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Fiduciary Duties in LLCs and LPs: Considerations for Modifying or Waiving Duties of Alternative Entity Managers

Lessons From Delaware and Other Key States on Whether, When and How to Eliminate or Modify Default Duties

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Fiduciary Duties in LLCs and LPs

Considerations for Modifying or Waiving Duties of Alternative Entity Managers

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OCTOBER 28, 2015

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FIDUCIARY DUTIES IN LLCS AND LP

I. Relevance of default fiduciary duties to LLCs and LPs

II. Circumstances under which fiduciary duties may be waived or modified

   A. Delaware law

   B. Laws of other states

III. Potential Consequences /risks of modifying or waiving duties

IV. Drafting fiduciary duty modifications provision in the entity operating agreement – best practices

RELEVANCE OF DEFAULT FIDUCIARY DUTIES TO LLCs AND LPs

ORIENTATION

- Whether fiduciary duties applied by default in the LLC context had been the subject of academic and judicial debate:
  - The Delaware Court of Chancery had held that managers and controlling members owe default fiduciary duties (*Auriga Capital Corp. v. Gatz Properties, LLC,* 40 A.3d 839 (Del. Ch. Jan. 27, 2012)).
  - The Delaware Supreme Court held on appeal that the statements of the Court of Chancery in *Gatz* regarding fiduciary duties were to be considered "dictum without any precedential value"; but it did not take its own definitive position (59 A.3d 1206 (Del. Nov. 7, 2012)).
  - Following *Gatz*, the Delaware Court of Chancery continued to affirm its position that parties who owe fiduciary duties under ordinary equitable principles do owe fiduciary duties by default in the context of LLCs (*Feeley v. NHAOCG, LLC,* 62 A.3d 649 (Del. Ch. Nov. 28, 2012)).
- The Delaware legislature took action to clarify the statute.

ORIENTATION

- Statutory Amendment to the LLC Act was effective August 1, 2013.
- Section 18-1104 of the LLC Act:
  - In any case not provided for in this chapter, the rules of law and equity, including **the rules of law and equity relating to fiduciary duties** and the law merchant, shall govern.
- Synopsis
  - The amendment to Section 18-1104 confirms that in some circumstances fiduciary duties not explicitly provided for in a limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement.

FIDUCIARY DUTIES

- Duty of Loyalty
  - Motivated solely by the best interests of the limited partnership/LLC and its equityholders.
  - Not permitted to use their position of trust and confidence to further their private interests.
- Duty of Care
  - Be attentive and inform itself of all material facts regarding a decision before taking action.
  - Affirmative duty to protect the financial interests of the limited partnership/LLC and its equityholders and must proceed with a critical eye in assessing information.
- Duty of Disclosure
  - Honesty when communicating with equityholders.
  - Disclose all material information reasonably available when seeking equityholder action.

FIDUCIARY DUTIES

- Corporate opportunities doctrine has been applied to LLCs.
- *See Grove v. Brown*, 2013 WL 4041495 (Del. Ch. Aug. 8, 2013).
  - In the context of a dispute over ownership of a 4-member LLC, the Court of Chancery considered whether 2 members (the Groves) breached fiduciary duties by usurping an opportunity belonging to the LLC, and whether non-members aided and abetted a breach.
    - Corporate opportunity doctrine bars a fiduciary from taking a business opportunity if (1) the company is financially able to exploit the opportunity, (2) the opportunity is within the company's line of business, (3) the company has an interest or expectancy in the opportunity, and (4) by taking the opportunity, the fiduciary is placed in a position inimicable to his duties to the company.
    - The fiduciary bears the burden of demonstrating that there was no breach, which can be established by a showing that it either presented the opportunity to the company and the opportunity was rejected, or the company was not in a position to pursue the opportunity.
  - The Court concluded that the 2 members had breached their fiduciary duties and rejected claims for aiding and abetting breach of their fiduciary duties.

STANDARD OF REVIEW

- Business Judgment Rule

  - The rule presumes that "in making a business decision the fiduciary acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company/partnership." *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

  - Where the presumptions of the business judgment rule apply, a court will not substitute its judgment for that of the fiduciary—but will instead sustain the fiduciary's decision—if the decision "can be attributed to any rational business purpose." *Id.*

STANDARD OF REVIEW

- Enhanced Scrutiny
  - Generally requires that the fiduciary defendant "bear the burden of persuasion to show that [its] motivations were proper and not selfish" and that "[its] actions were reasonable in relation to [its] legitimate objective." *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 810 (Del. Ch. 2007).

  - Enhanced scrutiny applies in situations where the "decision making context can subtly undermine the decisions of even independent directors," such as a board's resistance to a hostile takeover or proxy contest; in contexts where "the law provides stockholders with a right to vote and the directors take action that intrudes upon the space allotted for stockholder decision making"; and in change-of-control transactions, such as cash-out mergers. *See Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457-58 (Del. Ch. 2011).

STANDARD OF REVIEW

- Entire Fairness
  - The entire fairness inquiry requires the fiduciary to demonstrate both fair price and fair dealing.
    - "[Fair price] relates to the economic and financial considerations of the proposed [transaction], including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).
    - "[Fair dealing] embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." *Id.*
  - The inquiry, however, is a holistic one; thus, if the price is very fair, an unfair process may not render a transaction unfair.

STANDARD OF REVIEW

- Rebutting Presumption of Business Judgment Rule

  - Assuming that a decision is made with the requisite care, a plaintiff seeking to rebut the presumptions of the business judgment rule must demonstrate that the fiduciary responsible for the decision had a disabling conflict of interest in the decision and/or was not independent or, if the decision did not result from self-interest, that the fiduciary did not act in good faith. *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989).

STANDARD OF REVIEW

- Interested
  - Fiduciaries are considered "interested" if they either "appear on both sides of a transaction" or "expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
    - Financial interest, motives of entrenchment, and abdication of directorial duty often lead to allegations of interestedness.
    - The test of financial interestedness is one of materiality and depends on whether the director's interest does or is likely to affect the director's action. *Cinerama, Inc. v. Technicolor Inc.*, 663 A.2d 1156, 1169 (Del. 1995).

STANDARD OF REVIEW

- Independence
  - A director is deemed to be independent "when he is in a position to base his decision on the merits of the issue rather than being governed by extraneous considerations or influences." *Kaplan v. Wyatt*, 499 A.2d 1184, 1189 (Del. 1985).
  - Mere conclusory allegations of structural bias on the part of a director, or of domination or control of that director by an interested party, will not be sufficient to demonstrate a disabling conflict to overcome the presumption of the business judgment. rule. *See, e.g.*, *Aronson*, 473 A.2d at 816.
    - But directors may be found to be not independent if facts are presented that "would demonstrate that through personal or other relationships the directors are beholden to the controlling person." *Id.* at 815.

WHO OWES FIDUCIARY DUTIES?

