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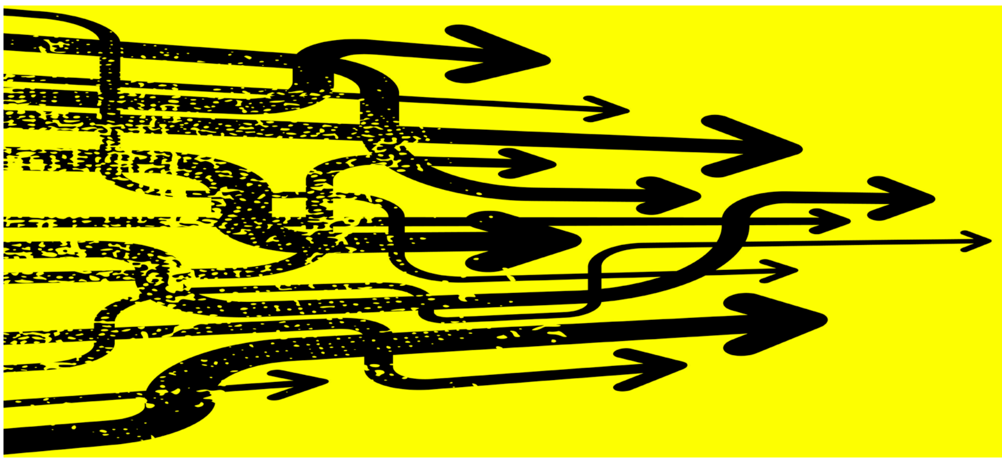
Filings Against Trusts and Trustees Under the 2010 Revisions to Article 9—Thirteen Variations

by Norman M. Powell*



INTRODUCTION. Certain amendments (the "2010 Amendments") to the official text of, and official comments to, Uniform Commercial Code Article 9 ("Article 9") have been promulgated by its sponsoring organizations and are intended to take effect on July 1, 2013. While most simply clarify existing text, some are noteworthy, including amendments relating to the naming of trusts and trustees as debtors. Over a decade ago, I attempted to provide clarity with respect to the seemingly ministerial tasks of filling out and filing financing statements where trusts or trustees are debtors. [1] The 2010 Amendments include changes intended to simplify the filling out, if not the filing, of such financing statements. This article reconsiders such financing statements in light of the 2010 Amendments. Unless otherwise noted, all citations in this article are to Article 9.

WHERE TO FILE. With limited exceptions,[2] Article 9 provides for filing in the debtor's location without regard to the location of the collateral to which the filing relates (§ 9-301(1)). A threshold question in filings against trusts and trustees is who, in fact, is the debtor. Section 9-102(a)(28) defines the term debtor as, among other things, "a person having an interest . . . in the collateral . . . ." Because the answer to this question is beyond the scope of both Article 9 and the Uniform Commercial Code generally, the inquiry begins with the analysis, under law other than the Uniform Commercial Code, of who holds an "interest" in the trust estate. There are several possible answers, depending on the law governing the creation and existence of the trust, and in particular the law governing those aspects of the trust relevant to who holds an interest in the trust estate.

__Trust Is Debtor and Is a Registered Organization__. Some trusts, including Delaware statutory trusts, are separate legal entities distinct from their settlors and trustees, and generally hold legal title to the trust estate (*see* Delaware Statutory Trust Act, 12 *Del. C.* §§ 3801(a), 3805(f)). In such cases, the debtor is the trust, the trust may be (and in the case of a Delaware statutory trust, is) a registered organization, and the filing should be made in the trust's location as determined under the applicable subsection of § 9-307 (subsection (e) in the case of a Delaware statutory trust). The location of the settlor, trustee, or any other party is irrelevant.

__Trustee Is Debtor__. Other trusts, such as Delaware common law trusts, do not feature the same separate legal entity status as Delaware statutory trusts. In such trusts, the trustee generally holds legal title to the trust estate for the benefit of the designated beneficiary. Thus, the trustee has the relevant and requisite interest in the trust estate and is the debtor (*see* § 9-102(a)(28)). The filing should be made in the trustee's location as determined under the applicable subsection of § 9-307.[3] A trustee that is a registered organization organized under state law is located in the state under whose laws it is organized (§ 9-307(e)). A trustee that is a registered organization organized under federal law is located in the jurisdiction designated by the federal law under which it is formed (§ 9-307(f)(1)), the jurisdiction designated by the trustee in accordance with the federal law under which it is formed (§ 9-307(f)(2)), or in the District of Columbia, if neither of the foregoing applies (§ 9-307(f)(3)).[4] A trustee that is an organization but not a registered organization organized under either state or federal law is located in its place of business if it has only one place of business (§ 9-307(b)(2)), or its chief executive office if it has more than one place of business (§ 9-307(b)(3)). A trustee that is an individual is located at such individual's principal residence (§ 9-307(b)(1)).

__Trust Is Debtor and Is Not a Registered Organization__. Certain trusts, while not registered organizations, may nevertheless hold legal title to the trust estate. In such cases, the debtor is the trust, and the filing should be made in the trust's location as determined under § 9-307(b). If the trust has only one place of business, the trust is located at its place of business (§ 9-307(b)(2)). If the trust has more than one place of business, the trust is located at its chief executive office (§ 9-307(b)(3)).

