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DELAWARE DISCUSSES FIDUCIARY OBLIGATION IN LIMITED LIABILITY COMPANIES

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A recent Delaware Supreme Court decision, *Auriga Capital Corp. et al. v. Gatz Properties, LLC, et al.*, (Del. Sup. Ct. Nov. 7, 2012), both clarifies and confuses Delaware law as to the fiduciary duties of managers of Delaware limited liability companies. Although intrinsically noteworthy, because of the Supreme Court's criticism of Court of Chancery Chancellor Leo E. Strine Jr. in its opinion, *Auriga* has received substantial publicity. We are likely to see shades of *Auriga* in other jurisdictions that look to Delaware law for guidance.

Auriga provides an immediate "take away" reminder to practitioners. The Delaware Supreme Court has held that one of the key statutory provisions supporting default fiduciary duties of limited liability company managers is "ambiguous." Therefore, when drafting limited liability operating agreements under New York, Delaware or any other law, make it very clear whether the managers are subject to traditional fiduciary standards or whether their only duties to the limited liability company and its members are those specifically set forth in the agreement itself.

New York and Delaware limited liability laws are quite different. Section 409(a) of the New York Limited Liability Company Law (McKinney's 1994), provides:

> (a) A manager shall perform his or her duties as a manager, including his or her duties as a member of any class of managers, in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances.

Although New York lower and intermediate courts have discussed fiduciary duties in the limited liability company context, the New York Court of Appeals had not spoken directly on the issue until its November 2012 decision in *Pappas v. Tzolis*, Index No. 60115-09 (Sup. Ct. N.Y. Co.), which is the subject of another note.

Delaware's Limited Liability Company Act, 6 De. C. 18-101 *et seq.*, in effect since 1992, does not contain an analog to Section 409(a). The Delaware section that Chancellor Strine primarily relied on was Section 18-1104, which provides: "In any case not provided for in this chapter, the rules of law and equity … shall govern." [1]

Summary of the Facts. Peconic Bay, LLC ("LLC"), a Delaware limited liability company, was managed by William Gatz and a Gatz family limited liability company ("Manager"). The Manager acquired majority voting control over both classes of the LLC's equity, thereby holding a veto over any strategic option. The LLC held a long-term lease on a Long Island, New York property owned by the Manager and the leasehold allowed the LLC to operate a golf course on the property. A golf management company operated the golf course pursuant to a sublease from the LLC, but would not be renewing the sublease, a fact known to the Manager. The Manager recognized that the land could be developed more profitably as a residential community, and refused to take any steps to find a new strategic option for the LLC that would protect the LLC's members, including actively frustrating a third party bid for the LLC in excess of $6 million.[2] The Manager, without disclosing to the minority investors the third party bid, offered to purchase the LLC for $5.6 million, and when the minority refused the Manager's offer, the Manager caused a rushed sham auction in 2009 to sell the LLC. The Manager won the auction as the only bidder with a bid of $50,000 in excess of the LLC's debt, resulting in a $22,777 return to the minority investors. The Manager merged the LLC into a family owned company and thereafter ran the golf course himself, retaining the right to sell the property for its own benefit at any time.

Delaware Chancery Court. The minority investors sued the Manager for breach of contract and fiduciary duties. In defense, the Manager claimed, in summary, that (1) the LLC Operating Agreement displaced any fiduciary obligations that otherwise might exist under equity—a defense it later abandoned; (2) since the Manager could veto any option for the LLC as its right as majority member, the Manager could legally use its chokehold over the LLC to pursue its own interests; and (3) at the time of the auction, the LLC had no value.

In a January 2012 decision, Chancellor Strine ruled for plaintiffs in the first definitive Delaware decision that traditional fiduciary duties of care and loyalty apply by default to managers of Delaware limited liability companies absent a contractual provision that clearly alters or eliminates those duties:

> [T]he LLC agreement here does not displace the traditional duties of loyalty and care that are owed by managers of Delaware LLCs to their investors in the absence of a contractual provision waiving or modifying those duties. The Delaware [LLC Act] explicitly applies equity as a default and our Supreme Court, and this court, have consistently held that default fiduciary duties apply to those managers of alternative entities who would quality as fiduciaries under traditional equitable principles, including managers of LLCs. Here, the LLC agreement makes clear that the manager could only enter into a self-dealing transaction, such as its purchase of the LLC, if it proves that the terms were fair. In other words, the LLC agreement essentially incorporates a core element of the traditional fiduciary duty of loyalty. Not only that, the LLC agreement's exculpatory provision makes clear that the manager is not exculpated for bad faith action, willful misconduct, or even grossly negligent action, *i.e.*, a breach of the duty of care.
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> The manager was free not to vote his membership interest for a sale. But he was not free to create a situation of distress by failing to cause the LLC to explore its market alternatives and then to buy the LLC for a nominal price. The purpose of the duty of loyalty is in large measure to prevent the exploitation by a fiduciary of his self-interest to the disadvantage of the minority. The fair price requirement of that duty, which is incorporated in the LLC

> agreement here, makes sure that if the conflicted fiduciary engages in self-dealing, he pays a price that is as much as an arms-length purchaser would pay.

