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Gatz and El Paso – The Latest in Alternative Entity Jurisprudence from Delaware Courts

By: Elena C. Norman and Tammy L. Mercer

Last week was an eventful one for the evolving jurisprudence relating to Delaware alternative entities. The Delaware Supreme Court considered the question of whether default fiduciary duties exist in limited liability companies (answer: maybe). The Delaware Court of Chancery addressed, as it has a handful of times over the past several months, how to interpret provisions of limited partnership agreements governing conflict transactions. In particular, the Delaware Supreme Court issued its eagerly awaited decision in *Gatz Properties, LLC v. Auriga Capital Corp.*, 2012 Del. LEXIS 577 (Del. Nov. 7, 2012) ("*Gatz*"), affirming in a *per curiam* decision the Court of Chancery's determination that the manager of a Delaware LLC violated a contractually imposed fiduciary duty in a conflict transaction between an affiliate of the manager and the LLC. Distinct from the contractual issue, the Delaware Supreme Court held that the Court of Chancery had improperly reached the question of whether default fiduciary duties apply when the LLC agreement is silent on the issue. The Supreme Court characterized the Court of Chancery's holding that default fiduciary duties exist "as dictum without any precedential value." In a separate case, *Brinckerhoff v. El Paso Pipeline GP Co.*, C.A. No. 7141-CS (Del. Ch. Oct. 26, 2012) (TRANSCRIPT) ("*El Paso*"), the Court of Chancery denied a motion to dismiss where the plaintiff had pleaded facts creating an inference that the defendants acted in subjective bad faith in approving a conflict transaction – even where the transaction was approved by a conflicts committee relying on the advice of a financial advisor. This holding is significant because the contractual provisions in *El Paso* are similar to provisions that have recently been interpreted by the Court of Chancery to shield conflict transactions from judicial review. Many of those recent cases are on appeal and will be considered by the Delaware Supreme Court over the coming months.

The Delaware Supreme Court's Decision in *Gatz*

The *Gatz* lawsuit related to the sale of a golf course. Minority members of Peconic Bay, LLC ("Peconic Bay"), sued Gatz Properties, LLC ("Gatz Properties"), the manager of Peconic Bay, and William Gatz ("Gatz"), who owned and controlled Gatz Properties. Peconic Bay was established to hold a leasehold interest in certain property, to develop the property into a golf course, and to sublease the property to a golf-course operator. The Gatz family and their affiliates held over 85% of the Class A membership interests of Peconic Bay and over 52% of the Class B membership interests of Peconic Bay.

Around 2004, it became clear to Gatz that the sublessee was intending to exercise an early termination provision of the sublease. Instead of attempting to identify a new sublessee to operate the golf course, Gatz took actions so that he could purchase Peconic Bay at a distressed price. Among other things, Gatz discouraged a potential third-party purchaser, provided misleading information to minority members about potential buyers, and conducted a "sham" auction. Gatz

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About The Authors

Elena C. Norman (enorman@ycst.com) is a partner and Tammy L. Mercer (tmercer@ycst.com) is an associate in the Corporate Counseling & Litigation Section at Young Conaway. Their practices include counseling and litigation in connection with merger and acquisition transactions, corporate stock appraisal, and cases involving breach of fiduciary duties. Ms. Norman and Ms. Mercer also represent alternative entities, along with their members, partners, managers, trustees, and governing bodies in litigation involving a broad range of cases, including actions for breach of contractual or fiduciary duties, contests for control and other governance disputes. Ms. Norman and Ms. Mercer wish to thank Lakshmi Muthu for her assistance.

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purchased Peconic Bay at the auction, at which he was the only bidder. Plaintiffs sued for damages, arguing that Gatz Properties breached its fiduciary duties to the minority members of the LLC. The Court of Chancery ruled in favor of the plaintiffs on both contractual and statutory grounds. The defendants appealed.

First, the Delaware Supreme Court affirmed the finding that Gatz Properties had violated the contracted-for fiduciary duty by refusing to negotiate with a third-party bidder and causing the company to be sold to himself at an unfair price in the flawed action. The relevant contractual provision provided:

> Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).

Gatz at *14-15. The Supreme Court held that, "[v]iewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review." *Id.* at *15. It further found that, based on extensive record support for the Court of Chancery's determination that Gatz had acted in bad faith, Gatz was not entitled to exculpation or indemnification pursuant to the terms of a separate provision of the LLC Agreement, which had a carve-out for acts of gross negligence, willful misconduct or willful misrepresentation. *Id*. at *27.

