



Delaware Chancery Court Explores LLC Fiduciary Principles

Delaware Chancery Court confirms that fiduciary duties apply to LLC managers in absence of contrary LLC agreement provisions and distinguishes the implied covenant of good faith and fair dealing.

A Delaware LLC leased from and developed into a golf course property owned by the LLC's manager and his family, which subsequently gained voting control over the LLC. The golf course was subleased to a golf management company, which mismanaged the property. Recognizing the property's greater value unencumbered by the lease, the manager sought to wrest from the minority LLC members their interest in the property, as the sublease's term approached. Rather than pursuing strategic alternatives as the sublease expired, the manager discouraged and misled the minority regarding an unsolicited third-party proposal to buy the lease and, ultimately, pursuant to a buyout provision in the LLC agreement, conducted a sham auction at which the manager was the only bidder. The minority's claim for damages for breach of contract and fiduciary duty afforded the Chancery Court, in [Auriga Capital Corp. v. Gatz Properties, LLC](#), C.A. 4390-CS, a forum to discuss how equitable and legal principles govern conduct of LLC fiduciaries, as well as specific contract provisions.

As is generally recognized, the Delaware LLC Act authorizes the parties to an LLC agreement to modify or eliminate fiduciary duties of an LLC's members and managers. However, the Act also expressly provides that legal and equitable principles govern cases not otherwise provided for by the statute. Therefore, Delaware courts hold managers to traditional corporate fiduciary standards, in absence of contrary language in an LLC agreement.

With respect to the manager's buyout of the minority at the auction, the court interpreted an LLC agreement provision authorizing arms-length transactions between the manager

and the LLC as substituting a fair-price requirement for an entire-fairness analysis, but not as eliminating the fair-dealing element altogether, because evidence of fair dealing is necessary to establish fair price. In the case at hand, the manager's conduct designed to discourage bids that would maximize value for the minority substantially undermined his claim that the buyout price was fair. Because not supplanted by express contract language, traditional duties of loyalty and care applied to other manager conduct. As described below, the court distinguished these fiduciary duties from the implied covenant of good faith and fair dealing, which cannot be eliminated by agreement.

That the manager and his family, as members, could have voted down any third-party transaction did not relieve the manager of his affirmative duty, as fiduciary, to maximize value for the minority. Conduct characterized by the manager in relation to the minority as "hardball" is inequitable and breaches the manager's fiduciary duty.

An individual controlling an LLC's manager may have fiduciary duties directly to the LLC.

From the perspective of measurement of damages, the manager may not assert as a defense the uncertainty or decline in value of the LLC's assets resulting from the manager's inequitable conduct.

The court explained that the implied covenant of good faith and fair dealing applies only when the express terms of a contract indicate how the parties would have agreed on a disputed matter, had they thought to negotiate the point. The terms "good faith" and "fair dealing" do not have the same meaning as the terms are used in the fiduciary duties context, and the covenant, which arises under contract law,

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does not substitute for general equitable principles. Courts are to apply the covenant cautiously, to avoid re-writing the parties' agreements.

In addition to modest damages amounting to a return of investment plus one percent per year, the chancellor took the unusual step of awarding the minority a portion of the legal fees they incurred in the litigation, because of defendant's bad faith conduct in the litigation, evidenced by legally and factually implausible assertions and an apparent aim to defend by attrition.

For more information about the content of this alert, please contact David Fischer, David Ansel or Giovanni Caruso.

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