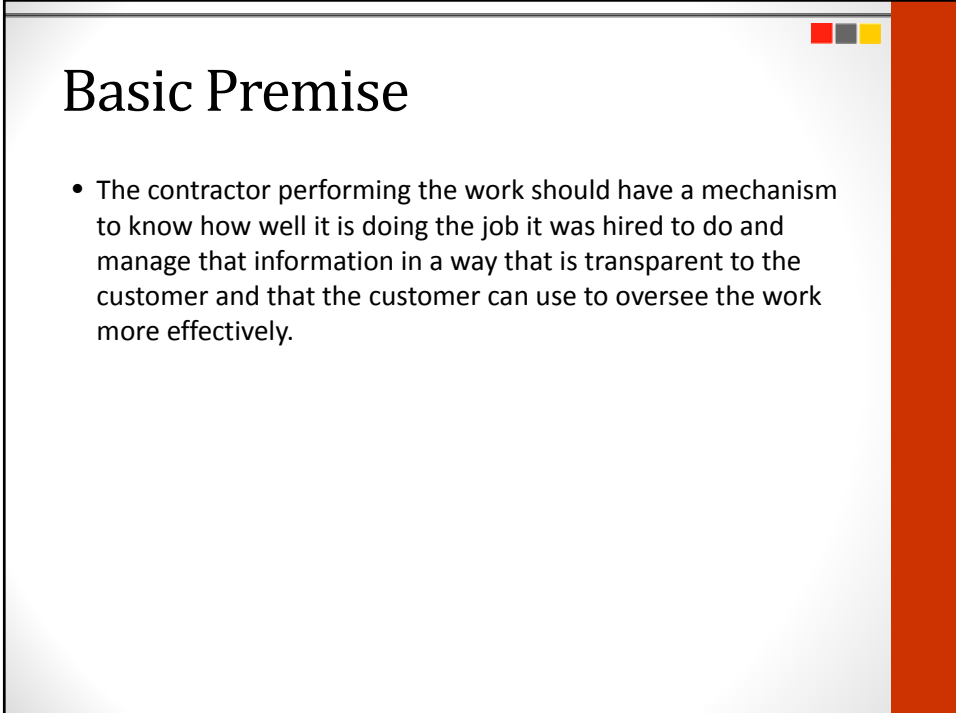
Kenneth B. Weckstein
Brown Rudnick LLP
kweckstein@brownrudnick.com / (202) 536-1750



LLC Governance

Thoughts on the Government's Perspective

Tyler Przybylek



Basic Premise

- The contractor performing the work should have a mechanism to know how well it is doing the job it was hired to do and manage that information in a way that is transparent to the customer and that the customer can use to oversee the work more effectively.

Critical Element

- Underlying every good management assurance system is a three way partnership based on trust and respect.
- The partners are the contractor, the parent organization and the government representative.

Barriers

- The contractor/laboratory believes that the site office personnel are the C students from a tier 3 school who “don’t get it.”
- The site office personnel believe that the contractor/laboratory is “hiding the ball” until it is convenient to disclose.
- The participation by the parent organization is “pro forma” and mechanical.

Barriers (cont.)

- Management (contractor) assurance is the “flavor du jour” and this, too, will pass with time.
- Federal jobs have to be restructured and that is a daunting task.
- Contractor/laboratory has to lean out its own operations, too.

Enablers

- All management and operating contracts are relational; the quintessential feature is “trust with consequences.”
- Technology: the good management assurance systems use it, the others have it.
- DOE/NNSA understanding that the main thing is that they provide government furnished services.



LLC Governance

A Contractor's Perspective

Rob Humphries



Definition of Corporate Governance

Corporate governance refers to the system of structures, rights, duties, and obligations by which corporations are directed and controlled. The governance structure specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, regulators, and other stakeholders) and specifies the rules and procedures for making decisions in corporate affairs. Governance provides the structure through which corporations set and pursue their objectives, while reflecting the context of the social, regulatory and market environment. Governance is a mechanism for monitoring the actions, policies and decisions of corporations. Governance involves the alignment of interests among the stakeholders.

It might be shortened to:

Governance is the system of management and controls exercised in the stewardship of the organization.

LLC Governance

For our DOE/NNSA work, “governance” has many levels:

- The rights and obligations of the LLC to the members;
- The rights and obligations of the Members to their shareholders/owners/trustees
- The rights and obligations of the members to each other;
- The obligations of the members to oversee the LLC to the protection of third parties

Where does the “system of structures, rights, duties, and obligations”, e.g., the “rules” come from.

