DIRECTORS OF PRIVATE COMPANIES: DUTIES, CONFLICTS AND LIABILITY
First Run Broadcast: December 12, 2013
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In private companies, it is common for individuals to wear several hats – some combination of shareholder, director and officer. These are distinct roles that come with fiduciary duties which may be overlooked and create substantial conflicts between an individual's personal interests and those of the company or other shareholders. Breaches of these duties are a fertile source of conflict and litigation, and can give rise to personal financial liability. This program will provide you with a practical guide to the fiduciary duties of private company officers, directors and shareholders, discuss those duties in a range of transactional and operational contexts that give rise to conflicts, and best practices for avoiding liability.

- Fiduciary duties and standards for closely held company officers, directors and shareholders
- Practical application of duties in different transactional and operational contexts
- Duty of loyalty, conflicts and the corporate opportunity doctrine
- Corporate opportunity doctrine in the context of non-corporate entities
- Duties of good faith and fair dealing
- Special issues related to minority-interest stakes in close held companies

Speakers:

Frank Ciatto is a partner in the Washington, D.C. office of Venable, LLP, where he has 20 years' experience advising clients on mergers and acquisitions, limited liability companies, tax and accounting issues, corporate finance transactions and related antitrust matters. He is a leader of his firm's private equity and hedge fund groups and a member of the Mergers & Acquisitions Subcommittee of the ABA Business Law Section. He is a Certified Public Accountant and earlier in his career worked at what is now PricewaterhouseCoopers in New York. Mr. Ciatto earned his B.A., *cum laude*, at Georgetown University and his J.D. from Georgetown University Law Center.

Tara L Dunn is an attorney in the Denver office of Morrison & Foerster, LLP, where represents public and private enterprises in corporate financial transactions. She has substantial experience in public offerings and private placements of equity and debt securities, bank credit financings, and venture capital financings. Ms. Dunn published "The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket after Disney IV?," which was cited in In re The Walt Disney Derivative Litigation, 906 A.2d 27, 64 (Del. 2006). Earlier in her career, Ms. Dunn helped open and served as director and officer of Great Divide Brewing Company in Denver, Colorado. Ms. Dunn earned her B.A. and M.A. from the University of Colorado and her J.D. from the University of Denver College of Law.

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DIRECTORS OF PRIVATE COMPANIES: DUTIES, CONFLICTS AND LIABILITY

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Directors of Private Companies: Duties, Conflicts, & Liability Teleseminar

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Fiduciary Duties of Officers and Directors of Closely-Held Companies

Frank A. Ciatto, Venable LLP
Tara L. Dunn, Morrison & Foerster LLP

Overview

- Overview of fiduciary duties/standards of review (Dunn)
- Application of duties in different contexts (Ciatto)
- Duty of loyalty and conflicts/corporate opportunity doctrine (Dunn)
- Application of the corporate opportunity doctrine to non-corporate entities (Ciatto)
- Loyalty, good faith and fair dealing situations (Dunn)
- Special issues with minority-interest stakes (Ciatto)
- Q & A

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Overview of Fiduciary Duties and Standards of Review

Tara L. Dunn

Duty of Care

- Directors must fully inform themselves – of all material information reasonably available to them
  - May rely on experts and advisors (DGCL §141(e))
- Must act with care in discharge of their duties – as if they were conducting their own affairs
- In considering whether the directors have met their duty of care:
  - Review of materials
  - Amount of deliberation
  - Documentation
- Gross negligence – a "reckless indifference" or "deliberate disregard"
- DGCL §102(b)(7) exculpatory charter provision – shields directors against monetary damages for breaches of the duty of care

Duty of Loyalty

- Directors must hold the interest of the corporation/its stockholders ahead of their own personal interests
  - Is the director interested?
  - Is the director independent?
- Good Faith – not a standalone fiduciary duty, but a subset of the duty of loyalty
  - Subjective bad faith – an actual intention to do harm
  - Intentional/conscious disregard for your duties (often in a compliance/monitoring situation)
    - Challenge to directors' oversight is assertion that directors failed to act
    - Oversight cases in M+A – not an inaction situation – rather the directors are acting
    - Oversight duties do not include ordinary business risk (*In re Citigroup Shareholder Litigation (Del. Ch. 2009)*)

Standards of Review

- Business Judgment Rule – presumption that the directors were informed, acted in good faith and in the best interest of the corporation
  - To rebut the presumption:
    - Self-dealing
    - A conflict has not been expunged
    - A lack of good faith
    - Fraud
    - Gross negligence
  - §102(b)(7) bars claims for money damages for breaches of the duty of care
- Entire Fairness – duty of loyalty claims or when the business judgment rule has been rebutted
  - Burden shifts to defendant directors to prove entire fairness – fair dealing + fair price
    - Fair dealing – looks at process
    - Fair price – is the price one that would be obtained in an arm's-length transaction?

