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# LLC Provisions Regarding Directors and Managers: Recent Delaware Decisions and Key Practice Points for Counsel

Crafting Safe Harbors, Eliminating Corporate-Type Fiduciary Duties, Implied Covenants and More

WEDNESDAY, OCTOBER 31, 2018

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# LLC Provisions Regarding Directors and Managers

Christopher N. Kelly

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## Recent Delaware Cases

- ***Miller v. HCP & Co.,* 2018 WL 656378 (Del. Ch. Feb. 1, 2018), *aff'd*, 2018 WL 4600818 (Del. Sept. 20, 2018).**
  - Co-founder/minority investor in LLC brought suit challenging sale of LLC to independent third party
  - Sale yielded controlling member 200% investment return but little or nothing for other members
  - Plaintiff claimed controller and board designees breached implied covenant of good faith and fair dealing
    - Waterfall allegedly created divergent incentives giving rise to implied auction requirement to maximize price
  - On defense motion, Court of Chancery dismissed case
    - LLC agreement waived all fiduciary duties
    - LLC agreement had no gap for implied covenant to fill
      - LLC agreement gave controlled board sole discretion to sell—if to independent third party
      - Third-party sale requirement defined board's discretion; board acted within scope of discretion
    - Even if there were a gap, plaintiff's claim would fail because reasonable expectations not frustrated
      - LLC agreement contemplated private negotiation rather than auction
      - Defendants' putative conduct not arbitrary, unreasonable or unanticipated
  - On appeal, Delaware Supreme Court affirmed on different grounds

## Recent Delaware Cases

- ***In re Oxbow Carbon LLC Unitholder Litig.*, 2018 WL 818760 (Del. Ch. Feb. 12, 2018), and 2018 WL 3655257 (Del. Ch. Aug. 1, 2018).**
  - Minority members sought to force exit sale of LLC under purported terms of operating agreement
  - LLC agreement defined “exit sale” as “transfer of all, but not less than all, of” equity or assets of LLC
  - LLC agreement precluded exercising party from requiring another member to engage in exit sale unless resulting proceeds to such member (plus prior distributions) equaled at least 1.5x capital contributions
  - LLC agreement required that exit sale exceed fair market value and treat unitholders equally
  - Minority members secured buyer who offered purchase price greater than fair market value but would not satisfy 1.5x clause for two small unitholders controlled by LLC’s majority member
  - At summary judgment, Court found LLC agreement supported interpretation that if different members need different amounts to satisfy 1.5x clause, then equal treatment requirement meant all members must receive highest amount necessary to satisfy 1.5x clause, and that a member could not be left behind
  - After trial, Court invoked implied covenant to fill gap created when small holders invested in LLC, finding “issues of compelling fairness call for” inference of “seller top off” to satisfy 1.5x clause for small holders
  - According to Court, majority member breached reasonable efforts clause by seeking to disrupt sale
  - Court awarded specific performance of exit sale, potential award of damages to account for any lost transaction or time value, and damages equal to minority members’ share of expenses incurred by LLC

## Recent Delaware Cases

- ***MHS Capital LLC v. Goggin*, 2018 WL 2149718 (Del. Ch. May 10, 2018).**
  - Member of Delaware LLC brought suit against manager and others alleging defendants engaged in scheme to divert part ownership of LLC's assets to consortium of entities defendants controlled
  - The assets were subject to lien held by LLC against bankrupt third party, which gave LLC right to bid using its secured interest, rather than cash, as consideration in bankruptcy sale
  - Plaintiff alleged that defendant manager arranged for bankruptcy court to transfer the assets not to LLC but to group of entities (of which LLC was only one) associated with manager and his friends
  - LLC agreement eschewed default fiduciary duties in favor of contractual duties
  - LLC agreement waived members' right to seek damages from manager, except as required by LLC act
  - On defendants' motions to dismiss, the Court of Chancery granted them in part and denied them in part
    - Court found breach of contract claim stated colorable claim for relief under LLC agreement
    - Court found equitable relief not precluded by bankruptcy court sale orders
    - Court found damage award conceivable notwithstanding LLC agreement's exculpatory clause
    - Court dismissed remaining claims for, *inter alia*, breach of fiduciary duty, fraud, aiding and abetting, breach of implied covenant, unjust enrichment and misappropriation of trade secrets