- Delaware Courts have imposed fiduciary duties upon those who act for the benefit of another.

  - *See In re USACafes, L.P. Litig.*, 600 A.2d 43 (Del. Ch. 1991). The *USACafes* Court stated that "the principle of fiduciary duty, stated most generally, [is] that one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner." *Id.* at 48

WHO OWES FIDUCIARY DUTIES?

- In *USACafes*, the Court found that directors of a corporate general partner owed fiduciary duties to the partnership and its limited partners. The Court stated such fiduciary duty as "the duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership." *Id* at 49.

WHO OWES FIDUCIARY DUTIES?

- Controlling Members
  - In *Kelly v. Blum*, a controlling member initiated and completed a freeze-out merger, at the expense of minority owners of the LLC; the court held that such controlling member in fact owed fiduciary duties absent a clear waiver (which was absent). 2010 WL 629850 (Del. Ch., February 24, 2010).
    - Controlling shareholders-typically defined as shareholders who have voting power to elect directors, cause a break-up of the company, merge the company with another, or otherwise materially alter the nature of the corporation and the public shareholder's interests owe certain fiduciary duties to minority shareholders. Specifically…such fiduciary duties include the duty 'not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders.
  - *Zimmerman v. Crothall, et al.*, C.A. No. 6001-VCP (Del. Ch. Jan. 31, 2013). The claim against the majority members failed as the Court found that they were not acting in concert.

WHO OWES FIDUCIARY DUTIES?

- In *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012), the court addressed who may owe fiduciary duties in the absence of an operating agreement provision to the contrary, including passive investors who take on an active role in management of the entity.
  - The court discusses the *USA Cafes* line of Court of Chancery precedents and notes that an individual "controller" owes only the duty of loyalty.
    - Declined to expand *USA Cafes* to duty of care claims.
  - The court held that claims of aiding and abetting breach of contract, while not recognized for commercial contracts, plead a valid claim in the context of an operating agreement where the agreement provides a contractual fiduciary duty standard.
  - The court discussed the difference between eliminating fiduciary duty and eliminating liability.

WHO OWES FIDUCIARY DUTIES?

- *Bay Ctr Apartments* held that a complaint stated a breach of fiduciary duty claim against the owner of an entity that managed the LLC where the complaint alleged that the owner had used his control to stave off personal liability under a guarantee. *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del. Ch., April 20, 2009).
  - The Court noted that the scope of fiduciary duties of a controlling entity may be limited, but at least included "the duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership."(citing *USACafes*)
- The *Feeley* Court held that an individual who managed an entity controller could be held liable only for breaches of duty of loyalty, but not breaches of duty of care. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 670-71 (Del. Ch. 2013).

WHO OWES FIDUCIARY DUTIES?

- Recently, in *Friedman v. Aimco Props, L.P.*, 2015 Del. Ch. LEXIS 33 (Feb. 10, 2015), the Court of Chancery clarified that the concept of controlling stockholder from corporate law may be misplaced in the limited partnership context where a limited partner with a large or minority ownership had no power to manage or control the limited partnership because that power was contractually given to the general partner.

CASE LAW

- In *CanCan Dev., LLC v. Manno*, C.A. No. 6429-VCL (Del. Ch. May 27, 2015), the Court of Chancery addressed claims asserting breaches of fiduciary duties in an LLC context.
  - The facts described a number of self interested actions by the initial managing member of an LLC.
    - The Court applied an entire fairness standard and found the manager had breach her duty of loyalty.
  - Counter claims were made by the initial managing member against the member who took control of the Company.
    - The Court applied an entire fairness standard of review to the new controller's actions in causing the dissolution of the LLC since he held a preferred interests with rights senior to the ordinary interests of the other members.
      - The new managing member was found to not have breached his fiduciary duties even under an entire fairness standard of review.

CASE LAW

- In *Ross Holding and Management Company v. Advance Realty Group, LLC,* 2014 WL 4374261 (Del. Ch. Sept. 4, 2014), the Court of Chancery applied fiduciary duties to a board of an LLC in a spin off transaction and reviewed conduct under the entire fairness standard.
  - The Court found that the defendants did not demonstrate the entire fairness of the reorganization.
    - Although the value of the plaintiff's units increased through the transaction, the process employed by the defendants in structuring the transaction was unfair.
  - The Court concluded that although the process was not fair, the plaintiffs were not damaged by the transaction
    - While attorney's fees have been awarded in other similar cases (see e.g. *SIGA Technologies, Inc. v. PharmAthene, Inc.*, 67 A.3d 330, 352 (Del. 2013)), the Court declined to award attorneys' fees and expenses in the case because of prior, unopposed rulings in the case.

CASE LAW

- In *In re KKR Financial Holdings LLC Shareholder Litigation*, Consol. C.A. No. 9210-CB (Del. Ch. Oct. 14, 2014), the Court of Chancery granted defendants' motions to dismiss with prejudice a suit challenging the acquisition of KKR Financial Holdings LLC ("KFN") by KKR & Co. L.P. ("KKR").
  - In December 2013, KKR and KFN executed a stock-for-stock merger agreement, which was subject to approval by a majority of KFN shares held by persons other than KKR and its affiliates. The merger was approved on April 30, 2014, by the requisite majority vote.
  - Nine lawsuits challenging the merger were brought in the Court of Chancery and consolidated. The operative complaint alleged that the members of the KFN board breached their fiduciary duties by agreeing to the merger, that KKR breached its fiduciary duty as a controlling stockholder by causing KFN to enter into the merger agreement, and that KKR and its subsidiaries aided and abetted the KFN board's breach of fiduciary duty.

CASE LAW

KKR Financial cont'd

- The Court ruled that KKR, which owned less than 1% of KFN's stock, was not a controlling stockholder. Plaintiffs focused on a management agreement by which a KKR affiliate managed the day-to-day business of KFN, but the Court ruled that the plaintiffs' allegations were not sufficient to support an inference that KKR thereby controlled the KFN board "such that the KFN directors could not freely exercise their judgment in determining whether or not to approve and recommend to the stockholders a merger with KKR." Therefore, the Court dismissed the claim premised on KKR's status as an alleged controlling stockholder.

CASE LAW

KKR Financial cont'd

- The Court then held that business judgment review applied to the merger because a majority of the KFN board was disinterested and independent. The Court held alternatively that, even if a majority of the KFN directors were not independent, "the business judgment presumption still would apply because of the effect of untainted stockholder approval of the merger."
- The Court rejected the plaintiffs' disclosure challenges and ruled that the business judgment standard of review would apply to the merger "because it was approved by a majority of the shares held by disinterested stockholders of KFN in a vote that was fully informed." Accordingly, the Court dismissed the claim against the KFN directors. Because the plaintiffs had not pleaded a viable claim against the KFN directors, the Court also dismissed the claim for aiding and abetting.

TO WHOM ARE DUTIES OWED?