Sources of Authority

Law—LLC’s are creatures of state law

Citizens United v. Federal Election Commission, 558 U.S. 310 (2010),
corporations are people too

Guidelines

The Contracts with DOE

Delaware Limited Liability Company Act

- An LLC may carry on any lawful business, purpose or activity, whether or not for profit
- An LLC shall possess and may exercise all the powers and privileges as are necessary or convenient to the conduct, promotion or attainment of the business, purposes or activities of the LLC
- An LLC shall have the power and authority to make contracts of guaranty and suretyship and enter into interest rate, basis, currency, hedge or other swap agreements or cap, floor, put, call, option, exchange or collar agreements, derivative agreements, or other agreements similar to any of the foregoing.

(DE Title 6, Subtitle II, § 18-106)

Delaware Limited Liability Company Act

An LLC agreement may provide:

- for classes or groups of members having such relative rights, powers and duties as the limited liability company agreement may provide,
- for the taking of an action without the vote or approval of any member or class or group of members,
- that any member or class or group of members shall have no voting rights.

Id., § 18-302

Delaware Limited Liability Company Act

Liability to third parties.

- The debts, obligations and liabilities of an LLC shall be solely the debts, obligations and liabilities of the LLC, and no member or manager of a limited liability company shall be obligated personally for any such debt, obligation or liability of the limited liability company

Id. § 18-303

Delaware Limited Liability Company Act

Access to Records. Each member has the right to obtain from the LLC for any purpose reasonably related to the member's interest as a member of the LLC:

- True and full information regarding the status of the business and financial condition of the LLC;
- A copy of the LLC's federal, state and local income tax returns;
- A current list of the name and last known business, residence or mailing address of each member and manager;
- A copy of any written LLC agreement and certificate of formation and all amendments;
- True and full information regarding the amount of cash and a description and statement of the agreed value of any other property or services contributed by each; and
- Other information regarding the affairs of the limited liability company as is just and reasonable.

Id., § 18-305

Delaware Limited Liability Company Act

Management of limited liability company. Unless otherwise provided in LLC agreement:

- The management of a limited liability company shall be vested in its members in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all of the members,
- The decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling; provided however, that
- If a limited liability company agreement provides for the management of a limited liability company by a manager, the management of the limited liability company shall be vested in the manager
- A limited liability company may have more than 1 manager.
- Unless otherwise provided, each member and manager has the authority to bind the limited liability company.

Id., § 18-402

Duties of the Majority to the Minority

- Traditional internal governance law has long supplied the duty of loyalty and the duty of care in recognition of power disparities between manager and investor and between controlling and minority investors. In jurisdictions such as Delaware, fiduciary duties in alternative entities may be eliminated, except that the implied covenant of good faith and fair dealing may never be contractually waived.
- Fiduciary duties, including the duty of loyalty and the duty of care, are standard terms that respond to the costs of monitoring management of public companies do to the separation between those who manage and those who bear the risk.

Legal Realism, The LLC, and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing, 45 Wake Forest L. Rev. 729 (Fall 2010)

Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, Case No. 3658-VCS (Del. Ch. Apr. 20, 2008)

- *Bay Center* decision arises out of a failed condominium project in Emeryville, California—there were a lot of separate entities
 - Venture of two entities, Bay Center LLC (“Bay Center”)(Entity 1), and Emery Bay PKI, LLC (“PKI”)(Entity 2)
 - Bay Center and PKI formed Emery Bay Member, LLC (“Emery Bay”)(Entity 3)
 - Emery Bay agreement provided:
 - The Members shall have the same duties and obligations to each other that members of a [Delaware] limited liability company have to each other
 - Except for any duties imposed by [the LLC agreement]...each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties...
 - Emery Bay ETI, LLC (“ETI”)(Entity 4), subject to common control with Entity 2, had day-to-day management of the project, under Contract with wholly-owned subsidiary (Entity 5) of Emery Bay (Entity 3)
 - Emery Bay (Entity 3) obtained a third party loan guaranteed by the common owner of PKI (Entity 2) and ETI (Entity 4)
 - Emery Bay (Entity 3) issued an unsecured note to Bay Center (Entity 1) in consideration for transferring the real property for the project
 - Emery Bay (Entity 3) subsequently defaulted on the third party loan.

Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, Case No. 3658-VCS (Del. Ch. Apr. 20, 2008)

- Bay Center (Entity 1) alleged that Emery Bay (Entity 3), at the hands of Entity 2, secretly renegotiated the 3rd party loan, diverting cash that should have repaid the unsecured loan to avoid triggering the guarantee of the third party loan or capital calls to PKI
- Chancery Court recognized that DE code permits an LLC agreement to expand, restrict or eliminate duties; but it may not eliminate the implied contractual covenant of good faith and fair dealing;
- Where the LLC agreement is silent or ambiguous, they will be subject to the traditional fiduciary duties that directors of a Delaware corporation owe.