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Fiduciary Duties in Different Contexts

Frank A. Ciatto

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Duty of Loyalty: Conflicts and Corporate Opportunity

Tara L. Dunn

Conflicts and Loyalty Issues

- Privately-held corporations' ownership, oversight and management structures
  - The conflict itself ≠ a breach of the duty of loyalty
- Officers – the same fiduciary duties as directors
  - Inherent conflict of interest – job security
  - §102(b)(7) does not apply to or afford protection for officers

Self-Dealing

- A director must put the best interest of the corporation ahead of and above any personal interest
  - Interested directors
  - Directors who are not independent
- In a conflict of interest situation, directors can protect themselves by utilizing the statutory protections contained in DGCL §144:
  - By having the transaction approved by the members of the board or a committee of the board who are disinterested and independent
  - By having the transaction approved by fully informed, disinterested stockholders
  - §144 gets defendant directors back to the protection of the business judgment rule
- Private company challenge – board disinterest/independence issues and difficulty with obtaining a majority of the minority – may lead to settlements

Disclosure

- Duty of disclosure applies when stockholders (or directors) are being asked to act
  - Private company information issues
  - Communications must be complete and accurate
- Action – vote, appraisal rights

Corporate Opportunity Doctrine

- Director interest in opportunity for the corporation
  - Misappropriation:
    - Corporation's line of business;
    - Corporation's interest or expectancy;
    - Corporation is financially able to exploit the opportunity; and
    - Director would be in adverse position to corporation if director acted on the opportunity
  - Director may take the opportunity:
    - Opportunity presented to director in individual capacity;
    - Opportunity is not essential to the corporation;
    - Corporation has no interest or expectancy;
    - Director does not wrongfully use corporate resources
  - Additionally, the director or officer may take the opportunity if full disclosure is made to the board and approved by its disinterested directors (but consider closely-held company challenges)

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Corporate Opportunity and Non-Corporate Entities

Frank A. Ciatto

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Addressing Loyalty/Good Faith and Fair Dealing Situations

Tara L. Dunn

Loyalty/Good Faith & Fair Dealing

- There are two common ways to address good faith and fair dealing issues that can come up in privately-held company transactions
  - Majority of the minority vote or majority of the independent/disinterested directors under DGCL §144 (Frank will discuss majority of the minority vote)
  - Use of special committee in a conflict or controlling stockholder situation

Special Committees in Controlling Stockholder Transactions

- In transactions with a controlling stockholder, use of a well-functioning, independent and informed special committee with a clear and adequate mandate, including an express right to negotiate and the condition of a fully-informed and upfront supermajority vote may allow defendants to shift the burden of proving entire fairness to the plaintiffs and/or avoid liability (*In re Southern Peru Copper Corporation Shareholder Derivative Litigation* (Del. Ch. October 14, 2011))
  - The defendants were unable to shift the burden of proof of entire fairness to the plaintiffs because:
    - 1) the special committee, although independent and informed, was not "well functioning" because it was only authorized to evaluate the proposed transaction and did not have express authority to negotiate
    - 2) the transaction was not conditioned at the outset on a supermajority vote to approve the deal and the vote was not fully informed
  - The transaction could not meet the entire fairness standard and the court awarded the plaintiffs just under $1.3 billion in damages

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Issues Related to Minority-Interest Stakes in the Company

Frank A. Ciatto

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Questions?

Frank A. Ciatto and Tara L. Dunn

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Thank you.

December 12, 2013

Tara L. Dunn, Morrison & Foerster LLP
Denver, Colorado

VENABLE® LLP

Fiduciary Duty Presentation

Frank A. Ciatto
Venable LLP

Practical Application of Duties in Transactional Context

- Change of Control Transactions – Implicates duties of care and liability
- Standards of Review: Under Delaware law, there are generally three standards against which the courts will measure director conduct in a change in control transaction:
  - *business judgment rule* -- for a decision to remain independent or to approve a transaction not involving a sale of control;
    - policy that courts will not second guess the valid business judgment made by informed boards
  - *enhanced scrutiny* -- for a decision to adopt or employ defensive measures or to approve a transaction involving a sale of control; and
  - *entire fairness* -- for a decision to approve a transaction involving management or a principal shareholder or for any transaction in which a plaintiff successfully rebuts the presumptions of the business judgment rule.