- The LLC
- The Members
- Creditors?
- What is the difference?

TO WHOM ARE DUTIES OWED?

- Unlike corporations, creditors do not have standing to bring derivative actions on behalf of an LLC under the Delaware LLC Act and thus do not have standing to bring claims for breach of fiduciary duty, even when the LLC is insolvent.
  - *CML v. Bax*, C.A. No. 735,2010 (Del. Sept. 6, 2011).
    - The Court stated that Section 18-1002 of the LLC Act expressly limits the right to sue derivatively on behalf of an LLC to members and assignees. The Court noted Appellant had ample remedy at law because it could have negotiated its remedies by contract.

IMPLIED CONTRACTUAL COVENANT

- Implied Contractual Covenant of Good Faith and Fair Dealing
  - The purpose of the Covenant is to enforce the reasonable expectations of parties to a contract where situations arise that are not expressly contemplated and provided for in the language of the contract itself.
    - *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005).

IMPLIED CONTRACTUAL COVENANT

- The Courts have described the covenant as a "limited and extraordinary remedy that addresses only events that could not reasonably have been anticipated at the time the parties contracted," which is meant to "protect[] a party from arbitrary conduct that was objectively unanticipated by the terms of the contract and that frustrates the fruits of the bargain that the asserting party reasonably expected."
  - *In re Atlas Energy Res., LLC*, 2010 WL 4273122, at *13 (Del. Ch. Oct. 28, 2010).

IMPLIED CONTRACTUAL COVENANT

- The implied covenant of good faith and fair dealing involves a 'cautious enterprise,' inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated."
  - *Nemec v. Shrader*, 991 A.2d 1120, 1125 (Del. 2010).
- The Courts have asserted that when parties have expressly agreed to contractual provisions addressing an issue, the covenant cannot be invoked to override such express provisions.
  - *See Nemec*, 991 A.2d at 1128 (citing Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 888 (Del.Ch.2009))("[T]he implied covenant cannot be invoked to override express provisions of a contract.")

IMPLIED CONTRACTUAL COVENANT

- Unlike fiduciary duties, the implied covenant may not be eliminated in the limited partnership and limited liability company context.
  - *See*, 6 *Del C.* § 18-1101(c) and 6 *Del C.* § 17-1101(d).

IMPLIED CONTRACTUAL COVENANT

- Application of Implied Covenant
  - The use of the covenant to imply contract terms is a fact-intensive exercise governed by issues of compelling fairness.
    - *Dunlap v. State Farm & Cas. Co.*, 878 A.2d 434, 422 (Del. 2005).
  - The test for determining whether the covenant has been breached requires the court to extrapolate the "spirit" of the contract from its express terms, and to determine whether it is clear that the parties would have agreed to proscribe the act complained of as a breach of the agreement had they thought to negotiate with respect to that matter.
    - *PAMI-LEMB I Inc. v. EMB-NHC, L.L.C.*, 2004 WL 1488720, at *14 (Del. Ch. 21, 2004)

IMPLIED CONTRACTUAL COVENANT

- "Good Faith" may be a fiduciary duty or a contractual duty, but in either case, it is fundamentally distinct and different from the Implied Contractual Covenant of Good Faith and Fair Dealing.
  - In *Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400 (Del. June 10, 2013), the Delaware Supreme Court considered on appeal a ruling by the Delaware Court of Chancery that defendants had not breached the implied covenant of good faith and fair dealing because their actions complied with the contractual standard of "good faith" as defined in the partnership agreement.
  - The Delaware Supreme Court overruled on this point, holding that the Chancery Court's opinion "improperly conflates two distinct concepts.

IMPLIED CONTRACTUAL COVENANT

- Duty of Good Faith vs. Implied Covenant
  - In *Gerber*, the Delaware Supreme Court adopted the discussion in *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC,* 50 A.3d 434 (Del. Ch. 2012).
  - Temporal focus.
    - Fiduciary/Contractual Duty –"[L]iablity depends on the parties' relationship when the alleged breach occurred, not on the relationship as it existed in the past."
    - Implied Covenant – "Looks to the past." The court asks, "what the parties would have agreed had they considered the issue in their original bargaining positions at the time of contracting?"
    - The fact that the phrase "good faith" is used in both instances is not relevant.

IMPLIED CONTRACTUAL COVENANT

- "Fair dealing" is not akin to the fair process component of entire fairness, *i.e.*, whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care whose contours are mapped out by Delaware precedents. It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose.
- Likewise "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally

GOOD FAITH—CONTRACTUALLY DEFINED

- *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93 (Del. 2013)
  - The LPA eliminated default fiduciary duties, but required that that when the GP made a determination or declined to take an action concerning the partnership that it do so in good faith.
    - Good faith was defined as "belie[f] that the determination or other action is in the best interest of the Partnership."
  - LPA also established special committee conclusive presumption of good faith, and provided that an LP bringing a claim challenging the special approval would bear the burden of overcoming the presumption.

GOOD FAITH—CONTRACTUALLY DEFINED

- *Allen v. Encore (cont'd)*
- Court applied contractual definition of good faith.
  - Required subjective belief (contrast with "reasonably belief").
    - Plaintiff would have to establish either that defendants (i) subjectively believed they were acting against the Partnership's best interests, or (ii) consciously disregarded their duty to form a subjective belief that the action was in the Partnership's best interests.
    - Objective factors may inform the analysis of subjective belief.
      - Some actions may objectively be so egregiously unreasonable that they seem essentially inexplicable on any ground other than [subjective] bad faith.
      - However, the court cautioned against focusing on a hypothetical, reasonable actor.

GOOD FAITH—CONTRACTUALLY DEFINED

- *Allen v. El Paso Pipeline Partners, L.P.*, C.A. 7520-VCL (Del. Ch. June 20, 2014)
- Another MLP case involving a drop down transaction. LPA eliminated fiduciary duties. The court noted that the relevant inquiry was whether the members of the Special Committee subjectively believed, in good faith, that the drop down transaction was in the best interests of the Partnership.
  - The court focused the term "Partnership" and read it broadly to include various interest holders in the Partnership, including the Limited Partners and the General Partner (IDR interests).
  - The court declined to follow *Gerber* in the context that it didn't rely on the conclusive presumption provision in the LPA and therefore didn't need to examine the fairness opinion.
    - This case demonstrates the difficulty in proving failure to meet a subjective good faith standard and that the implied covenant should be used sparingly and not to re-write a contract.