## Recent Delaware Cases

- ***In re Energy Transfer Equity, L.P. Unitholder Litig.*, 2018 WL 2254706 (Del. Ch. May 17, 2018).**
  - Unitholders of MLP brought suit challenging private offering placed largely with insiders
  - MLP issued securities in contemplation of merger with third party to raise cash due to industry downturn
  - In private offering, subscribers agreed to accumulate credit redeemable as common units at later date in return for forgoing distributions (and were guaranteed some credit even if distributions reduced)
  - Merger ultimately did not close; energy market boomed; and value of MLP units soared
  - Plaintiffs alleged private offering was non-*pro rata* distribution and conflicted transaction in breach of LPA
  - Plaintiffs sought cancellation of issued securities and permanent injunction prohibiting conversion or transfer
  - Court of Chancery declined to cancel securities or issue injunction
    - Court found private offering was not a "distribution," but rather was issuance of securities for value
    - Court found private offering was conflicted transaction that was not objectively fair and reasonable to MLP
    - Court found safe harbor of conflicts committee approval not satisfied (committee not properly constituted)
    - Court found no evidence indicating directors considered minimum accrual term fair and reasonable
    - However, Court denied plaintiffs' request for rescission and permanent injunction, finding such relief inappropriate because unfair to unaffiliated subscribers and because MLP suffered no damages

# LLC PROVISIONS REGARDING DIRECTORS AND MANAGERS

# Duties

Lisa R. Jacobs

# Duties

- Separate sections provide rules on the duties of:
  - members in a member-managed LLC (§409(a))
  - managers in a manager-managed LLC (§409(i)(1))

- The duties in the two sections are largely the same, but the sections are tailored to the specific situations of members and managers.

# Member-Managed

**Members**

- **§ 409 (a) General rule. -** A member of a member-managed limited liability company owes to the company and, * * * the other members the duties of loyalty and care stated under subsections (b) and (c).

**Managers**

- **§ 409(i)(1) General rule. - Subsection (a) [of § 409] applies to the manager** of a manager-managed limited liability company and not the members.

# Limited Member Duties

- Section 409(i)(6) provides that "a member does not have any duty to the company or to any other member of the company solely by reason of being or acting as a member.

# Basic Duties

- **Fiduciary duty of loyalty. (§§ 409(b), 409(i)(1))**
- **Duty of care. (§§ 409(c), 409(i)(1))**
  - The duty is "to refrain from engaging in gross negligence, recklessness, willful misconduct or knowing violation of law."
- **Contractual obligation of good faith and fair dealing. (§§ 409(d), 409(i)(3))**
  - Is different from the corporate law concept of good faith which is an aspect of the duty of loyalty, as articulated in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).
  - Comment: "[T]he contractual obligation of good faith and fair dealing and thereby invokes the implied obligation that exists in every contract. Pennsylvania's comment sheds more light:
  - it is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in the partner's own self-interest … [T]he purpose … is to protect the arrangement the partners have chosen for themselves, not to restructure the arrangement under the guise of safeguarding it."

# Aspects of the Duty of Loyalty

1. Do not conduct the company's activities for personal gain.
2. Do not use company property for personal gain
3. Do not appropriate a company opportunity.
4. Do not engage in self-dealing.
5. Refrain from competing with the company.

These duties apply both during the life of the company and also during winding up.

# NEW: Duties Variable

- In a major change from prior law in most jurisdictions (***not Delaware***), the duties of members in a member-managed LLC and managers in a manager-managed LLC will be ***subject to variation*** by agreement of the members.

- Look to operating agreement

# Varying Duties

- Duties other than care and loyalty may be altered or eliminated by the OA, if not manifestly unreasonable.
- The OA may alter the duty of care, except to authorize conduct involving bad faith willful or intentional misconduct or knowing violation of law.
- The OA may not eliminate the contractual obligation of good faith and fair dealing, but may prescribe the standards by which it is measured, if not manifestly unreasonable.

# Varying Duties

- Aspects of Duty of Loyalty (§ 409(b)):
- - account to company and hold for for its benefit any property, profit or benefit derived by the member
- - refrain from dealing with the company during its life and in windup on behalf of a "person" with an adverse interests
- - refrain from competing with the company before dissolution

- The OA may **identify types of activities** that do not violate the duty of loyalty.
- Subject to the "not manifestly unreasonable" standard, the OA may **eliminate all** aspects of the duty of loyalty listed in 409(b).
- The OA may freely alter, and may **eliminate entirely**, the aspects of the duty of loyalty stated in 3 and 5.