Practical Application of Duties in Transactional Context

- Rejecting an Offer - the business judgment rule applies
  - The Board must determine in the exercise of its business judgment whether the offer is in the best interests of the corporation and its stockholders.
  - Directors must have a reason for rejecting the offer – even in a closely-held corporation.
- Defensive Measures – enhanced scrutiny will be applied if the Board employs defensive measures in response to a takeover bid
  - Directors must satisfy two tests before the business judgment rule applies: (1) did the directors have reasonable grounds for believing that a danger to corporate policy or effectiveness existed, and (2) was the action reasonable in relation to the threat posed.
  - May not be likely in the case of a closely-held corporation (where disinterestedness is rarely the case)

Practical Application of Duties in Transactional Context

- Sale of Control – Revlon Duties
  - In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court imposed an affirmative duty on the board of directors to seek the highest value reasonably obtainable to the stockholders when a sale of the company becomes inevitable.
  - The duty established in Revlon was restated in *Paramount Communications Inc. v. QVC Network Inc.*, in which the Delaware Supreme Court further explained the extent of enhanced scrutiny:
    - The consequences of a sale of control impose special obligations on the directors of a corporation. In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.

Practical Application of Duties in Transactional Context

- Sale of Control – Revlon Duties (cont.)
  - If a change of control transaction is challenged, the care with which the directors acted will be subjected to close review. For this review there will be no "bright line" tests, and it may be assumed that the board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances.
  - A recent Delaware case noted that no "court can tell directors exactly how to accomplish [the goal of getting the best price for the company] because they will be facing a unique combination of circumstances."
  - In the absence of bright lines and blueprints that fit all cases, the process to be followed by the directors will be paramount.

Practical Application of Duties in Transactional Context

- Sale of Control – Revlon Duties (cont.)
  - Boards also will be subject to Revlon duties when the following circumstances exist:
    - Bidding process
    - Abandoning a long-term strategy in response to a bidder
  - Certain contractual provisions are ripe for enhanced security:
    - No shop/no solicitation/no talk
    - Break-up fees
    - Lock-up options/voting lock-up from majority shareholder

Practical Application of Duties in Transactional Context

- Duty of Loyalty in Change of Control Context
  - Did the directors fail to act in good faith – assuming no conflict of interest
  - May be the dispositive issue if no personal liability for breaches of duty of care
  - In *Lyondell Chemical Company, et al. v. Ryan*, 970 A.2d 235 (Del. 2009), the Delaware Supreme Court applied the Disney bad-faith standard in the transactional context
- In *Lyondell*, the Supreme Court discussed its analysis of good faith in the Disney case, in which it had identified three types of bad faith conduct by a director:
  - intentionally acts with a purpose other than that of advancing the best interests of the corporation;
  - acts with the intent to violate applicable positive law; or
  - intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.

Practical Application of Duties in Transactional Context

- The Supreme Court found that:
  - "Directors' decisions must be reasonable, not perfect. 'In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.' The trial court denied summary judgment because the Lyondell directors' 'unexplained inaction' prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. **Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty**. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been **whether those directors utterly failed to attempt to obtain the best sale price**."

Practical Application of Duties in Transactional Context

- The fiduciary obligations of Directors and majority shareholders of closely held corporations require "complete candor" in disclosing all facts and circumstances of a transaction that involves minority shareholders. (*Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977).
- Controlling group of a closely held corporation should be able to demonstrate that a "legitimate business purpose" exists for any action which the controlling group causes the corporation to take, and that such purposes could not be accomplished in a manner "less harmful to the minority's interest." (*Stanley J. Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976).

Practical Application of Duties in Transactional Context

- Majority shareholders cannot make decisions based solely on self-interest.
- Preferred/Common Stock Issues
  - Stratified equity could result in disparate consideration for preferred vs. common Shares.
  - General duty to favor the interests of common stockholders over preferred stockholders when their interest diverge. *In re Trados, Inc. Shareholders Litigation* (Del. Ch. 2009)
  - A board may consider the contractual rights of holders of preferred stock, but owes nothing to preferred stockholders beyond those contractual rights. *LC Master Fund, Ltd. v. James* (Del. Ch. 2000)
  - To the extent preferred stockholders do not have any preferential rights implicated, the board may elect to favor common stockholders' interests ahead of the preferred stockholders, so long as the board does not violate any fiduciary duty owed to the preferred stockholders. *Equity-Linked Investors, L.P. v. Adams* (Del. Ch. 1997)

Practical Application of Duties in Transactional Context

- Impediments to objective decision making (i.e., “no shop” provisions, “break up” fees, and voting agreements) should not be so restrictive as to prevent fiduciaries from resisting unreasonable terms proffered by a potential acquiror.