Sentencing Guidelines

- The organization's governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.
- High-level personnel shall be assigned overall responsibility for the compliance and ethics program.
- Ethics and Compliance shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program.

2013 Guidelines Manual, Part B Section 8B2.1(b)(2)- Remediating Harm from Criminal Conduct, and Effective Compliance and Ethics Program

DOE and the Contracts

- NAP -21 2-28-2011, Transformational Governance and Oversight
- Identify the principles, responsibilities, processes, and requirements that the NNSA will utilize to transform and improve Federal governance and oversight of M&O Contractors.
- Governance transformation is based on a supporting partnership with Contractors for mission success
 - Chapter One, Overview,
 - Chapter Two, NNSA Operating Principles
 - Chapter Three, Definitions,
 - Chapter Four, Description of Governance,
 - Chapter Five, Organizational Roles and Responsibilities,
 - Chapter Six, Framework for a Contractor Assurance System (CAS)
 - Chapter Seven, Requirements Analysis Process,
 - Chapter Eight, Validating Line Oversight and Contractor Assurance Systems
 - Chapter Nine, Integrated Oversight and Assessment Schedule,
 - Chapter Ten, Performance Evaluation Plan (PEP) and Metrics

NAP -21

- The M&O Contractor senior executive is responsible for the effective management of their enterprise.
- M&O Contractors work in full partnership with NNSA to design, certify, test, and assess the Nation's nuclear deterrent.
- M&O Contractors provide the leadership and foundation of the Nation's science and technology base
- M&O Contractors steward the nation's NSE science, engineering, and production resources and knowledge and are accountable and responsible for the long-term health and success of the enterprise.
- NNSA line management provides direction to the M&O Contractors by authorized individuals pursuant to contracting requirements.
- M&O Contractors are tasked with efficiently and innovatively implementing the long-term Federal strategic vision of the NSE. They ensure work in the national interest is done consistent with contract requirements and focused on delivering mission results.

NNSA Line Oversight and Contractor Assurance System Supplemental Directive, NA-1 M 226.1A

NNSA Site Office Line Oversight: Each Site Office oversight program must provide for:

- Assessing the effectiveness of the CAS using a variety of methods by, for example:
 - shadowing contractor assessments;
 - comparing contractor assessment results and performance metrics with the results of similar assessments conducted by NNSA or credible outside evaluators, and
 - evaluating contractor performance in resolving previously identified issues.
- Developing and documenting an oversight program and annual implementation plan and schedule for evaluating overall contractor performance using "risk-informed" evaluations. Using a Contract Management Plan (CMP), the program must also establish requirements for the frequency, approach, and level of effort of Site Office assessments. Tailored criteria should reflect
 - The significance of the requirement;
 - the uniqueness and complexity of contractor operations, and
 - the potential consequences of failing to meet contract requirements.

Contractor Assurance System Contractor Requirements Document, Attachment 1

The contractor must submit a detailed contractor assurance system (CAS) program description to the Site Office Manager for review and approval that addresses, at a minimum, the following aspects of operations:

- nuclear safety;
- environment, safety, and health.
- safeguards and security;
- emergency management;
- cyber security; and
- business management.

The contractor must submit any updates to the detailed CAS program description to the Site Office Manager for review and approval whenever significant changes occur. The contractor shall facilitate effective sharing of all CAS information with NNSA. Including electronic access.

DOE and the Contracts

Contractor Assurance System. An effective CAS must integrate contractor management, contractor governance, and DOE oversight systems into a single comprehensive site performance management system to:

- provide reasonable assurance that:
 - mission objectives will be met
 - contract requirements fulfilled;
 - site workers, the public, and the environment are protected;
 - operations, facilities, and business systems are effectively run and continuously improved
- define acceptable performance outcomes,
- provide oversight of contract performance, holding contractor management accountable for outcomes
- build trust between DOE and its contractor; ensure alignment between the DOE and contractors; and allow DOE to optimize its oversight function.

Contractor Assurance Working Group of the Energy Facility Contractors Group

The Contracts

One element CAS in contracts is the Parent Oversight Plan:

- (a) If a Parent Oversight Plan is requested by the Contracting Officer . . . the Parent Oversight Plan will be attached and made part of the Contract at Section J. Elements of the Plan may be incorporated into the Performance Evaluation Plan. The Parent Oversight Plan shall identify the official(s) responsible for administration of the plan.
- (b) The Contractor shall provide periodic reports of Parent Oversight activities and costs incurred as required by the Contracting Officer. Costs associated with Plan shall only include: the actual direct labor costs of the persons performing such services; a percentage factor of direct labor costs to cover fringe benefits and payroll taxes; travel; and other direct costs. Any fee or other indirect costs such as allocation for overhead, General and Administrative (G&A), and Cost of Money will not be reimbursed.

