Power Of The Fiduciary Duty Contractual Waiver In LLCs

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In Miller v. HCP, the Delaware Court of Chancery on Feb. 1, 2018, dismissed claims made against the members of a limited liability company board, a majority of whom had been appointed by the private equity firm that was the company’s controlling stockholder, for approving a sale of the company to an unaffiliated third party that was championed by the controller — without attempting to maximize the price.

Under the LLC operating agreement’s “waterfall” provisions governing the allocation of proceeds on a sale of the company, the controller was entitled to receive almost all of the proceeds of any sale up to $30 million and almost none of any proceeds above that amount (which, the court acknowledged, created little incentive for the board to negotiate a price higher than $30 million). The buyer initially offered $31 million and ultimately increased the price to $43 million (after the company had received a competing offer for $36 million and an unsolicited indication of interest that valued the company at $50 million-$60 million — neither of which the controller-allied board members pursued). Only $48,000 of the $13 million price increase was allocated to the plaintiff, who was a co-founder of the company, with the balance being allocated to other minority stockholders who had priority over the plaintiff in the waterfall. Under the waterfall, the plaintiff was entitled to an allocation of significant proceeds on a sale only if the price reached $60 million.

The plaintiff claimed that an open auction process would have resulted in a much higher sale price that would have made proceeds available to all of the preferred unitholders. Although, under the LLC operating agreement, all fiduciary duties of the board to the LLC members and of the LLC members to one another were waived, and the board was granted “sole discretion” to approve a sale to an unaffiliated third party, the plaintiff contended that, based on the contractual implied covenant of good faith (which adheres to every contract and cannot be waived), the board was obligated to seek to maximize the price. The court disagreed and granted the motion of the controller and the controller-allied board members to dismiss the case.

Key Points

The decision underscores that minority investors in noncorporate entities typically have
very limited rights as compared to investors in corporations. In contrast with the corporate context, where fiduciary duties apply under the common law (and cannot be waived), the relationship between an LLC board and the investors (and among the investors) is contractual in nature and the board’s fiduciary duties can be waived. Miller highlights (1) the significant impact of the contractual waiver of fiduciary duties common in agreements governing noncorporate entities and (2) the general reluctance of the court to “read in” protections for minority investors, based on the implied covenant of good faith, that were not specifically negotiated for and expressly set forth in the governing agreement.

It is also worth noting that the implied covenant of good faith did not require that the board seek to maximize the price on a sale of the company to an unaffiliated third party. The court observed that, based on consistent precedent, the implied covenant of good faith and fair dealing may be invoked only when there is a “gap to be filled” in the parties’ agreement because an event arose that the parties could not have anticipated. The court found no gap in this agreement, as the agreement expressly provided that the board had sole discretion to approve a sale of the company other than to an insider. The court inferred from this language that the parties had “considered and addressed” the potential of a sale to an unaffiliated party and had not intended to restrict the board’s sole discretion in that context.

The court also distinguished between the defendants acting in bad faith and their acting in the controller’s self-interest as contemplated by the agreement. The implied covenant of good faith may have been invoked if there had been allegations of bad faith by the defendants, the court stated. Here, however, the court reasoned, the controller-allied board members had not acted with the “purpose of harming” the other investors, but had simply acted in “their own self-interest manifest from the waterfall provisions in the [operating agreement]” — provisions that the controller had specifically negotiated for and the parties had agreed to. In the court’s view, the board conducting an auction could have risked the $31 million transaction — thus depriving the controller of the negotiated-for benefit of the board having sole discretion to accept a sale with an unaffiliated party even if the sale favored the controller’s interests (which in this case it did because the controller was the only investor to obtain a full payout under the waterfall provisions).

Background

When the co-founders of Trumpet Search LLC sought capital investment, private equity firm HCP & Co., with a $15 million investment, became the owner of 78 percent of Trumpet’s units and appointed a majority of Trumpet’s board. As noted, the LLC operating agreement provided that all fiduciary duties were disclaimed, that the LLC board had “sole discretion” to approve any sale to an unaffiliated third party, and that the class of units acquired by HCP were entitled to receive almost all of the first $30 million in proceeds on any sale of the company and almost none of any proceeds above that amount.