Fiduciary Duties and Non-Corporate Entities

- Application of fiduciary duties - While states vary on the nature of the obligations, there is general agreement that partners in a partnership, and members and managers of an LLC owe fiduciary obligations to the entity, as well as their co-participants.
  - Care, loyalty, good faith
  - Competing business opportunities
- Threshold Issue: How is an LLC fundamentally different from a corporation? It is a creature of contract and the operating agreement is generally dispositive on the issue of fiduciary duties.
- In some states (*e.g.*, Delaware, Virginia), the operating agreement of an LLC can expand, restrict or eliminate the fiduciary obligations of the members and managers.
  - Not permitted in all jurisdictions

Fiduciary Duties and Non-Corporate Entities

- LLC Agreement – Precise drafting is critical:
  - Scope of fiduciary duties
    - Fully inclusive, complete disclaimer or modified duties
  - Parties to which duties are owed
  - Indemnification
  - Pursuing competing business opportunities is often the key issue
- Interpretive Issues
  - Will a court "read-in" fiduciary duties where the statute and operating agreement are silent – depends on the jurisdiction
    - Delaware – yes
    - Virginia - no
  - Implied covenant of good faith and fair dealing – court may "read-in" implied terms to the contract if the contract is silent – not applied when the express terms are clear

Fiduciary Duties and Non-Corporate Entities

- Recent Statutory Development in Delaware:
  - In the recent Delaware Supreme Court case of *Gatz Properties, LLC v. Auriga Capital Corp*., 59 A.3d 1206 (Del. 2012), the Court created a question as to whether default fiduciary duties applied to managers of limited liability companies where the LLC agreement was silent. In this case, the Court held that the LLC agreement in question expressly stated the fiduciary duties that applied, and therefore the lower court holding stating that default duties did imply were dicta (and did not need to be addressed).
  - Due to the subsequent confusion, in response, the Delaware legislature amended the DLLCA Section 18-1104 to make clear that in accordance with the common law rules of law and equity relating to fiduciary duties, managers, managing members, officers and possibility majority or controlling members owe fiduciary duties to LLC equity owners that are not explicitly provided for in LLC agreements. (*See DLLCA Section 18-1104*).

Fiduciary Duties and Non-Corporate Entities

- Following the amendment, cases applied the amended law, as was done in *Grove v. Brown*, C.A. No. 6793-VCG (Del. Ch. Aug. 8, 2013) (the LLC agreement must expressly modify fiduciary duties owed by the managing members – as permitted by the DLLCA – to avoid the application of default corporate-like fiduciary duties).

Special Issues related to Minority Shareholders

- In situations in which the board uses a vote of the majority of the **minority to address a conflict, once that vote is made a condition to** the approval or acceptance of an offer for a sale or change of control, such condition cannot be waivable, even by the special committee, in order to be deemed to have expunged the taint of the conflict (*In re John Q. Hammons Hotels Inc. Shareholder Litigation* – (Del. Ch. 2009))
- In order to determine whether the majority of the minority vote has been obtained, you must calculate based on all of the minority shares, not just those minority shares voted, which can make getting a majority of the minority harder to get (*In re PNB Holding Co. Shareholders Litigation* (Del. Ch. August 18, 2006))

Special Issues related to Minority Shareholders

- As noted, in conflict of interest/loyalty situations, a board should consider:
  - Forming a “well-functioning” special committee of disinterested and independent directors
  - Authorizing the special committee to consider alternatives, expressly authorize it to negotiate and to hire independent and competent advisors (and provide funding for such special committee)
  - Requiring a non-waivable vote of a majority of the minority or a supermajority vote as a condition to the deal
  - Obtaining a fairness opinion from independent third-party advisors and updating it if circumstances warrant
  - Documenting its rationale for the transaction (this should be done by both the board and the special committee)

Special Issues related to Minority Shareholders

- Uncertainty exists as a result of *Kahn*
  - In regular third-party merger transaction where duty of loyalty issues are not implicated, the business judgment rule applies. As discussed in certain interested-party transactions, the board may take certain and multiple cleansing actions to be entitled to the business judgment rule.
  - In *Kahn v. Lynch*, however, the Delaware Supreme Court held that the board could not avail itself of the business judgment rule in the sale of the company to a controlling shareholder where the board formed a special committee of independent disinterested directors but did not have an unwaivable majority of the minority stockholder vote. The *Kahn* decision has long been interpreted to mean that, in a sale to the controlling stockholder, entire fairness would be applied (irrespective of procedural protections).

