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Delaware Court of Chancery Holds That Limited Liability Company Agreements Impose Fiduciary Duties by Default

by Andy Kostoulas

The Delaware Court of Chancery recently held that the manager of a limited liability company owes fiduciary duties to its members even though the text of the limited liability company agreement did not explicitly impose fiduciary duties on the manager. (*Auriga Capital Corp. v. Gatz Props., LLC*, C.A. 4390-CS, 2012 Del. Ch. LEXIS 19 (Del. Ch. Jan. 27, 2012).) The decision was the first by a Delaware court to examine in depth whether or not common law fiduciary duties can be read into a limited liability company agreement where the agreement is silent on the subject.

Factual Background

In *Auriga Capital*, the LLC at issue, Peconic Bay, LLC ("Peconic Bay"), was managed by Gatz Properties, LLC ("Gatz Properties"), an entity managed, controlled, and partially owned by William Gatz. While Gatz Properties had fairly broad powers as manager, the authority of Gatz Properties to act on behalf of Peconic Bay on certain matters was contingent on receiving the approval of certain members. Peconic Bay had two classes of members: Class A and Class B. The Peconic Bay LLC agreement prohibited Gatz Properties from making any "major decision" on behalf of Peconic Bay without the approval of 66.67% of the Class A interests and 51% of the Class B interests. Gatz Properties owned 85.07% of the Class A interests. Gatz's family members and their affiliates initially owned 39.6% of the Class B interests, but subsequently "acquired control of the Class B interests through questionable purchases." (*Id*. at *14.) As a result, the Gatz group had control over any action that Peconic Bay might take, control that Gatz subsequently used to benefit himself at the expense of the other members of Peconic Bay.

Peconic Bay was initially set up as a conduit for cash flow arising from certain leases to which it was a party. Gatz Properties held title to a piece of real estate that was leased to Peconic Bay pursuant to a ground lease with an initial term of 40 years that restricted the property's use to "a high-end daily fee public golf course" absent agreement between Gatz Propeties and Peconic Bay to the contrary. (*Id*. at *13.) Peconic Bay, in turn, subleased the property to American Golf Corporation ("American Golf"), a large golf course operator. The sublease had a term of 35 years, but American Golf had an option to terminate the sublease after the tenth full year of operation, at its sole discretion and without penalty. American Golf never operated the golf course at a profit, and Gatz expected, no later than five years into the sublease and with a high degree of certainty, that American Golf would terminate the sublease early. Nevertheless, Gatz took no action to prepare for the sublease termination. Instead, he engaged in a series of actions that ultimately resulted in his purchasing Peconic Bay at a significant discount through an auction process that the court characterized as a "bad faith sham." (*Id*. at *97.)

The minority members of Peconic Bay brought suit, alleging breach of fiduciary duties and breach of contractual duties under the Peconic Bay LLC agreement. Specifically, the minority members alleged in their complaint that Gatz engaged in a "protracted course of self-interested conduct conceived and implemented in bad faith" designed to eliminate the equity interests

held by the minority members. Gatz maintained "that he acted reasonably and in good faith," though the court noted that "[t]hroughout the litigation, Gatz took the view that he either owed no fiduciary duties at all [or] that if these duties existed, they allowed him to engage in a self-dealing transaction[.]" (*Id*. at *21.) The matter went to trial, and the court found for the plaintiffs.

Default Fiduciary Duties in an LLC

The court began its legal analysis by noting that the Delaware LLC Act (the "LLC Act") has a catch-all provision stating that equity governs in any case not covered by the LLC Act. (*See* 6 *Del. C.* § 18-1104.) Thus, as the court noted, the LLC Act has language more explicitly incorporating fiduciary duties than does the Delaware General Corporation Law (the "DGCL"). Since a manager of an LLC, like a director of a corporation, manages the entity for the benefit of its equity holders, the court reasoned a manager of an LLC clearly owes fiduciary duties to its members.

The court further supported its conclusion with an analysis of the legislative history of the Delaware LLC Act. The language of the LLC Act permitting LLC agreements to eliminate fiduciary duties was adopted in response to dicta in the Delaware Supreme Court's opinion *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002). At the time *Gotham Partners* was decided, the LLC Act provided that fiduciary duties could be "expanded or restricted" by agreement. Presented with a limited partnership agreement that purported to eliminate fiduciary duties, the *Gotham Partners* court questioned whether fiduciary duties could be entirely eliminated by contract. Responding to the Supreme Court's concern, the Delaware General Assembly amended both the Delaware Revised Limited Uniform Partnership Act and the LLC Act to permit the *elimination* of fiduciary duties. The *Auriga Capital* court reasoned that if a manager of an LLC had no default fiduciary duties, such amendments would make no sense.