# Statutory Provisions Authorizing

**EXCEPTIONS:**

**§ 105. Operating Agreement; Scope, Function and LImitations.**

***          *          ***

**(c) Limitations.--An operating agreement may not do any of the following:**

***          *          ***

**(6) *Eliminate* the contractual obligation of good faith and fair dealing under section 409(d), but the OA may prescribe the standards, if not manifestly unreasonably, by which the performance of the obligation is to be measured.**

# Statutory Provisions Authorizing

**EXCEPTIONS: § 8815(d)**

(1) The operating agreement may:

(iA **specify the method** by which a specific act or transaction that would otherwise violate the **duty of loyalty** may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts;

(3) If not ***manifestly unreasonable,*** the operating agreement may:

(A) alter or eliminated the aspects of the **duty of loyalty** stated in Section 409(b) [member-managed] and (i) [manager-managed]

(B) identify specific **types or categories** of activities that do not violate the **duty of loyalty**;

(C) alter the **duty of care;** and

(D) alter or eliminate any **other fiduciary duty.**

# Statutory Provisions - Discussion

- **Subsection (c)(11) and (12) (duty of loyalty/care)–** These limitations are less far-reaching than might first appear because subsection (d) specifically authorizes substantial alterations to the duties of loyalty and care, including restricting and substantially eliminating those duties under certain circumstances.
- **105 (c)(6)** (good faith/fair dealing)– §409(d) referS to the "contractual obligation of good faith and fair dealing," which contract law implies in every contract.
  - An operating agreement that seeks to "prescribe the standards … by which the performance of [that] obligation … is to be measured" should expressly refer to the obligation. See Gerber v. Enter. Prods. Hldgs., LLC, 67 A.3d 400, 418 (Del. 2013) (distinguishing between the implied contractual covenant and an express contractual obligation of "good faith" as stated in a limited partnership agreement).

# Statutory Provisions - Discussion

- **Subsection (d) –** The operating agreement has complete power over the matters described in subsection (a), except as specifically limited by subsections (c) and (d)(3). However, subsection (d)(1) and (2) list various arrangements often found in operating agreements. Subsection (d)(3) lists arrangements subject to the "not manifestly unreasonable" standard. Subsection (e) delineates the manifestly unreasonable standard.
- **Subsection (d)(2) –** in member-managed limited liability companies: (i) managers are collectively responsible; and (ii) managers may properly delegate a duty but the delegation does not discharge the duty. However, subject to subsection (d)(3) the operating agreement may alter or even eliminate fiduciary duties.
- **Subsection (d)(3) –** This Act seeks to balance the virtues of "freedom of contract" against the dangers that inescapably exist when some have power over the interests of others, rejecting the notion that fiduciary duty within a business organization is merely a set of default rules.

# Statutory Provisions - Discussion

- A properly drafted operating agreement may substantially alter and even eliminate fiduciary duties, subject to two important limitations:
  - First, arrangements subject to this subsection ***may not*** be "manifestly unreasonable" as that concept is delineated in subsection (e).
  - Second, the operating agreement ***may not*** transform the relationship among the members, managers, and the limited liability company into an entirely arm's length arrangement. For example, displacement of fiduciary duties is effective only to the extent that the displacement is stated clearly and with particularity. See, e.g., Paige Capital Management, LLC v. Lerner Master Fund, LLC, Civ. A. No. 5502–CS, 2011 WL 3505355 at *31 (Del.Ch. Aug. 8, 2011) (even under a statute that permits complete waiver of fiduciary duty, such waivers must be set forth clearly").

# Statutory Provisions - Discussion

(e) Determination of manifest unreasonableness. – The ***court*** shall decide as a matter of law whether a term of an operating agreement is manifestly unreasonable under subsection (c)(6) or (d)(3). The court:

(1) makes its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and

(2) may invalidate the term only if, in light of the purposes, activities and affairs of the limited liability company, it is readily apparent that:

(i) the objective of the term is unreasonable; or

(ii) the term is an unreasonable means to achieve the term's objective.

# Statutory Provisions - Discussion

Subsection (e) sets forth a demanding standard for persons claiming that a term of an operating agreement is “manifestly unreasonable” - - the court may invalidate the term only if, in light of the purposes, activities, and affairs of the limited liability company, it is readily apparent that the objective of the term is unreasonable or that the term is an unreasonable means to achieve the term’s objective.