*An earlier version of this article appeared in the *Uniform Commercial Code Law Journal*, 42 UCC L.J. 375 (2010).

Filings Against Trusts and Trustees Under the 2010 Revisions to Article 9 - Thirteen Variations

UCC 1 Financing Statement Box	Trust is Debtor and is a Registered Organization	Trustee is Debtor										Trust is Debtor and is not a Registered Organization		
		Trust with a Name			Trust without a Name							Trust with a Name	Trust without a Name	
		Individual Trustee	Registered Organization Trustee	Organization Trustee (other than Registered Organization)	Individual Trustee		Registered Organization Trustee		Organization Trustee (other than Registered Organization)				
					Individual Settlor or Testator	Organization Settlor	Individual Settlor or Testator	Organization Settlor	Individual Settlor or Testator	Organization Settlor		Individual Settlor or Testator	Organization Settlor (including Registered Organization)
Box 1a	A	A	A	A	N/A	H	N/A	H	N/A	H	A	N/A	H
Box 1b	N/A	N/A	N/A	N/A	H	N/A	H	N/A	H	N/A	N/A	H	N/A
Box 1c	B	C	C	C	C	C	C	C	C	C	B	B	B
Box 5	N/A	K	K	K	K	K	K	K	K	K	K	K	K
Addendum Box 10	N/A	N/A	N/A	N/A	J	J	J	J	J	J	N/A	J	J
Where to File	D	E	G	F	E	E	G	G	F	F	I	I	I

KEY

A	Name of trust per RA-9 § 503(a)(1) or (a)(3)(A)(i)	G	Trustee's location per RA-9 § 307(e) or (f)
B	Mailing address of trust*	H	Name of settlor or testator indicated in trust's organic record per RA-9 § 503(h)(1) or (2)
C	Mailing address of trustee*	I	Trust's location per RA-9 § 307(b)(2), (b)(3), or (c)
D	Trust's location per RA-9 § 307(e)	J	Information to distinguish debtor (whether trust or trustee) from other trusts with same settlor or trustor per RA-9 § 503(a)(3)(B)(ii)
E	Trustee's location per RA-9 § 307(b)(1) or (c)	K	Check first item (Collateral is held in a Trust)
F	Trustee's location per RA-9 § 307(b)(2), (b)(3), or (c)		

* Where the name in box 1a or 1b is not commonly associated with the address in box 1c, consider specifying the address in box 1c "in care of" or "c/o" a name commonly associated with such address, *e.g.*, the trustee's name.

HOW TO PROVIDE DEBTOR-RELATED INFORMATION ON THE UCC1 FINANCING STATEMENT. Section 9-503 sets forth the rules for providing the debtor's name on the financing statement. These rules are revised, and their interrelation clarified, by the 2010 Amendments. Section 9-503(a)(1) provides the rule applicable where the debtor is a registered organization, and requires that the debtor's own name be used. The 2010 Amendments clarify that Section 503(a)(1) is controlling where collateral is held in a trust that is a registered organization (regardless of whether the trust or its trustee is the "debtor"). In a move toward simplification, the 2010 Amendments provide rules applicable where collateral is held in a trust that is not a registered organization. Unlike their analogs in effect prior to July 1, 2013, these rules no longer turn on the question of whether the debtor is the trust or a trustee.[5] If the organic record of the trust specifies the name of the trust, § 9-503(a)(3)(A)(i) requires that such name be used. If no name is so specified, § 9-503(a)(3)(A)(ii) requires that the settlor's or testator's name be used. The 2010 Amendments include a new Section 9-503(a)(3)(B) clarifying the requirement for additional and distinguishing information, and emphasizing that such information should not appear in the portion of the financing statement indicated for designation of the debtor's name. In the case of a named trust to which Section 9-503(a)(3)(A)(i) is applicable, the financing statement must indicate that the collateral is held in a trust. In the case of an unnamed trust to which Section 9-503(a)(3)(A)(ii) is applicable, the financing statement must provide additional information sufficient to distinguish the trust from other trusts having one or more of the same settlors or the same testator and, unless the additional information so indicates, must indicate that the collateral is held in a trust. Thus, under the 2010 Amendments the name of the debtor is determined and provided without regard to the question of whether, under applicable non-UCC (e.g., trust) law, the trust or the trustee has rights in the collateral and thus meets the definition of "debtor" in Section 9-102(a)(28). Consistent with their new focus on whether the collateral is held in a trust, rather than whether the trust or trustee has rights in the collateral and thus meets the definition of "debtor" in Section 9-102(a)(28), the 2010 Amendments include a revised form of UCC1 financing statement. The first check box in box 5 of the revised form should be checked to indicate when collateral is held in a trust, and is thought to be simpler for users than the approach under the forms appearing in Section 9-521 of Article 9 as in effect prior to July 1, 2013, wherein filers were invited to check the appropriate check box in box 17 of the UCC1 financing statement addendum to indicate either that the debtor is a trust or that the debtor is a trustee acting with respect to property held in a trust, as appropriate.

