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Eliminating Fiduciary Duty Uncertainty:

The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements

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Unincorporated business entities, and in particular limited liability companies, are fast becoming a preferred form of business entity for structuring businesses and transactions. Such legal entities serve a wide range of functions. As with corporations, Delaware is often the jurisdiction of choice for forming unincorporated entities. Delaware limited liability companies are creatures of contract; they afford the parties involved the maximum amount of freedom of contract, private ordering and flexibility. To that end, the Delaware Limited Liability Company Act, 6 *Del. C.* §§ 18-101, *et seq*. (the LLC Act), makes certain statutory rules applicable only by default (i.e., only in situations in which members of a Delaware limited liability company (an LLC) have not otherwise provided in their limited liability company agreement (an LLC agreement)). As a result, members of an LLC are free to contract among themselves concerning a myriad of issues, including the management and standards governing the internal affairs of an LLC. Members of an LLC may also choose to govern their relationships exclusively by contract, without regard to corporate-style fiduciary duties of loyalty and care.

Fiduciary Duties and Delaware LLCs

Fiduciary duties generally apply to those who are entrusted with the management or control of another party's property or assets. *See*, e.g., *In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. June 7, 1991). The LLC Act does not affirmatively establish default fiduciary duties, but the existence of fiduciary duties is contemplated by the LLC Act and such duties have been applied by the Delaware Court of Chancery. In *Auriga Capital Corp. v. Gatz Properties, LLC*, 40 A.3d 839 (Del. Ch. Jan. 27, 2012), the Court of Chancery applied default fiduciary duties to a manager of an LLC. The court reasoned that the LLC Act contemplates the application of principles of equity, LLC managers are fiduciaries, and fiduciaries owe the fiduciary duties of loyalty and care. The court concluded that the LLC Act provides that managers of LLCs owe default fiduciary duties of loyalty and care. The Delaware Supreme Court affirmed the *Auriga* decision in *Gatz Properties, LLC v. Auriga Capital Corp.*, ___ A.3d ___, 2012 WL 5425227 (Del. 2012) on the grounds that the LLC agreement at issue imposed fiduciary duties, but noted that the lower court's reasoning applying default fiduciary duties to managers of LLCs was mere dicta and had no precedential value. The Delaware Supreme Court observed that the LLC agreement in *Auriga* contractually adopted fiduciary standards and so the issue of whether default fiduciary duties apply in the LLC context should not have been addressed by the Court of Chancery. Notably, the Delaware Supreme Court did not take a position on the existence of default fiduciary duties under the LLC Act, but did indicate that reasonable minds may disagree on the issue. Nevertheless, in *Feeley v. NGAOCG, LLC*, 2012 WL 5949209 (Del. Ch. Nov. 28, 2012), the Court of Chancery recognized that while the Court of Chancery's reasoning in *Auriga* does not represent controlling precedent, it is persuasive and consistent with prior opinions of the Court of Chancery on the issue of default fiduciary duties in the unincorporated entity context. In *Feeley*, plaintiffs alleged that the managing member of the LLC breached the default fiduciary duties it owed as a manager. The LLC agreement in *Feeley* did not modify fiduciary duties. Thus, directly at issue in the case was whether default fiduciary duties should apply to the managing member of the LLC. In deciding the issue, the court considered the Court of Chancery's reasoning in *Auriga* regarding default fiduciary duties as akin to a law review article informing the court's decision. Further, the court noted that although the long line of Court of Chancery precedents regarding default fiduciary duties in unincorporated entities does not bind the Delaware Supreme Court, the precedents are viewed as *stare decisis* by the Court of Chancery. The court concluded that since the Supreme Court has not addressed the issue, and because prior Court of Chancery decisions and the dictum by the Court of Chancery in *Auriga* were persuasive, default fiduciary duties applied to the managing member of the LLC.

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In light of *Feeley* and prior Delaware Court of Chancery precedents, although the Delaware Supreme Court has not yet decided the question, the authors believe 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 all 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.

Modifications of Fiduciary Duties in the LLC Agreement

The traditional fiduciary duties described above may be modified or eliminated by including clear and unambiguous language to that end in an LLC agreement. Until such time as the Delaware Supreme Court decides the issue or the "organs of the bar" (*see Gatz* at *10) act to clarify the point, the authors will continue to advise parties to LLC agreements that they should clearly and unambiguously supplant traditional fiduciary duties in their LLC agreement if they desire certainty that such duties do not apply. Absent clear and unambiguous modification or limiting language, parties to an LLC agreement may find themselves subject to fiduciary duties.

In construing fiduciary duty modification provisions in the LLC context, Delaware courts have analogized to cases concerning Delaware limited partnerships due to the similarities between the LLC Act and the Delaware Revised Uniform Limited Partnership Act, 6 *Del. C.* §§ 17-101, *et seq*. In *Miller v. American Real Estate Partners L.P.*, 2001 WL 1045643 (Del. Ch. Sept. 6, 2001), the Court of Chancery found that the language in a partnership agreement failed to clearly preclude the application of default fiduciary duties. It noted that given the great freedom afforded to drafters of such agreements, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. The same principle, in our view, applies to LLCs.