GOOD FAITH—CONTRACTUALLY DEFINED

- Subsequently, the Court of Chancery decided a case in a similar transaction involving the El Paso MLP
  - *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, C.A. No. 7141-VCL (Del. Ch. Apr. 20, 2015)
- In this case, the Court awarded significant damages against the general partner of the MLP
  - the Court concluded that, despite trial testimony to the contrary, the conflicts committee members did not actually conclude that the challenged transaction was in the best interest of El Paso MLP.
  - "Despite their trial testimony, the Committee members did not conclude that the Fall Dropdown was "in the best interests of the Partnership." LPA § 7.9(b). They viewed El Paso MLP as a controlled company that existed to benefit Parent by providing a tax-advantaged source of inexpensive capital. They knew that the Fall Dropdown was something Parent wanted, and they deemed it sufficient that the transaction was accretive for the holders of common units. The Fall Dropdown was the fifth since El Paso MLP's IPO, and the participants had established a comfortable pattern. Everyone understood the routine and expected the transaction to go through with a tweak to the asking price. No one thought the Committee might bargain vigorously or actually say no."

GOOD FAITH—CONTRACTUALLY DEFINED

- In the recent decision in *In re Kinder Morgan, Inc. Corporate Reorganization Litigation*, C.A. No. 10093-VCL (Del. Ch. Aug. 20, 2015), confirms that the Delaware courts will continue to enforce the language of partnership agreements (and modifications of fiduciary duty in partnership agreements) as written.

GOOD FAITH—CONTRACTUALLY DEFINED

Kinder Morgan cont'd

- The Court ruled that based on the language of the Partnership's partnership agreement and Delaware Supreme Court precedent interpreting identical language, all default fiduciary duties had been eliminated and replaced by a contractual obligation for the general partner to act in manner that it "reasonably believed … to be in, or not inconsistent with, the best interests of the Partnership." Therefore, there could be no breach of fiduciary duty claim.

GOOD FAITH—CONTRACTUALLY DEFINED

Kinder Morgan cont'd

- The Court held that the relevant standard in the partnership agreement required that the conflicts committee consider and make a determination as to the fairness of the transaction to, and the best interests of, the Partnership itself as opposed to the limited partners of the Partnership.
  - Notably, the Court stated that if the partnership agreement had required the conflicts committee to make a determination as to the best interests of the limited partners, then the complaint would have been sufficient to withstand a motion to dismiss.

CIRCUMSTANCES UNDER WHICH FIDUCIARY DUTIES MAY BE WAIVED OR MODIFIED

MODIFYING FIDUCIARY DUTIES

- Fiduciary duties may be expanded, restricted or eliminated in an LLC/LP Agreement
  - Sections 18-1101(c) and 17-1101(d).

- The Delaware Court of Chancery distinguished the LLC/LP ability to modify fiduciary duties from the corporate context, stating that unlike the corporate context, the relationship between limited partners and a general partner is "primarily contractual in nature."
  - *In re Cencom Cable Income Partners, L.P. Litigation*, C.A. No. 14636, at 5. (Del. Ch. Feb. 15, 1996)

MODIFYING FIDUCIARY DUTIES

- In order to modify the default traditional fiduciary duties, the language in the LLC/LP Agreement must be clear and unambiguous.
  - *See, e.g., Miller v. Am. Real Estate Partners, L.P.*, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (citing *Sonet v. Timber Co., L.P.*, 772 A.2d 319, 322 (Del. Ch. 1998)).
- The Court will attempt to reconcile the application of traditional default fiduciary duties with the terms of the partnership agreement. Default fiduciary duties will only be supplanted when the application of those duties irreconcilably conflicts with the rights and obligations of partners as set forth in the partnership agreement.
  - *See R.S.M. Inc. v. Alliance Capital Mgmt. Holdings L.P.*, 790 A.2d 478 (Del. Ch. 2001); *Miller v. American Real Estate Partners, L.P.*, 2001 WL 1045643 (Del. Ch. Sept. 6, 2001).

MODIFYING FIDUCIARY DUTIES

- Drafting is critical
  - *In re Atlas Energy Resources, LLC*, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010) held that even though the LLC Agreement modified the fiduciary duties of directors and officers for an interested transaction through the approval of a special committee, it did not specifically modify the fiduciary duties of the controlling member, and therefore the controlling members still owed fiduciary duties to the minority members in an interested transaction.
    - Although the LLC Act explicitly allows modification or elimination of members' fiduciary duties, § 7.9(d) eliminates only directors and officers' fiduciary duties... Because the LLC Agreement does not eliminate [the controlling unitholder's] fiduciary duties, [the controlling unitholder] owes [the] minority unitholders "the traditional fiduciary duties that controlling shareholders owe minority shareholders."

MODIFYING FIDUCIARY DUTIES

- *Bay Center Apartments* provisions
  - Relationship of Members. Each Member agrees that, to the fullest extent permitted by the Delaware Act and except as otherwise expressly provided in this Agreement or any other agreement to which the Member is a party: ... (b) The Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other.
  - Liability of Members. ... Except for any duties imposed by this Agreement ... each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise.
  - *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

MODIFYING FIDUCIARY DUTIES

- *Zimmerman v. Crothall, et al.*, C.A. No. 6001-VCP (Del. Ch. Jan. 31, 2013). The decision is the Court of Chancery's post-trial opinion concerning challenges to a series of financing transactions, alleging, *inter alia*, breach of contract and breach of fiduciary duties by LLC directors and majority members.
- As to the fiduciary duties claims, the claim against the majority members failed as the Court found that they were not acting in concert. Concerning the plaintiff's claim for breach of fiduciary duties under common law and the operating agreement against the directors:
  - The operating agreement stated that the directors were fiduciaries of the LLC and required them to act with subjective good faith and with objective reasonableness.
  - The operating agreement also set forth a standard for directors engaging in transactions with the LLC.
    - Contractually-adopted requirement that such transactions be entirely fair.

MODIFYING FIDUCIARY DUTIES

- *Zimmerman v. Crothall (cont'd)*
- However, the Court focused upon the question of who bears the burden of proof on the question of fairness of a transaction. The Court noted that in the case of a default fiduciary duty in the LLC context, the initial presumption would be that the defendant director would have the burden of proving entire fairness of the relevant transaction.
  - Such presumption was not applicable in the instant case, because the fiduciary duties were contractual in nature.
  - The drafting of the specific provision was important: The Court compared the *Auriga* provision, which left the burden of proof upon the LLC manager to prove fairness, with that at issue in the case. The Court found that, in contrast, the *Zimmerman* provision established a right to engage in certain transactions so long as they were fair.
  - Consequently, the burden of proof fell on the plaintiff to prove a breach of the contractual requirement of fairness.

MODIFYING FIDUCIARY DUTIES

- In *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012), The *Gatz* LLC Agreement provided:

"Neither the Manager nor any other Member shall be entitled to cause the Company to … enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holder of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement)."