In the time since Article 9 took effect, a number of jurisdictions have enacted or considered enacting non-uniform provisions applicable to the identification of individual debtors on financing statements.[6] The 2010 Amendments, reflecting a variety of views on the matter, offer two alternatives: requiring, or merely permitting, that an individual debtor's name be rendered as indicated on the individual's driver's license (or other specified document). As revised by the 2010 Amendments, Section 9-503(a)(3)(A)(ii) may require use of an individual's name where collateral is held in a trust that is not a registered organization and the organic record of the trust does not specify a name for the trust. As noted above, the name required is that of the settlor or testator, not the name of the debtor (which, as suggested above, under applicable non-UCC law may be either the trust or the trustee, but is unlikely to be the settlor or the testator). Section 9-503(h) provides guidance on how such names are to be rendered. Where the settlor is a registered organization, its name is determined and rendered in the usual manner. In other cases, its name is rendered as indicated in the trust's organic record – the rendering of any individual's name on his or her driver's license is irrelevant.

The remainder of box 1 is streamlined by the 2010 Amendments, which retain box 1c (debtor's mailing address), but omit boxes 1d through 1g (taxpayer or employer identification number, type of organization, jurisdiction of organization, and organizational identification number). These changes conform to the 2010 Amendments' deletion of Section 9-516(b)(5)(C), eliminating failure to provide the latter three informational items as a basis for rightful rejection of a record by the filing office to which it is tendered. As a practical matter, in any instance in which Article 9 requires that box 1a or 1b contain a name that might not be readily associated with the address which follows in box 1c, consider completing box 1c so as to specify a "care of" address. Thus, communications addressed to the trust by name or, if it has none, to the settlor or testator, would be sent in care of the person readily associated with the address appearing in box 1c (e.g., the trustee), better assuring proper delivery and routing than might occur should communications arrive at such address without such person's name.[7]

TRANSITION PERIOD. The 2010 Amendments are intended to be effective on July 1, 2013 (§ 9-801), but of course will only become effective in any jurisdiction when and as enacted by its legislature or similar body. Under the transition rules of the 2010 Amendments, financing statements properly filed prior to July 1, 2013 generally remain effective until the earlier of the time they would have ceased to be effective under the law of the jurisdiction in which they were filed, or June 30, 2018 (§ 9-805(b)). Thus, an otherwise proper filing which does not identify the debtor in the manner required by the 2010 Amendments to § 9-503 need not be cause for immediate alarm. But such a financing statement must be amended so as to meet the requirements of § 9-503 as in effect in the relevant jurisdiction at such time as the financing statement is otherwise amended or is continued (§ 9-807(b)).

As in effect prior to July 1, 2013, Article 9 requires that a financing statement indicate, whether in the debtor's name or otherwise, that the debtor is a trust or is a trustee acting with respect to property held in a trust, except in instances where a trust is the debtor and is a registered organization. § 9-503(a)(3)(B). This indication was often provided by checking the first (if a trust) or second (if a trustee) check box in financing statement addendum box 17. By contrast, the 2010 Amendments simply require in such circumstances an indication that the collateral is held in a trust. 2010 Amendments § 9-503(a)(3)(B). As suggested elsewhere in this article, filers may wish to provide such information by checking the first item in box 5 of the financing statement form as revised by the 2010 Amendments. In light of this change, the last sentence of Section 9-805(e) (a transition rule) provides "A financing statement that indicates that the debtor is a trust or is a trustee acting with respect to property held in a trust indicates that the collateral is held in a trust within the meaning of Section 9-503(a)(3) as amended by this [Act]," with the consequence that this change in law does not, by itself, necessitate amendment of existing filings made in compliance with Article 9 as in effect prior to the effectiveness of the 2010 Amendments.

THIRTEEN VARIATIONS SUMMARIZED. The chart on page two summarizes and provides step-by-step guidance for the completion and filing of UCC1 financing statements relating to trusts and trustees as debtors after giving effect to the 2010 Amendments. It includes nine variations where a trustee is the debtor, three variations where a trust which is not a registered organization is the debtor, and a single variation where a trust which is a registered organization is the debtor. Finally, the chart indicates where UCC1 financing statements prepared in each of the thirteen variations should be filed.

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[1] *See Filings Against Trusts and Trustees Under Revised Article 9 – Thirteen Variations*, 35 UCC L.J. 91 (2002).

[2] E.g., with respect to filings relating to fixtures (§ 9-301(3)(A)), timber to be cut (§ 9-301(3)(B)), and as-extracted collateral (§ 9-301(4)).

[3] Note that a trustee can have but one location under Article 9. That is, a trustee is located in one jurisdiction notwithstanding that it may administer various trusts from a number of offices in multiple jurisdictions.