The Supreme Court then turned to the question of whether Gatz had violated statutory default fiduciary duties and held that the Court of Chancery had improperly considered the question of whether Gatz's behavior was also governed by such default duties. The Court of Chancery had held that the "Delaware Limited Liability Company Act imposes 'default' fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties do not apply." *Id*. at *29. The Supreme Court made clear that the Court of Chancery's "statutory pronouncements must be regarded as dictum without any precedential value." *Id.* It found that the issue had not been properly raised below, and that in any event, it need not have been reached given the explicit duties set forth in Section 15 of the governing LLC Agreement. Moreover, according to the Delaware Supreme Court, "the merits of the issue whether the LLC statute does – or does not – impose default fiduciary duties is one about which reasonable minds could differ" and one that has not previously been decided by the Delaware Supreme Court. *Id*. at *32-33 n.70. The Supreme Court expressed its view that one could reasonably conclude the LLC statute is "consciously ambiguous" in that regard, and suggested that the "'organs of the Bar' . . . may be well advised to consider urging the General Assembly to resolve any statutory ambiguity on this issue." *Id*. at *32-33.

The Supreme Court's decision in the *Gatz* case is important because it undoes what many practitioners had expected to be a durable principle based on prior Court of Chancery decisions—that the Delaware LLC Act does indeed impose fiduciary duties on LLC managers unless the parties provide otherwise in their agreement. The Delaware Supreme Court made it clear that the existence of default fiduciary duties is a "question [that] remains open." *Id.* at *29 n.62. The lesson for drafters of alternative entity agreements governed by Delaware law is clear: use language that makes clear exactly what duties are – and are not – intended to apply to those who control and manage the LLC.

The Delaware Court of Chancery's Ruling in *El Paso*

A few days before the Delaware Supreme Court's opinion in *Gatz*, the Court of Chancery gave an oral bench ruling that addressed limited partner challenges to conflict transactions between a master limited partnership and a controller. The court denied defendants' motion to dismiss breach of contractual duty claims. In doing so, the court held that plaintiff had pleaded a claim that a conflicts committee had acted in subjective bad faith in approving a conflicted transaction between a publicly traded master limited partnership, El Paso Pipeline Partners, LP ("El Paso"), and the controller of El Paso's general partner, El Paso Corporation ("EPC"). Moreover, the court refused to give the general partner ("EPGP") the benefit of a provision in the limited partnership agreement that created a conclusive presumption of good faith if EPGP relied upon advice from an independent financial advisor. The court's conclusion on the latter point is noteworthy insofar as this ruling is arguably a departure from the Court of Chancery's prior opinions holding that a provision in a limited partnership agreement that gives a general partner a conclusive presumption

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of good faith for acting in reliance on an expert's opinion applies not only where the general partner relies on the opinion, but also where a committee formed to recommend a transaction to the general partner relies on the opinion.

The transaction challenged by the plaintiff in *El Paso* was a conflicted transaction in which EPC sought to sell to El Paso a 51% interest in two entities EPC owned. El Paso's limited partnership agreement (the "LPA") eliminated any common law fiduciary duties and displaced those duties with contractual duties. Specifically, in the context of transactions involving a conflict of interest between El Paso and EPGP or EPGP's affiliates, the LPA provided four methods by which the transaction may be approved. If one of those four methods was employed, the LPA provided that the transaction "shall be permitted and deemed approved by all partners, and . . . shall not constitute a breach of [the LPA]." (Tr. at 7) EPGP chose the Special Approval method, which required "approval by a majority of the members of the conflicts committee acting in good faith." (*Id.)* The Special Approval provision also provided that if Special Approval were sought, "it shall be presumed that in making its decision, the conflicts committee acted in good faith . . . ." (*Id.*) Thus, if EPGP chose to use the Special Approval method, the conflicts committee was entitled *ab initio* to a rebuttable presumption of good faith. Significantly, the LPA also granted EPGP a conclusive presumption of good faith for acts taken in reliance on the opinion of an expert as to matters the general partner reasonably believed to be "within the person's professional or expert competence." (Tr. at 34-35) Thus, per the express terms of the LPA, if EPGP acted in reliance on an expert opinion, the good faith of EPGP was conclusively established.