Special Issues related to Minority Shareholders

- But in *MFW Shareholders Litigation*, C.A. No. 6566-CS (Del. Ch. May 29, 2013), Chancellor Strine resolved the *Kahn* uncertainty when he held that a "take private" merger of a company by its controlling stockholder is subject to the business judgment rule (not entire fairness) where the board:
  1) formed a properly functioning special committee of independent disinterested directors; and
  2) required an unwaivable majority of the minority stockholder that is informed and uncoerced.

Special Issues related to Minority Shareholders

- Documenting the specific background of the transaction (*i.e.* – establishing the robustness of the auction process, the communications between board members (while being mindful of what those communications specifically may document))
- Ensuring the board meets its disclosure obligations - whether that be to a special committee of the board or the stockholders (including, if significantly different than the proposed transaction, any counterproposals)

➢ Particularly in the private company context, these protections may not be available

➢ Private equity funds should consider negotiating drag rights at the time of their initial investment, in order to provide a contractual right to be able to force a sale

Questions

Frank A. Ciatto
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Washington, D.C.
December 12, 2013

Fiduciary Duties of Partners, Managers and Members: The Current State of Delaware Law

THE FIDUCIARY DUTIES AND THEIR HISTORICAL APPLICATION IN DELAWARE

Review of the Fiduciary Duties

Delaware case law sets forth three "default" fiduciary duties pertaining to partners, managers and members in the absence of express language to the contrary contained in a partnership or LLC agreement: [1]

- Duty of Loyalty
    - **General Rule:** A partner, manager or member must not engage in transactions that adversely affect the interests of the partnership or LLC or the partners or members, including self-interested transactions with the partnership or LLC.
- Duty of Care
    - **General Rule:** A partner, manager or member cannot make business decisions affecting the partnership or LLC or its partners or members without considering all material information reasonably available.
- Duty of Good Faith **("Fiduciary GF")**
    - **General Rule:** A partner, manager or member must not act egregiously or intentionally ignore its general obligations to the partnership or LLC and its partners or members.
    - **Example:** A member cannot intentionally lie to the members of the LLC in conducting the LLC's affairs, even if it does not create a conflict of interest or implicate the duty of care.[2]

In addition, Delaware applies the following principle of contract law:

- Implied Covenant of Good Faith and Fair Dealing **("Implied Covenant GF")**
    - **General Rule:** Pursuant to Implied Covenant GF, the court will "read-in" implied terms into a contract in instances *where a contract is silent* in order to uphold the spirit of the express contractual obligations.

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[1] *See, e.g.*, Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); VGS, Inc. v. Castiel, 2000 WL 21277372 (Del. Ch. Aug. 31, 2000), *aff'd* 781 A.2d 696 (Del. 2001); Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007).

[2] *See* Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 133 (2006). Note that scholars, and even a member of the Delaware court, admit that the application of Fiduciary GF is unclear from case law. *See, e.g.*, Steele, *supra* note 1, at 5 and n.12.

- **Key Concept:** Implied Covenant GF is not a mechanism where courts will alter express terms in a contract or insert reasonable terms not clearly intended under the contract; rather, courts can only apply Implied Covenant GF in light of the express terms of the contract.[3]

- **Distinction from Fiduciary GF:** Implied Covenant GF is distinct from Fiduciary GF because Fiduciary GF mandates that partners, manager or members meet a certain standard of conduct; Implied Covenant GF only requires partners, managers or members to act in accordance with the express terms of the contract and what is plainly inferred from the express terms.

- **Implied Covenant GF in Practice:**

    - ***In re Vylene Enterprises* Case:** A franchisee sued a franchisor after the franchisor opened new chain restaurant in close proximity to the franchisee's branch, though no territorial restriction was provided in the franchise agreement. The court ruled that the franchisor breached Implied Covenant GF because it was implied under the terms of the franchise agreement that the franchisee would not have entered into the agreement otherwise.[4]

    - ***Kahm & Nate's Shoes* Case:** A bank refused to make a loan advance to a shoe store pursuant to an agreement expressly allowing the bank to cease such advances. The store argued that the bank was in breach of Implied Covenant GF because it was contrary to the spirit of the credit agreement for the bank to withhold loan advances. The court dismissed the store's claim given that the contract expressly provided the bank with the right to cease loan advances.[5]

History of Statutory and Case Law

- Statutes Prior to 2004

    - Delaware Limited Liability Company Act (DLLCA) / Delaware Revised Uniform Limited Partnership Act (DRULPA)

        - **General Rule:** These statutes allowed partners and members to contractually *expand or restrict* the duties (including fiduciary duties) owed by a partners, managers or members to the partnership or LLC and the partners or members.