The unpredictability resulting from the potential application of traditional "corporate" fiduciary duties to an LLC agreement may add costs and inefficiencies to an LLC and its operations. Legal uncertainty complicates business planning, promotes costly litigation, and unduly impedes managerial discretion. Expressly overriding any default fiduciary duties in an LLC agreement will help to eliminate the uncertainty stemming from potential challenges based on fiduciary duty violations. In the following sections, we examine scenarios in which modifications or elimination of fiduciary duties may benefit the parties involved in LLCs, and in certain instances, we suggest means for modifying or eliminating such duties.

LLCs as Private Equity/Hedge Funds

Hedge funds and private equity funds are frequently formed as Delaware limited partnerships or LLCs, and are an example of a structure that may have fiduciary duty problems if such duties are not addressed in the governing documents of the fund.

In an LLC fund, a manager typically manages the fund while the investors invest in the fund as non-managing members in a relatively passive role. Under such structure, the manager will owe fiduciary duties to the LLC fund and its investor members. Since the manager or an affiliate is typically managing other similarly situated funds, this structure creates an inherent conflict of interest for such managers.

Accordingly, fund managers benefit from provisions modifying or eliminating fiduciary duties in the governing documents of the fund wherever possible. Such provisions permit fund managers to more efficiently manage the operations of the fund because such persons are able to make investment and other management decisions for the fund without the specter of a breach of fiduciary duties claim impeding their every action. In addition, modifications allow fund managers to mitigate their potential risks and enable them to act in their various capacities in managing multiple funds.

There are several practical ways in which fiduciary duties of fund managers may be effectively modified or eliminated. One way is to simply include a provision in the fund's governing documents that explicitly eliminates all fiduciary duties of the fund manager and its affiliates to the fund and its investors in a clear and unambiguous manner. However, investors typically resist such an outright provision in a fund agreement.

Another approach involves the use of a "sole discretion" provision. Such provision modifies fiduciary duties only in specified situations when a manager acts in its "sole discretion." If an LLC agreement contains an appropriate "sole discretion" provision, default principles of fiduciary duty are not applicable to actions of the manager that are subject to a sole discretion standard. An appropriate "sole discretion" provision both defines the term "sole discretion" in a manner inconsistent with traditional fiduciary duties, and contains language that precludes application of traditional duties.

A third option for modifying fiduciary duties in a fund LLC agreement involves providing for advisory committee approval, thus invoking a mechanic similar to that of a "special committee" approval in the corporate context. If properly drafted, this structure permits fund managers to contractually "cleanse" interested transactions and avoid becoming subject to entire fairness review.

Finally, parties to a fund LLC agreement may specifically authorize certain relationships or transactions in the LLC agreement, notwithstanding duties otherwise existing at law or in equity (including fiduciary duties), and so displace fiduciary duties in those specific situations. In so doing, fund managers may at a minimum address specific situations where fiduciary duty issues tend to arise and deal with them upfront in the LLC agreement

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by specifically authorizing them even if broader modifications of fiduciary duties are not feasible in a particular fund.

Regardless of which approach is pursued, the most important requirement in drafting any such modification or elimination provision is that it is clear and unambiguous as to its intent since the Delaware Court of Chancery narrowly construes provisions that purport to modify fiduciary duties.

Joint Ventures/Multimember LLCs

LLCs are used for structuring joint ventures, start-up companies, large and small businesses (collectively, "Multimember LLCs") and, as discussed below, even publicly held companies. Modifications of fiduciary duties may be desirable for Multimember LLCs. There are a number of factors to consider when limiting the fiduciary duties within a Multimember LLC, including the duration of such duties, manager versus non-manager duties, duties as among the members, and conflicts of interest. Parties to a Multimember LLC may wish to define the parameters of their relationship in the contract and avoid the uncertainty of having default fiduciary duties apply. Doing so provides more efficiency in management and establishes clear expectations among the parties. Below are a couple of scenarios in which modifications of fiduciary duties may be beneficial to a manager, member, or board of a Multimember LLC.

Conflicts of interest. Usurpation of corporate opportunity, competition and other conflict of interest issues may arise in the course of the operation of a Multimember LLC. For example, parties to Multimember LLCs, especially those involved in joint ventures, may be competitors or have a number of other business ventures. Contractually modifying fiduciary duties promotes economic efficiency in the use of the united resources of the parties in a particular venture. Likewise, conflict situations should be dealt with in the LLC agreement in order to eliminate the risk of a manager or a member unintentionally being subject to duties for which the parties did not bargain.

For example, parties to an LLC agreement may avoid application of the corporate opportunity doctrine by including in the LLC agreement clear provisions on what the business of the LLC will be, what it will accomplish, and what, if any, opportunities the members and managers of the LLC will be able to pursue without having to present them to the LLC. Alternatively, an LLC agreement for a Multimember LLC may eliminate fiduciary duties altogether. The parties may also wish to consider including procedures to address future conflict situations as they arise, such as providing for board or committee approval or establishing a defined standard that displaces the traditional fiduciary standard. By addressing fiduciary duties in the LLC Agreement, compliance, litigation, indemnification, and other costs may be reduced for an LLC.