Rules for applying the concept of “not manifestly unreasonable” and specifies:

- who decides the issue of “manifestly unreasonable”:

  ***the court … as a matter of law***

- what is the framework for determining the issue:

  ***determination to be made “in light of the purposes, activities and affairs of the limited liability company,”***

- the temporal setting for determining the issue:

  ***determination [to be made] as of the time the challenged term became part of the operating agreement”***

- what information is admissible for determining the issue:

  ***“only circumstances existing” when “the challenged term became part of the operating agreement,”***

# Variations: Sample Language – General Waiver

This Agreement is not intended to, and does not, create or impose any fiduciary duty on any Member, [Manager], [Director, or Officer] *[insert appropriate positions]*. Each of the Members and the Company hereby waives any and all fiduciary duties that, absent that waiver, may be implied or imposed by applicable law, and in doing so, acknowledges and agrees that the duties and obligations of each Member, [Manager], [Director, and Officer] to each other and to the Company are only as expressly set forth in this Agreement. The Members hereby acknowledge and agree that the provisions of this Agreement, to the extent that they restrict the duties and liabilities of a Member, [Manager] [Director, or Officer] otherwise existing at law or in equity, expressly replace such other duties and liabilities of such Member, [Manager], Director, or Officer. Each Member expressly waives, to the fullest extent permitted by applicable law, any rights to assert any claim based on any matter arising out of or in connection with any fiduciary duty owed to the Company or any Member.

# Variations: Sample Language – General Waiver Discussion

- The previous slide purports to limit fiduciary duties to those set expressly set forth in the Agreement – although on its face, with nothing more, this language would serve to eliminate such duties in their entirety. § 105(d)(3)(D). [See 15 Pa. C.S. § 8815(d)(3)(v). Any such waiver must be express and stated with particularity. See comment to subsection (d)(3).] The acknowledgement and consent language in the last two sentences support the hallmark determinations of enforceable waivers: knowing, voluntary and intelligent.

- **Discussion**: is such a broad limitation "not manifestly unreasonable"?

# Variations: Sample Language – Limitation on Duty of Loyalty (ex. 1)

Each Member hereby agrees that in the event it becomes aware of any bona fide opportunity [***within a specified category aligned to the Company's function***] (each, a "***Subject Opportunity***"), it shall be first be offered to the Company. Such Member shall provide information to the [Manager][Members] sufficient for the [Manager][Members] to properly evaluate the Subject Opportunity, or sufficient to permit the Manager to obtain such relevant information to enable such evaluation. ***[insert mechanism for time frame and consideration of transaction]***. In the event the Company does not pursue such Subject Opportunity [***within time frame***] or does not consummate such Subject Opportunity, the introducing Member shall be free to so pursue. Other than with respect to Subject Opportunities, each Member is otherwise free to engage in any venture or activity in any fashion, and the independent pursuit of other ventures and activities by Members or Managers is hereby consented to by the Members and shall not be deemed wrongful or improper."

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# Variations: Sample Language – Limitation on Duty of Loyalty Discussion

- The previous slide highlights the level of detail necessary to create a limitation that is both properly expressed and not manifestly unreasonable.
- In certain circumstances, it may be reasonable to permit full competition with no restrictions. In others, it may be reasonable to permit no such latitude.
- A proper, focused description of Subject Opportunity is critical. *[Note – RULLCA does not expressly require the particularity that Pennsylvania does]*
- The obligations of good faith and fair dealing continue to be applicable to the actions of the parties notwithstanding the permissions in the above language.

# Variations: Sample Language – Limitation on Duty of Loyalty (ex. 2)

Nothing herein shall prevent the Manager or any Member from conducting any other business, including any business with respect to securities, regardless of whether such business is in competition with the Company. Without limiting the generality of the foregoing, the Member, its members, officers, affiliates and employees may act as [manager] [advisor] for others, may manage businesses, operations, investments or capital for others, may have, make and maintain investments in its own name or through other entities, and may serve as a consultant, member, partner or stockholder of one or more businesses engaging in the same or similar businesses as the Company and may act as a director, officer and/or employee of any corporation, or other business organization, a trustee of any trust, an executor or administrator of any estate, or an administrative official of any other business entity.

# Variations: Sample Language – Limitation on Duty of Loyalty Discussion

- The previous slide is a typical broadly constructed grant of permission in the investment industry for managers and advisors to act for other investment vehicles and their affiliates.

- Given its context, it is rarely challenged.

- Quaere whether it would survive the "not manifestly unreasonable" for more general operating company managers.

# Variations: Sample Language – Limitation on Duty of Loyalty (ex. 3)

- No Exclusive Duty to Company. No Member or Manager shall be required to manage, or act on behalf of, the Company as his or its sole and exclusive function. Subject to the fulfillment of any Member's or Manager's obligations pursuant to this Agreement, each Member and Manager may have other business interests and may engage in other businesses, investments and activities in addition to those relating to the Company even if such other businesses, investments and/or activities compete with the business of the Company. Neither the Company, nor any other Member, shall have any right, by virtue of this Agreement, to share or participate in such other businesses, investments or activities of any Member or Manager or to the income or proceeds derived therefrom. No Member or Manager shall incur any liability to the Company or to any of the other Members as a result of engaging in any such other business, investment or activity.