[3] Fisk Ventures, LLC v. Segal 2008 WL 1961156 (Del. Ch. May 7, 2008) (noting that Implied Covenant GF is used only "to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter").
[4] In re Vylene Enterprises, Inc. v. Naugles, Inc., 90 F.3d 1472 (9th Cir. July 29, 1996).
[5] Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351 (7th Cir. 1990).

- Case Law Prior to 2004

  - **Pre-*Gotham* Case:** Courts relied heavily upon the concept of freedom of contract, and, in addition to modifying duties, construed the Delaware statutes as providing the authority to eliminate the fiduciary duties altogether.[6]

  - ***Gotham* Case:** In *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, the court responded to previous court rulings by clarifying that nothing in the Delaware statutes provided "that a limited partnership agreement may eliminate the fiduciary duties or liabilities of a general partner."[7]

THE CURRENT STATE OF THE LAW IN DELAWARE

The 2004 Amendments

In 2004, Delaware passed amendments to DLLCA and DRULPA to reverse the court's holding in *Gotham*. The current statutes allow parties the ability to modify duties owed by partners, managers or members, or eliminate them in their entirety with certain exceptions.

- DLLCA § 18-1101(c) and DRULPA § 17-1101(d)

  - **General Rule:** Both statutes expressly provide parties the ability to expand, restrict *or eliminate* the duties owed by a partner, manager or member to the partnership or LLC and the partners or members by the terms of the partnership or LLC agreement *except that such agreement cannot eliminate Implied Covenant GF*.

  - **Blanket Waiver?:** Though the statutory language appears to allow parties to employ a "blanket waiver" of duties in the partnership or LLC agreement, there has not been a court decision determining whether a blanket waiver of fiduciary duties will be upheld by a Delaware court.

  - **Key Consideration:** Despite the ability to eliminate the duties owed, partners, managers, members and their counsel will need to consider how, if at all, a court nevertheless could "gap fill" the partnership or LLC agreement by applying Implied Covenant GF.

The 2013 Amendment

Effective August 1, 2013, Delaware passed an amendment to § 18-1104 of DLLCA providing that, unless the LLC agreement otherwise provides, the managers and controlling members of an LLC owe fiduciary duties of care and loyalty to the LLC and its members. The amendment to § 18-1104 as the following underlined words: "In any case not provided for this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern." The amendment was in response to the Chancery Court's opinion in *Gatz Properties, LLC v. Auriga Capital Corp* which expressly rejected lower court dictum on the issue.

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[6] *E.g.*, Sonet v. Timber Co., 722 A.2d 319 (Del. Ch. 1998) (noting the Delaware statute's "apparently broad license to enhance, reform, or even eliminate fiduciary duty protections'"); Elf Atochem N. Am. Inc., v. Jaffari, 727 A.2d 286, 291 (Del. 1999).

[7] No. CIV. A. 15754, 2000 WL 1476663 (Del. Ch. Sept. 27, 2000), *aff'd in part rev'd in part*, 817 A. 2d 160 (Del. 2002).

Application of "Default" Duties

Given that the amended statutes provide the ability to waive duties of partners, managers and members, how will a court proceed in the event that a partnership or LLC agreement is silent with respect to these duties?

- "Silent Duties" Rule

  - **General Rule:** In the event that the partnership or LLC agreement is silent as to the duties that the partners, managers or members owe to the partnership or LLC and the partners or members, the courts will "read-in" the standard fiduciary duties from Delaware case law into the agreement as default duties.[8]

- Issue: When Are the "Default" Duties Waived?

  - **Current Cases:** It is currently unclear when an agreement effectively eliminates the application of the default duties. Delaware court decisions have evidenced both a liberal and strict application of the "silent duties" rule: [9]

    - **Liberal Application (*R.S.M. Inc.* Case):** If the terms of the partnership or LLC agreement are inconsistent with common law fiduciary duties, the inconsistency alone is sufficient to establish the parties' intent to eliminate the fiduciary duties.[10]

    - **Strict Application (*Miller* Case):** The court will apply the "silent duties" rule unless the partnership or LLC agreement expressly states the parties' desire to eliminate the application of the common law fiduciary duties.[11]

  - **Practical Significance:** If it is the intention of the parties to waive the fiduciary duties in the partnership or LLC agreement, it should be expressly provided in the agreement that the fiduciary duties are waived by the parties in the event a court applies a strict application of the "silent duties" rule.

