

# Delaware Alternative Entities: Governing Documents Should Address Fiduciary Duties Carefully

The fiduciary duties of directors and controlling persons of Delaware corporations are well understood and cannot be varied (although directors' personal liability for breaches of some fiduciary obligations may be eliminated by an appropriate charter provision). By contrast, the fiduciary duties of managers and controlling members of Delaware limited liability companies are less well understood and can be varied. The recent decision of the Delaware Supreme Court in the *Auriga* case contributes a little to our understanding of LLC related fiduciary obligations, but leaves some important questions unanswered.

In *Gatz Properties, LLC v. Auriga Capital Corp.*, No. 148, 2012 (Del. Supr. Nov. 7, 2012) (Per Curiam), the Supreme Court (affirming the Chancery Court's decision) interpreted an LLC's governing instrument as a contract that imposed fiduciary duties and adopted the equitable standard of entire fairness in a conflict of interest transaction between an LLC and its manager and controlling member.

## The *Auriga* Case – Factual Background

The *Auriga* case involves a dispute between the minority and controlling members of Peconic Bay, LLC, a Delaware LLC (the "LLC"), structured as a holding company for a long-term ground lease for a golf course known as the Long Island National Golf Course.

A few investors took a minority position in the LLC, which was formed to hold the ground lease and develop a golf course on land owned by William Gatz, who also indirectly held the majority interest and was sole manager of the LLC. Gatz brought in a golf course operator under a sublease with a minimum 10-year term. After only a few years it became apparent that the operator would not renew the sublease. Instead of finding a new strategic option for the LLC that would protect its investors, Gatz decided that he could develop the land more profitably as a residential community, discouraged third-party offers to take over the golf club operations, made a low bid to buy out the minority investors, and eventually conducted a sham auction for the LLC at which he was the only bidder.

A group of minority investors sued for damages arguing that Gatz breached his contractual and fiduciary duties through this course of conduct.

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## Delaware Statutory Background

- The Delaware Limited Liability Company Act (the "DLLC Act") does not expressly state that the traditional fiduciary duties of loyalty and care apply by default to managers or members of limited liability companies.
- The DLLC Act was amended in 2004 to provide that fiduciary and other duties, to the extent they apply, can be modified or eliminated by contract, but the obligations imposed under the implied covenant of good faith and fair dealing cannot be eliminated.

## The LLC Operating Agreement in *Auriga*

- A section of the LLC operating agreement considered in the *Auriga* case, Section 15, provided that "[n]either the Manager nor any other Member shall be entitled to cause the Company to 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)."
- The LLC operating agreement contained an exculpatory provision to the effect that the manager could not be held liable for its actions unless those actions were taken in bad faith or comprised willful misconduct.
- The LLC operating agreement did not contain a provision to the effect that the only duties owed by the manager or any controlling member to the LLC and its members were those expressly set forth in the agreement. (In our experience, this type of provision frequently has been used since the 2004 amendments to the DLLC Act and, had it been used in this LLC Agreement, may have produced a different result.)

## The Decisions of the Delaware Chancery and Supreme Courts

- Both the Chancery Court and the Supreme Court found that Section 15 of the LLC operating agreement imposed fiduciary duties on the manager in respect of transactions between the LLC and affiliated persons and required application of the entire fairness standard. The Chancery Court found that Section 15 "makes clear that the manager could only enter into a self-dealing transaction, such as its purchase of the LLC, if it proves that the terms were fair. In other words, the LLC agreement essentially incorporates a core element of the traditional fiduciary duty of loyalty." The Supreme Court held that "there is no requirement in Delaware that an LLC agreement use magic words, such as 'entire fairness' or 'fiduciary duties.'" The Court construed the language of Section 15 as "an explicit contractual assumption" of an obligation to obtain a fair price, which it held to be "the equivalent of the entire fairness equitable standard of conduct and judicial review."
- Both courts also applied the two prongs of the entire fairness review traditionally imposed in respect of Delaware corporations (fair dealing and fair price), even though the language of Section 15 only expressly addressed fairness of price.
- Both courts also found that based on the facts of the case, Gatz was not entitled to exculpation under the LLC operating agreement because he had acted in bad faith.
- The Delaware Supreme Court went out of its way in *Auriga* to disclaim statements made by the Chancery Court to the effect that the default standard of manager/controller person conduct (the one that applies if the LLC operating agreement is silent on the topic) is defined by a traditional fiduciary duty analysis. That issue, said the Supreme Court, was not properly before the Chancery Court and therefore must be left for another day. Thus, the Supreme Court expressly left open the possibility that if a Delaware LLC operating agreement does not impose fiduciary obligations, none will be imposed by operation of law.

## Takeaways

- *Default fiduciary obligations.* The Supreme Court's decision regarding default fiduciary duties is cold comfort for LLC managers and controlling members, who should not take the risk that when the issue finally is properly before a court, the court will decide against them and in favor of a default standard of fiduciary obligation. Instead, managers and controlling members should insist, when they can, on including in their operating agreements both exculpatory provisions and provisions expressly eliminating any fiduciary or other obligations (other than the implied covenant of good faith and fair dealing).
- *Finding contractually imposed fiduciary obligations.* The decisions of both the Chancery Court and Supreme Court in *Auriga* make clear that managers and other controlling members may be found subject to contractually imposed fiduciary obligations pursuant to provisions in an LLC operating agreement that do not on their face appear to do that. In *Auriga*, a provision that required a special vote of non-affiliated LLC members for an affiliated party transaction on terms less favorable than arm's-length was found to impose an "entire fairness" obligation on the controlling member - an obligation to both follow a fair process and obtain a fair price - even though a casual reader of the operating agreement paragraph relied on by both courts might strain to find the basis for this construction.
- *Courts don't like egregious misconduct.* Which brings us to a more pragmatic observation – the controlling member's conduct in this case was so egregious that it was perhaps inevitable that a court would find a basis to condemn and punish it.

## Recommendations

In light of the *Auriga* decisions, we recommend –

- Managers and controlling members should always seek to include strong provisions in the LLC operating agreement limiting and/or eliminating their fiduciary obligations. This is expressly authorized by the DLLC Act, and nothing in the *Auriga* decisions in any way questions the viability of such protective provisions.
- Managers and controlling members should take care to qualify any provisions of the LLC operating agreement that govern affiliate transactions or grant approval or voting rights to non-affiliates to make clear that those provisions do not impose fiduciary obligations.
- Regardless of how protective the provisions of a governing LLC operating agreement may be, managers and controlling members should avoid conduct that appears devoid of good faith.

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