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MHS Capital LLC v. Goggin: Reviewing Fiduciary Duty and Exculpation Provisions in Limited Liability Company Agreements

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In *MHS Capital LLC v. Goggin*, the Delaware Chancery Court, in addressing claims for breach of contract and breach of fiduciary duty, provided guidance to members and managers of limited liability companies (LLCs) and their counsel regarding issues to consider when negotiating and adopting fiduciary duty modifications and exculpatory provisions in limited liability company agreements.

BACKGROUND

In *Goggin*, a member of East Coast Miner LLC (ECM) brought suit against ECM's manager and his associates challenging several allegedly self-dealing transactions. The plaintiff alleged, among other things, that ECM's manager had caused ECM's part ownership of specified assets to be diverted to different entities that the manager and his associates owned and controlled. The assets in question were subject to a lien that ECM held against a bankrupt entity. Pursuant to the lien, ECM had the right to credit bid on the secured assets in a bankruptcy auction. The plaintiff alleged that ECM's manager had arranged for the bankruptcy court's order to transfer the assets to a consortium of entities, all the members of which, other than ECM, were allegedly owned and controlled by ECM's manager and his associates. The plaintiff brought series of claims against ECM's manager, including claims for breach of ECM's LLC agreement and breach of fiduciary duty.

ECM's manager moved to dismiss, arguing that the provisions of ECM's LLC agreement operated to preclude any recovery of monetary damages, and that any award of equitable relief was precluded by the bankruptcy court's order with respect to the asset transfer. In analyzing the claims, the Delaware Chancery Court noted that two provisions of ECM's LLC agreement were particularly relevant. First, it contained provisions specifying the standard of conduct applicable to the manager, dispensing with traditional fiduciary duties and replacing them with a provision obligating the manager to "discharge his duties in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances." Second, it contained a broad exculpatory clause providing that "[t]he Manager shall not be liable to [ECM] or any Member [of ECM] for monetary damages for breach of such person's duty as a Manager, except as otherwise required under the [LLC] Act."

The Breach of Contract Claims

On the record before it, at the motion to dismiss stage, the Delaware Chancery Court assumed that the conduct of ECM's manager challenged in the complaint constituted a breach of the LLC agreement's contractual standard of conduct. The key question, in view of the breadth of the LLC agreement's exculpatory clause, was whether plaintiff had stated a breach of contract claim for which relief could be granted. Given that the exculpatory clause broadly eliminated claims for monetary damages, the court principally considered whether an award of equitable relief could be granted and, if so, whether any such award would conflict with the bankruptcy court order. That order specified that the purchasers in the bankruptcy sale would take title to the underlying assets free and clear of encumbrances, and that persons holding claims would be enjoined from asserting those claims against the purchasers with respect to the assets.

Ruling on the motion to dismiss, the Delaware Chancery Court found that its "'broad discretionary power to fashion appropriate equitable relief,'" as well as its ability to "'depart from strict application of the ordinary forms of relief where circumstances require,'" would potentially allow it to craft an equitable remedy. The Delaware Chancery Court noted that so long as the plaintiff stated a claim for which relief could be granted, its claim would survive defendant's motion to dismiss, regardless of the nature of the exact relief that would ultimately be granted. By way of illustration, the court cited precedent where it had "declined to dismiss an otherwise well-pled claim for promissory or equitable estoppel that rested on a request for rescission which may have been 'impossible' to grant," on the basis that, in light of its broad equitable powers, "it did not need to evaluate the effect of any remedial order at the pleading stage." Without speculating as to any specific type of relief (or its viability), the court noted that "it may be possible" to grant equitable relief that would not run afoul of the bankruptcy court's order. That analysis, however, involved "a fact-intensive question" not capable of resolution at the motion to dismiss stage.

The Breach of Fiduciary Duty Claims

The Delaware Chancery Court next addressed the defendant's motion to dismiss the plaintiff's claims for breach of fiduciary duty. It reviewed the nature of the fiduciary duty claims—including the allegations that the defendant failed to act in the best interests of ECM by usurping opportunities belonging to ECM—and held that they were duplicative of the plaintiff's claim for breach of contract. Noting that "Delaware law is clear that fiduciary duty claims may not proceed in tandem with breach of contract claims absent an 'independent basis for the fiduciary duty claims apart from the contractual claims,'" the Delaware Chancery Court dismissed plaintiff's fiduciary duty claims, noting that in order for a breach of fiduciary duty claim to proceed simultaneously with a breach of contract claim, the former would have to "depend on additional facts," be "broader in scope, and involve different considerations in terms of a potential remedy.'" In the present case, all of the conduct that could have been the subject of a breach of fiduciary duty claim was already the subject of plaintiff's breach of contract claim—and was being reviewed under the contractual standard. Moreover, the plaintiff was seeking the same remedy for both claims.

