Delaware Chancery Court Clarifies that Default Fiduciary Duties Apply to LLC Managers

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In 2004, the Delaware General Assembly amended both the Delaware Revised Limited Uniform Partnership Act ("DRULPA") and the Delaware Limited Liability Company Act (the "LLC Act") to permit the wholesale elimination of fiduciary duties in an LLC Agreement. Specifically, the LLC Act was amended to permit full contractual exculpation for breaches of fiduciary and contractual duties, except for the implied contractual covenant of good faith and fair dealing. Chancellor Strine's recent decision in *Auriga Capital Corp. v. Gatz Properties, LLC* clarifies, however, that unless the LLC Agreement explicitly restricts or eliminates fiduciary duties, an LLC's managers are constrained by the same fiduciary principles that apply to corporate fiduciaries. *See* No. C.A. 4390-CS, 2012 WL 361677 (Del. Ch. Jan. 27, 2012).

In many ways, the facts and holding in *Auriga* are beside the point. The decision is noteworthy for Chancellor Strine's comprehensive explanation why traditional fiduciary principles apply to LLC managers or members by default.[1] Nonetheless, we begin by providing a brief summary of the facts and holding, and then discuss Chancellor Strine's analysis of LLC default fiduciary duty standards.

Background

The case involves an LLC that was majority-owned by defendant, William A. Gatz ("Gatz"), and his family. Gatz was the sole manager of defendant, Gatz Properties LLC (the "LLC"). The LLC was the owner and passive operator of a property in Long Island, New York. The LLC and its investors had invested heavily in the property, building a golf course designed by a prominent designer and a first-rate clubhouse. In 1998, the LLC entered into a 35-year lease with a national golf course management company that would run the golf course. Shortly after entering into the lease, the management company was purchased by investors who neglected the maintenance and operations of the golf course. By 2004, it became apparent that the

management company would exercise a clause that allowed it to terminate the lease early. *Id.* at *4-6.

Rather than take steps to find a strategic option for the LLC, Gatz took steps that culminated in an auction in which his family was the only bidder. Gatz's "winning" bid represented only $50,000 in excess of the LLC's outstanding debt, and resulted in only $22,700 being distributed to the LLC's minority shareholders. *Id.* at *2.

As a result, a group of minority shareholders sued Gatz and Gatz Properties, LLC for damages, alleging that Gatz breached his fiduciary duties to the LLC. Gatz asserted two primary defenses: (1) because he and his family, as majority shareholders, had a veto power over any strategic option for the LLC, they were permitted to act in their own interests, without regard for the interests of the minority shareholders, and (2) by the time of the auction, the LLC was valueless such that the minority shareholders suffered no damages. *Id.* at *2, 6-7.

Holding

In a lengthy, post-trial decision, Chancellor Strine held that Gatz breached both his contractual and fiduciary duties by exploiting his position as sole manager. Specifically, Chancellor Strine found that Gatz had pursued a plan that allowed his family to buy the golf course from the LLC at a bargain price and to squeeze-out the LLC's minority shareholders. *Id.* at *3. In anticipation of the lease termination, Gatz failed to explore whether the golf course could be run profitably or to conduct a legitimate search for a buyer. To the contrary, when a credible buyer emerged, Gatz feigned interest but stonewalled due diligence and any semblance of legitimate negotiations until the buyer walked away. *Id.* at *14-15, 17-19.

Chancellor Strine further found that the auction was a sham. Gatz made no serious effort to market the auction to legitimate buyers. Furthermore, the marketing materials stated that the majority shareholders – *i.e.,* Gatz and his family – intended to bid and reserved the right to cancel the auction for any reason. *Id.* at *2, 22-24. Chancellor Strine stated that "[t]he auction had all the look and feel of a distress sale, but without any of the cheap nostalgic charm of the old unclaimed freight tv commercials." *Id.* at *2.

Chancellor Strine awarded the minority shareholders $776,515, representing their full, initial capital contribution plus $72,500, which was slightly less than the value that they would have received had Gatz sold the property in 2007 for $6.5 million. In addition, Chancellor Strine partially shifted the plaintiffs' fees to Gatz based on his finding that Gatz and his counsel made frivolous and factually implausible arguments that made the case unduly expensive. *Id.* at 28-29.

Analysis Regarding Default LLC Standards

In assessing whether fiduciary duties apply to LLC managers by default, Chancellor Strine examined, among other things, the text of the LLC Act, its legislative history and relevant Delaware caselaw. The principal points of Chancellor Strine's analysis are summarized below.