[4] Article 9 provides that such entities are "located" in the states they designate, begging the question whether designation of a main office, home office, or other comparable office is tantamount to designation of a location within the contemplation of § 9-307(f)(2). When it initially enacted Article 9, Delaware included a non-uniform clarifying sentence in § 9-307(f), which provides, "For purposes of paragraph (2) [of § 9-307(f)] above, if a registered organization designates a main office, a home office, or other comparable office in accordance with the law of the United States, such registered organization is located in the state that such main office, home office, or other comparable office is located." Modifications to the Official Comments to Article 9 approved in December 2001 by the Executive Committee of the National Conference of Commissioners on Uniform Laws, Permanent Editorial Board for the Uniform Commercial Code, likewise attempted to remove any doubt as to whether designation of a main office, home office, or other comparable office constitutes designation of state of location for purposes of § 9-307(f)(2). The 2010 Amendments include new text at the end of Section 9-307(f)(2) to like effect (such an entity is located in the state it designates "including by designating its main office, home office, or other comparable office").

The Reporter's Note indicates this new statutory text is intended to "remove any doubt" and should not be understood as a change in existing law.

[5] This simplification notwithstanding, the 2010 Amendments in no way change the requirement that to be effective a financing statement generally must be filed in the debtor's location – see ***Where to File*** above.

[6] These include Texas, which by non-uniform text in Section 9-503 (enacted prior to the 2010 Amendments) requires use of the name shown on an individual's driver's license or identification certificate. Delaware chose to address the issue in its initial enactment of Article 9, not by non-uniform text in Section 9-503, but rather by excepting financing statements naming individual debtors from the strict search logic test of Section 9-506(b).

[7] This suggestion is intended to avoid the confusion and delay which could accompany attempted delivery at the trustee's address of correspondence identifying only the settlor or testator as addressee.

Delaware Supreme Court Applies *Contra Proferentem* Doctrine to Ambiguous Provision of LLC Agreement: *Bank of New York Mellon v. Commerzbank Capital Funding Trust II*

by John J. Paschetto

Faced with a "hopelessly ambiguous" definition in the operating agreement of a Delaware limited liability company ("LLC"), the Delaware Supreme Court recently resolved an interpretive dispute by applying the canon of *contra proferentem* rather than looking to extrinsic evidence of the parties' intent. (*Bank of New York Mellon v. Commerzbank Capital Funding Trust II*, No. 372, 2012 (Del. Mar. 19, 2013).) The *Commerzbank* ruling thus required the entity that had prepared the LLC agreement to bear the costs associated with its imprecise drafting, regardless of what the extrinsic evidence might have shown.

A policy of the Delaware Limited Liability Company Act (the "Act") is "to give the maximum effect to the principle of freedom of contract[.]" (6 *Del. C.* § 18-1101(b).) Or, in the words of another Delaware court: "For Shakespeare, it may have been the play, but for a Delaware limited liability company, *the contract's the thing*." (*R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, C.A. No. 3803-CC, 2008 Del. Ch. LEXIS 115, at *1 (Del. Ch. Aug. 19, 2008).) Accordingly, the Act gives parties to LLC agreements generous leeway in how they may structure their relationships among one another and with the LLC.

In the context of the archetypal, privately held LLC, the members will have had a chance to bargain over the terms of the LLC agreement. Those terms therefore fit comfortably within the framework of rules that courts have developed for interpreting negotiated contracts. But as it becomes less unusual for LLCs to seek equity capital from sources beyond founders, friends, and family, courts may grow more receptive to interpretive approaches that, like the one employed in *Commerzbank*, do not assume bargaining power on the part of members or other investors, other than the power to decline to invest at all.

Commerzbank Raises Capital, Then Runs into Difficulties

Commerzbank Aktiengesellschaft, a German stock corporation ("Commerzbank AG"), formed two Delaware entities through which it offered securities entitled to a flow of payments on its debt. Commerzbank Capital Funding Trust II (the "Trust") was a Delaware statutory trust that issued trust-preferred securities to public investors. Commerzbank Capital Funding LLC II ("Commerzbank LLC") was a Delaware LLC that issued preferred securities to the Trust in exchange for the funds the Trust raised through the sale of the trust-preferred securities. Commerzbank LLC in turn used those funds to buy subordinated notes from Commerzbank AG, which controlled both the Trust and Commerzbank LLC. The payments that Commerzbank AG would make on the subordinated notes would then be downstreamed from the noteholder (Commerzbank LLC), through the Trust, to the holders of the trust-preferred securities.

The provisions on which the *Commerzbank* court focused its attention were contained in Commerzbank LLC's operating agreement. The agreement obligated Commerzbank LLC to make distributions to the Trust, as a holder of the LLC's preferred securities, if Commerzbank AG made any distributions on "any Parity Securities[.]" (*Commerzbank*, slip op. at 7 (terming this requirement the "Pusher Provision").) The definition of "Parity Securities," in turn, plainly dealt with certain securities and other instruments of Commerzbank AG and its affiliates. But the definition was drafted in such a way that its multiple clauses could reasonably be construed in a number of different combinations, not all of which gave consistent answers to the question whether a given security was a Parity Security.

