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 2

By **Gail Weinstein, Steven Steinman, Randi Lally and Maxwell Yim**
(June 25, 2018, 1:36 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 often are 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 discussed recently issued Delaware decisions relating to the obligations of LLC directors under Delaware law. In part two, we 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.)

Key Principles

Broad Authority of LLC Directors

LLC agreements typically expressly confer very broad authority on LLC directors to operate the LLC in their discretion, including with respect to transactions in which they and/or the controlling member who appointed them is self-interested. The underlying judicial premise in these cases (often reiterated by the court in its opinions) is that, when an investment is made in a noncorporate entity, the investor is "consciously choosing" to give up the protection of fiduciary duties in exchange for specifically negotiated contractual protections. Thus, the courts have been disinclined to "read in" obligations that are not clearly stated in the agreement. (We note that, in an article published in 2014, Chief Justice Leo Strine and Vice Chancellor J. Travis Laster questioned the validity of this premise, argued that minority investors in alternative entities typically do not actually negotiate terms, and advocated that the Delaware statute should be amended to make the duty of loyalty nonwaivable.)

Difference From the Corporate Context

As is well known, in Delaware, in the corporate context, the common law has established that directors owe fiduciary duties of due care and loyalty to the corporation and its stockholders, and these duties cannot be disclaimed or modified by agreement. Although LLC directors have fiduciary duties pursuant to statute, given that the entities are themselves created by contract, the duties can — and typically are — modified or entirely disclaimed by agreement. When an LLC agreement clearly disclaims all statutory fiduciary duties of the directors, the directors' duties are limited to (1) those expressly set forth in the agreement and (2) those that a court deems to arise under the implied covenant of good faith and fair dealing (which adheres to every contract and, by statute, cannot be waived or modified).

Limited Application of the Implied Covenant of Good Faith and Fair Dealing

Generally, the implied covenant of good faith is deemed applicable by the Delaware courts only under quite limited circumstances — thus, typically, LLC directors' only obligations are those that are expressly set forth in the LLC agreement. The implied covenant has been deemed applicable only if there is (1) a "gap" in the agreement because the parties did not consider an unanticipatable event that has arisen and (2) evidence as to what the parties would have agreed had they considered the possibility of that event arising. (However, in a recent case involving an alternative entity, the Delaware Court of Chancery expanded the applicability of the implied covenant to a forseeable event when the parties failed to express the terms that would apply only because they were "too obvious to need expression.")

Meaning of "Good Faith" in the Context of the Implied Covenant

Importantly, "good faith" in the context of the implied contractual covenant has been viewed by the court differently than "good faith" as part of the corporate fiduciary duty of loyalty. In the context of the implied contractual covenant, the concept has been limited to a requirement that a party not take action to defeat the expectations clearly implied by the explicit terms of an agreement — and has not encompassed the concept applicable in the corporate fiduciary context of acting as a loyal fiduciary to advance the best interests of the stockholders. In recent cases, the court has reiterated that, even if there is a gap in the agreement, the implied covenant "does not establish a free-floating requirement that a party act in some morally commendable sense." Rather, "good faith" in this context "entails faithfulness to the scope, purpose, and terms of the parties' contract"; and "fair dealing" "does not imply equitable behavior …[; rather,] it simply means actions consonant with the terms of the parties' agreement and its purpose."

Moreover, the court has written, the implied covenant does not impose "obligations from [the court's] own notions of justice or fairness," but, instead, determines whether, from the contract terms, it can be determined "what the parties themselves would have agreed to had they considered the issue in their original bargaining positions at the time of contracting." (Nonetheless, in the infrequent cases in which the court, in the context of an LLC agreement in which fiduciary duties have been disclaimed, has found the implied covenant of good faith to be applicable, the backdrop has been alleged facts that have indicated that the challenged conduct constituted "arbitrary" or "deceitful or manipulative" conduct the purpose of which was "to harm" the other investors or "to deprive them of the fruits of their bargain.")