# Variations: Sample Language – Limitation on Duty of Loyalty Discussion

- The previous slide reflects a more moderate expression of permission for a manager to engage in activities other than managing the subject company.

- ***Key drafting consideration***: where to draw the line in order to optimize a conclusion (in an action attacking a Manager’s conduct) that the contractual provision is “not manifestly unreasonable” and therefore should be honored.

# Variations: Sample Language – Limitation on Duty of Loyalty/Self Dealing

No Member and no Person which is an Affiliate of any Member, (a) may be employed by the Company or any Affiliate of the Company or otherwise deal with the Company, any Affiliate of the Company or any Property, or (b) may be paid any compensation, fees or other remuneration, directly or indirectly, by the Company or any Affiliate of the Company, except in either such case with the prior written consent of all Members. Notwithstanding the foregoing, the Company or any Affiliate of the Company may enter into a written management agreement with ABC Management Services, Inc., an affiliate of [Member X] or an Affiliate thereof, to provide property management, leasing and brokerage services with respect to any Property acquired by the Company, subject to the written approval of [Member Y] in each instance. The enforcement of any such agreement by or on behalf of the Company and/or any Affiliate of the Company shall be controlled exclusively by [Member Y].

# Variations: Sample Language – Duty of Loyalty/Self Dealing Discussion

- The language in the previous slide reflects specific negotiated consent to engage in a limited form of self-dealing for affiliates of Member X, subject to the consent of Member Y (in reality, there were 10 additional members, but all with significantly more modest involvement).

- Other "not manifestly unreasonable" governors could include a statement that the compensated services to the company would be at a price not exceeding market price, or that the manager may pursue certain categories of opportunities that otherwise would be company opportunities. Such arrangements are commonplace and permissible.

- Consider appropriate limitations to address the "not manifestly unreasonable" standard (in the example, governors imposed by a non-affiliate member consent, in the alternative, market price).

# Variations: Sample Language – Method of Ratification: § 105(d)(1)(A)

[A]NY resolution or course of action by the [Manager] or its Affiliates in respect of such conflict of interest shall be permitted and deemed approved by all Members, and shall not constitute a breach of this Agreement … or of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is (i) approved by Special Approval, (ii) approved by the vote of a majority of the Common Units (excluding Common Units owned by the Manager and its Affiliates), (iii) on terms no less favorable to the Company than those generally being provided to or available from unrelated third parties, or (iv) fair and reasonable to the Company, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the Company).

# Variations: Sample Language – Method of Ratification: § 105(d)(1)(A)

- Special Approval" means approval by a majority of the members of the Conflicts Committee.
- The Conflicts Committee must be: [A] committee of the Board of Directors of the Manager composed entirely of two or more directors who are not (a) security holders, officers or employees of the Manager, (b) officers, directors or employees of any Affiliate of the Manager, (c) holders of any ownership interest in the Company other than Common Units and who also meet the independence standards required of directors who serve on an audit committee of a board of directors established by the Securities Exchange Act of 1934, as amended, and the rules and regulations of the Commission thereunder and by the National Securities Exchange on which the Common Units are listed or admitted to trading.

# Variations: Sample Language – Method of Ratification Discussion

- The above language was “borrowed” from the recent Delaware Supreme Court decision in *Dieckman v. Regency GP LP*, C.A. No. 11130 (Del. Jan. 20, 2017), which confirms that, although Delaware courts will enforce clear, express and unambiguous language modifying or eliminating default fiduciary duties, a conflict of interest transaction may still run afoul of implied contractual standards. (while a limited partnership case, the law is substantially similar to that governing LLCs)
- The *Dieckman case* involved a merger of Regency Energy Partners LP, a publicly traded Delaware limited partnership (the "MLP"), with an affiliated entity. To reconcile this inherent conflict of interest, the general partner (GP) of the MLP attempted to satisfy two safe harbor mechanisms set forth in the partnership agreement, either of which could be used to insulate the transaction from legal challenge—"Special Approval" by an independent Conflicts Committee and "Unaffiliated Unitholder Approval."

# Variations: Sample Language – Method of Ratification Discussion

- The plaintiff, a common unitholder of the MLP, alleged that (1) the GP failed to satisfy the Special Approval safe harbor because there was a conflicted member on the Conflicts Committee, and (2) the GP failed to satisfy the Unaffiliated Unitholder Approval safe harbor because the GP made false and misleading statements in a proxy statement to secure such approval.