The flaws inherent in the definition became apparent not long after Commerzbank AG acquired Dresdner Bank AG in 2009 and assumed all of its obligations. One such obligation was to make distributions on certain trust certificates issued by Dresdner Bank. In 2009, Commerzbank AG made those distributions as well as payments on the notes held by Commerzbank LLC. But the following year, beset by "serious financial difficulties" (*id*. at 10), Commerzbank AG failed to make payments on the notes, with the ultimate result that the holders of the Trust's trust-preferred securities did not receive their distributions.

Commerzbank Prevails in the Court of Chancery

In response to the drying-up of distributions, the Bank of New York Mellon ("BNY Mellon"), as the Property Trustee for the holders of the trust-preferred securities, notified Commerzbank AG that (among other things) Commerzbank LLC was obligated to make payments to the Trust under the Pusher Provision, because the Dresdner Bank trust certificates were Parity Securities respecting which Commerzbank AG had made distributions. Commerzbank AG countered that it could have no such obligation, since the trust certificates were *not* Parity Securities.

BNY Mellon therefore sought relief in the Delaware Court of Chancery. On cross-motions for summary judgment, the Court of Chancery ruled for Commerzbank AG. By construing the Commerzbank LLC agreement and the Trust agreement together (given that they were executed at the same time), and by referring to parallel provisions elsewhere in the LLC agreement, the court determined that the LLC agreement's definition of "Parity Securities" unambiguously did not encompass securities having the characteristics of the

Dresdner Bank trust certificates. Consequently, Commerzbank AG's distributions on those trust certificates did not implicate the Pusher Provision, and Commerzbank LLC did not owe anything to the Trust. (*Bank of New York Mellon v. Commerzbank Capital Funding Trust II*, C.A. No. 5580-VCN, 2011 Del. Ch. LEXIS 111 (Del. Ch. Aug. 4, 2011).) BNY Mellon appealed.

The Supreme Court Selects a Different Interpretive Approach

Agreeing with the Court of Chancery and the parties that the definition of "Parity Securities" was central to the case, the Delaware Supreme Court first addressed whether the definition was ambiguous. The court rejected the Court of Chancery's interpretation because it rendered part of the definition surplusage, and because the provision of the contemporaneous Trust agreement on which the Court of Chancery relied was not dispositive. The interpretation urged by BNY Mellon, however, was also found to be flawed, as it made a different part of the definition surplusage. With each side's reading similarly objectionable yet otherwise reasonable, the court was compelled to find the definition ambiguous. (*Commerzbank*, slip op. at 23.)

The court then observed that, where a contract term is ambiguous, it would "normally" look to extrinsic evidence to aid in interpreting the term. "Occasions arise, however—and this is one of them—where it is unhelpful to rely upon extrinsic evidence to determine the parties' intent in drafting the contract." (*Id*. at 24.) Such extrinsic evidence "would serve no useful purpose" in this case "because it would yield information about the views and positions of only one side of the dispute[,]" i.e., those of Commerzbank AG, Commerzbank LLC, and the Trust. By contrast, the holders of the trust-preferred securities had an important interest in the matter, yet they "were neither consulted about, nor involved in the drafting of," the relevant agreements. This case therefore did not "fit the conventional model of contracts 'negotiated' by and among all the interested parties." (*Id*.)

With the goal, then, of "tak[ing] into account the public securityholders' legitimate contractual interests[,]" the court passed over the "conventional" approach and turned instead to the principle of *contra proferentem*, under which "ambiguities in a contract will be construed against the drafter." (*Id*. at 25.) For policy support, the court drew on its discussion in *Kaiser Aluminum Corp. v. Matheson*, where it used *contra proferentem* in interpreting ambiguous language governing preferred redeemable increased dividend equity securities (a/k/a PRIDES). (681 A.2d 392, 398-99 (Del. 1996).) The *Commerzbank* court explained, quoting *Kaiser*, that the "'drafting burden that the *contra proferentem* principle would impose'" on a securities issuer is appropriate because the issuer is in a better position than the investor to ensure that contract terms are clear enough "'to avoid future disputes[.]'" (*Commerzbank*, slip op. at 25.) Nonetheless, again in line with *Kaiser*, the court "caution[ed] against liberal use" of this approach "as a 'short cut' for interpreting ambiguous contractual provisions." But in *Commerzbank*, as in *Kaiser*, it was appropriate to construe the ambiguities against the drafter "as a 'last resort,' because the Defendants could have easily drafted the 'hopelessly ambiguous' [definition] in a straightforward manner." (*Id*. at 25-26.)

Plaintiff's Interpretation Reflected the Investors' Reasonable Expectations

When applied to a contract that "creates rights in public securities investors[,]" *contra proferentem* requires that the contract's terms be interpreted so as to give effect to the reasonable expectations of the investors—in this case, the holders of the trust-preferred securities. (*Id*.) Their reasonable expectation, the court then held, was that the Dresdner trust certificates would be Parity Securities under the Commerzbank LLC agreement. Commerzbank AG created this expectation in its communications with regulators, in "its own internal communications," and in communications with third parties, where the Dresdner trust certificates were characterized as parity securities that implicated the Pusher Provision. (*Id*. at 26.) *Contra proferentem* therefore directed that the ambiguous definition of "Parity Securities" be construed to include the Dresdner trust certificates.