The court also identified two problematic consequences that would result from holding that no default fiduciary duties exist in a Delaware LLC. First, parties to existing LLC agreements drafted in reliance on default fiduciary duties would be left with an uncertain framework within which the court could examine LLC management disputes. Although the implied covenant of good faith and fair dealing would remain in all LLC agreements, using it in a way to ensure fairness would "at best, reinvent what already exists in another less candid guise, or worse, inject unpredictability into entity and contract law." (*Auriga Capital*, 2012 Del. Ch. LEXIS 19, at *37.) Second, such a holding could undermine the State of Delaware's "credibility with investors in Delaware entities." (*Id*. at *40.)

Fiduciary Duties in the Peconic Bay LLC Agreement

Having held that default fiduciary duties exist in an LLC, the court proceeded to analyze the fiduciary duties that Gatz Properties owed to the members of Peconic Bay. Because "the Peconic Bay LLC Agreement contains no general provision stating that the only duties owed by the manager to the LLC and its investors are set forth in the Agreement itself," Gatz Properties was held to owe fiduciary duties to Peconic Bay and its members. (*Id*. at *47-48.)

Thus, as the court noted, the LLC Act has language more explicitly incorporating fiduciary duties than does the Delaware General Corporation Law.

Those duties were modified by several provisions in the Peconic Bay LLC agreement. Section 15 of the agreement prohibited any self-dealing transaction unless (1) the terms of the transaction were no "less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties" or (2) the transaction was approved by a majority of disinterested members. (*Id*. at *48.) The court interpreted this provision to impose a type of entire fairness review on self-dealing transactions.

Section 16 of the agreement provided exculpation for actions that were not in bad faith or the result of gross negligence, willful misconduct, or willful misrepresentation. The court noted that this provision was both broader and narrower than the exculpation permissible in the corporate context under § 102(b)(7) of the DGCL. Because actions resulting from gross negligence were not entitled to exculpation under the Peconic Bay LLC agreement, a director of a corporation with a standard § 102(b)(7) exculpatory charter provision would be entitled to broader protection than a fiduciary would enjoy under the Peconic Bay LLC agreement. However, while § 102(b)(7) of the DGCL does not permit exculpation for breach of the duty of loyalty, the exculpation provision in Peconic Bay extended to breaches of the duty of loyalty. In this sense, then, the exculpation permitted in the corporate context was narrower than that provided under the Peconic Bay LLC agreement. Ultimately, the court concluded that Gatz's actions constituted breaches committed in bad faith and therefore outside the scope of the exculpation provision in the Peconic Bay LLC agreement.

The *Auriga Capital* opinion is notable in that it provides a detailed analysis of why default fiduciary duties exist in the context of an LLC. However, whether the Delaware Supreme Court will adopt the reasoning or conclusion in *Auriga Capital* remains an open question. (*See, e.g.*, Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 Am. Bus. L.J. 221, 241 (2009) ("I conclude that an economic analysis mandates that the courts reject default fiduciary duties.").)

Definition of "Good Faith" in Limited Partnership Agreement Constrains Application of Implied Covenant of Good Faith and Fair Dealing under Delaware Law: *Gerber v. Enterprise Products Holdings, LLC* [1]

by John J. Paschetto

In a recent opinion, the Delaware Court of Chancery held that a limited partnership ("LP") agreement's specification of what can constitute "good faith" filled gaps that would otherwise have left room for application of the implied contractual covenant of good faith and fair dealing. (*Gerber v. Enterprise Products Holdings, LLC*, C.A. No. 5989-VCN, 2012 Del. Ch. LEXIS 5 (Del. Ch. Jan. 6, 2012).) The court also held that two transactions involving potential conflicts of interest could not be challenged as breaches of fiduciary duties because the defendants had followed the procedures set forth in the governing LP agreement. All counts in the amended complaint were therefore dismissed.

Underlying the issues presented in *Gerber* was the freedom of contract permitted by the Delaware Revised Uniform Limited Partnership Act ("DRULPA"). Among other things, DRULPA permits an LP agreement to "provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person" owed to the LP, a partner, or any person that is a party to or bound by the LP agreement. (6 *Del. C.* § 17-1101(f).) But DRULPA does not permit the limitation or elimination of liability for "any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." (*Id.*) In *Gerber*, the court was called upon to review alleged conduct in light of an LP agreement that both limited liabilities and gave structure to the concept of "good faith." As the court observed, "[t]he facts of this case take the reader *and* the writer to the outer reaches of conduct allowable under 6 *Del. C.* § 17-1101." (*Gerber*, 2012 Del. Ch. LEXIS 5, at *53.)

