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Fiduciary Duties of Managers of LLCs: The Status of the Debate in Delaware

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The Delaware Limited Liability Company Act (the LLC Act) does not expressly provide that managers of Delaware limited liability companies (LLCs) owe the common law fiduciary duties of care and loyalty that apply to the actions of directors and officers of Delaware corporations. However, in allowing fiduciary duties to be waived or eliminated, the LLC Act provides: "To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement . . . ." 6 Del. C. § 18-1101(c). The LLC Act also permits the LLC agreement to exculpate managers for liability for breaches of duties, including fiduciary duties. 6 Del. C. § 18-1101(e). Some commentators and practitioners take the position that such fiduciary duties must exist as a matter of law for there to be something to restrict or eliminate by contract. Others, focusing more on section 18-1101(b)'s announcement that "[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract," contend that an LLC agreement must provide that managers owe fiduciary duties for them to exist.

In the most extensive discussion of the issue by a Delaware court to date, in *Auriga Capital Corporation v. Gatz Properties, LLC*, __ A.3d __, 2012 WL 361677 (Del. Ch. Jan. 27, 2012), the Delaware Court of Chancery found that, unless eliminated or restricted in the LLC agreement, managers of LLCs owe default fiduciary duties. Given Delaware Chief Justice Myron T. Steele's writings on the subject off the bench, however, it is possible that a majority Delaware Supreme Court will not reach the same conclusion if the issue is presented on appeal.

In this article, we will: (1) address the Delaware Supreme Court's most recent decision on the issue pre-dating *Auriga Capital*; (2) analyze Chancellor Strine's opinion in *Auriga Capital*; and (3) summarize Chief Justice Steele's writings on this topic.

Delaware Supreme Court Has Not Ruled on the Issue

In *William Penn Partnership v. Saliba*, 13 A.3d 749 (Del. 2011), the defendant managers of an LLC appealed from the Court of Chancery's decision that the managers breached their fiduciary duties. William Penn Partnership managed Del Bay Associates, LLC, and William and Bryce Lingo managed William Penn. William Penn, which was owned by William and Bryce Lingo and their relatives, owned a 50 percent interest in Del Bay. The Lingos caused Del Bay to sell the Beacon Motel to an entity in which they had a 40 percent stake and controlled the board of directors. Although the Lingos did not control enough of Del Bay to cause the sale alone, they were able to obtain support of another member of the LLC. During the sales process the Lingos provided misinformation to members, withheld other information from members, and imposed an artificial deadline. Following trial, the Court of Chancery found that the Lingos were self-interested in the transaction, and thus had the burden of proving that the transaction was entirely fair. The court also found that the Lingos breached their fiduciary duty of loyalty because they could not prove that the self-interested transaction was entirely fair.

On appeal, the Lingos did not challenge the assertion that they owed fiduciary duties. Preferring to draft a narrowly tailored opinion that addressed only the issue before it, the court avoided finding that such duties were owed. Writing for the court, Chief Justice Steele stated that "[t]he parties here agree that managers of a Delaware limited liability company owe traditional fiduciary duties of loyalty and care to the members of the LLC, unless the parties expressly modify or eliminate those duties in the operating agreement." Ultimately, based on the facts of the case and the parties' agreement that fiduciary duties were owed, the Delaware Supreme Court found that it was impossible for

the Lingos to prove the fair dealing prong of entire fairness review because of the misleading and incomplete disclosures to the other members of the LLC.

Court of Chancery: Managers of LLCs Owe Default Fiduciary Duties

Although the Court of Chancery previously has held that managers of LLCs owe fiduciary duties in the absence of elimination in the LLC agreement, in his opinion issued last month in *Auriga Capital*, Chancellor Strine offered the court's most comprehensive analysis to date of why managers of LLCs owe fiduciary duties under Delaware law. The court systematically lays out the case for LLC managers owing fiduciary duties based on: (1) equitable principles incorporated into the LLC Act; (2) a textual analysis of section 18-1101 and its drafting history; and (3) two policy reasons.

First, the court found, pursuant to the LLC Act, that equity governs situations not specifically addressed by the LLC Act. Specifically, section 18-1104 of the LLC Act provides that "[i]n any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern." The court acknowledged that the LLC Act does not expressly state that managers of LLCs owe fiduciary duties by default. However, as the court explained, "[i]n that respect, of course, the LLC Act is not different than the [Delaware General Corporation Law], which does not do that either." Despite the absence of language in the DGCL establishing fiduciary duties, the Delaware Supreme Court found that equitable fiduciary duties still apply to the actions of directors of Delaware corporations. Furthermore, Chancellor Strine found that "unlike in the corporate context, the rules of equity apply in the LLC context by statutory mandate, creating an even stronger justification for application of fiduciary duties grounded in equity to managers of LLCs to the extent that such duties have not been altered or eliminated under the relevant LLC agreement." Under Delaware law, a fiduciary relationship arises when a person "reposes special trust in and reliance on the judgment of another or where a special duty exists on the part of one person to protect the interests of another." Traditionally, equity has found that corporate directors, trustees, and general partners meet this definition. The court held that managers of LLC, much like directors of corporations, have discretion to manage the company on behalf of others. Consequently, the relationship is of a fiduciary rather than commercial nature.

