Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Survey Of LLC Director Obligations In Delaware: Part 1

By **Gail Weinstein, Steven Steinman, Randi Lally and Maxwell Yim**
(June 22, 2018, 1:35 PM EDT)



Gail Weinstein



Steven Steinman



Randi Lally



Maxwell Yim

There are now more than twice as many limited liability companies and other alternative entities formed in Delaware as are corporations. Private equity funds and hedge funds are often formed as LLCs or limited partnerships to take advantage of the structural flexibility and tax treatment available. A key advantage is the ability to modify or eliminate traditional corporate-type fiduciary duties and, specifically, to facilitate conflicted transactions that arise due to the fund managers' various roles in managing multiple funds. In part one of this article, we discuss the recently issued Delaware decisions relating to the obligations of LLC directors under Delaware law; in part two, we will outline the key principles elucidated in these decisions and offer related practice points.

(Where we refer to LLCs, the same generally pertains to other alternative entities such as limited partnerships; where we refer to LLC directors, the same generally pertains to LLC managers and to general partners of limited partnerships.)

Recent Delaware Decisions

In re Energy Transfer Equity LP Unitholder Litigation (May 17, 2018)

This decision underscores that the protections of a safe harbor provision for conflicted transactions may be lost if the board does not comply with the precise terms of the provision. The Delaware Court of Chancery ruled that the conflicts committee safe harbor was not available as the committee had initially been established with three members, two of whom were ineligible to serve under the terms of the limited partnership agreement — and, although only the one eligible member actually served, the committee had never been formally reconstituted. We note that the court may have been influenced in this case by the overall negative factual context, including the inexperience and ineffectiveness of the sole director who served on the committee. The court found that (1) absent the safe harbor protection, the limited partnership agreement terms required that conflicted transactions be "fair and reasonable" to the partnership and (2) the defendants had not established that the transaction (a private offering of securities primarily to insiders) was fair. The court awarded only nominal damages, however, because the unit holders were not actually harmed (as the value of their units had increased significantly after the challenged transaction due to an improvement in

conditions in the energy market).

MHS Capital v. Goggin (May 10, 2018)

The decision highlights the importance of careful drafting of the LLC agreement given that ambiguity in the interrelationship of the provisions can provide a basis for the court to reject dismissal of breach of contract claims. The Court of Chancery, at the pleading stage, rejected dismissal of the plaintiff's breach of contract claim against the LLC manager, who allegedly had diverted LLC interests and funds to enrich himself and his friends. The LLC was entitled to receive certain assets it had purchased in a bankruptcy sale but the LLC manager allegedly had (a) directed the bankruptcy court to deliver some of the assets to other companies owned by the manager and his friends and (b) used LLC funds to pay significant fees to an attorney who represented the manager's (and not the LLC's) interests. The manager contended that the breach of contract claims should be dismissed on the basis that the exculpatory clause of the LLC agreement provided that he could not be liable for monetary damages. The court rejected the motion to dismiss, finding that it was unclear under the agreement how the provision setting forth the general standard of care required of the manager ("good faith and ordinary care") was "meant to work with the exculpatory clause, which purports to eliminate all damages."

Eames v. Quantlab (May 1, 2018)

The decision reflects the ambiguity that can arise with respect to the interrelationship of various provisions within and among agreements relating to a general partner's duties — as well as the court's general predilection for narrow interpretation of the rights of minority investors in noncorporate entities. The Court of Chancery granted the defendants' motion to dismiss the plaintiffs' claims that, under (1) the limited partnership agreement and (2) the LLC agreement governing the general partner, the limited partners had the right to remove and replace the general partner. The LPA provided that admission of a new general partner required the consent of the limited partnership units and the consent of the existing general partner. The LPA also provided that, absent removal for cause, a general partner could not be removed unless there was at least one remaining general partner. The LLC agreement governing the general partner provided that each of the GP's managers could act alone to transact business "for the benefit" of the GP — but could not, without the consent of the other, take any act that would make it impossible for the GP to carry on its or the limited partnership's ordinary business or make a major change in the principal business of either. The court held that one of the GP managers' purported consent on behalf of the GP to the appointment of a new general partner was invalid, as the consent of both managers of the GP was required because the removal was not for the GP's benefit and changed its business. The court reasoned that adding a general partner caused the GP to cease being *the* general partner, and to become instead just *a* general partner of the limited partnership. The court wrote: "While certain of the limited partners may now be displeased with their inability to direct [the limited partnership]'s day-to-day business, this arrangement reflects a bargained-for allocation of interests and influence."