A Purchase and a Sale, Followed by a Merger

The plaintiff in *Gerber* was a limited partner of Enterprise GP Holdings, L.P. ("EPE"), a Delaware LP. As the complaint alleged, EPE's sole substantial asset was a wholly owned subsidiary that was, in turn, the general partner of Enterprise Products Partners, L.P. ("Enterprise Products"). The operations of Enterprise Products in the oil and gas business generated profits for Enterprise Products' limited partners and general partner, the general partner then upstreaming those profits to EPE and its partners. EPE and Enterprise Products were both allegedly controlled by the estate of Dan L. Duncan.

In May 2007, Gerber alleged, EPE purchased Texas Eastern Products Pipeline Company, LLC ("Teppco"), an operating company, from another entity affiliated with Duncan. In this transaction, EPE issued to the selling entity $1.1 billion in EPE LP units. Approximately two years later, in June 2009, EPE sold Teppco to Enterprise Products for total consideration valued at $99.95 million. EPE continued to derive income from Teppco after this sale (the "2009 Sale") through EPE's ownership of the general partner of Enterprise Products.

> *The LP agreement contained a provision to the effect that any act taken in reasonable reliance on the opinion of a professional with applicable expertise would be "'conclusively presumed to have been done . . . in good faith[.]'"*

In July 2010, a possible merger of EPE with Enterprise Products allegedly began to be discussed by the boards of Enterprise Products and of the general partner of EPE, Enterprise Products Holdings, LLC ("Enterprise Products GP"). After rejecting several offers by Enterprise Products, Enterprise Products GP finally agreed to a transaction in which EPE would merge with a wholly owned subsidiary of Enterprise Products, and the limited partners of EPE would receive 1.5 LP units of Enterprise Products in exchange for each LP unit they held in EPE. The merger was approved by a majority of the EPE limited partners, with Duncan's affiliates, which allegedly held 76% of the EPE LP units, voting in favor.

Gerber initiated the present action shortly after the EPE/Enterprise Products merger was announced. He claimed, among other things, that Enterprise Products GP and its board had breached their duties under the EPE LP agreement and DRULPA by approving the 2009 Sale and the merger. The defendants moved to dismiss Gerber's claims relating to the 2009 Sale on the grounds that they were derivative in nature and he therefore lost standing to assert them when the merger took place. In addition, the defendants moved to dismiss all the counts of Gerber's complaint for failure to state a claim.

The court first addressed the defendants' standing argument. While a merger would typically terminate standing of the merged LP's partners to bring derivative claims on its behalf, the court noted that an exception exists "when a principal purpose of a merger is the inequitable termination of derivative claims[.]" (*Id.* at *19.) This case, the court held, presented one of the "few situations" in which a plaintiff adequately alleged that elimination of derivative claims was a principal purpose of the merger. Gerber therefore had standing to challenge the 2009 Sale derivatively on behalf of EPE.

Defendants Did Not Breach Their Fiduciary Duties

The court then turned to the defendants' arguments that the complaint failed to state a claim. The court began its analysis by holding that fiduciary duties were owed to the EPE limited partners by Enterprise Products GP (as EPE's general partner), by the board of Enterprise Products GP, by Duncan (as the "controller" of Enterprise Products GP), and by another defendant entity that was part of Duncan's control group. No fiduciary duties, however, were owed to the EPE limited partners by Enterprise Products, because

Gerber had not alleged that Enterprise Products had any control over EPE.

The court next examined provisions of the EPE LP agreement on which the defendants primarily relied in seeking dismissal. The agreement stated that, in any transaction involving EPE where Enterprise Products GP or its affiliates suffered from conflicts of interest, "'any resolution or course of action'" by Enterprise Products GP or its affiliates would not constitute a breach of the agreement, or "'any duty stated or implied by law or equity,'" if any one of four conditions was satisfied. (*Id*. at *30 (quoting the EPE LP agreement).) Those conditions were that the action was approved by a majority of LP units held by partners other than Enterprise Products GP and its affiliates, the action was on terms at least as favorable to EPE as those available in an arm's-length transaction, the action was "'fair and reasonable'" to EPE, and the action received "'Special Approval.'" (*Id*. (quoting the EPE LP agreement).)