MODIFYING FIDUCIARY DUTIES

- The LLC Agreement in *Zimmerman* provided:
  - The Members, Directors, and officers and any of their respective Affiliates shall have the right to contract or otherwise deal with the Company or its Subsidiaries in connection therewith as the Board of Directors shall determine, provided that such payments or fees are comparable to the payments or fees that would be paid to unrelated third parties providing the same property, goods, or services to the Company or its Subsidiaries. No transaction between the Company or its Subsidiaries and one or more of its Members, Directors or officers . . . shall be void or voidable solely for this reason, or solely because the Director or officer is present at or participates in the meeting of the Directors that authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if (a) the material facts as to the transaction are disclosed or are known to the disinterested Directors and the contract or transaction is approved in good faith by the vote or written consent of the disinterested Directors; or (b) the transaction is fair to the Company or its Subsidiary as of the time it is authorized, approved or ratified by the Board of Directors or the Member.

MODIFYING FIDUCIARY DUTIES

- The LLC Agreement in *Zimmerman* provided:
  - The Members, Directors, and officers and any of their respective Affiliates shall have the right to contract or otherwise deal with the Company or its Subsidiaries in connection therewith as the Board of Directors shall determine, provided that such payments or fees are comparable to the payments or fees that would be paid to unrelated third parties providing the same property, goods, or services to the Company or its Subsidiaries. No transaction between the Company or its Subsidiaries and one or more of its Members, Directors or officers . . . shall be void or voidable solely for this reason, or solely because the Director or officer is present at or participates in the meeting of the Directors that authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if (a) the material facts as to the transaction are disclosed or are known to the disinterested Directors and the contract or transaction is approved in good faith by the vote or written consent of the disinterested Directors; or (b) the transaction is fair to the Company or its Subsidiary as of the time it is authorized, approved or ratified by the Board of Directors or the Member.

MODIFYING FIDUCIARY DUTIES

- The *Auriga* LLC Agreement provided:

  "**Neither** the Manager **nor** any other Member **shall be entitled to** cause the Company to …"

- The *Zimmerman* LLC Agreement provided:

  "The Members, Directors, and officers and any of their respective Affiliates **shall have the right** to contract or otherwise deal with the Company or its Subsidiaries in connection therewith as the Board of Directors shall determine..."

MODIFYING FIDUCIARY DUTIES

- *Zimmerman v. Crothall (cont'd)*
- Other points of interest (drafting considerations):
  - The Court noted that some of the ambiguities in the operating agreement may have derived from importation of corporate principles that do not have the same significance in the LLC context.
    - Issued vs. authorized shares.
    - 144 void or voidable language.

MODIFYING FIDUCIARY DUTIES

- *Norton, et al. v. K-Sea Transp. Ptrs. L.P., et al.*, -- A.3d --, 2013 WL 2316550 (Del. May 28, 2013).
  - Delaware Supreme Court considered a GP's obligations under an LPA in connection with a merger approval. Construing the LPA as a whole, the Court found that the LPA eliminated any duties that otherwise exist, and replaced them with a contractual fiduciary duty that the GP must reasonably believe that its action is in, or is not inconsistent with, the best interests of the partnership.

MODIFYING FIDUCIARY DUTIES

- *Norton v. K-Sea (cont'd)*
- The Court held that the LPA's conflict of interest provision did not impose an affirmative obligation to establish that the merger was fair and reasonable, but created a safe harbor for approving interested transactions.
  - The Court also considered an LPA provision establishing a conclusive presumption of good faith if the GP relied on a competent expert's opinion, holding that the GP had satisfied its contractual duty to exercise its discretion in "good faith" as defined in the LPA.
    - The conflicts committee of the GP's board obtained an expert opinion that the consideration paid to limited partners was fair, which the Court found satisfied the LPA's requirements.

MODIFYING FIDUCIARY DUTIES

- *Brinckerhoff v. Enbridge Energy Co., Inc.*, -- A.3d --, 2013 WL 2321598 (Del. May 28, 2013).
- The Delaware Supreme Court considered a conflict of interest provision in an LPA providing that conflicted transactions must be "fair and reasonable to the Partnership", which standard is satisfied "as to any transaction the terms of which are no less favorable to the [P]artnership than those generally being provided to or from unrelated third parties."
  - The special committee obtained an opinion that the terms of the transaction at issue were consistent with arm's-length terms in all material respects.

VARYING APPROACHES TO DEFAULT FIDUCIARY DUTIES

Two basic (and opposite) approaches to default fiduciary duties

1. Assume that managers/general partners, by default, all of the traditional fiduciary duties of corporate directors.

2. No default duties exist and that the managers have only the duties assigned to them in the entity's governing documents.

Jurisdictions differ on the extent to which default fiduciary duties, if they exist, can be modified.

DEFAULT FIDUCIARY DUTIES ASSUMED

- Some states have adopted laws assuming or implying that default corporate fiduciary duties apply to the managers and general partners of alternative entities. For example, Massachusetts Limited Liability Company Act assumes that managers have default fiduciary duties. Such duties, however, may be amended and even eliminated by contract via the certificate of organization or written operating agreement.

  - Mass. Gen. Laws 156C § 8; *Knapp v. Neptune Tower Associates, et al.*, 892 N.E.2d 820, 824 (Mass. App. 2008).

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

- A number of states, including California and New York, have adopted statutes expressly setting forth the scope of fiduciary duties applicable to alternative entity management.

- "A manager shall perform his or her duties as a manager, including his or her duties as a member of any class of managers, in **good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances**."

  - N.Y. Limit. Liab. Co. § 409(a)

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

California's statute (Cal. Corp. Code § 17704.09) is even more specific:

(a) The fiduciary duties that a member owes to a member-managed limited liability company and the other members of the limited liability company are the duties of loyalty and care ...

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

(b) A member's duty of loyalty to a limited liability company and the other members is limited to the following:

(1) To account to a limited liability company and hold as trustee for it any property, profit, or benefit derived by the member in the conduct and winding up of the activities of a limited liability company or derived from a use by the member of a limited liability company property, including the appropriation of a limited liability company opportunity.

(2) To refrain from dealing with a limited liability company in the conduct or winding up of the activities of a limited liability company as or on behalf of a party having an interest adverse to a limited liability company.

(3) To refrain from competing with a limited liability company in the conduct or winding up of the activities of the limited liability company.

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

(c) A member's duty of care to a limited liability company and the other members in the conduct and winding up of the activities of the limited liability company is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A member shall discharge the duties to a limited liability company and the other members under this title or under the operating agreement and exercise any rights consistent with the obligation of good faith and fair dealing.

(e) A member does not violate a duty or obligation under this article or under the operating agreement merely because the member's conduct furthers the member's own interest.

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

(f) In a manager-managed limited liability company, all of the following rules apply:

(1) Subdivisions (a), (b), (c), and (e) apply to the manager or managers and not the members.

(2) Subdivision (d) applies to the members and managers.

(3) Except as otherwise provided, a member does not have any fiduciary duty to the limited liability company or to any other member solely by reason of being a member.

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

Both California and New York recognize that the default fiduciary duties of managers can be amended or eliminated by contract (via the operating agreement or other governing instruments).