- The Chancery Court did not address the defendants' Special Approval defense, but found that the Unaffiliated Unitholder Approval safe harbor had been satisfied because (i) the partnership agreement had eliminated all fiduciary duties, including the duty of disclosure, and (ii) the disclosures expressly required by the partnership agreement had been made. The Chancery Court therefore granted the defendants' motion to dismiss.

# Variations: Sample Language – Method of Ratification Discussion

- On appeal, the Delaware Supreme Court noted that even when a partnership agreement waives fiduciary duties, investors still have, *inter alia,* protections afforded to them through the implied covenant of good faith and fair dealing.

- The Supreme Court focused on the safe harbor process in its entirety and found that the language in the partnership agreement's conflict resolution provision implicitly required the GP to act in a manner that would not undermine the protections afforded to the unitholders in connection with the safe harbor process.

- The Supreme Court analyzed aspects of ***both*** the Special Approval Defense and the Unaffiliated Unitholder Approval Defense.

# Variations: Sample Language – Method of Ratification Discussion

- In analyzing the Unaffiliated Unitholder Approval defense, the Supreme Court noted that the GP had issued a comprehensive proxy statement, which went far beyond the minimal disclosures required by the express terms of the partnership agreement, to induce the unitholders to approve the merger transaction, but then held that once the GP determined to go beyond the minimal disclosure requirements under the partnership agreement, then—pursuant to the implied covenant of good faith and fair dealing—the GP had an obligation not to mislead investors.

- The Supreme Court found that the plaintiff pled facts raising sufficient doubt concerning whether the proxy statement misled investors by creating the false appearance that the Conflicts Committee, which had approved the transaction, was composed solely of unaffiliated and independent persons.

# Variations: Sample Language – Method of Ratification Discussion

- The Court, in analyzing the Special Approval defense, found that the GP had an obligation to form a conflicts committee as required by the partnership agreement (committee members independent from and unaffiliated with the GP). The plaintiff alleged the GP created a two-member committee that included an individual who began reviewing the merger transaction while still a member of an affiliate board, which contravened the independent status requirement of the Conflicts Committee members. The Court concluded that the plaintiff raised sufficient doubt as to whether the Conflicts Committee was properly constituted, which called into question whether the GP could use the partnership agreement's safe harbor provisions agreement to preclude judicial review of the merger transaction.
- *Dieckman* illustrates the tension between contractual flexibility afforded to Delaware limited partnerships and general good faith requirements to perform obligations imposed by contractual responsibilities in the partnership agreement.

Strafford Webinar
October 31, 2018

# LLC PROVISIONS REGARDING DIRECTORS AND MANAGERS: RECENT DELAWARE DECISIONS AND KEY PRACTICE POINTS FOR COUNSEL



Holland & Knight LLP

Strafford Webinar
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# Crafting Safe Harbors, Eliminating Corporate-Type Fiduciary Duties, Implied Covenants and More



Holland & Knight LLP

# Background for Changes to Fiduciary Duties in RULLCA

- 1. Fiduciary Duties in unincorporated entities developed initially from early common law, starting with courts of equity addressing trusts and partnerships.
- 2. The term "fiduciary" was adopted to apply to situations in which one person controlled or directed property for the benefit of another but fell short of a Trust/Trustee/Beneficiary relationship.
- 3. In 1916 UPA was promulgated by the NCCUSL and touched sparingly on a duty of loyalty for the GP, leaving the common law of agency to fill out the duty.
- 4. In 1928 Cardozo's seminal opinion in Meinhard v. Salmon compared a JV between Meinhard and Salmon to a partnership and a trust in applying a duty of loyalty upon Salmon as the person in control of the JV.

# Background of Changes Cont’d.

- 5. Meinhard provided the foundation for modern business entity fiduciary duties, the fiduciary relationship between those in control of a business on the one hand and their obligation to the entity and its owners on the other hand.
- 6. RUPA was the first statutory codification of the duties of loyalty and care for unincorporated business entities.
- 7. Courts and statutes have universally applied the duties of loyalty and care (as well as the obligation of good faith and fair dealing) to those in control of corporations, partnerships, and LLCs.
- 8. The definitions of those duties have varied however. See the MBCA, RUPA, RULPA, RULLCA and various state statutes definitions of loyalty and care.

# Background of Changes cont'd

- 9. The ULC, and many states, have been trying to "harmonize" unincorporated business entity laws for the past twenty plus years.
- 10. RULLCA's fiduciary duties definitions for Loyalty and Care, and the obligation of "Good Faith and Fair Dealing" have indeed been "harmonized", at least for partnerships and LLCs, with one exception – cabined vs. un-cabined fiduciary duties.
- 11. RUPA continues to "cabin-in" fiduciary duties, so with the changes to un-cabin fiduciary duties in RULLCA, the uniform Partnership and LLC statutes are no longer harmonized in that regard.