Special Approval was defined in the agreement as approval by a committee of at least three directors meeting the "'independence, qualification and experience requirements established by the Securities Exchange Act'" and the NYSE. (*Id*. at *33 (quoting the EPE LP agreement).) The court found that the Audit, Conflict, and Governance Committee (the "ACG Committee") of the Enterprise Products GP board satisfied those requirements. The ACG Committee was therefore capable of giving the Special Approval that, under the LP agreement, would provide a safe harbor for the EPE fiduciaries. Moreover, as the complaint alleged, all of the members of the ACG Committee had indeed approved the 2009 Sale. The 2009 Sale thus could not have breached "any duty stated or implied by law or equity," and Gerber's fiduciary-breach claims based on the 2009 Sale failed.

"The Defendants," as the court acknowledged, "argue that that is where the Court's inquiry should end." The court, however, proceeded to examine the Special Approval process under the implied contractual covenant of good faith and fair dealing, noting that an October 2010 Chancery Court opinion declining to enjoin the EPE/Enterprise Products merger had held that "the implied covenant constrains the Special Approval process." *Lonergan v. EPE Holdings LLC*, 5 A.3d 1008, 1021 (Del. Ch. 2010).

Defendants Are "Conclusively Presumed" to Have Acted in Good Faith

Of the defendants, the *Gerber* court held, only Enterprise Products GP could be liable under the implied covenant, since none of the other defendants was a party to the EPE LP agreement. The court then interpreted the complaint as alleging that the 2009 Sale's terms were so unfair that they could not have met any of the four safe-harbor conditions under the LP agreement other than Special Approval. Accordingly, Gerber's theory of liability was taken to be that "Enterprise Products GP exercised, in bad faith, the discretion it had to use the Special Approval process to take advantage of the [LP agreement's] duty limitations." (*Gerber*, 2012 Del. Ch. LEXIS 5, at *46.)

The court rejected this theory. The LP agreement contained a provision to the effect that any act taken in reasonable reliance on the opinion of a professional with applicable expertise would be "'conclusively presumed to have been done . . . in good faith[.]'" (*Id*. at *47 (quoting the EPE LP agreement).) When approving the 2009 Sale, the ACG Committee had relied on a fairness opinion by Morgan Stanley, which thus entitled the ACG Committee's action to a conclusive presumption of good faith. This presumption precluded Gerber's claim that, by approving the 2009 Sale, Enterprise Products GP had breached the implied contractual covenant of good faith and fair dealing.

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In a footnote, the court discussed an apparent tension between this holding and Section 17-1101 of DRULPA, which provides in part that an LP agreement may not eliminate the implied covenant. The court explained that the implied covenant "is a gap-filler[,]" and that "if a contract has no gaps, then the implied covenant is not applicable to that contract." (*Id*. at *51-52 n.58.) Thus, because the EPE LP agreement provided that following a specified procedure would result in the presumption of good faith, "any possible gap that Gerber might be able to find in the use of the Special Approval process" had been filled, and the implied covenant could not apply. (*Id*. at *53 n.58.)

The same reasoning also disposed of Gerber's claims in connection with the EPE/Enterprise Products merger. Since the merger, like the 2009 Sale, had received Special Approval in reliance on a fairness opinion by Morgan Stanley, the decision to enter into the merger could not be attacked as a breach of fiduciary duty or of the implied covenant. Moreover, since the court had dismissed the claims for breach of contractual or other duties, Gerber's claims of tortious interference with the EPE LP agreement and of aiding and abetting the alleged breach also failed.

The *Gerber* opinion reaffirms the established principle of Delaware law that "'one generally cannot base a claim for breach of the implied covenant on conduct authorized by the agreement.'" (*Id*. at *50 (*quoting Nemec v. Shrader*, 991 A.2d 1120, 1126-26 (Del. 2010)).) In addition, *Gerber* may provide guidance for drafters seeking to insulate partners from potential liability to the greatest extent permissible under Delaware law.

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[1] Certain defendants in *Gerber* were represented by Young Conaway Stargatt & Taylor, LLP. The views expressed herein are those of the author alone and should not be taken as representing the views of Young Conaway or its professionals or clients.

About the Update:

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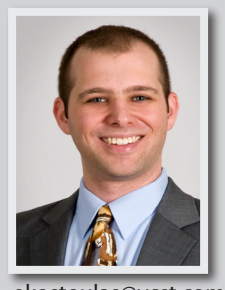

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