Meaning of a General "Good Faith" Standard Expressed in an Agreement

An LLC agreement frequently includes a provision stating that the directors must "act in good faith." Critically, the meaning of "good faith" in this context will be whatever it is defined as being in the agreement. For example, an agreement may define "good faith" for this purpose as the directors acting in what they believe to be the best interests of the LLC (a "subjective good faith" standard, which is

satisfied so long as the directors actually had such belief; or it may be defined as the directors acting in what they reasonably believe to be the best interests of the LLC (an "objective good faith" standard, which is satisfied if the directors had a reasonable basis for the belief). In many agreements, although there is a general good faith standard, there are safe harbor procedures set forth which, if satisfied, provide a conclusive presumption of good faith under certain circumstances (for example, for approval of conflicted transactions).

Risk of Ambiguity Based on the Interrelationship of Provisions

LLC agreements often include a disclaimer of fiduciary duties, a general standard of subjective good faith for the directors, exculpation for directors other than for acts taken in bad faith, a conclusive presumption of good faith for actions taken in reliance on experts (such as reliance on a fairness opinion), and safe harbor provisions (providing a conclusive presumption of good faith with respect to self-interested transactions if they have been approved by a conflicts committee). When the court has found an LLC agreement to be unclear or ambiguous, it has most often been as a result of a lack of clarity with respect to the interrelationship among these various provisions relating to the directors' obligations.

Lack of Awareness by Minority Investors

In our experience, notwithstanding disclosure to minority investors at the time they invest, they often are surprised — for example, when the board approves a transaction in which the directors (and/or the controller who appointed them) are self-interested — that the directors not have fiduciary duties to the LLC or the investors, that the general good faith standard of conduct does not require that the directors act in the best interests of the investors expected, and that the directors have broad authority to approve conflicted transactions.

Importance of Drafting

As the judicial focus in these cases is on the precise terms of the entity's governing agreement, the most critical factor in seeking to avoid future disputes and litigation uncertainty is to ensure that the agreement includes "state-of-the-art" provisions that reflect the parties' intent. As reflected in the discussion of recent cases that follows, most of the litigation in this area relates to LLC agreements that do not reflect modern forms of LLC or limited partnership agreements. State-of-the-art provisions, which take into account the most recent judicial contractual interpretations, will clearly: disclaim all fiduciary duties; define any general "good faith" standard of conduct; not include language in the exculpation or indemnification provisions that can suggest that some fiduciary duties may continue; and provide safe harbor procedures for approval of conflicted transactions (with a well-defined standard for evaluation of the transaction and specified requirements with respect to eligibility for committee members). The specific drafting is critical and small wording differences can lead to very different judicial results. Chief Justice Strine and Vice Chancellor Laster have written that, while LLC agreements "coalesc[e] around particular features and concepts," this "superficial standardization" is "overwhelmed by diversity in implementation," which "limits the efficacy of precedent and creates fertile opportunities for future litigation."

Practice Points

More Flexibility Than in the Corporate Context

While Delaware law relating to corporate fiduciary duties and exculpation for personal liability has been transformed over the past several years, resulting in even less potential for liability of corporate directors than there was previously, the LLC (or other alternative entity) format still offers even more flexibility for directors when the governing agreement is properly drafted and followed.

Minority Investor Awareness Before Investing

Persons considering a minority investment in a noncorporate entity should read and understand the offering materials and the governing agreement before investing. Often, under the governing agreement, directors, managers and general partners have no fiduciary duties to the other investors and have very broad discretion, including with respect to conflicted transactions.

Definition of the Scope of the Board's Discretion

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 v. HCP (discussed in part one), where "sole discretion" was granted to the directors, a critical factor in the court's finding that the implied covenant was not applicable was that the agreement language, in the court's view, indicated that the parties had considered the potential for action by the controller that might favor the controller's interests and had specifically addressed it by limiting the board's discretion with respect to a sale to a controller, 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 a controller should seek to include a statement that the specified limitations are the only ones intended by the parties.

Limiting the Role of the Implied Covenant of Good Faith

As noted, the implied covenant adheres to every contract and cannot be waived or modified; however, as discussed, the covenant is rarely invoked by the court to "read in" provisions that the parties did not expressly set forth in the agreement. All reasonably anticipatable events should be considered and any intended protections for the minority investors should be expressly included. While we have not seen this provision in any agreement, in an effort to further limit the potential of the implied covenant being invoked, a provision could be included that states that the agreement reflects all of the minority protections intended by the parties, that the parties believe that there are no "gaps" in the agreement, and that, to the extent that any gap may develop, the parties mutually intend that any gap be filled by the directors in their sole discretion and notwithstanding any possible self-interest.

