

Delaware Supreme Court Disclaims Court of Chancery's Conclusions on Fiduciary Duties of Managers of Delaware LLCs

In an opinion issued on November 7, 2012, the Delaware Supreme Court left open the long-standing question of whether the Delaware Limited Liability Company Act imposes default fiduciary duties on managers of Delaware LLCs in the absence of an express contractual elimination of such duties. Earlier this year, in *Auriga Capital Corp. et al. v. Gatz Properties, LLC*, Chancellor Strine of the Delaware Court of Chancery answered this question in the affirmative and held that the manager in question, Gatz Properties, LLC, owed traditional implied fiduciary duties to the members of the LLC it managed, Peconic Bay, LLC, in addition to the duties imposed under the underlying LLC agreement. On appeal, the Delaware Supreme Court upheld the Court of Chancery's interpretation of the LLC agreement but not its reading of the Delaware LLC Act. Instead, the Delaware Supreme Court instructed courts and practitioners that the Court of Chancery's opinion that "the LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties" was mere dictum without any precedential value.

Gatz Properties, LLC was a family-owned entity that held title to property on Long Island in New York. The Gatz family set up Peconic Bay, LLC, which was managed by Gatz Properties and owned in part by third-party investors, and Peconic Bay entered into a long-term ground lease for the property with Gatz Properties. Peconic Bay subleased the property to an independent golf-course management company, but the golf course struggled. According to the Court of Chancery and the Supreme Court, Gatz Properties then sought to unlock the value in the underlying property, which by that time was worth more as vacant land for development than as an operating golf course, but it acted at the expense of the third-party investors in Peconic Bay. In particular, Gatz Properties stonewalled an unaffiliated investor interested in purchasing Peconic Bay and instead conducted what the Court of Chancery described as a "sham" auction to allow Gatz Properties to purchase Peconic Bay for itself at a "fire sale price."

The Court of Chancery held that Gatz Properties violated both express and default fiduciary duties owed to the members of Peconic Bay. First, the Peconic Bay LLC agreement contained a provision prohibiting the manager from entering into agreements with affiliates on terms and conditions less favorable to Peconic Bay than could be obtained from an arms-length negotiation with third parties without the consent of a majority of the third-party investors. The Court of Chancery construed this provision as an explicit assumption by Gatz Properties of the obligation to obtain a fair price for the LLC in affiliate transactions and determined that the "sham" auction violated this contractual duty. Second, the Court of Chancery concluded that the LLC Act imposes fiduciary duties on LLC managers by default unless such duties are expressly eliminated in the applicable LLC agreement. Because the Peconic Bay LLC agreement did not expressly eliminate these duties, the Court of Chancery held that Gatz Properties also breached its default fiduciary duties through its conduct leading up to and during the auction. The Delaware Supreme Court, acting *en banc*, affirmed the Court of Chancery's reading of the Peconic Bay LLC agreement but held that, because the Court of Chancery was able to rule on the questions presented solely through its review of the LLC agreement and the factual background, its analysis of the Delaware LLC Act was therefore unnecessary.

By refusing to affirm, or even engage with, the Court of Chancery's statutory analysis, the Delaware Supreme Court left unanswered the enduring question of whether the Delaware LLC Act imposes default fiduciary duties on managers of LLCs unless such duties are expressly eliminated. In particular, Section 18-1101(c) of the Delaware LLC Act permits managers and members of LLCs to eliminate or restrict fiduciary duties through provisions in the LLC agreement, except for the implied contractual covenant of good faith and fair dealing, which cannot be disclaimed. Thus, in the absence of further judicial guidance, managers and members of Delaware LLCs can best protect their interests and reduce uncertainty by expressly stating in the

underlying LLC agreement the particular fiduciary duties and standards of care that the members and manager will (or will not) be bound by. In addition, if the parties wish to confirm that the duties delineated in the LLC agreement displace any traditional fiduciary duties that may (or may not) be owed to the LLC and its members under the Act, the LLC agreement should also include a provision stating that the only duties owed by the manager or any member to the LLC or its members (if any) are those set forth in the LLC agreement itself.

Contractual specificity and clarity can also reduce uncertainty surrounding the scope of the manager's and members' implied contractual covenant of good faith and fair dealing. While the Delaware LLC Act specifies that this covenant cannot be eliminated via contract, "the implied covenant has rightly been narrowly interpreted by [the Delaware Supreme Court] to apply only 'when the express terms of the contract indicate that the parties would have agreed to the obligation had they negotiated the issue.'" *Auriga v. Gatz Properties*, citing *Nemec v. Sbrader*. In *Nemec v. Sbrader*, the Delaware Supreme Court held that Booz Allen Hamilton, Inc. was entitled to exercise put options in a Stock Plan at the expense of the plaintiff individual shareholders that were parties to the Stock Plan. First, because the scope of the company's right to exercise the put option was expressly set forth in and governed by the Stock Plan, the Court reviewed the claims only as breach of contract claims and not as duty of loyalty claims. Second, the plaintiffs' claim for a breach of the implied covenant of good faith and fair dealing was dismissed because the put option was bargained for by the parties and its exercise was expressly authorized by the terms of the Stock Plan. The *Nemec v. Sbrader* ruling thus supports the proposition that the proper exercise of a specified contractual right will, absent arbitrary and unreasonable conduct during circumstances that could not be anticipated, comport with the implied covenant of good faith and fair dealing. Together, the holdings in *Auriga v. Gatz Properties* and *Nemec v. Sbrader* illustrate for managers and a members of Delaware LLCs that clear and specific drafting will help keep judicial review within the four corners of the LLC agreement.

If you would like to learn more about the issues in this alert, please contact your usual Ropes & Gray attorney, or any of the attorneys listed below.

[Richard E. Gordet](#)
[Peter L. Welsh](#)