Because the Delaware Supreme Court reversed that portion of the Chancellor's decision holding that default fiduciary duties exist in this context (see *infra*), we pass over that extensive portion of the decision.

With respect to liability under the LLC Operating Agreement, the Chancellor focused on Section 15, which he concluded reaffirmed "that a form akin to entire fairness review" applied to LLC agreements with affiliates, including the Manager, that are not approved by a majority of the unaffiliated members' vote.[3] Section 15 imposes "the equivalent of the substantive aspect of entire fairness review, commonly referred to as the 'fair price' prong." The Chancellor concluded that the auction process was "a bad faith sham. The process used was so far short of minimally responsible as to render [the Manager's] continued defense of it frivolous and burdensome. . . . the culmination of [the Manager's] bad faith efforts to squeeze out the Minority Members."

The Chancellor also focused on Section 16, governing Exculpation and Indemnification"[4] and concluded that the Manager escaped liability if he could prove that his fiduciary breach was <u>not</u> "(1) in bad faith, or the result of (2) gross negligence, (3) willful misconduct or (4) willful misrepresentation." Thus, the provision insulated the Manager only for actions taken in accordance with the other stand-alone provisions of the LLC Agreement. Because he found that the auction and follow-on merger were effected in violation of Section 15 and were taken in bad faith, the Manager was not entitled to exculpation.

Chancellor Strine determined that had the Manager acted properly, a 2007 transaction would likely have yielded the minority return of their invested capital of $725,000 plus a 10% total return of $72,500. He also awarded plaintiffs half of their reasonable attorneys' fees and costs, which was "justified under the bad faith exception to the American Rule, and also ensures that the disloyal manager is not rewarded for making it unduly expensive for the minority investors to pursue their legitimate claims to redress his serious infidelity."

Delaware Supreme Court. On the Manager's appeal, the Delaware Supreme Court affirmed in a 34 page *en banc per curiam* decision, based <u>solely</u> on the Manager's violation of Section 15 of the LLC agreement "by refusing to negotiate with a third-party bidder and then, by causing the company to be sold to himself at an unfair price in a flawed auction that the manager himself engineered." It also affirmed the damages award "solely on contractual grounds" and the award of attorneys' fees.

The Supreme Court agreed that Section 15 imposed fiduciary duties in transactions between the LLC and affiliated persons:

> [W]e construe its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons.
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> Section 15 … by its plain language, contractually adopts the fiduciary duty standard of entire fairness, and the "fair price" obligation which inheres in that standard. Section 15 imposes that standard in cases where an LLC man-

ager causes the LLC to engage in a conflicted transaction with an affiliate without the approval of a majority of the minority members. There having been no majority-of-the-minority approving vote in this case, the burden of establishing the fairness of the transaction fell upon Gatz.

It also agreed that Section 16 did not permit exculpation and indemnification because the Chancellor properly found that the Manager acted in bad faith and made willful misrepresentations in the course of breaching his contracted-for fiduciary duty.

Of particular note, and the source of much comment among lawyers, the Court held that the Chancellor's "improvident and unnecessary" statutory construction of default fiduciary duty after the Manager no longer contested the existence of fiduciary duties under the LLC Operating Agreement "must be regarded as dictum without any precedential value." It gave five reasons, which the Court discussed at length, for its harsh rebuke: (1) Section 15 of the Operating Agreement specifically addressed the fiduciary duty issue; (2) since neither party asked the Court to decide the default fiduciary duty issue as a matter of statutory law the Court should have refrained; (3) the Chancellor's "stated reason for venturing into statutory territory creates additional cause for concern; (4) whether the LLC statute does or does not impose default fiduciary duties "is one about which reasonable minds could differ;" and (5) "the court's excursus on this issue strayed beyond the proper purview and function of a judicial opinion."

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[1] The Chancellor also referenced Section 18-1101(e): "A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person … provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."

[2] A bank-retained appraiser concluded in 2007 that the value of the land vacant was $15 million but as improved as a golf course its value was only $10.1 million.

[3] "15. Neither the Manager nor any other Member shall be entitled to cause the Company to enter … into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members…."

[4] "16. No … Member, Manager … shall be liable to the Company, … for any loss, damage or claim incurred by reason of any act or omission performed or omitted … in good faith … on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such … Person by this Agreement, except that a … Person shall be liable for any such loss, damage or claim incurred by reason of such … Person's gross negligence, willful misconduct or willful misrepresentation."

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