See, e.g., Cal. Corp. Code § 17701.10(e); *In re Die Fliedermaus LLC*, 323 B.R. 101, 110 (Bankr. S.D.N.Y. 2005).

THE LESS COY APPROACH – DEFAULT FIDUCIARY DUTIES EXPRESSLY ESTABLISHED BY STATUTE

The New York Appellate division has held that:

> While it is true [] that partners are accountable as fiduciaries and owe a duty of good faith and fairness to their partners, the parties to a partnership may include in the partnership articles any agreement they wish, including contemplated and authorized self-dealing, and the agreement as so written controls.

Carella v. Scholet, 5 A.D.3d (N.Y.A.D. 2004) (dismissing claims for breach of fiduciary duty predicated on self-dealing conduct expressly authorized in a limited partnership agreement, and citing *Pace v. Perk*, 81 A.D.2d 444 (N.Y.A.D. 1981); *Riviera Congress Assoc. v. Yassky*, 223 N.E.2d 876 (N.Y.A.D. 1966); *Lanier v. Bowdoin*, 24 N.E.2d 732 (N.Y.A.D. 1939)).

THE SELF-CONTRADICTING RULLCA APPROACH

In 2006, the National Conference of Commissioners on Uniform State Laws drafted the Revised Uniform Limited Liability Company Act ("RULLCA").

The RULLCA has been adopted in DC, Florida, Idaho, Iowa, Nebraska, New Jersey, Utah and Wyoming. Portions of the RULLCA are also in effect in California and Illinois.

THE SELF-CONTRADICTING RULLCA APPROACH

Rev. Unif. Lim. Liab. Co. Act § 110 addresses the modification or elimination of default fiduciary duties:

(c) **An operating agreement may not … eliminate the duty of loyalty, the duty of care, or any other fiduciary duty**; [or] subject to subsections (d) through (g), eliminate the contractual obligation of good faith and fair dealing under Section 409(d);

THE SELF-CONTRADICTING RULLCA APPROACH

Rev. Unif. Lim. Liab. Co. Act § 110 addresses the modification or elimination of default fiduciary duties:

(d) **If not manifestly unreasonable, the operating agreement may … alter the duty of care**, except to authorize intentional misconduct or knowing violation of law; alter any other fiduciary duty, **including eliminating particular aspects of that duty**; and prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under Section 409(d).

(e) The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.

THE SELF-CONTRADICTING RULLCA APPROACH

States adopting portions or all of the RULLCA either allow modification of fiduciary duties where not "manifestly unreasonable" or restrict modification but allow the establishment of contractual categories of activities not deemed to be violations of a duty (again, under a "manifestly unreasonable standard of review).

E.g., N.J. Stat. § 42:2C-11(h); 805 Ill. Comp. Stat. § 180/15-5.

THE SELF-CONTRADICTING RULLCA

The invitation for courts to become arbiters of what is "unreasonable" may be troubling for a practitioner attempting to determine the enforceability of contractual limitations to fiduciary duties.

Compare, e.g., *Kostyszyn v. Martuscelli*, 2015 WL 721291, at **4-5 (Del. Super. Feb. 18, 2015) (holding that the judiciary will not rescue a party from the adverse effects of an inadvisable, but otherwise unenforceable contractual provision, or seek to substitute the court's notion of reasonableness for the parties' express agreement.).

THE SELF-CONTRADICTING RULLCA

Andrea J. Sullivan and Steven B. Gladis, "New Remedies for LLC Members Oppression and Fiduciary Duties Under the Revised Uniform Limited Liability Company Act," 287 N.J. Law. 72, 74 (April 2014):

> In deciding whether a term is manifestly unreasonable, a court must "make its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time." A court may only invalidate a provision as manifestly unreasonable "if, in light of the purposes and activities of the limited liability company, it is readily apparent that: (a) the objective of the term is unreasonable; or (b) the term is an unreasonable means to achieve the provision's objective." *Given this restrictive standard of review, manifestly unreasonable challenges will likely be a narrow avenue of relief for litigants whose operating agreements bar fiduciary-duty claims*.

(emphasis added and internal citations omitted)

THE HIGHLY RESTRICTIVE APPROACH

15 Pa. Stat. § 8943(b)(1):

"[a] written provision of the operating agreement may increase, **but not relax**, the duties of representatives of the company to its members under those [corporate] sections [of the statute]."

THE LEAST RESTRICTIVE APPROACH

At the opposite end of the spectrum, Texas courts have never held that fiduciary duties exist by default for managers of an LLC. Rather, whether fiduciary duties exist is a question of fact determined by interpretation of the agreement or agreements governing the company.

Entertainment Merchandising Technology, L.L.C. v. Houchin, 720 F. Supp. 2d 792, 797 (N.D. Tex. 2010) (citing *Gadin v. Societe Captrade*, 2009 WL 1704049 (S.D. Tex. June 17, 2009); *Suntech Processing Sys., L.L.C. v. Sun Comm., Inc.*, 2000 WL 1780236 (Tex. App. 2000); *Kaspar v. Thorne*, 755 S.W.2d 151,155 (Tex. App. 1988)).

Note, however, that Texas appears to take a different approach, similar to the RULLCA standard, with respect to partnerships (including limited partnerships). Tex. Bus. Orgs. Code § 152.002.

POTENTIAL CONSEQUENCES /RISKS OF MODIFYING OR WAIVING DUTIES

MODIFYING FIDUCIARY DUTIES

- Why Modify?
  - Avoid uncertainty and inefficiency
    - Existence of inherent conflicts with control persons
    - Allocation of opportunities
  - Avoid divided loyalties
  - Requirements of third parties
  - Other effects
    - Burden of proof shift

ELIMINATION OF FIDUCIARY DUTIES

- MLP Cases
  - Common themes.
    - LPAs typically eliminate fiduciary duties.
      - Replaced with a contractual duty, language of this contractual duty is critical.
    - LPAs have contractual provisions that operate to create a conclusive presumption of good faith.
    - Implied contractual covenant of good faith and fair dealing is the floor of protection.
    - LPAs contractually define "good faith"
  - What's left?
    - Contractually defined standards of conduct.
    - The Implied Contractual Covenant of Good Faith and Fair Dealing.

CONSIDERATIONS IN DRAFTING

- Context
  - Private Equity/Hedge Fund
  - Joint Venture
  - Public/MLP
  - Structured Finance
- Effects of negotiation
- Entirety of agreement
  - "limited partnership agreements that attempt to modify, rather than eliminate, fiduciary duties often create a Gordian knot of interrelated standards in different sections of the agreement." (*Norton, et al. v. K-Sea Transp. Ptrs. L.P., et al.*, -- A.3d --, 2013 WL 2316550 (Del. May 28, 2013).)