The plaintiff argued that the consideration EPC extracted from El Paso for the assets was far above the fair value of those assets. Moreover, the plaintiff asserted that critical information was omitted or not considered by the conflicts committee and its advisors in granting Special Approval. This information included information about contemporaneous and comparable transactions and EPC's refusal to exercise a right of first refusal it held as to certain of the same assets. Accordingly, the plaintiff argued that he had rebutted the presumption of good faith created by the Special Approval.[1] The defendants argued that the plaintiff had not pleaded facts rebutting the presumption of good faith. But even if the plaintiff had rebutted the presumption (the defendants argued), they were entitled to a conclusive presumption of good faith because the conflicts committee had obtained the opinion of a financial advisor.

The court held that the plaintiff had pleaded facts that, if true, showed that the "committee consciously approved a transaction that it believed was unduly favorable to the parent at the expense of the interest the committee was charged to protect." (Tr. at 56) These facts included the conflict committee's failure to consider "a contemporaneous transaction in the same asset space involving the parent, a transaction that the pricing terms of which create[d] an inference of fairly gross price mismatching," and the fact that the parent "eschew[ed] the option" to buy into the same space as the assets being sold to El Paso. (Tr. at 57) The court observed that "the conflicts committee and its financial advisor, if they were doing their job, would have known of these inconvenient facts. The absence of candid dealing with them and explanation of why they're distinct, and the pricing of the transaction at a multiple that the plaintiffs plead was exceedingly disparate, does to my mind create a pleading stage inference." (Tr. at 58)

As to the conclusive presumption of good faith, the court held, by implication, that this standard did not apply because the Special Approval process was employed. The court observed that "it seems fairly clear to me that when [the LPA] says that the conflict committee acts under a particular standard, that's the standard; and that the general partner is benefitted for this reason." (Tr. at 55) The court resisted the notion that where the Special Approval process is chosen, defendants also get the benefit of a conclusive presumption by the conflicts committee's reliance on a financial advisor.

El Paso is important because it provides an alternative point of reference as to how provisions in limited partnership agreements that potentially create rebuttable and conclusive presumptions will be interpreted. In several decisions in the last two years, the Court of Chancery has held that the contractual provisions shielded the transaction from judicial review and have dismissed the challenges.[2] *El Paso* is the first to allow a plaintiff to get past the dismissal stage.

<u>Conclusion</u>

Gatz and *El Paso* provide a preview of what is looking to be an active few months at the Delaware Supreme Court as the court addresses a number of interpretive and policy arguments in connection with challenges to transactions involving Delaware alternative entities. *Gatz* also serves as a judicial message to the Delaware legislature that the court believes the issue of whether default fiduciary duties exist to be one for the legislature to decide and not the courts. Alternative entity enthusiasts will certainly be on the lookout for the response from the Delaware legislature.

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[1] The plaintiff also asserted that the conflicts committee was not effective because the members did not meet the contractual independence requirements. The court dismissed this portion of the plaintiff's claim.

[2] *In re Encore Energy Partners LP Unitholder Litig.*, Cons. C.A. No. 6347-VCP (Del. Ch. Aug. 31, 2012) (Parsons, V.C.) (dismissing challenge to transaction where the defendants received "Special Approval" and where the general partner was entitled to a conclusive presumption of good faith for relying on a financial advisor's fairness opinion), *appeal pending* No. 534, 2012; *In re K-Sea Transp. Partners L.P. Unitholders Litig.*, 2012 Del. Ch. LEXIS 67 (Del. Ch. Apr. 4, 2012) (Parsons, V.C.) (dismissing claims for breach of a limited partnership agreement although plaintiffs had pleaded facts that created a reasonable inference that the general partner had approved the merger in bad faith where the limited partnership agreement created a conclusive presumption of good faith when relying on advice of an investment banker), *appeal pending* No. 238, 2012; *Gerber v. Enter. Prods. Hldgs. LLC*, 2012 Del. Ch. LEXIS 5 (Del. Ch. Jan. 6, 2012) (Noble, V.C.) (granting defendants' motion to dismiss plaintiff's claims where limited partnership agreement restricted express duties and created a conclusive presumption of good faith), *appeal pending* No. 46, 2012; *Brinckerhoff v. Enbridge Energy Co.*, 2011 Del. Ch. LEXIS 149 (Del. Ch. Sept. 30, 2011) (Noble, V.C.) (dismissing complaint challenging interested transaction based on provision of a limited partnership agreement that created a conclusive presumption that the general partner acted in good faith when relying on the advice of an investment banker), *appeal pending* No. 574, 2011.

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