# “Cabined” vs “Un-Cabined” Fiduciary Duties

- Cabined Fiduciary Duties – RUPA first codified fiduciary duties by taking the then radical approach of “Cabining-In” fiduciary duties, stating:
- “*The **<u>only</u>** fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (C)*” [Section 404].
- Courts in different states had been creating various iterations of the fiduciary duties owed to partners in a partnership, so the rational for *“cabining-in”* the duties to those described in RUPA was an attempt to bring uniformity to fiduciary duties within partnerships.

# Un-Cabined Fiduciary Duties

- RUPA was controversial in cabining in fiduciary duties, because while the idea of uniformity may have been worthy, common law fiduciary principles had evolved as a way for courts to provide equity to parties in disputes, so many thought it was better to leave it to the discretion of the courts to determine whether a fiduciary breached his or her duties.
- So, leaving it to the Court and common law principles represents the "Un-Cabining" of fiduciary duties which had been the norm prior to the original ULLCA.
- That change in legislative policy followed with the "Un-cabined" approach of RULLCA (2006, as amended through 2016).

# “Un-Cabined” vs “Cabined”

(2) The **duty of loyalty** includes ~~is limited to~~:

(a) Accounting to the LLC ...

(b) Refraining from dealing ...

(c) Refraining from competing ...

(3) The **duty of care** in the conduct or winding up of the company’s activities and affairs is ~~limited~~ to refrain ~~refraining~~ from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of the law.

(2) The **duty of loyalty** ***is limited to:***

(a) Accounting to the LLC ...

(b) Refraining from dealing ...

(c) Refraining from competing ...

(3) The **duty of care** in the conduct or winding up of the company’s activities ***is limited to*** refraining from engaging in grossly negligent or reckless conduct, willful or intentional misconduct, or a knowing violation of the law.

# Un-Cabined Fiduciary Duties of Members and Managers cont’d

## The Operating Agreement

- The Operating Agreement may not eliminate the duty of loyalty or the duty of care, except as otherwise provided in s.105(4), nor may it eliminate the obligation of good faith and fair dealing. See s. 105(3)(e) and (f).
- However, the OA may provide for the alteration or elimination of certain aspects of the duty of loyalty under s. 605.04091, and may prescribe standards by which the Obligation of GF&FD is to be measured, so long as the alteration or elimination of duties or standards is not “*manifestly unreasonable*.”

# “Manifestly Unreasonable” limitations on fiduciary duties or obligations

- “*Manifestly Unreasonable*” is explicitly a matter of law for the judge (not the jury) to decide. See 605.0105(5)
- “ *The court shall decide as a matter of law whether a term of an operating agreement is manifestly unreasonable under paragraph (3)(f) or (4)(c)”.*
- In making the determination of whether a term of an operating agreement is “manifestly unreasonable” the court shall make its determination as of the time it was made a part of the OA, considering circumstances at that time, and may invalidate the term if it is “*readily apparent”* that the objective of the term is unreasonable or the term is an unreasonable means to achieve the term’s objective.

# Rules of Construction and Supplemental Principles of Law

- The original s. 605.0111(1) provided: "***It is the intent of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements…***".
- It also provided 605.0111(2) : "***<u>Unless displaced by a particular provisions of this chapter</u>, the principles of law and equity apply to supplement this chapter***".
- **There was some confusion (differing judicial interpretations) as to whether 605.0111(2) meant that common law fiduciary principles supplemented 605.04091, or whether the explicit *"limitations"* in 605.04091, trumped the *"supplemental principles rule"* because of the *"unless otherwise displaced by a particular provision"* language.**

# Revised Rules of Construction and Supplemental Principles of Law

- The revised RULLCA s.111 provides:
- Unless displaced by particular provisions of this [act], the principles of law and equity supplement this [act].
- Some states go even further. Florida for example states that common law principles relating to fiduciary duties of loyalty and care are specifically included within the principles of law and equity which supplement the FL Revised LLC Act.
- Most states' LLC Acts statutorily establish that anyone who has duties, including fiduciary duties, <u>*may contract around those duties in the operating agreement, but only to the extent allowed under 605.0105*</u>.

## RULLCA s.111

Unless displaced by particular provisions of this [act], the principles of law and equity supplement this [act].

