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## **Minority Investors in LLCs: Contractual Limitations, Waivers of Fiduciary Duties, Other Key Provisions**

Protecting Minority Interests, Choice of Entity in Litigation, Implied Covenants, Contractual Discretion and More

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WEDNESDAY, JULY 11, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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## **Strafford Webinar**

# **Minority Investors in LLCs: Contractual Limitations, Waivers of Fiduciary Duties, Other Key Provisions**

Christopher N. Kelly  
Michael P. Maxwell  
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July 11, 2018

# I. Waivers of Fiduciary Duties in Limited Liability Companies

- Contractual Flexibility
- Default Fiduciary Duties
- Eliminating or Modifying Fiduciary Duties in LLCs
- Implied Covenant of Good Faith and Fair Dealing



# Contractual Flexibility for Alternative Entities

- Freedom of Contract

- The Delaware Limited Liability Company Act (the “LLC Act”) is intended to give maximum effect to the principle of freedom of contract. See 6 *Del. C.* § 18-1101(b)

- Fiduciary Duties may be Eliminated

- LLC Act permits parties to an LLC Agreement to eliminate fiduciary duties that members or managers would otherwise owe. See 6 *Del. C.* § 18-1101(c)

- Implied Covenant may not be Eliminated

- LLC Agreements may not eliminate the implied covenant of good faith and fair dealing. See 6 *Del. C.* § 18-1101(c)



# Default Fiduciary Duties in LLCs

- *Auriga Capital Corp. v. Gatz Properties, LLC*
- *Feeley v. NHAOCG, LLC*
- 18-1104 clarifies that traditional "corporate" fiduciary duties of loyalty and care are applicable to persons controlling an LLC and its property, unless expressly and clearly modified or eliminated in an LLC agreement
  - The traditional duty of care essentially requires managers to be attentive and inform themselves of the material facts regarding a decision before taking action
  - The traditional duty of loyalty generally requires that managers' actions be motivated solely by the best interests of the LLC and its members and that such actions not further personal interests of the manager at the expense of the LLC and its members



# Eliminating or Modifying Fiduciary Duties in LLCs

- The traditional fiduciary duties may be modified or eliminated by including clear and unambiguous language to that end in an LLC agreement
  - Section 18-1101(c) of the LLC Act
- Application of traditional "corporate" fiduciary duties to an LLC agreement and the uncertainty that stems from such application may add costs and inefficiencies to an LLC and its operations



# Implied Covenant of Good Faith and Fair Dealing

- Exists in every contract governed by Delaware law
- Gap filler
- Faithfulness to the scope, purpose, and terms of the parties' contract
- The Court will not rewrite a contract simply because a party later wishes it had gotten a better deal
- Rarely invoked successfully



# Recent Delaware Cases

- *In re Energy Transfer Equity, L.P. Unitholder Litigation*
  - Safe harbor provisions in conflict transactions
- *MHS Capital v. Goggin*
  - Contractual vs. default duties; exculpation
- *Eames v. Quantlab*
  - Narrow interpretation of rights
- *Miller v. HCP & Company*
  - Corporate vs. alternative entity law; minority protections



## II. Corporate vs. pass-through entity form in breach of fiduciary duty claims

- Corporations are fundamentally different than LLCs
- Breach of contract and breach of fiduciary duties claims are not both sustainable unless independent basis to support breach of fiduciary duty claims exist
- Modifications or elimination of fiduciary duties resulting in solely contractual duties may preclude breach of fiduciary duty claims
- *Miller v. HCP* case



# Miller v. HCP: Facts

- Trumpet Search, a Delaware LLC
- HCP and its affiliates (the HCP entities) control Trumpet
  - Own majority of units (including ~80% of Class E Units and ~90% of Class D Units)
  - Entitled to elect 4 out of 7 members of the Trumpet Board
- Sale Proceeds Distribution Waterfall
  - HCP entities entitled to significant portion of first \$30 million in sale proceeds
- The Trumpet Operating Agreement
  - Waives all fiduciary duties
  - Grants Trumpet Board sole discretion as to manner of any sale of the company as long as the sale is to an unaffiliated third party



## Miller v. HCP: Facts (cont.)

- HCP-designated board members pursued sale of Trumpet to an unaffiliated third party, MTS Health Partners, for approximately \$31 million
- Non-HCP board members objected due to lack of an open-market sales process and low purchase price
- HCP-designated board members allowed minimal process to evaluate potential competing bids but rejected fulsome open-market process
- “Process” extended over several months and eventually led to an increased purchase price of \$43 million from MTS, which resulted in the HCP entities receiving their full distribution at the top of the waterfall but very little or no consideration to the other investors