Given its interpretation of "Parity Securities," the court proceeded to decide, in the interest of judicial economy, two additional issues raised below by BNY Mellon but not reached by the Court of Chancery. The Supreme Court held that Commerzbank AG's 2009 and 2010 distributions respecting the Dresdner trust certificates triggered Commerzbank LLC's obligation to make distributions to the Trust under the Pusher Provision. In addition, the court held that Commerzbank AG was obligated to "elevate" the trust-preferred securities "to rank equal to" the Dresdner trust certificates under a separate agreement between Commerzbank AG and Commerzbank LLC.

The Supreme Court's resolution of the contractual ambiguities presented in *Commerzbank* suggests that drafters of operating agreements for LLCs with (direct or indirect) public investors should exercise special care toward detecting and clarifying potentially ambiguous provisions that, when read in the manner most favorable to the investors, could be found to impose unintended obligations on the company. The decision also suggests that, in situations where members *have* had the opportunity to request modifications to the LLC agreement before making their investments, the company should obtain written acknowledgment by the members that such an opportunity was afforded them.

Allegations of an Unfair Deal with an Interested Party Were Not Enough to Establish the Absence of Subjective Good Faith: Dismissal of Claims in *Gerber I*

by John J. Paschetto

The Delaware Court of Chancery recently provided further guidance on the practical application of standards of conduct specified in a limited partnership ("LP") agreement. On this occasion, the court discussed at some length, among other issues, the difficulties faced by plaintiffs when the standard set forth in an LP agreement compels dismissal unless the plaintiffs' factual allegations can establish a *subjective belief* by the defendants that their actions were against the LP's interests.

Gerber v. EPE Holdings, LLC, C.A. No. 3542-VCN (decided January 18, 2013) ("*Gerber I*"), involved the same entities and the same LP agreement at issue in *Gerber v. Enterprise Prods. Holdings, LLC*, C.A. No. 5989-VCN (decided January 6, 2012) ("*Gerber II*"), which was discussed in the spring 2012 issue of the *Update*.[1] Both cases were brought by a limited partner of Enterprise GP Products Holdings, LP, a Delaware LP ("EPE"), against, among others, EPE's general partner (the "General Partner") and the General Partner's board of directors.

Each case related to different transactions in a series of three involving EPE. The first transaction was the purchase of a limited liability company (an "LLC") from an entity that was indirectly controlled by the same individual who indirectly controlled EPE, Dan L. Duncan (the "2007 Purchase"). Second in the series was the sale of the same LLC, two years later, by EPE to an LP of which EPE was the indirect general partner (the "2009 Sale"). And third was the merger of EPE into an LLC wholly owned by the purchaser in the 2009 Sale (the "2010 Merger"). The plaintiff's challenge to the 2009 Sale and the 2010 Merger was the subject of *Gerber II*. Meanwhile, the *Gerber I* litigation, commenced earlier but resolved later, challenged the 2007 Purchase.

According to the plaintiff, the circumstances surrounding the 2007 Purchase and the 2009 Sale indicate that both were unfair to EPE. In the 2007 Purchase, EPE bought indirectly from Duncan an LLC that he had acquired 27 months earlier, and though EPE paid to Duncan the same price he had paid when acquiring the LLC, the assets of the LLC had allegedly been depleted by half shortly before EPE bought it. Then, in the 2009 Sale, EPE sold the same LLC to an affiliate for (it was alleged) less than one tenth of what EPE had paid to acquire it from Duncan in 2007.

The Dismissal of Claims in *Gerber II*

The court in *Gerber II* dismissed the plaintiff's claims regarding the 2009 Sale because the defendants, by complying with certain provisions of the LP agreement, had shielded themselves from liability potentially arising from the transaction's alleged unfairness. The LP agreement provided that any "resolution or course of action" by the General Partner or its affiliates involving a conflict of interest on their part would not "constitute a breach of [the LP agreement] or of any duty stated or implied by law or equity" if one of four conditions was satisfied. One of the four conditions, Special Approval of the resolution or course of action, was defined as approval by a majority of the Audit and Conflicts Committee of the General Partner's board (the "Committee"). Because the 2009 Sale received Special Approval, the *Gerber II* court held that it did not constitute a breach of the LP agreement or a breach of fiduciary duty (insofar as the LP agreement did not disclaim fiduciary duties).

The *Gerber II* court then proceeded to examine the plaintiff's claim that the General Partner had breached the implied contractual covenant of good faith and fair dealing (which Delaware LPs and LLCs may not disclaim[2]). The court took this claim to be that the General Partner had breached the implied covenant by unreasonably exercising its discretion in choosing to cleanse the 2009 Sale by means of Special Approval, as opposed to the other, allegedly more onerous options available under the LP agreement.