Less than a year after HCP made the investment, HCP proposed a sale of Trumpet to MTS Health Partners, an unaffiliated third party. MTS initially offered a purchase price of $31 million. The HCP-allied majority of Trumpet’s board favored the proposal and decided not to conduct any market check. When the non-HCP-allied board members (including the plaintiff) “pushed back” at the absence of any sale process, they were given five days “to find competing offers” and the Trumpet CEO was permitted to speak to two entities that had previously expressed an interest in Trumpet. The HCP-allied board members continued to champion the MTS deal and to reject investigating the possibility of any other deal notwithstanding that, during the “abbreviated” sale process (which was not made public), the company received an offer from another party of $36 million and an unsolicited indication of interest that valued Trumpet at $50 million-$60 million. Based on these developments, MTS, feeling “pressure,” raised its price to $43 million. The company then entered into the sale to MTS at that price. HCP
received $30 million of the sale proceeds, and minority investors received the additional $13 million (with the plaintiff receiving only $48,000, based on his position under the waterfall provisions).

Discussion

The court stated that (a) the waiver of fiduciary duties in the LLC operating agreement meant that the board could act in the controller’s interest in the event of a sale to an unaffiliated third party — subject only to the contractual implied covenant of good faith, and (b) the implied covenant did not require that the board seek to maximize the price. Unlike in the corporate context, where boards have fiduciary duties to the stockholders by common law (which cannot be waived), the relationship between an LLC board and the investors, or among LLC investors, is solely contractual in nature. Therefore, although an LLC board has fiduciary duties, they can be modified or eliminated in the LLC operating agreement.

In addition, the agreement can specify a standard or safe harbor under which the LLC board can approve conflicted transactions. In this case, in the operating agreement, the parties expressly waived all fiduciary duties and expressly granted the board “sole discretion” with respect to a sale of the company to any unaffiliated third party (while imposing restrictions with respect to a sale to an affiliated party). According to the plaintiff, based on the implied covenant of good faith, “implying an auction condition [was] necessary ... in light of the incentive created by the [operating agreement’s] waterfall provisions” (i.e., the incentive to negotiate only for a deal price up to $30 million). Notwithstanding the waiver of fiduciary duties, the plaintiff argued, the minority investors could not have anticipated that, in the event of a sale to an unaffiliated third party, the board would not seek to maximize the sale price. The plaintiff contended that the contractual covenant of good faith “provide[d] a term that the parties would have employed had they considered the matter: that any sale of Trumpet required an open-market sale or auction to ensure maximum value for all members.”

The court found that the sale of the company without an auction was anticipated on the face of the contract — as the controller’s lack of incentive to negotiate for a price higher than $30 million was clear under the waterfall provisions. The LLC members, “despite creating this incentive, eschewed fiduciary duties, and gave the Board sole discretion to approve the manner of sale, subject to a single protection for the minority, that the sale be to an unaffiliated third party,” the court wrote. Moreover, the court reasoned, based on the “language of the agreement,” the parties had “considered and addressed” the possibility of a sale to an unaffiliated third party and had not expressed any obligation to maximize the price. According to the court, the provision limiting the board’s discretion with respect to a sale to any affiliated party reflected that the parties did not intend to include any restriction with respect to the exercise of sole discretion in the case of a sale to an unaffiliated party. The court concluded that it “appear[ed] that the parties to the [operating agreement] did consider the conditions under which a contractually permissible sale could take place. They avoided the possibility of a self-dealing transaction but otherwise left to [HCP] the ability to structure a deal favorable to [its] interests.” Further, the defendants’ actions were not arbitrary or unreasonable, according to the court, as conducting an auction could have risked loss of the $31 million offer — which would have “deprive[d] the Defendants of a negotiated-for benefit.”