CONTRACTUALLY DRAFTING GOOD FAITH

- Should we define "Good Faith"?
  - Reduces ambiguity
  - Potentially opens a can of worms

CONTRACTUALLY DRAFTING GOOD FAITH

- *Policemen's Annuity and Benefit Fund of Chicago, Illinois, et al. v. DV Realty Advisors LLC*, 2012 WL 3548206 (Del. Ch. Aug. 16, 2012).
- The Court considered whether the implied covenant imposed a requirement that LPs' decision to remove a partnership's general partner be "objectively reasonable".
- The Court held that, because the removal provision granted the LPs the discretion to remove the general partner and established a specific standard for exercise of their discretion, the implied covenant was not applicable.
- The Court addressed the definition of "good faith" in the LPs' exercise of discretion standard.
  - "Because the LPA provides that it 'is made pursuant to and shall be governed by the laws of the State of Delaware' the Court will presume that the parties intended to adopt Delaware's common law definition of good faith as applied to contracts." *Id.* at 33.
- The Court described the standard as predominately subjective, with objective boundaries when dealing with utterly unreasonable conduct

CONTRACTUALLY DRAFTING GOOD FAITH

- Examples of definitions of Good Faith.
  - Notwithstanding anything to the contrary contained in this Agreement, it is understood and agreed by the Members that the term "good faith" as used in this Agreement shall, in each case,…
    - means the subjective belief that an act or omission to act was in, or not opposed to, the best interests of the Company.
    - means that an act or omission to act was not done in conscious disregard of the best interests of the Company.
    - means "subjective good faith" as understood and interpreted under Delaware law.
    - means that an act or omission to act was not so far beyond the bounds of reasonable judgment that they seem essentially inexplicable on any ground other than bad faith.

CONTRACTUALLY DRAFTING GOOD FAITH

(b) Reliance. A Covered Person shall incur no liability to the Company or any Member in acting in **good faith** upon any signature or writing believed by such Covered Person to be genuine, may rely in **good faith** on a certificate signed by an executive officer of any Person in order to ascertain any fact with respect to such Person or within such Person's knowledge, and may rely in **good faith** on an opinion of counsel selected by such Covered Person with respect to legal matters…Each Covered Person may consult with counsel, appraisers, engineers, accountants and other skilled Persons selected by such Covered Person and shall not be liable to the Company or any Member for anything done, suffered or omitted in **good faith** in reliance upon the advice of any of such Persons… No Covered Person shall be liable to the Company or any Member for any error of judgment made in **good faith** by an officer or employee of such Covered Person, provided that such error does not constitute Disabling Conduct of such Covered Person.

CONTRACTUALLY DRAFTING GOOD FAITH

- An agreement may also set up a conclusive presumption regarding compliance with a fiduciary or contractual good faith standard.
- For example, the partnership agreement at issue in *Gerber v. Enterprise Products Holdings, LLC,* 67 A.3d 400 (Del. June 10, 2013), established a good faith standard for the general partner and then provided that:
  - "The General Partner may consult with . . . [experts or] investment bankers . . ., and any act taken or omitted to be taken in reliance upon the opinion . . . of such Persons as to matters that the General Partner reasonably believes to be within such Person's professional or expert competence shall be conclusively presumed to have been done or omitted in good faith and in accordance with such opinion."

CONSIDERATIONS IN DRAFTING

- Context
  - Private Equity/Hedge Fund
  - Joint Venture
  - Public/MLP
  - Structured Finance
- Effects of negotiation
- Entirety of agreement
  - "limited partnership agreements that attempt to modify, rather than eliminate, fiduciary duties often create a Gordian knot of interrelated standards in different sections of the agreement." (*Norton, et al. v. K-Sea Transp. Ptrs. L.P., et al.*, -- A.3d --, 2013 WL 2316550 (Del. May 28, 2013).)

CONSIDERATIONS IN DRAFTING

- *Bay Center Apartments* provisions
  - Relationship of Members. Each Member agrees that, to the fullest extent permitted by the Delaware Act and except as otherwise expressly provided in this Agreement or any other agreement to which the Member is a party: ... (b) The Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other.
  - Liability of Members. ... Except for any duties imposed by this Agreement ... each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise.
  - *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

CONSIDERATIONS IN DRAFTING - INDEMNIFICATION

- The Delaware Limited Liability Company Act (the "LLC Act") does not have any "default" indemnification provisions to consider providing
  - Section 18-108 of the LLC Act permits an LLC, subject to such standards and restrictions set forth in its LLC Agreement, to have the power to indemnify and hold harmless any member, manager or other person for an against any and all claims and demands whatsoever
  - Sections 18-1101(b) of the LLC Act states that it is the policy of the LLC Act to give maximum effect to the principle of freedom of contract and to the enforceability of LLC Agreements.

CONSIDERATIONS IN DRAFTING - INDEMNIFICATION

- Consider including mandatory and/or permissive indemnification provisions in the LLC Agreement.
  - Potential conflict situation for management in determining to give indemnification to themselves in discretionary provisions
  - Provide standard of conduct
    - without a standard, a court will create one, and it likely will not indemnify for negligence
      - In order to indemnify for negligence or gross negligence, must be express
        - *Downey v. Sanders*, Del. Super., C.A. No. 93C-02-005, Graves, J. (Mar. 22, 1996) ("[The language must be] crystal clear or sufficiently unequivocal to show that the contracting party intended to indemnify the indemnitee for the indemnitee's own negligence.")
    - Question is how low can you go with your standard?
      - *James v. Getty Oil Co.*, 472 A.2d 33, 36 (Del. Super. 1983) ("A contract to relieve a party from its intentional or willful acts is invariably held to be unenforceable as being against clear public policy.")

CONSIDERATIONS IN DRAFTING - INDEMNIFICATION

Address Priority of Indemnification sources, if applicable

- *Levy v. HLI Operating Co., Inc.*, 2007 WL 1500032 (Del. Ch., May 16, 2007)
  - Corporate case but probably applicable in an LLC/LP context as the provisions at issue were contractual in nature

CONSIDERATIONS IN DRAFTING - EXCULPATION

- Limited statutory provisions
  - Section 18-1101(d) of the Delaware LLC Act has a limited statutory exculpation for liability for breach of fiduciary duty for such persons good faith reliance on the provisions of the LLC Agreement.
    - May be overridden by the LLC Agreement
  - Section 18-406 of the Delaware LLC Act gives protection in the limited context of good faith reliance on experts with respect to valuation of assets or other facts pertinent to the existence and amount of assets from with distributions to members or creditors might properly be paid
  - Section 18-1101(e) provides for exculpation provisions to be included in the LLC Agreement provided that an LLC Agreement "may not limit or eliminate liability for an act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair deal
    - Unclear what is a "bad faith" violation of the implied contractual covenant of good faith and fair dealing

CONSIDERATIONS IN DRAFTING

- Additional considerations
  - Addressing former Indemnitee/Covered Person
    - Is term defined to cover former officers, managers etc.?
  - Can provisions be amended without consent by person benefiting from such provision?
    - No statutory protection in the LLC Act unlike with respect to a corporation under the DGCL.
  - Advancement of expenses
    - Mandatory v. Permissive provisions
      - Consider limiting obligation to advance expenses to indemnitees when claim against them is by the Company?