Need to Eliminate Ambiguity Arising From the Interrelationship of Provisions

Any ambiguity in the drafting of an alternative-entity governing agreement can not only lead to future disputes between the parties but also opens the door to possible invocation by the court of the implied covenant of good faith. A frequent source of ambiguity is the interrelationship among the various provisions relating to disclaimer of fiduciary duties, a general good faith standard, exculpation and indemnification provisions, and provisions governing conflicted transactions. State-of-the-art provisions — which clearly and unambiguously reflect the parties' intentions and which take into account the most recent judicial pronouncements on these types of provisions — should be utilized. The duties of LLC directors will be most clearly circumscribed where the LLC operating agreement expressly disclaims all fiduciary duties; states that any good faith standard is limited to subjective good faith or to good faith

only as required under the implied covenant of good faith and fair dealing; excludes from exculpation or indemnification only actions not taken in accordance with the good faith standard set forth in the agreement; and provides clear safe harbors for conflicted transactions, with conclusive presumptions of good faith for reliance on experts or approval by a conflicts committee (with a subjective good faith standard for the committee's determination, and without any qualifications relating to the reliance on experts).

Wide Latitude in Crafting Safe Harbors, but Compliance With the Process is Key

While an LLC agreement can provide for very limited obligations of the directors in connection with affiliated transactions, the process established in the agreement must be followed; and the directors will be advantaged to the extent that, notwithstanding the elimination of fiduciary duties by contract, the conflicts committee takes its job seriously and functions well. Conflict committee members should:

- Meet the independence requirements for membership set forth in the LLC agreement;
- Know the standard set forth in the LLC agreement for the committee's approval of the transaction;
- Ensure that they have the information necessary to make a determination that meets the standard for approval;
- Be appropriately engaged in the process of considering the transaction;
- Consider retaining independent financial and legal advisers (and, if advisers are retained, consider retaining them before the financial terms of the transaction are "fully baked"); ask questions to ensure that the advice and analyses are understood; consider obtaining a fairness opinion or legal opinion; and remain in control of the committee process;
- Consider whether to negotiate the terms of the conflicted transaction with the parent company (unless the determination is clear, some level of negotiation is often advisable as a basis for forming a good faith judgment about the transaction); and
- Make a determination that meets the standard for approval (tracking the language set forth in the LLC agreement with respect to the standard of approval), and memorialize their determination in the formal record of the committee's deliberations.

Notwithstanding the definition of independence set forth in the LLC agreement, the more independent (and the more experienced) the members of the conflicts committee are, the more protective the process may be from a legal point of view. If the agreement provides a clear safe harbor process (based on conflicts committee approval or otherwise) and that process is followed — and, as highlighted in Dieckman (discussed in part one), there is no "deception" in obtaining the conflicts committee approval — then, based on compliance with the safe harbor, any challenge to the transaction should be dismissed at the pleading stage of litigation.

Attention to Specific Phrases When Drafting

Drafting of an alternative-entity governing agreement should take into consideration the most recent

judicial pronouncements on these types of agreements, including with respect to the interpretation of specific phrases. For example, we note the following:

- "Unless the board otherwise determines": When a specified procedure for making a determination is subject to the caveat "unless the board otherwise determines," that phrase may be interpreted by the court as suggesting some implied fiduciary-type duty of the board (as discussed in part one relating to Capone).

- "Sole discretion": There is a possibility of the court finding that the implied covenant of good faith applies when a provision authorizes a board to use "sole discretion" — unless it is clear that the parties considered and addressed the potential for self-interested action inherent in an exercise of sole discretion (as discussed in part one relating to Miller).

- "Gross negligence" exclusion: The court possibly could interpret an exclusion from the exculpation or indemnification provision for "gross negligence" as suggesting that the parties may have intended corporate law fiduciary duty concepts to apply (given that gross negligence is the traditional standard for pleading and proving a breach of the fiduciary duty of care under business judgment rule review). Under this interpretation, an LLC manager could be sued for a breach of the duty of care notwithstanding the waiver of fiduciary duties (and, ironically, notwithstanding the fact that in the corporate context the claim would not survive the pleading stage based on an exculpatory provision in the charter). Accordingly, where fiduciary duties are disclaimed, concepts that could suggest that they may persist should be avoided.

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.