Second, Chancellor Strine determined that the text of section 18-1101 and its drafting history weighed in favor of finding that managers owe fiduciary duties as a default matter. In *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002), the Delaware Supreme Court questioned whether the fiduciary duties of a general partner could be fully eliminated by the partnership agreement under the statutory text of the LLC Act at the time. In response, the General Assembly revised both the Delaware Revised Limited Uniform Partnership Act and the LLC Act to expressly provide that fiduciary duties may be restricted or eliminated. According to Chancellor Strine, if the General Assembly intended for there to be no default fiduciary duties, it would have so provided at the time of the revisions to the LLC Act following *Gotham Partners*. In other words, the General Assembly could have legislated a default position of *no* fiduciary duties and permitted members of LLCs to agree contractually that managers owe fiduciary duties. To the contrary, the General Assembly left in place section 18-1104's equitable default, created a provision in section 18-1101(c) that clearly permitted the elimination of fiduciary duties by contract, and permitted the exculpation of liability through section 18-1101(e). As the court rhetorically asks: "why would the General Assembly amend the LLC Act to provide for the elimination of (and the exculpation for) 'something' if there were no 'something" to eliminate (or exculpate) in the first place?"

Third, Chancellor Strine offers two policy reasons weighing against a finding that managers of LLCs do not have fiduciary duties. "The first is that those who crafted LLC agreements in reliance on equitable defaults that supply a predictable structure for assessing whether a business fiduciary has met his obligations to the entity and its investors will have their expectations disrupted." The court acknowledged that the implied covenant of good faith and fair dealing would remain since section 18-1101(c) prohibits its elimination, but noted that the implied covenant is not and should not be a substitute for traditional fiduciary duties. Citing the Delaware Supreme Court's recent opinion of *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010), Chancellor Strine explained that "the implied covenant is not a tool that is designed to provide a framework to govern the discretionary actions of business managers acting under a broad enabling framework like a barebones LLC agreement," and that it may only be applied in situations that could not be anticipated at the time of drafting. By contrast, fiduciary duties may protect against manager abuse of discretion legally granted by the LLC Act or contract and that could have been anticipated at the time of the LLC agreement. Analyzing the second policy reason, the court explained that "a judicial eradication of the explicit equity overlay in the LLC Act could tend to erode our state's credibility with investors in Delaware entities." According to the court, a reasonable investor would have concluded, prior to investing in a Delaware LLC, that LLC managers owe default fiduciary duties because: (1) section 18-1104 provides an equitable overlay to the LLC Act and (2) the General Assembly would not have provided for the elimination of fiduciary duties in section 18-1101(c) if such duties did not exist.

Chief Justice Steele's Article and Recent Presentations on LLC Managers' Duties

Chancellor Strine's opinion in *Auriga Capital* explains the statutory and equitable rationale for finding that managers of Delaware LLCs, unless restricted or eliminated by the LLC agreement, owe fiduciary duties. The question remains: will the Delaware Supreme Court adopt the Chancellor's logic? As discussed above, in *William Penn*, the Supreme Court only assumed without deciding that the managers of the

LLC at issue owed fiduciary duties because the parties assumed that to be the case. Therefore, the Delaware Supreme Court is not bound by its own precedent to find that managers owe fiduciary duties. In fact, it would appear that there may be at least one vote on the five-member Delaware Supreme Court to find just the opposite.

In his 2007 article *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1 (2007), Delaware Chief Justice Myron T. Steele concluded that managers of Delaware LLCs should not owe traditional fiduciary duties unless the parties to the LLC agreement agree that fiduciary duties exist. Chief Justice Steele faults Delaware courts for turning to the law governing corporations by analogy rather than to the contractual language of the LLC agreement. In his article, the Chief Justice does not address the equitable overlay that Chancellor Strine references from section 18-1104. Rather, the Chief Justice focuses on section 1101(b)'s instruction that "[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." According to the Chief Justice, "[c]ourts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties, or the judicial scrutiny associated with them, where the parties have not contracted for those governance mechanisms in the documents forming their business entity."