Capone v. LDH (April 25, 2018)

The decision reflects that, notwithstanding the disclaimer of fiduciary duties in the agreement, inclusion of certain types of phrases can be interpreted by the court as suggesting an intention of the parties that the directors have duties beyond those specified in the agreement. The Court of Chancery reasoned that, although the LLC agreement provided that membership units to be purchased from terminated employees would be valued by the LLC board as of a specified date, when new information (which became available after the specified date but before the units were purchased) clearly indicated that the

board's valuation had significantly undervalued the units, the board had an implicit duty to revise the valuation. The court, at the pleading stage, denied the defendants' motion to dismiss, emphasizing that the valuation provision included the caveat that the valuation was to be produced as specified "unless otherwise determined by the board" (which, according to the court, suggested that the board had discretion that perhaps should have been exercised).

Leaf Invenergy v. Invenergy Wind (April 19, 2018)

The decision highlights the importance of expressly memorializing the parties' expectations in specific terms in the LLC agreement (in this case, with respect to a liquidated damages remedy for a breach of the agreement). The LLC agreement provided that the company could not engage in a sale of assets without the consent of certain of its members unless those members would achieve at least a specified agreed rate of return (the "target multiple"). The Court of Chancery found, at the pleading stage, that the agreement had been breached by the LLC board when it sold assets without the consent of one of these members, and that the clear expectation of the LLC and that member had been that, if such a breach occurred, the company would pay the member an amount equal to the target multiple. However, after a trial to determine the proper remedy for the breach, the court awarded the member only nominal damages of $1 because (1) the LLC agreement itself did not contain a provision clearly stating what the damages would be and (2) the member did not suffer harm from the breach (because the asset sale that had been effected without its consent was at an "attractive price" that increased the value of its LLC interest). The court wrote, "The parties' subjective beliefs about a remedy are not controlling unless they are implemented in a remedial provision in an agreement, such as a liquidated damages clause." Here, "the parties did not memorialize their subjective beliefs about the expected remedy in a contractual provision."

Miller v. HCP (Feb. 1, 2018)

The decision highlights the contrast between LLC and corporate law, with the court commenting that if the case had been decided in the corporate context, the directors would have had a fiduciary duty under Revlon to seek to maximize the price of the company on its sale (and the judicial standard of review for the challenged transaction would have been entire fairness). The Court of Chancery rejected the plaintiff's contention that the implied covenant of good faith required that the controller-dominated board had to seek to maximize the price of the company on its sale to an unaffiliated third party. Although the sale was to an unaffiliated third party, the controller's interests allegedly were not aligned with the other investors' interests, as the LLC operating agreement's "waterfall" provisions allocated to the controller almost all of the proceeds up to $30 million on a sale of the company and almost none of the proceeds above that (resulting in the controller having no incentive to obtain a price above $30 million). The LLC agreement granted "sole discretion" to the board with respect to a sale of the company so long as the sale was to an unaffiliated third party. The court rejected the plaintiff's argument that, under the implied covenant of good faith, the manager had a duty to seek to maximize the price when the company was sold to the unaffiliated third party. The court reasoned that there was no gap in the agreement as to the board's discretion relating to a sale to an unaffiliated third party — to the contrary, sole discretion was expressly granted under the agreement for sales other than to insiders. Moreover, the court stated, even if there had been a gap, it was anticipatable that the board might not conduct an auction in connection with a sale to an unaffiliated third party given that, based on the waterfall provisions in the LLC agreement itself, it was clear that the controller had no incentive to obtain a sale price above $30 million.