# Miller v. HCP: Claims

- Breach of implied covenant of good faith and fair dealing
- Plaintiff, a minority investor in Trumpet, alleged that the HCP entities and their Trumpet board designees engineered a quick exit that gave them a maximum return on their investment with no consideration of members below them on the distribution waterfall
- Plaintiff claimed that the implied covenant required the Trumpet board to pursue the highest value reasonably available for all Trumpet members, contending that an open-market sales process would have resulted in a much higher price



# Miller v. HCP: Decision

- Motion to dismiss granted
- Implied covenant of good faith and fair dealing claim rejected
- LLC agreement eliminated all fiduciary duties
- No gaps in the LLC agreement
- No requirement to conduct open-market sales process
- Sole discretion standard was qualified with one caveat: sale needed to be to a third party
- Plaintiff's reasonable expectations were not frustrated
- Defendants' conduct was not arbitrary, unreasonable, or unanticipated



## Miller v. HCP: Decision (cont.)

- If the Plaintiff wanted protection from self-interested conduct by Defendants, he should have bargained for language requiring the Board to implement a sales process designed to achieve the highest value reasonably available for all of Trumpet's members
- Plaintiff also could have sought other protections, such as a minimum sales price, a majority of the minority sale provision, or a period during which sales were prohibited
- The Plaintiff struck an investor-friendly bargain with which he was now dissatisfied
- It is not the Court's responsibility to give Plaintiff what he failed to get at the bargaining table



# III. Issues for Minority Investors in Challenging Board Actions

- Corporations are Fundamentally Different than LLCs
- The Implied Covenant is Not a Substitute for Fiduciary Duties
- Be Clear and Comprehensive when Drafting
- Specify Minority Rights
- Incorporate Parameters Around Discretion
- Arbitrary, Unreasonable, and Unanticipated Conduct Remains Problematic



# Corporations are Fundamentally Different than LLCs

- *In re Trados Inc. Shareholder Litigation*

- A former common stockholder brought suit challenging a sale of the company wherein preferred stockholders received nearly all of the sale proceeds due to a liquidation preference and common stockholders received no consideration at all
- Following trial, the Court of Chancery found that a disinterested and independent majority of the board did not approve the transaction because, among other conflicts, directors affiliated with the preferred stockholders were focused on their firms' desire to exit their investments in the company

- *Miller and Trados* reflect the potential difference of outcomes in using the corporate form in contrast to using an alternative entity form that permits contractually modifying and defining applicable fiduciary duties



# Claims when there has been a modification or elimination of fiduciary duties

- If an LLC agreement explicitly replaces default fiduciary duties with contractual duties, then claims for breach of contract or claims for breach of fiduciary duties may be sustained but typically not both unless there is an independent basis to support both such claims
- Aiding and abetting claims?
- Contractual Interpretation issues



# Implied Covenant Claims

- Relief through Implied Covenant?
  - The Court will not rewrite a contract simply because a party later wishes it had gotten a better deal
  - Rarely invoked successfully
- Arbitrary, unreasonable, and unanticipated conduct is still problematic



# IV. Avoiding pitfalls and protecting minority interests in LLCs

- Drafting for Minority Investors
  - Be Clear and Comprehensive when Drafting
  - Specify Minority Rights
  - Consider Applicable Fiduciary Duties and their Effect on Minority Rights



# Draft Specific Minority Rights

- Books and Records / Information Rights
- Direct consent, voting and other approval rights in specified circumstances
  - For example, a majority of the minority sale provision
- Protections with respect to Conflict of Interest Transactions
- Indemnification standards



# Draft Specific Minority Rights (cont.)

- Restrictions on issuance of new units
  - Anti-dilution
  - Pre-emptive rights
- Restrictions on transfers
  - Buy/Sell provisions
  - Tag along provisions
- Management representation
- Non-competes and other restrictive covenants



# Fiduciary Duties Issues for Minority Investors

- What fiduciary duties apply to minority investor and to controlling members and/or managers of the LLC?
  - Default or contractual?
  - Modified?
- Consider limiting fiduciary duty modifications in some or all circumstances.
  - E.g., “sole discretion” provisions



# Fiduciary Duties Issues for Minority Investors (cont.)

- Incorporate parameters around discretion
  - For example, clearly define “good faith” and other standards of conduct
- Provide for special approvals for evaluating conflicts or other specific types of transactions



# Q&A

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