PRACTICAL OBSERVATIONS

As the Delaware Chancery Court in *Goggin* indicated, section 18-1101(c) of the Delaware Limited Liability Company Act (the LLC Act) provides members and managers with broad authority to expand, restrict, or eliminate duties (including fiduciary duties) pursuant to an LLC agreement, subject to the implied covenant of good faith and fair dealing. In addition, section 18-1101(e) of the LLC Act provides that an LLC agreement may eliminate or limit the liability of members or managers for breach of contract and breach of duty, including any fiduciary duty, except for bad faith violations of the implied contractual covenant of good faith and fair dealing. The Delaware Chancery Court's opinion in *Goggin* serves as an important reminder that fiduciary duty modifications and exculpatory provisions must be considered together, and must be carefully crafted to ensure that in the event of a dispute, they will operate as the parties intended.

Although not expressly addressed in the opinion, several important observations emerge from a review of *Goggin*. First, the Delaware courts will apply and respect contractual modifications that supplant traditional fiduciary duties of care and loyalty. Parties seeking to modify fiduciary duties, however, should make their desire to override fiduciary duties clear, and they should carefully consider the scope of the duties, if any, that will be used in lieu of the traditional duties of care and loyalty. To that end, parties seeking to pare back fiduciary duties should ensure that the language deployed to that end does not effectively build back traditional duties by contract. Next, once the scope of duties has been identified, parties should consider the circumstances under which members or managers may be held liable for falling short of the standard of conduct. The LLC Act's authorization of provisions that exculpate members and managers from liability in a broad range of circumstances contrasts sharply with the Delaware General Corporation Law's (the DGCL) relatively limited authorization of exculpation. Section 102(b)(7) of the DGCL, which deals with exculpation, only permits a corporation, through its certificate of incorporation, to exculpate its directors (not officers) against liability to the corporation or its stockholders for monetary damages for breaches of the duty of care. (Section 102(b)(7) specifically disallows exculpation for any breach of the duty of loyalty as well as for unlawful dividends and stock redemptions and repurchases, acts not in good faith or involving intentional misconduct, or a knowing violation of law or transactions from which a director derives an improper personal benefit.)

Although certificates of incorporation of Delaware corporations routinely provide for exculpation of directors to the fullest extent permitted by the DGCL, LLC agreements are more likely to contain bespoke provisions regarding the exposure of managers and members to liability for breach of contractual or fiduciary duties. Many LLC agreements, for example, will preclude exculpation for damages stemming from specified types of conduct, such as bad faith or willful misconduct. Some agreements, however, will decline to exculpate members or managers for losses resulting from their own gross negligence. See, for example, LLCs, Partnerships, Unincorporated Entities Committee, Single-Member LLC Entity Member Form. Although claims for gross negligence may be difficult to plead, prior decisions of the Delaware courts indicate that successfully pleading such claims may not be as challenging as one might expect. See William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law (observing that the Delaware Supreme Court, in two cases following its adoption of a standard of review requiring plaintiffs to plead gross negligence in order to state a claim for a breach of the duty of care, "purport[ed] to apply the gross negligence standard of review [but] in reality applied an ordinary negligence standard"). Indeed, the exposure of directors to liability for action taken in good faith under this pleading standard prompted the adoption of section 102(b)(7) of the DGCL. See generally 1 R. Franklin Balotti & Jesse A. Finkelstein, The Delaware Law of Corporations & Business Organizations § 4.13[B], at 4-99 (3d ed. 2018 Supp.). Accordingly, managers of LLCs who are not entitled to exculpation for conduct that is grossly negligent run a substantial risk of liability for breach of the duty of care (or any analogous contractual duty) in connection with action otherwise taken in good faith. Indeed, managers of an LLC in that scenario may be afforded less protection against claims based on the duty of care than the directors of nearly every Delaware corporation. Even more problematic from the standpoint of a manager is the circumstance in which the LLC agreement establishes an "ordinary negligence" standard of care but fails to provide that the manager is exculpated for monetary liability for breaches of duty.

CONCLUSION

Given the contractual freedom provided by the LLC Act, there are numerous potential formulations of the standards of conduct of members and managers and of the circumstances under which they will (or will not) be exculpated from liability against breach. Members and managers and their counsel must consider the interplay between the standards of conduct (whether stemming from default fiduciary duties or contractually specified analogues) and the nature and scope of any clauses exculpating members and managers for breach of duty to ensure that the parties achieve the desired balance of incenting (or not unduly discouraging) value-maximizing risk-taking on the one hand, and providing means of policing and enforcing specified classes and categories of misconduct on the other.