But the implied-covenant claim, like the claims involving fiduciary and express contractual duties, could not survive. The LP agreement provided that any act by the General Partner taken in reasonable reliance on the opinion of a qualified adviser would be conclusively presumed to have been taken in good faith. In approving the 2009 Sale, the Committee had relied on a fairness opinion by Morgan Stanley. Attributing the Committee's reliance to the General Partner, the court held that "the only reasonable interpretation of the well-pled facts is that [the General Partner] relied upon [the Morgan Stanley opinion] in deciding whether to use the Special Approval process[.]" (C.A. No. 5989-VCN, 2012 Del. Ch. LEXIS 5, at *47-48 (Del. Ch. Jan. 6, 2012).) And since the General Partner's exercise of its discretion was therefore contractually entitled to a conclusive presumption of good faith, it followed that the General Partner could not have breached the implied covenant in obtaining Special Approval of the 2009 Sale. A similar analysis also led to dismissal of the plaintiff's claims based on the alleged unfairness of the 2010 Merger.

Analysis of the Contractual Good-Faith Standard in *Gerber I*

Initially, the court's analysis of the claims in *Gerber I*—challenging the fairness of the 2007 Purchase—proceeded along much the same lines as in *Gerber II*. Like the 2009 Sale, the 2007 Purchase received Special Approval. But unlike the 2009 Sale, the 2007 Purchase was approved without the aid of an expert opinion. The defendants therefore could not avail themselves of the conclusive contractual presumption that they had acted in good faith, and a way was opened for the plaintiff to attack the Special Approval as an act in violation of both the good-faith standard specified in the LP agreement and the implied covenant.

The LP agreement provided that whenever the General Partner acted, it had to do so in good faith unless the LP agreement specified another standard that was applicable (the "Default Good-Faith Requirement"). Further, under the Default Good-Faith Requirement, the General Partner's actions would be in good faith if the General Partner believed that they were in the best interests of the LP.

The *Gerber I* court approached the plaintiff's claim under the Default Good-Faith Requirement by holding, first, that the Default Good-Faith Requirement was displaced in situations where Special Approval applied. The Special Approval provision constituted a separate standard (one not mentioning good faith) applicable specifically to actions involving a General Partner conflict. Since the 2007 Purchase had received Special Approval, the General Partner's action was not subject to review under the Default Good-Faith Requirement.

The court then undertook to show that the plaintiff had failed to allege sufficient facts to establish a breach of the Default Good-Faith Requirement, even assuming it was not displaced by Special Approval. Under the definition of "good faith" incorporated in the Default Good-Faith Requirement, the General Partner or its affiliates would be deemed to have acted in good faith "if the persons taking the action 'believe that the . . . action is in the best interest of [EPE].'" (C.A. No. 3543-VCN, slip op. at 6 (Del. Ch. Jan. 18, 2013).) In line with recent Court of Chancery precedent, the *Gerber I* court held that this language means "'an act is in good faith if the actor *subjectively believes* that it is in the best interests of [the limited partnership.]'" (*Id.* at 20 (quoting *In re Atlas Energy Resources, LLC*, Consol. C.A. No. 4589-VCN, 2010 Del. Ch. LEXIS 216, at *41 (Del. Ch. Oct. 28, 2010) (emphasis added by *Gerber I* court)).) Thus, for his claim to survive the motion to dismiss, the plaintiff had to "allege facts from which the Court [could] reasonably infer that the members of the [Committee] subjectively believed that they were acting against EPE's interests in granting Special Approval." (*Id.*)

The plaintiff's complaint highlighted the alleged fact, noted above, that the price paid to Duncan by EPE in the 2007 Purchase implied a doubling of the value of the underlying LLC in the 27 months since Duncan had acquired it. The plaintiff also alleged a series of shortcomings in the Committee's process when granting Special Approval of the 2007 Purchase, including the failure to consult an independent financial or legal adviser, to obtain a fairness opinion, to consider that the LLC owned half as many assets as it had when Duncan acquired it, and to negotiate the purchase price. Were these allegations enough to show, for purposes of a motion to dismiss, that the members of the Committee subjectively believed they were acting against EPE's interests in approving the 2007 Purchase?

The court recognized that an answer in the negative raises important questions. Underlying its discussion of these questions was the court's apparent assumption that a party to a contract specifying a standard of conduct must have some realistic chance of validly alleging a breach of that standard. In other words, the counterparty may not indirectly insulate its conduct from judicial review "simply by imposing an almost inherently unknowable standard" (*id.* at 22), such as a standard requiring a plaintiff to establish another individual's belief. On the other hand, subjective and objective standards of good faith are not the same, and courts should not (explicitly or implicitly) treat them as if they were: "It is difficult to avoid drifting toward some sort of objective good faith standard—but that is not what the agreement specifies." (*Id.* at 23.)

Accordingly, the court acknowledged that requiring plaintiffs to allege a direct admission of bad faith would set the bar too high. "No director is likely to confess—ever—that his conduct was not in the company's best interest and he knew it at the time." (*Id.* at 22.) Rather, the appropriate standard of review on a dismissal motion would "approximate[] the obverse of the more familiar bad faith test." (*Id.* at 23.) In this regard, the court cited *Stoner v. Ritter*, in which "bad faith [was] shown by acts with a purpose other than advancing the best interests of the company" (911 A.2d 362 (Del. 2006)), and *In re Alloy, Inc. S'holder Litig.*, in which the challenged conduct was "inexplicable on grounds other than bad faith" (C.A. No. 5626-VCP, 2011 Del. Ch. LEXIS 159 (Del. Ch. Oct. 13, 2011)). (*Gerber I*, slip op. at 23 n.84).