Morris v. Spectra Energy (June 27, 2017)

The decision reflects the potential that the court may find a breach of the implied covenant in the context of a conflicted transaction that is, on its face, "patently unfair and unreasonable." The Court of Chancery found it likely, at the pleading stage, that the general partner of a master limited partnership had breached its express contractual obligation to act in good faith in connection with a sale, by the MLP to the indirect parent of its general partner, of an asset that the purchaser already had publicly committed to contribute to a joint venture at a much higher valuation than it was paying the MLP for the asset. The difference between the two prices was about half a billion dollars. Although the transaction had, we note, apparently been approved as specified under the MLP agreement, the court found that the large facial disparity between the alleged value of the asset sold and the price paid for it gave rise to a reasonable inference that the general partner had approved the transaction in bad faith. The MLP agreement required that the general partner make determinations "in good faith," which was defined as a subjective belief by the GP that the action taken was in the best interests of the MLP. The agreement provided a rebuttable presumption of good faith by the GP with respect to any conflicted action that was approved by a conflicts committee and provided a conclusive presumption of good faith by the GP with respect to any action taken in reliance on an expert opinion.

The court identified the threshold issue as whether the rebuttable presumption applicable to conflicted transactions or the conclusive presumption relating to reliance on expert opinions governed with respect to the transaction. The court acknowledged the general contract interpretation principle that more specific provisions (such as a provision relating to conflicted transactions) override more general provisions (such as an "overarching" good faith standard), and acknowledged Delaware Supreme Court precedent holding that a general conclusive presumption of good faith arising from reliance on advisers trumps a specific conflict provision's rebuttable presumption of good faith. The court emphasized, however, that the judicial precedents do not represent "totemic statements," as the court's interpretation of an agreement in any case will depend on the "precise language" of the specific agreement and a reading of the agreement as a whole. In this case, the court ruled, the rebuttable presumption applicable to conflicted transactions applied. The court stated that, given the "broad contractual freedoms" afforded to alternative entities and the limited bargaining power of the unit holders, ambiguities in the agreement should be resolved in favor of the unit holder. Perhaps most tellingly, the court wrote: "[W]hen sophisticated entities intend to provide a conclusive presumption in a conflicts situation, they know how to draft such a provision." Thus, the court found a pleading stage inference of a breach of GP's contractual obligation of good faith. (The court also ruled that the implied covenant of good faith was not applicable as there was no gap to be filled in the agreement because GP's conduct was to be evaluated under the good faith standard set forth in the agreement.)

Brinckerhoff v. Enbridge Energy (March 20, 2017)

The case involved interpretation of a non-state-of-the-art limited partnership agreement (which did not provide safe harbors for affiliated transactions). The Delaware Supreme Court, overturning the Court of Chancery decision below, interpreted the limited partnership agreement as imposing a "fair and reasonable" standard for self-interested transactions, and thus ruled that the Court of Chancery's dismissal of the plaintiff's claims at the pleading stage was improper. The master limited partnership had repurchased from its general partner an asset that it had recently sold to the general partner at a significantly lower price — despite strong evidence that the value of the asset had actually significantly declined since the time of the sale to the general partner. The Court of Chancery, in the decision below, held that the LPA's general good faith standard modified and overrode the separate, more specific provisions, such as the "fair and reasonable" standard for affiliated transactions). The court interpreted

the general good faith standard as requiring a subjective belief by the general partner that an action was in the best interests of the MLP — and as therefore requiring, for the plaintiff to prevail, that the board's actions were taken in bad faith and amounted to the equivalent of "waste."