The Contractual Implied Covenant of Good Faith is a Weak Tool for Plaintiffs

The Delaware Supreme Court has long viewed the implied covenant as only “rarely” capable of imposing obligations that are not specifically set forth in an agreement. The Delaware Supreme Court’s 2010 Nemec decision narrowed even further the limited circumstances under which the implied covenant previously could be invoked. Nemec held that “[t]he implied covenant only applies to developments that
could not be anticipated, *not developments that the parties simply failed to consider.*” (emphasis added). Moreover, for the court to “fill the gap” in an agreement based on an event having arisen that could not have been anticipated, it must be apparent what the parties would have agreed to provide had they anticipated the event. Further, it is well established that the covenant must be considered in the context of the agreement as a whole and, in an operating agreement governing a noncorporate entity, it cannot revive fiduciary duties that have been expressly waived.

We note that, in contrast to Miller, in the Feb. 12, 2018, Oxbow Carbon LLC Unitholder Litigation decision, Vice Chancellor J. Travis Laster, in a 178-page post-trial opinion (more than 100 pages of which recites the factual background of the case), found that the implied covenant of good faith was available to fill a gap in the parties’ LLC operating agreement. The Oxbow facts vary considerably from Miller, and Vice Chancellor Laster reiterated in his opinion that the implied covenant is “deployable” only in “rare cases.”

**Contrast with the Corporate Form**

The court noted in Miller that, if Trumpet had been a corporation rather than an LLC, the board would have had fiduciary duties to the other investors that would have required that it seek to obtain the best price reasonably available. In addition, the court noted, in connection with any challenge to the sale, given that the controller’s interest was not fully aligned with the other investors’ interest, the applicable standard of judicial review would have been “entire fairness,” requiring that both the price and process were fair to the minority investors (unless the procedural protections for minority stockholder set forth in the MFW decision are in place). The court explained that the co-founders of Trumpet, when they sought investment capital, “forwent the suite of common law protections available with the corporate form and instead chose to create an LLC” — which, the court commented, made the investment opportunity they were offering more attractive to HCP because, although acquiring a majority of the company’s units, HCP would not have fiduciary duties to the co-founders or the other minority investors. The court noted that the co-founders chose this trade-off “despite the presence of a controller [i.e., HCP] with an incentive to take a quick sale, and a Board with sole discretion to approve such a sale, with the single safeguard that the sale must not be to [HCP or its affiliates].”

**Cases in Which the Court Has Found That “Sole Discretion” Must Be Exercised in Good Faith**

The court acknowledged a number of Delaware decisions holding that, when a contract provides a party with discretion to be exercised, that discretion, based on the implied covenant of good faith, must be exercised in good faith. However, the court stated, “if the scope of the discretion is specified, there is no gap in the contract as to the scope of discretion, and there is no reason for the Court to look to the implied covenant to determine how the discretion should be exercised.”

In this case, the court determined, the LLC operating agreement “define[d] the scope of the board’s discretion by providing it with sole discretion to determine how to conduct a sale process, cabined by the requirement that any transaction be with an unaffiliated third party.” According to the court, this language indicated that “the members considered the implications of vesting discretion in a conflicted board” and it “thus [left] no room for the implied covenant to operate.” The court acknowledged that the implied covenant was applied in a number of Delaware cases when an agreement granted the board “sole discretion” to approve a sale of the company — but found that these precedents were distinguishable because, in the instant case (unlike the precedents), the parties had set forth restrictions on sole discretion with respect to certain matters (sale to an affiliated party) but not with respect to other matters (sale to an unaffiliated party) — indicating that they did not intend sole discretion to be
restricted in the latter cases.

“[B]y providing that the Board [did] not retain sole discretion to sell the company to insiders,” the parties indicted that they had considered and addressed “the potential for self-dealing inherent in [the provision granting sole discretion with respect to selling the company to unaffiliated parties],” the court wrote.