Request for Proposal No. DE-SOL-0001458 (Pantex/Y-12), Clause H-6

The Contracts

- Governance is the system of management and controls exercised in the stewardship of the organization.
- The governance system shall be consistent with NNSA governance documents
- Contractors must self-govern and deliver mission results in a safe and secure manner.
- The Contractor shall implement governance through a collaborative partnership with NNSA to form the self-governance framework by which the mission is accomplished in an effective and efficient manner.
- The Contractor shall have a CAS as a subordinate and supporting feature of Governance.
 - primary tool used by Contractor management to measure and improve performance,
 - ensure that mission objectives and Contract requirements are met;
 - ensure that workers, the public and the environment are protected; and
 - ensure that operations, facilities, and business systems are efficiently and effectively operated and maintained.
- NNSA oversight shall not be relied upon by the Contractor as the primary feedback in assessing its performance.

Request for Proposal No. DE-SOL-0001458 (Pantex/Y-12), SOW

The Contracts

Parent Organization(s)

- A multi-year strategy and oversight plan that details
- M& Contractor's planned efforts and expected accomplishments by year, to continuously improve its management and performance, and
- the planned efforts and contributions of its Parent Organizations; including the Board's
 - monitoring of the Contractor's performance
 - assistance to the Contractor in meeting NNSA's mission and operational requirements.

Request for Proposal No. DE-SOL-0001458 (Pantex/Y-12),
SOW

LANL/LLNL LLC Agreement

Integrate the expertise of the Members and the Independent Governors into oversight of the management and operation of the Laboratory

Six standing committees:

- The Mission Committee to address current and future issues related to the nation's security and their relation to current Laboratory initiatives, capabilities and strategic plans.
- The Science and Technology Committee to address the state of the Laboratory's scientific expertise and the ability to attract and retain scientific staff in core and critical technical areas.
- The Nominations and Compensation Committee to address the selection, performance, compensation and other aspects of the Laboratory Director and other Key Personnel.
- The Ethics and Audit Committee to address the integrity of the Laboratory financial system and other aspects of Laboratory operations
- The Business and Operations Committee to address the quality and efficacy of the business and operations of the Laboratory and will seek to install best practices throughout the Laboratory.
- The Safeguards and Security Committee to address the adequacy of security and safeguards at the Laboratory




Governance

Transparency, Integrity & Teamwork

Bob Cochran



A World of Solutions




Roles and Responsibilities of Governance Team

The Board of Managers Must Deliver:

- Clear alignment between customer and contractor
- Implement an effective Contractor Assurance System
- Leverage parent company experience and bring resources, systems, lessons learned and best practices – reach back
- Develop a risk based oversight plan & deliver a graded risk management program
- Provide fiduciary oversight through board sponsored assessments and audits
- Solicit independent feedback from the customer relative to contract performance
- Apply strategic benchmarks and assure performance exceeds expectations
- Prepare key personnel succession plan

A World of Solutions


 Structures


Not necessary to be an LLC/Venture:

- Commitment to delivering the promise
- Fundamentals of sound project and operating practices
- Engagement and ownership of most senior management
- Invite independent view

Committees:


- Ethics and audit
- Safeguards and security
- Operations or mission
- Human resources and compensation
- Continuous improvement
- Science and technology (for labs)
- Nuclear operations (labs & production sites)
- Need to have independent members (i.e. not affiliated with any of the parent companies)


A World of Solutions  33

 Best Practices

Essentials:

- Full transparency with the customer at all levels
- Willingness to provide top notch people as part of corporate reach back (assessments/judgment of needs/corrective action/surge)
- Provide vision and strategy for the operation
- Ensure Board members are both qualified and have the time to commit to this important duty
- Provide staffing for the board (someone that can do upfront planning, coordination and actual work. Someone that is "connected" to the site so that they are aware of issues that the Board should be looking at)


A World of Solutions  34



Pitfalls

Becoming part of the mission:

- Having just a "Dine and Dash" Board (The Board members need to be engaged throughout the year, not just for one day every quarter at the Board meetings)
- Not understanding the site/project (The members must have the background and expertise necessary to understand the operations of the site)
- Not allocating or budgeting resources (time and money) necessary to provide appropriate oversight and governance
- Not listening to customer input, or thinking too much from the parent company perspective
- Complacency (need to keep a genuine focus on having a questioning attitude)
- Avoid the death of a thousand razor blade cuts

A World of Solutions  35