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Fiduciary Duties In Delaware LLC Agreements

Law360, New York (March 31, 2010) -- Delaware affords contracting parties of an LLC wide latitude to expand, restrict, or eliminate fiduciary duties owed by managers and controlling members.

While the Delaware Limited Liability Company Act (the "LLC Act") does not specify a statutory default provision, a recent Delaware Chancery Court decision has confirmed that in the absence of an explicit contrary provision in the LLC agreement, LLC managers and controlling members owe traditional fiduciary duties of loyalty and care to each other and to the LLC.[1]

Such a default rule requires corporate practitioners to specifically delineate the desired fiduciary duties applicable to managers and members, and to explicitly disclaim (if so desired) all other fiduciary duties.

Facts

Plaintiff Thomas Kelly formed Marconi Broadcasting Co. LLC ("Marconi") in 2007, and in a series of transactions, Marconi sold units to, and borrowed money from, ELB Capital Management LLC ("ELB") through various wholly owned subsidiaries of ELB (the "ELB Members").

Facing a significant liquidity crisis in 2008, Marconi received a loan from an ELB Member, and the ELB Members and Kelly entered into a second amended LLC Agreement (the "LLC Agreement") pursuant to which the ELB Members received all the Class A and Class C common membership units of Marconi, and Thomas Kelly retained all the Class B common membership units of Marconi. Each class was entitled to elect its own set of managers.

The LLC Agreement required that all actions of Marconi be approved by managers holding a majority of the voting power of Marconi and established a hierarchy under which Class A managers held 24 percent, the Class B manager held 25 percent, and the Class C manager held 51 percent of the voting power.

The LLC Agreement also explicitly provided that Marconi could not enter any merger, conversion, or consolidation agreements without the prior written approval of the Class A member or managers and the Class C member or managers.

Marconi faced another liquidity crisis in 2009. ELB questioned Kelly's management of Marconi and proposed recapitalizing Marconi through a merger with a wholly owned affiliate of ELB, pursuant to which each Class A, B and C interest would convert into the right to receive \$1 per class (the "Merger").

The Merger was approved by the ELB Members through a written consent, and on April 17, 2009, the merger was consummated. The aggrieved minority member Kelly brought suit the same day.

The Court of Chancery considered six separate direct and derivative claims on various motions to dismiss and a motion for summary judgment. Defendants succeeded in dismissing those claims that were not based on alleged breaches of fiduciary duties.

The court found that (1) the notice of the Merger was substantially provided and the Merger was therefore effective, (2) Kelly lacked standing to sue derivatively because his membership interest in Marconi dissipated with the Merger, and (3) Kelly did not adequately state a claim for breach of the implied covenant of good faith and fair dealing as Kelly did not allege a specific implied contractual obligation that had been breached.

However, Kelly's claims that the ELB Members and their appointed managers had breached their fiduciary duties, and a corresponding claim that ELB had aided and abetted such breaches, each survived defendants' motion to dismiss.

Breach of Fiduciary Duty

In reviewing Kelly's claims that the managers and members of the LLC breached their fiduciary duty of loyalty by approving the Merger, the Court of Chancery reviewed prior case law and concluded that:

"even though contracting parties to an LLC agreement have the freedom to expand, restrict, or eliminate fiduciary duties owed by managers to the LLC and its members and by members to each other, in the absence of a provision explicitly altering such duties, an LLC's managers and controlling members in a manager-managed LLC owe the traditional fiduciary duties that directors and controlling shareholders in a corporation would."^[2]

The court then proceeded to review those specific provisions contained in the LLC Agreement which might explicitly alter the fiduciary duties of each of the managers and the members of Marconi.

The Fiduciary Duties of the Marconi Managers

The court examined two provisions in the LLC Agreement that may have altered the fiduciary duties of the managers of Marconi.

The first provided that: "[t]he Board of Managers shall manage the affairs of the Company in a prudent and businesslike manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs."^[3]

The court found that this first provision did not limit the managers' duties so much as place control of Marconi's affairs in the board of managers (rather than the members), and permit each manager to determine the amount of time to be devoted to running Marconi.

The second examined provision of the LLC Agreement provided that: "[i]n carrying out their duties hereunder, the Managers shall not be liable for money damages for breach of fiduciary duty to the Company nor to any Member for their good faith actions or failure to act ... but only for their own willful or fraudulent misconduct or willful breach of their contractual or fiduciary duties under this Agreement."^[4] The court found this exculpatory provision contemplated that fiduciary duties did in fact apply.