The Factual Context

We note below a number of factors that were favorable to the defendants in the case (notably, however, under the court’s reasoning, the plaintiff’s claims apparently would have been dismissed even if the board had simply accepted the initial offer — that is, even if the board had engaged in no sale process and the buyer had not increased its price):

- **Some Sale Process and a Price Increase.** The board did not simply accept MTP’s initial offer of $31 million but ultimately engaged in an “abbreviated” (albeit nonpublic) sale process, and ultimately the buyer did increase its price by more than a third (to $43 million) even though the controller did not benefit from the increase.

- **No Bad Faith.** The court noted that there were no allegations of “bad faith” against the defendants. The court wrote: “There are no allegations of fraud or a kickback from the buyer. There is no indication that the Defendants acted from any perverse or cryptic incentive, other than their own self-interest manifest from the waterfall provisions in the [operating agreement] — there is, for example, no allegation that they acted with the purpose of harming the nonaffiliated members. Such actions plausibly would be of the type addressed by the implied covenant.” Thus, we note, the court might have reached a different result if, say, a credible $60 million offer had actually been received and was still on the table when the board agreed to the $31 million sale. In that situation, bad faith might have been found if there was no conceivable explanation for the board’s choice other than an intent to harm the minority investors.

- **Remorse Over the Waterfall Provisions.** As noted, under the waterfall provisions, HCP received the first $30 million of the sale process. Of the remaining $13 million in sale proceeds, the plaintiff received only $48,000 (“next to nothing,” the plaintiff complained) and other minority investors received the balance. Notably, however, the plaintiff’s allocation represented an almost 70 percent return of his investment of just $70,000. The plaintiff would have received his full investment back if the sale price had reached $53 million; and would have received a significant return on his investment only if the sale price reached $60 million. (The controller would not have received additional proceeds until the sale price exceeded $60 million, at which point the investors would share pro rata in the proceeds.) We note that the other minority investors — almost all of whom had priority over the plaintiff in the waterfall — did not join the lawsuit. The court appeared to view the plaintiff’s claim as based on “remorse [having] set in” over the waterfall provisions that he had negotiated and agreed to, rather than on any improper conduct by the board.

Practice Points

Persons considering a minority investment in a noncorporate entity (such as an LLC or a master limited partnership) should read and understand the offering materials and the governing agreement before
investing — as they are frequently surprised, after the fact, to discover that (a) the agreement provides very limited rights to the minority investors and (b) the implied covenant of good faith only rarely can be invoked to provide for protections not expressly set forth in the agreement. Often, LLC managers or general partners have no fiduciary duties to the other investors and have very broad discretion, including with respect to conflicted transactions.

Controllers should seek to specify in the governing agreement the broadest possible waiver of fiduciary duties permitted under law and sole discretion for the board. On the other hand, minority investors, taking into account all anticipatable events, should seek to specifically negotiate for and expressly include in the agreement any minority investor protections. In Miller, minority investor protections could have included, for example, that, on a sale of the company, the board would be required to conduct an auction, or to implement a sale process designed to, or use reasonable efforts to, maximize price. Other possible protections include a minimum sale price or a majority-of-the-minority stockholder approval requirement.

The scope of the board’s discretion (including “sole discretion”) should be defined as clearly as possible to avoid any ambiguity. A grant of discretion to a board generally will be subject to exercise in good faith unless the agreement clearly specifies a different standard. In Miller, a critical factor in the court’s finding that the implied covenant was inapplicable was that the agreement language, in the court’s view, indicated that the parties had considered the potential for action by HCP that might favor HCP and had specifically addressed it by limiting the board’s discretion with respect to a sale to HCP, but not limiting the board’s discretion with respect to any sale to an unaffiliated party. If “sole” discretion is granted, any limitations on that discretion should be clearly stated and the controller should seek to include a statement that the specified limitations are the only ones intended by the parties. A controller may seek to specify that there is no obligation to conduct an auction or otherwise seek to maximize the price on a sale.

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