The Supreme Court overruled the decision below and held that the general good faith standard operated in the spaces between the LPA's specific provisions — that is, was applicable only to the extent that there was not a more specific applicable provision. Therefore, the Supreme Court ruled, the affiliated repurchase transaction was governed by the provision that imposed the specific obligation that affiliated transactions be objectively fair and reasonable. Moreover, the Supreme Court interpreted the general good faith standard differently; the court found that it was more consistent with the overall terms of this particular agreement so that it meant a reasonable belief that the action taken was in, or not inconsistent with, the best interests of the MLP (rather than the lower standard for good faith used by the Court of Chancery, which would have required that the action was so beyond the bounds of reason as to be inexplicable other than by bad faith and, so, was similar to "waste"). The Supreme Court also held that the board's reliance on a fairness opinion did not result in a conclusive presumption of good faith under the LPA, as the LPA provided that "reasonable reliance" was required — and, given the alleged errors of the banker, whether the reliance in this case had been reasonable presented a question of fact requiring discovery.

Importance of Factual Context

While, as discussed, the Delaware courts extend a high degree of deference to LLC and partnership agreement provisions, importantly, the facts and circumstances can very much affect a court's result. For example, in the case of El Paso Pipeline (2015), in the context of extremely negative facts relating to the conflict committee's process, the Delaware Chancery Court concluded that the committee did not satisfy the safe harbor requirement of a subjective belief that the transaction at issue was in the best interests of the MLP. The transaction involved a purchase of assets by the MLP from its general partner's parent — at a price significantly higher than the MLP had paid for the same type of assets from the general partner's parent only months earlier and notwithstanding a significant decline in the market for this type of asset. Emphasizing the incomplete, inaccurate and "manipulative" nature of the information provided to the committee by its financial adviser, as well as the committee ignoring the information it had relating to the MLP's other recent drop-down transactions, and the committee members apparently not even understanding the terms of the transaction, the court's view appeared to be that the committee did not have a base of information upon which it was even possible to form a subjective belief as to whether the transaction was in the MLP's best interests. It is to be noted that, in addition, there were contemporaneous emails among the committee members that indicated that they actually believed that the transaction would not be in the best interests of the partnership.

Dieckman (2016) provides another example. The Delaware Supreme Court ruled that, although the conflicts committee members technically had met the independence requirements of the safe harbor provision, the committee's approval of the transaction at issue was not effective because of "deceptive," "manipulative" and "misleading" conduct by the general partner. As one example, to satisfy the independence requirement for committee members that they not be directors of any affiliates of the general partner, the general partner had one MLP director selected to serve on the committee resign his directorship with one of the general partner's affiliates just before the committee was formed and to rejoin just after the committee process ended. The court also held that the safe harbor based on approval by the unaffiliated unit holders had not been satisfied because the disclosure that an "independent" conflicts committee had approved the transaction did not reveal the members' conflicts of interest.

The court rejected the lower court's determination that the express obligation of the general partner to act "in good faith" did not impose any disclosure obligation beyond the minimal disclosure requirement specifically set forth in the agreement. The court stated that, once the general partner went beyond the minimal disclosure requirements set forth in the partnership agreement and instead issued a comprehensive proxy statement, it had an obligation under the implied covenant of good faith not to mislead the unit holders to "induce" them to approve the transaction. The court focused on the safe harbor process in its entirety and found that the language implicitly required the general partner to act in a manner that would not undermine the (minimal) protections afforded to the unit holders in connection with the safe harbor process. Finally, in one 2018 decision, the Court of Chancery found that the implied covenant of good faith was applicable where, in the court's view, the controller of an LLC was responsible for the gap in an agreement and held that it therefore would be inequitable for the controller to benefit from the gap.

In part two of this series, we will outline the key principles elucidated in these decisions and offer related practice points.

Gail Weinstein is senior counsel and Steven J. Steinman, Randi Lally and Maxwell Yim are partners at Fried Frank Harris Shriver & Jacobson LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.