The court concluded that because no clause in the LLC Agreement explicitly restricted or eliminated the default applicability of the managers' fiduciary duties, the managers appointed by the ELB Members were required to treat Kelly in accordance with such traditional fiduciary duties.

Assuming the truth of Kelly's allegations at the motion to dismiss stage, it is presumed that such managers entered into the Merger largely intending to profit from a premeditated scheme to squeeze Kelly out of Marconi and seize control of its assets.

Exculpation of the Marconi Managers

While the court found the exculpatory provision referenced above contemplated fiduciary duties did in fact apply, the provision also excused any breaches of such duties, unless the managers acted willfully. Kelly argued the definition of "willful" was voluntary and intentional.

The court expressed sympathies towards such an easily satisfied definition, but found that even defendants' proffered definition of "actual, specific or evil intent to harm someone or acting recklessly and outside the bounds of reason" could characterize defendants' actions, as alleged in Kelly's complaint.

Other courts have similarly noted that "[w]illful" is a notoriously ambiguous word, which can indicate any of a number of mental states."^[5] Given the ambiguity of the word "willful" in the context of a corporate agreement, practitioners should avoid introducing the word, and instead should rely on more well-developed standards such as voluntary, intentional, negligent, reckless, wrongful or fraudulent.

The Fiduciary Duties of the Marconi Members

In turning to the members of Marconi, the Court noted that similar to LLC managers, in the absence of provisions in the LLC Agreement explicitly disclaiming the applicability of default principles of fiduciary duty, controlling members owe minority members the traditional fiduciary duties owed by controlling shareholders to minority shareholders.

The court found the LLC Agreement was silent as to what duties the Marconi controlling members owed minority members, and that the members therefore owed Kelly traditional fiduciary duties, including the duty not to cause Marconi to enter into a merger that would benefit the controlling members at the expense of Kelly, Marconi's minority member.

While the court appeared to be looking for an explicit disclaimer of the members' fiduciary duties (a disclaimer that was clearly lacking), a footnote in the opinion suggests that a provision permitting related party transactions would have appropriately cleansed the actions approved by the ELB Members, had the provision's procedures been appropriately followed.^[6]

The court further noted to the extent defendants sought to dismiss Kelly's breach of fiduciary duties claims because the LLC Agreement authorized self-interested transactions such as the Merger, Kelly had "alleged facts sufficient to suggest that the Merger was not 'done on an arm's length basis,' as required by Section 7.21 of the Agreement."^[7]

Curiously, the court seems to suggest had the Merger been "done on an arm's length basis" as required by the LLC Agreement, then the ELB Members' approval of the transaction would have been cleansed.

This, despite the fact there was no explicit disclaimer of fiduciary duties, and an "arm's length" standard imposed by the LLC Agreement may not have equaled the more stringent entire fairness standard imposed by the fiduciary duty of loyalty in related party transactions.

Conclusion

With respect to the controlling members of the LLC, it is clear an explicit disclaimer of fiduciary duties will curtail those duties, and a prescribed contractual voting right to approve an action will not alone curtail fiduciary duties that may otherwise apply.

Through a single footnote, though, the court creates an ambiguity regarding the effect of an LLC agreement that provides both for certain voting rights, and also provides some procedural steps or substantive standard (such as an "arm's length basis") that may serve as a substitute for the fiduciary duties themselves.

Practitioners should not rely on courts to view explicit contractual voting rights or clear standards or procedures used to test the fairness of a transaction as substitutes for fiduciary duties, and should instead explicitly disclaim fiduciary duties as, and where, applicable, in the LLC agreement itself.

Explicit disclaimers of fiduciary duties may oftentimes be overreaching — for example, the Marconi members may have wished to provide for explicit voting rights and an arm's length standard in place of any fiduciary duties in a related party Merger context, but may have also desired that fiduciary duties otherwise fill the gaps not directly addressed by the LLC agreement.

Practitioners should therefore understand their client's business objectives, elucidate specific approval rights governing related party transactions and other common areas of concern (e.g., corporate opportunities), and gap-filling default duties (including, if so desired, fiduciary duties), and otherwise explicitly disclaim all other fiduciary duties in the LLC agreement itself.

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[1] Kelly v. Blum, C.A. No. 4516-VCP (Del. Ch. Feb. 24, 2010).

[2] Id. at 2.

[3] Id. at 31.

[4] Id.

[5] Johnson & Johnson v. Guidant Corp., 525 F. Supp. 2d 336, 349-50 (S.D.N.Y. 2007).

[6] Kelly, at 38, n.93.

[7] Id.