Current Case Law

- *Fisk Ventures, LLC v. Segal* (2008): A Delaware decision that upholds the ability to eliminate the fiduciary duties pursuant to DLLCA § 18-1101(c).[12]

  - **Language in Question:** "No member shall have any duty to any member … unless the loss or damage caused by such member shall have been the result of gross negligence, fraud or intentional misconduct by the member."

  - **Facts:** A founding member of an LLC sued the Class B members for breach of the fiduciary duties owed to the plaintiff in reaction to the Class B members' refusal to agree to certain proposals related to research, financing and other matters related to the company.

[8] *E.g.*, Steele, *supra* note 1, at 9; Gold, *supra* note 2, at 131-32.
[9] Steele, *supra* note 1, at 9 n.32.
[10] *See* R.S.M. Inc. v. Alliance Capital Mgmt. Holdings L.P., 790 A.2d 478, 497-98 (Del. Ch. 2001).
[11] *See* Miller v. Am. Real Estate Partners, L.P., No. 16,788,2001 Del. Ch. LEXIS 116, at *29 (Del. Ch. Sept. 6, 2001).
[12] 2008 WL 1961156 at *8-*10.

- **Holding:** The court ruled there was no breach because (i) the fiduciary duties had been replaced by the duty expressed by the terms of the agreement and (ii) the Class B members' actions did not rise to level of "gross negligence, fraud or intentional misconduct" as required by the LLC agreement.

- **Significance:** *Fisk Ventures* was the first case upholding DLLCA § 18-1101(c) after is passage.

- *Wood v. Baum* (2008)*:* A Delaware decision that upholds DLLCA § 18-1101(c) in the context of a public LLC.[13]

  - **Language in Question:** The LLC agreement expressly provided that members of the company's board of directors were exempt from any liability "except in the case of fraudulent or illegal conduct."

  - **Facts:** A shareholder of a publicly-traded LLC sought to raise a derivative suit claiming that the defendant directors breached their fiduciary duties owed to the company by improperly valuing non-performing assets, making improper charitable contributions, etc. The plaintiff moved to demonstrate that the directors breached their duties to the company in order to meet the "demand-futility" standard required to proceed with the derivative suit.[14]

  - **Holding:** The court denied the plaintiff's motion noting that the directors did not breach the duties owed to the company as set forth in the LLC agreement. The court noted that, in order to demonstrate the directors' breach, the plaintiff was required to prove scienter and demonstrate that the directors' actions met the high bar required to demonstrate fraudulent or illegal conduct, which the plaintiff was unable to do.

  - **Significance:** Prior to *Wood*, it was unclear if the §18-1101(c) would apply to public LLCs, since some commentators believe there should be no distinction between the duties required of managers and directors of public LLCs and corporations.

  - **Potential Shift in Corporate Law:** Some commentators believe that the *Wood* case will cause Delaware to amend the Delaware corporate statutes to allow similar authority to expand, restrict or eliminate duties owed by directors in corporations.

  - **Practical Consideration:** Despite the application of §18-1101(c) to public LLCs, public companies will still be subject to public disclosure laws even if managers are exempt from duties pursuant to the terms of the company's LLC agreement.

- *Kahn v. Portnoy* (2008)*:* A Delaware decision illustrating the effects of unclear language in an LLC agreement modifying or eliminating the fiduciary duties owed by managers to the LLC and its members.[15]

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[13] 953 A.2d 136 (Del. 2008).

[14] In order to proceed with a derivative action, a shareholder must either demand the directors to raise the claim or prove that making such demand would be futile. In order to demonstrate "demand-futility", the shareholder must demonstrate that the directors would be conflicted in raising a claim, which is most often established by demonstrating that the directors breached their duties to the company. *See* Wood, 953 A.2d at 4-5.

[15] Khan v. Portnoy, C.A. 3515-CC (Del. Ch. Dec. 12, 2008).

- **Language in Question:** "Whenever a potential conflict of interest arises between any shareholder and/or a director and/or the company, any resolution by the board shall be permitted and deemed approved and shall not constitute a breach of this agreement … It shall be presumed that, in making its decision, the board acted properly and in accordance with its duties, and the person bringing such proceeding shall have the burden of overcoming the presumption by clear and convincing evidence."

- **Facts:** A shareholder in a publicly traded LLC filed a derivative suit claiming that the directors breached the duty of loyalty to the company by approving a transaction designed to benefit a director at the expense of the company. The plaintiff argued that the second sentence above only applied to transactions between the shareholders and the directors or the company; the defendants claimed it applied to all actions taken by the board, including the interested transaction in question between the director and the company.