More recently, on October 11, 2011, Chief Justice Steele participated in a symposium sponsored by the Delaware State Bar Association entitled "Hot Topics on Delaware Limited Liability Companies and Limited Partnerships." Chief Justice Steele spoke and provided materials called "Eliminating Fiduciary Duties in LLC Formation Documents," which in part addressed the issue of whether managers of LLCs owed default fiduciary duties if the LLC agreement is silent on the issue. Chief Justice Steele proposed to let the parties decide the issue by contract. According to the Chief Justice, "[c]ourts *should not* imply traditional fiduciary duties when LLC agreements are silent." He offered several reasons for this view. First, he noted that LLCs did not exist at common law and fiduciary duties derive from common law. Consequently, the Chief Justice describes fiduciary duties and LLCs as "strange bedfellows." Second, again emphasizing the freedom of contract provided in section 18-1101(b), Chief Justice Steele suggested that the parties could contract for fiduciary duties if they so desired, and that "courts should assume the parties did not want them to apply at all" if they are not addressed in the LLC agreement. He also suggested that the General Assembly intended to leave it to the parties to decide by not taking a formal position on the issue. Third, the Chief Justice noted that the implied covenant of good faith and fair dealing provides an "immutable protective backstop." Ultimately, Chief Justice Steele concluded that this approach offered certainty and predictability, encouraged stronger management, and arguably provided more value to participants in the LLCs because of the enhanced flexibility. The Chief Justice also noted that he was not speaking for the Delaware Supreme Court and that he was still open to being persuaded if and when an actual case on the issue reaches the court.

CML V, LLC v. Bax and the Equitable Overlay of Section 18-1104

The Delaware Supreme Court's recent opinion in *CML V, LLC v. Bax*, 28 A.3d 1037 (Del. 2011), which Chief Justice Steele authored, is also relevant to the analysis. In *CML,* the Court of Chancery found that a creditor of an insolvent LLC does not have standing to bring a derivative claim because of specific language in the LLC Act. By contrast, a creditor may bring a derivative claim against an insolvent corporation. On appeal, CML argued, in part, that a derivative claim was not prohibited by the LLC Act because of the equitable overlay found in section 18-1104, the same provision on which Chancellor Strine relies, in part, in *Auriga Capital*. In *CML*, citing to section 18-1104, the Delaware Supreme Court found that the "General Assembly expressly acknowledged in the text of the LLC Act that common law equity principles supplement the Act's express provisions." The supreme court went on to explain, however, that "what this means is that where the General Assembly has not defined a right, remedy, or obligation with respect to an LLC, courts should apply the common law. It follows that if the General Assembly has defined a right, remedy, or obligation with respect to an LLC, courts cannot interpret the common law to override the express provisions the General Assembly adopted." The court found that equity could not extend derivative actions to creditors of insolvent LLCs, in part, because the LLC Act expressly limited such claims to members and assignees of LLCs. In contrast, in *Auriga Capital*, Chancellor Strine found that the LLC Act, which does not eliminate fiduciary duties, left room for equity to apply fiduciary duties to LLC managers when the LLC Agreement does not restrict or eliminate them. It is unclear if the Delaware Supreme Court would limit the reach of section 18-1104 and equitable principles on the ground that the LLC Act already addresses the question of default fiduciary duties through its express declaration to "give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."

Key Takeaways from the Current State of the Law

Although there is some uncertainty over the future of default fiduciary duties for managers of LLCs in Delaware based on the absence of a definitive opinion from the Delaware Supreme Court, members and managers of LLCs can draw certain conclusions about the current state of the law in Delaware. As always, because Delaware honors the freedom of contract, parties to LLC agreements are best advised to make their positions on fiduciary duties clear in the LLC agreement. However, as Chancellor Strine noted in *Auriga Capital*, "few LLC agreements contain an express, general provision that states what fiduciary duties are owed in the first instance." It is more typical for agreements to assume

that such duties exist and then to modify those duties. Moreover, it is of course easy for the authors of this article to advise others to draft agreements with clear provisions expressly adopting, restricting, or eliminating fiduciary duties since our advice is divorced from the complicated reality of the negotiating table. At times the uncertainty inherent in an agreement is the result of negotiations designed to get to "yes," where many competing considerations may trump the virtues of having clauses explicit as to the existence and scope of fiduciary duties. In other situations where counsel are not involved at the time of the LLC's formation, parties often use bare bones LLC agreements and do not consider whether they desire fiduciary duties to apply. Accordingly, despite the freedom to contract as to the existence and scope of fiduciary duties, some parties will continue to execute LLC agreements silent as to fiduciary duties. In those situations, it is important to remember that, to date, the Delaware Supreme Court has neither adopted nor rejected Chief Justice's Steele's position of no default fiduciary duties for LLC managers. Therefore, in the wake of *Auriga Capital*, managers and investors in LLCs with LLC agreements that are silent as to fiduciary duties should proceed under the assumption that managers owe the traditional corporate fiduciary duties of care and loyalty.

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