Applying this standard, the *Gerber I* court summarized the plaintiff's allegations in support of subjective bad faith as (1) the Committee did not obtain an expert opinion, and (2) the LLC that was acquired in the 2007 Purchase "could not have doubled in value" in 27 months. (*Id.* at 24.) Point one failed to make contact because the LP agreement did not require an expert opinion, and the Committee members "were experienced in the relevant industry." (*Id.*) As to point two, "[w]ithout more, relying on a run-up in price over a period in excess of two years does not trigger a reasonable inference as to a lack of a subjective belief that the ensuing purchase was in [EPE's] best interests. Price fluctuations—sometimes significant ones—do occur[.]" (*Id.* (footnote omitted).)

The court also observed, as an aside, that the plaintiff's answering brief (but not his complaint) contained "what, at least arguably, might have achieved his pleading objective." (*Id.* at 24 n.85.) This included factual assertions regarding price changes in the relevant industry during the same period and "work by Morgan Stanley" demonstrating a value of the purchased LLC substantially lower than the price EPE paid for it. The plaintiff's briefing, however, could not save his claim that the defendants had breached the Default Good-Faith Requirement by acting with an impermissible subjective belief.

Implied-Covenant Claims in *Gerber I*

The court next addressed the plaintiff's claim that the General Partner breached the implied covenant of good faith and fair dealing when (through the Committee) it granted Special Approval of the 2007 Purchase. As the court explained, consistent with precedent, if a party is permitted to exercise discretion under an agreement, and the agreement does not specify the scope of such discretion, the implied covenant requires that it be exercised reasonably. (*Id.* at 28 (citing, inter alia, *Policemen's Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC*, C.A. No. 7204-VCN, 2012 Del. Ch. LEXIS 188, at *42-43 (Del. Ch. Aug. 16, 2012)).) What constitutes a party's "reasonable" exercise of discretion in turn depends on the agreement and the party's reasonable expectations at the time of contracting.

The *Gerber I* plaintiff thus had to allege how the Special Approval of the 2007 Purchase frustrated his reasonable expectations. But the plaintiff's purported expectation—that any Special Approval would need to meet a test of objective fairness—could not be "reconciled with" a "contractual framework" that included (1) no specific factors that the Committee must consider when giving Special Approval; (2) a waiver of fiduciary duties; and (3) exculpation of the defendants for monetary damages unless they acted in bad faith, engaged in fraud or willful misconduct, or knowingly committed a crime. The plaintiff therefore could have had no reasonable expectation that Special Approval would involve protection of the limited partners' interests beyond what the LP agreement stated expressly, and his implied-covenant claim based on the 2007 Purchase was dismissed.

Other Issues: "Affiliate" Status and Demand Futility

Gerber I may also be noteworthy for two other holdings, which are here mentioned only briefly. First, the court held that the LP agreement's definition of "Affiliate," which tracked the familiar definition in Rule 12b-2 under the Securities Exchange Act of 1934,[3] included not only the General Partner's board considered as a board, but also each member of the board individually.

Second, the court held that for purposes of determining whether a limited partner has standing to bring a derivative claim against a general partner that is an entity, a finding that demand is excused as futile should be based on the interestedness or lack of independence of the general partner, not of the general partner's governing body. Thus, in *Gerber I*, the fact that a majority of the General Partner's directors were arguably disinterested and independent did not defeat the plaintiff's claim that demand was nevertheless excused as futile, because the General Partner, as an entity, was controlled by its conflicted majority owner, Duncan.

* * *

The *Gerber I* court's careful analysis of the subjective good-faith standard in the parties' LP agreement should be instructive to drafters of LP and LLC operating agreements, and to practitioners seeking to challenge or defend decisions that are subject to a contractual standard of conduct. Also significant is the court's suggestion of the types of facts that, if added to the striking change in value that the plaintiff alleged, might have been enough for his claim of subjective bad faith to survive the motion to dismiss.

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[1] The discussion of *Gerber II* can be found online at http://www.youngconaway.com//files//upload/DETransactionalandCorpLawUpdateSpring2012.pdf. Certain defendants in *Gerber I* were represented by Young Conaway in *Gerber II*. The views expressed in this article do not reflect the views of the firm or its clients. .

[2] *See* Section 17-1101 of the Delaware Revised Uniform Limited Partnership Act (6 *Del. C.* § 17-1101) and Section 18-1101 of the Delaware Limited Liability Company Act (6 *Del. C.* § 18-1101).

[3] I.e., a person that directly or indirectly "controls, is controlled by, or is under common control with" the person specified. (*Gerber I*, at 17).

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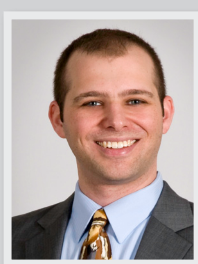

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