- **Holding:** Since facts had to be viewed in light most favorable to non-moving party, the court denied the plaintiff's motion claim assuming that the defendant's interpretation of the agreement was correct. The court did, however, note that a reasonable person could read the contract as adhering to the shareholder's interpretation.

- **Significance:** *Wood* illustrates how a poorly drafted provision in an LLC agreement with respect to a manager of member's duties can result in a court ruling against the original intention of the parties.

- **Practical Consideration:** If parties create distinct duties owed by managers or members, the court will not resort to default fiduciary duties but will attempt to determine what the parties intended in light of the expresses language of the LLC agreement. If the language is clear, it will lead to a predictable result; if the language is unclear, the court will decide what was intended based on the facts and the express language of the agreement.

DISCUSSION OF PRACTICAL IMPLICATIONS

Positive and Negative Aspects of Current State of Law

In light of the above discussion, there are both positive and negative implications of the current laws pertaining to partner, manager and member duties.

- Positive Aspects:

  - **Limited Liability:** The amended statutes allow partners, managers and members to limit their exposure to liability.

  - **Predictability:** By allowing the parties to define the duties owed by partners, managers and members in the partnership or LLC agreement, the parties themselves can dictate how the court should rule if such duties are called into question, as opposed to having the courts apply the less predictable fiduciary duties as defined in years of case law.

- **"Custom-Made" Agreements:** The current law allows parties to tailor partnership or LLC agreements to better accommodate informal business relationships where strict fiduciary duties are unnecessary.

- Negative Aspects:

  - **Heightened Caution:** Because a party can now presumably insert a blanket waiver of fiduciary duties, all parties must pay heightened attention to the language used in partnership and LLC agreements. This can cause serious issues for an unsophisticated or unrepresented party.

  - **Increased Negotiations:** Now that they can determine the duties applicable to partners, manager or members on their own, parties may be polarized with respect to how lenient or strict such duties should be which may lead to lengthened negotiations or stalemate.

  - **Unbalanced Leverage:** Parties with significant leverage, such as banks or key investors, may now require the freedom from fiduciary duties as a condition to entering a deal.

  - **Critical Drafting:** Given the unpredictability of court rulings in the event of unclear drafting, as evidenced from the *Portnoy*, *Miller* and *R.S.M.* cases, parties must pay more attention to drafting clear provisions with respect to the duties applicable to partners, managers and members, which may lead to increased legal fees related to document drafting.

Practical Considerations

In reviewing partnership and LLC agreements, it is crucial for the attorney to consider the following items, which may vary depending on whether the client (*i.e.*, a member or manager of an LLC) has significant or minimal leverage in the transaction and negotiation of the agreement.

- If the Client Has Significant Leverage

  - **Level of Aggression:** Will a significant restriction or waiver of the client's fiduciary duties owed to the company or the members deter the opposing parties from entering into the agreement?

  - **Sufficient Clarity:** Does the language in the LLC agreement clearly express the waiver or restriction of duties as intended by the parties, or could a reasonable person misinterpret the language?

  - **Application of Implied Covenant GF:** Even if you restrict or eliminate the duties owed by your client, what obligations would a court likely hold the client to under Implied Covenant GF?

  - **Required Public Disclosure:** Even if you restrict or eliminate the duties owed by your client, what disclosures will the client be required to make under the public disclosure laws?

- If the Client Has Little Leverage

- **Existence of Duties:** First and foremost, does the LLC agreement contain any provisions that expressly limit or eliminate the duties owed by any member or manager to your client?

- **Level of Acceptability:** If there is an express provision limiting or eliminating the duties owed by any member or manager to your client, is such provision acceptable or a deal-breaker for your client?

- **Adequacy of Protection:** If there is an express provision limiting or eliminating the duties owed by any member or manager to your client, does the LLC agreement still:

    - provide the client with adequate avenues to raise claims against malfeasant members and managers, and

    - make business sense in light of the proposed transaction?

- **Negotiation Strategies:** If the opposing party has limited or eliminated a duty owed by a member or manager to your client that you believe is essential for your client's protection, what is the best negotiation strategy to reinstate it?

- **Sufficient Clarity:** Does the proposed language clearly express the agreed upon terms with respect to duties, or could a reasonable person misinterpret the language?

- **Application of Implied Covenant GF:** If there is an express provision limiting or eliminating the duties owed by any member or manager to your client, what obligations would a court likely hold the other members or manager to under Implied Covenant GF? Would reliance on Implied Covenant GF be prudent or provide the client with sufficient protection in light of the LLC agreement?