Management actions and member consents. Modifications of fiduciary duties in an LLC agreement are also desirable because they provide flexibility and certainty for managers or members in making decisions in a management capacity. For example, in *Dawson v. Pittco Capital Partners, L.P.*, 2012 WL 1564805 (Del. Ch. Apr. 30, 2012), the court considered, among other things, a breach of fiduciary duty claim arising out of the merger of LaneScan, LLC (LaneScan), into another LLC. The provisions of the LaneScan LLC agreement clearly eliminated fiduciary duties of the directors and officers of LaneScan to the members of LaneScan. The court dismissed the complaint with respect to the directors' and officers' actions taken in connection with the merger. By clearly addressing duties of managers in an LLC agreement, managers of an LLC are able to act with more certainty in managing the affairs of an LLC.

Members acting *qua* member may find similar benefit from supplanting fiduciary duties. For example, in *Related Westpac LLC v. JER Snowmass LLC*, 2010 WL 2929708 (Del. Ch. July 23, 2010), the plaintiff, the operating member of two LLCs, sued the other member, alleging breach of the operating agreement and such member's fiduciary duties for its refusal to agree to fund a capital call or consent to various major decisions. The court dismissed the claims, noting that the defendant member was free to withhold consents to major decisions, unencumbered by any fiduciary duty because the fiduciary duties were inconsistent with the parties' LLC agreement. As with LLC managers, members of a joint venture LLC are able to act with more certainty in protecting their interests in the venture if the LLC agreement limits or eliminates their fiduciary duties.

Finally, contractual modifications of fiduciary duties also benefit members and managers of board-managed Multimember LLCs. In a board-managed Multimember LLC, board members are often appointed by the members of the LLC. Where default fiduciary duties are applicable, such board members will owe duties to the LLC and all members of the LLC. Modifying fiduciary duties or eliminating them for board members permits the board members to act for the benefit of the member who appointed them without risk of breaching fiduciary duties to the LLC and its other members and affords the members certainty as to the loyalties of their appointees.

Publicly Held LLCs

Managers and controlling members, and their affiliates, of publicly traded LLCs face many of the same thorny fiduciary duty issues as those highlighted above, and the number of potential plaintiffs magnifies their potential effect. Accordingly, the rationales for modifying fiduciary duties in this context are generally the same as those discussed above and, as the number of publicly traded LLCs increases, the authors expect that many of them will have modified fiduciary duties in their LLC agreements.

The means of effecting these modifications vary. For example, an LLC agreement may establish a "special approval" process for potential conflicts transactions that, if obtained, provides that a manager and its affiliates will not be deemed to

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have breached the LLC agreement or any fiduciary duty. If the specified approval procedures are followed, then a manager of an LLC and its affiliates should prevail with respect to breach of fiduciary duty claims. By providing clear standards, managers, controlling members, and their affiliates can prevail at the motion to dismiss stage of breach of fiduciary duty proceedings. As noted previously, however, parties should exercise caution when drafting such provisions to ensure that they are clear and that they adequately capture the intent to supplant or eliminate default fiduciary duties.

LLCs in Structured Finance Transactions

Finally, fiduciary duties are also routinely modified in structured finance transactions. Structured finance transactions often involve the use of single member LLCs established to own specific assets (SPEs). SPEs are set up as bankruptcy remote entities that have a limited purpose, own no other assets and, among other traits, have an individual with no relationship to the parent member designated as an "independent manager," who must approve the taking of material actions, including the filing of a voluntary petition in bankruptcy.

The independent manager concept is a key feature in these transactions. There is concern that a manager or board of managers composed only of parent employees or affiliates will follow a parent member's instructions even in a situation when the SPE is a solvent and financially viable legal entity. This could include instructions to file a voluntary bankruptcy petition for such an SPE. In order to alleviate this concern for lenders to such SPEs, the affirmative vote of the independent manager of an SPE is a prerequisite to the SPE's voluntarily filing of a bankruptcy petition.

In situations in which the independent managers owe fiduciary duties, lenders, and credit agencies require that such duties are modified so that such independent managers are required to take into account the interests of not only the SPE and the SPE's parent member, but also the SPE's creditors with respect to its interest in the SPE when deciding to approve a material action. The rationale for such modification is that the creditors of the SPE may be prejudiced by a voluntary bankruptcy filing by the SPE, and an independent manager owing fiduciary duties to the SPE's creditors will be less likely to approve an unjustified filing on behalf of the SPE.

Conclusion

Based on existing Delaware case law, the authors believe that traditional fiduciary duties apply with respect to LLCs in the absence of an effective modification or elimination in the LLC agreement. Modifications of fiduciary duties are motivated by different reasons and may be effected in different ways, depending upon the context. The Delaware Court of Chancery construes narrowly any attempted modification or elimination of fiduciary duties. Thus, any LLC agreement provisions modifying or eliminating fiduciary duties must be clear and unambiguous, regardless of the context.

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