OTHER DRAFTING NOTES

- Members and Permitted Transfers
- Withdrawal
- Affiliates (*USACafes*)
- Intellectual Property

DRAFTING FIDUCIARY DUTY MODIFICATIONS PROVISION IN THE ENTITY OPERATING AGREEMENT – BEST PRACTICES

MODIFYING FIDUCIARY DUTIES

- Sample full elimination:
  - To the fullest extent permitted by law, including Section 18-1101(c) of the Act, and notwithstanding any other provision of this Agreement or in any agreement contemplated herein or applicable provisions of law or equity or otherwise, the parties hereto hereby agree that the Manager shall owe no fiduciary duty to any Member or the Company; provided, however, that the foregoing shall not eliminate duty to comply with the implied contractual covenant of good faith and fair dealing.

MODIFYING FIDUCIARY DUTIES

- Sample mechanic to satisfy:
  - To the fullest extent permitted by law and notwithstanding any other provision of this Agreement or in any agreement contemplated herein or applicable provisions of law or equity or otherwise, [the General Partner, the Manager and any of their officers, directors, principles, equity owners or of any Affiliate thereof] shall not owe any fiduciary duty to the Partnership or any of the Partners, shall not be liable to the Partnership or any of the Partners and shall not be in breach of this Agreement or any other agreement contemplated herein or applicable provisions of law or equity with respect to any actions or in actions taken [in good faith] by them with respect to any matter if, with respect to such matter (i) the General Partner or the Manager consults with the Advisory Committee [or a majority in interest of the Limited Partners], and (ii) the General Partner or the Manager acts in a manner approved by the Advisory Committee [or a majority in interest of the Limited Partners] or pursuant to standards or procedures set by the Advisory Committee [or a majority in interest of the Limited Partners].

MODIFYING FIDUCIARY DUTIES

- Sample modification of duty of loyalty:
  - Any Member and any Affiliate of any Member may engage in or possess an interest in other profit-seeking or business ventures of any kind, nature or description, independently or with others, similar or dissimilar to the business of the Company, whether now existing or hereafter acquired or initiated, whether or not such ventures are competitive with the Company and the doctrine of corporate opportunity, or any analogous doctrine, shall not apply to any Member. No Member who acquires knowledge of a potential transaction, agreement, arrangement or other matter that may be an opportunity for the Company shall have any duty to communicate or offer such opportunity to the Company, and such Member shall not be liable to the Company or to the other Members for breach of any fiduciary or other duty existing at law, in equity or otherwise by reason of the fact that such Member pursues or acquires for, or directs such opportunity to another Person or does not communicate such opportunity or information to the Company. Neither the Company nor any Member shall have any rights or obligations by virtue of this Agreement or the relationship created hereby in or to such independent ventures or the income or profits or losses derived therefrom, and the pursuit of such ventures, even if competitive with the activities of the Company, shall not be deemed wrongful, improper or the breach of any duty to the Company or any Member existing at law, in equity or otherwise.

MODIFYING FIDUCIARY DUTIES

- Sample burden shift and presumption:
  - Notwithstanding any applicable provisions of law or equity or otherwise, absent a showing of intentional fraud on the part of a Manager, the parties hereto agree that (i) in any proceeding relating to the determination of whether the Managers have met their duties under this Agreement or any applicable law there shall be a presumption that the Managers have met such duties and (ii) any person bringing or prosecuting a proceeding in the name or on behalf of the Company or the Member challenging any determination or action, or decision not to act, of any Manager, the person bringing or prosecuting such proceeding will bear the burden of proving by clear and convincing evidence that such duties were not met regardless of whether any such Manager shall be regarded as an interested person or otherwise having a conflict of interest.

CONSIDERATIONS IN DRAFTING

- Sample provisions - conflicts safe harbor
  - Unless otherwise expressly provided in this Agreement, whenever a potential conflict of interest exists or arises between the General Partner or any of its Affiliates, on the one hand, and the Partnership or any Partner, on the other, any resolution or course of action by the General Partner or its Affiliates in respect of such conflict of interest shall be permitted and deemed approved by all Partners, and shall not constitute a breach of this Agreement, of any agreement contemplated herein, or of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is (i) approved by Special Approval, (ii) approved by the vote of a majority of the Outstanding Common Units (excluding Common Units owned by the General Partner and its Affiliates), (iii) on terms no less favorable to the Partnership than those generally being provided to or available from unrelated third parties or (iv) fair and reasonable to the Partnership, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the Partnership).

CONSIDERATIONS IN DRAFTING

- Sample provisions - exculpation
  - Notwithstanding anything to the contrary set forth in this Agreement, no Indemnitee shall be liable for monetary damages to the Company, the Members, or any other Persons who are bound by this Agreement for losses sustained or liabilities incurred as a result of any act or omission of an Indemnitee unless there has been a final and non-appealable judgment entered by a court of competent jurisdiction determining that, in respect of the matter in question, the Indemnitee acted in bad faith or engaged in intentional fraud, willful misconduct or, in the case of a criminal matter, acted with knowledge that the Indemnitee's conduct was criminal.

CONSIDERATIONS IN DRAFTING

- The indemnification obligation of the Company to an Indemnitee with respect to any Damages shall be reduced by any indemnification payments actually received by such Indemnitee from a Portfolio Company with respect to the same Damages. Solely for purposes of clarification, and without expanding the scope of indemnification pursuant to this Section __, the Members intend that, to the maximum extent permitted by law, as between the Portfolio Companies and the Company, this Section __ shall be interpreted to reflect an ordering of liability for potentially overlapping or duplicative indemnification payments, with any applicable Portfolio Company having primary liability, and the Company having only secondary liability. The possibility that an Indemnitee may receive indemnification payments from a Portfolio Company shall not restrict the Company from making payments under this Section __ to an Indemnitee that is otherwise eligible for such payments, but such payments by the Company are not intended to relieve any Portfolio Company from any liability that it would otherwise have to make indemnification payments to such Indemnitee and, if an Indemnitee that has received indemnification payments from the Company actually receives duplicative indemnification payments from a Portfolio Company for the same Damages, such Indemnitee shall repay the Company to the extent of such duplicative payments. If, notwithstanding the intention of this Section __, a Portfolio Company's obligation to make indemnification payments to an Indemnitee is relieved or reduced under applicable law as a result of payments made by the Company pursuant to this Section __, the Company shall have, to the maximum extent permitted by law, a right of subrogation against (or contribution from) such Portfolio Company for amounts paid by the Company to an Indemnitee that relieved or reduced the obligation of such Portfolio Company to such Indemnitee.