1. The LLC Act Supports the Conclusion that Fiduciary Duties are the Default Standard

Like the Delaware General Corporation Law (DGCL), the LLC Act does not explicitly state that traditional fiduciary duties apply by default. Chancellor Strine emphasized, however, that the LLC Act is even more explicit than the DGCL that equitable fiduciary duties are incorporated. Specifically, Chancellor Strine pointed to Section 18-1004 of the LLC Act, which provides that "[i]n any case not provided for in this chapter, *the rules of law and equity . . . shall govern*." *Id.* at *8.

Thus, Chancellor Strine concluded that, unlike in the corporate context, the rules of equity apply in the LLC context "*by statutory mandate*." *Id.* (emphasis in original). Chancellor Strine continued that, under traditional principles of equity, a manager of an LLC qualifies as a fiduciary of that LLC and its members. It follows, then, that, as fiduciaries, LLC managers owe the fiduciary duties of loyalty and care. Accordingly, Chancellor Strine concluded that the LLC Act starts with the default that managers of LLC's owe enforceable fiduciary duties. *Id.*

2. The LLC Act's Legislative History Supports the Conclusion that Fiduciary Duties are the Default Standard

As discussed above, the LLC Act was amended by the General Assembly to permit full contractual exculpation for breaches of fiduciary and contractual duties, except for the implied

covenant of good faith and fair dealing. Chancellor Strine reasoned that such an amendment to permit the elimination (and the exculpation for) fiduciary duties would have been unnecessary if the legislature did not believe that fiduciary duties were the default standard. *Id.* at *9 ("[W]hy would the General Assembly amend the LLC Act to provide for the elimination of (and the exculpation for) 'something' if there was no 'something' to eliminate (or exculpate) in the first place?").

3. The Implied Implied Covenant of Good Faith and Fair Dealing Cannot Be the Sole Equitable Gap-Filler Governing the Conduct of LLC Managers

Chancellor Strine opined that there would be two major consequences "if the equitable background contained in the [LLC Act] were to be judicially excised now." *Id.* at *10. First, if the fiduciary principles developed over many years by the Delaware judiciary were displaced by the implied covenant as the sole default principle of equity governing the conduct of LLC fiduciaries, the predictability of LLC Agreements as a tool to structure the obligations of a fiduciary, and the certainty of contracts in general, would be undermined. Historically, the implied covenant has been narrowly applied only "when the express terms of the contract indicate that the parties would have agreed to the obligation had they negotiated the issue." *Id.* (citation and quotations omitted). Thus, if the implied covenant became the sole equitable gap-filler, it would invite subjective judicial oversight contrary to the default fiduciary principles that are designed to minimize judicial second-guessing. Second, Chancellor Strine expressed concern that the failure to apply fiduciary principles to an LLC manager would erode Delaware's credibility with investors in Delaware entities. According to Chancellor Strine, reasonable investors have come to expect that managers of Delaware LLCs owe fiduciary duties of care except to the extent restricted or eliminated by the LLC Agreement. Ultimately, Chancellor Strine stated that changing that important default protection is a job for the General Assembly, not the Court. *Id.* at *10-11.

Conclusion

In sum, until the Delaware Supreme Court or General Assembly state otherwise, Chancellor Strine has definitively established that LLC managers are governed by the same well-

established fiduciary duties applicable to corporate fiduciaries, unless explicitly stated otherwise in the LLC Agreement. LLC managers thus can continue to look to Delaware corporate precedent to understand their duties and responsibilities as fiduciaries, and may take comfort in the certainty that this decision provides. On the other hand, to the extent the founders of an LLC wish to alter, modify or even eliminate fiduciary restrictions, the lesson to be learned is that the LLC Agreement should be drafted to explicitly address the nature and scope of the LLC manager's or members' fiduciary duties, if any. If the LLC Agreement is silent, fiduciary duties are the default.

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[1] We note that *Auriga* involved a manager-managed LLC, which is not the default form for a Delaware LLC. The default form under the LLC Act is a member-managed LLC. *See* 6 Del. Code § 18-101(6) (defining an LLC as "a limited liability company formed under the laws of the State of Delaware and having 1 or more *members*.") (emphasis added). Nonetheless, Chancellor Strine's analysis addresses the existence of default fiduciary duties for members and managers of LLCs.