## Revised 605.0111(2)

(2) To the extent that, at law or in equity, a member, manager, or other person has duties, including fiduciary duties, to a limited liability company or to another member or manager or to anther person that is a party to or is otherwise bound by an operating agreement, the duties of the member, manager, or other person may be restricted, expanded, or eliminated, including in the determination of applicable duties and obligations under this chapter, by the operating agreement, to the extent allowed by s. 605.105

(3) Unless displaced by particular provisions of this chapter, the principles of law and equity, including the common law principles relating to the fiduciary duties of loyalty and care, supplement this chapter.

# A&J Capital, Inc. v. Law Office of Krug, C.A.No. 2018-0240 (Del. Ch. July 18, 2018) V. C. Slights

- Chancery Court enforces LLC Agreement allowing removal of Manager without Notice or Reason, except for notice ***after*** removal.
- OA allowed Class B Members "sole and exclusive right" to remove the Manager for "gross negligence, intentional misconduct, fraud, or deceit".
- Manager received notice of removal, but no reason was given for removal. No previous indication of any issue with manager.
- Manager said such removal without reason or notice was contrary to DE common law and the LLC Act.

# A&J Capital Continued

- Court held removal was proper under both the LLC Agreement and common law.
- First noted DE 18-1101(b) policy of giving maximum effect to the principle of freedom of contract and enforceability of the Agreement.
- Unlike corporations, LLCs are first examined under their LLC Agreements, not common law or the statute.
- The LLC Act provision that states that principles of law and equity supplement the Act, do not allow for them to "***supplant the primacy***" of the LLC Agreement; and should only govern matters not addressed in the LLC Agreement or the LLC Act.

# Basho Technologies Inc. v. Georgetown Basho Investors, LLC C.A. No. 11802-VCL (Del. Ch. July 6, 2018) Vice Chancellor Laster

- Court reaffirmed the principle that a person with "actual control" of a DE corporation owed fiduciary duties, and violates its fiduciary duties by advancing its own rights to the detriment of the corporation and its other shareholders.
- Although a corporation case, it may well be applied to LLCs under similarly egregious circumstances (depending on how the LLC Agreement is drafted).
- Defendants were minority shareholders, and lenders under an onerous Series G financing to the Corp., and defendants' representatives served on the Board of the Corp.

# *Basho* continued

- **Court found that Defendants exercised effective control over Basho as a result of; (1) use of contractual blocking rights to channel Basho into accepting defendants onerous financing terms; (2)spread false and misleading information to potential third party investors to protect the defendants control rights over Basho; (3) Used provisions in the loan agreement to dominate Basho management and forced out two independent minded CEOs of Basho; (4) required Basho to retain an Investment advisor that was friendly to Defendants, and then instructed that investment advisor to filter the information it was providing to the CEO and Chairman of Basho; and (5) threatened to cut off funding from a temporary facility unless Basho accepted the onerous terms favorable to Defendants in the Series G round of financing.**

# *Basho*, finale

- Court examined the facts and duties owed under the *"Entire Fairness"* standard of review, placing the burden on the defendants to show that their actions were entirely fair under both concepts: **"fair dealing and fair price".**
- **Case stands for the principle that a fiduciary (even if a minority owner, but one having *"actual control"* because of other rights) may not abuse their control or power to coerce those to whom they owe duties into economic submission. Citing *Auriga Capital Corp. v. Gatz Props. 40 A.3d 839, 870 (Del. Ch. 2012)***

# *Yu v. Guard Hill Estates, LLC* et.al. 2018 BL 366614 (Sup. Ct. Sept. 28, 2018) Majority Opinion

- NY court holds that Fiduciary Duties limit the majority members of an LLC from using their control to adopt amendments to the LLC Agreement which were intended to freeze-out the minority member.
- Involved a family dispute among 3 family siblings.
- Two of the 3 siblings used a 51% vote requirement in the LLC agreement to amend the Agreement to remove their brother as a managing member, added a capital contribution requirement for all members, then declared a capital call which they knew the sibling could not fund, and added a provision that if a member failed to fund the capital call his interest could be foreclosed (as a means of forcing him out of the LLC)

## *Guard Hill Estates, LLC* continued

- Plaintiff sought a declaratory judgment for breach of fiduciary duties by his siblings, among other things.
- Siblings sought to dismiss, countered that the Declaratory action was not proper since their actions were explicitly permitted under the terms of the Operating Agreement and under NY's LLC Act.
- Justice Scarpulla of the Commercial Division held that even if LLC members have a contractual right to amend an operating agreement, they still must not exercise that right "*solely for personal gain in such a way as to deprive the other party of the fruits of the contract*", or "*in an unfair and inequitable manner*".