

INSIGHTS

The Debate Rages On Regarding Whether Default Fiduciary Duties Apply to LLC Managers Under Delaware Law

January 7, 2013

Earlier this year, we reported on the Delaware Court of Chancery's decision in *Auriga Capital Corp. v. Gatz Properties, LLC*, wherein Chancellor Strine held that traditional fiduciary principles apply to LLC managers or members by default. See Delaware Chancery Court Clarifies that Default Fiduciary Duties Apply to LLC Managers, March 15, 2012 available [here](#) (discussing *Auriga Capital Corp. v. Gatz Properties, LLC*, No. C.A. 4390-CS, 2012 WL 361677 (Del. Ch. Jan. 27, 2012)). We emphasized that "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."

On November 7, 2012, the Delaware Supreme Court issued its decision on appeal. In an *en banc* opinion, the Supreme Court affirmed the Court of Chancery decision, but declined to reach the issue whether default fiduciary duties exist for LLC managers. See *Gatz Properties, LLC v. Auriga Capital Corp.*, No. 148, 2012 (Nov. 7, 2012). The Supreme Court instead affirmed on the ground that the defendants breached their fiduciary duties arising from an express contractual provision in the operating agreement of the LLC. The Supreme Court's analysis focused on Section 15 of the LLC Agreement. Section 15 provided, in pertinent part, that no member or manager was permitted to cause the company to "enter into any additional agreements with affiliates on terms and conditions which [were] less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties . . ." Emphasizing that "there is no requirement in Delaware that an LLC agreement use magic words, such as 'entire fairness' or 'fiduciary duties[,]'" the Supreme Court construed Section 15 as an explicit contractual assumption by the contracting parties of a fiduciary duty to obtain a fair price for the LLC in transactions between the LLC and affiliated persons. Viewing Section 15 functionally, the Supreme Court treated it as the contractual equivalent of the entire fairness standard of conduct and judicial review. Thus, because there was no approving vote by the majority of the Company's minority members, the Supreme Court held that the defendant – the LLC's manager – had the burden of establishing the entire fairness of the transaction. Referencing the defendant's trial testimony and the evidentiary record, the Supreme Court held that he failed to meet this burden, and thus affirmed the Court of Chancery's holding that he had breached his contractually adopted fiduciary duties.¹

While the Supreme Court's contractual analysis is instructive, the decision has garnered far more attention based on the Supreme Court's analysis of Chancellor Strine's holding that default fiduciary duties apply to LLC managers, which it characterized as "dictum without any

precedential value." The Supreme Court reasoned that "[w]here, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction." The Supreme Court thus intentionally left unresolved the question whether default fiduciary duties apply to managers of an LLC.

However, the debate regarding default fiduciary duties did not end there. Just a few weeks later, Vice Chancellor Laster revisited the issue in *Feeley v. NJAOCG*, C.A. No. 7304-VCL (Del. Ch. Nov. 28, 2012), a case that, unlike *Auriga*, put the question of default fiduciary duties squarely before the court. Though he acknowledged that the *Auriga* decision could not be relied upon as precedent, Vice Chancellor Laster nonetheless adopted Chancellor Strine's analysis, "afford[ing] his views the same weight as a law review article, a form of authority the Delaware Supreme Court often cites." Based on Chancellor Strine's reasoning and "the long line of Chancery precedents holding that default fiduciary duties apply to the managers of an LLC[,]"¹ the Court held that default fiduciary duties apply to LLC managers. Vice Chancellor Laster recognized, however, that "[t]he Delaware Supreme Court is of course the final arbiter on matters of Delaware law."

Thus, in many ways these two decisions bring things full circle. Until the Delaware Supreme Court or General Assembly address the question whether default fiduciary duties exist for managers of Delaware LLCs, Delaware Chancery precedent provides that they do. However, while this may suggest extra caution be used when drafting an LLC agreement, the Supreme Court's contractual analysis in the *Auriga* decision suggests that the question of default fiduciary duties may often be beside the point. Even in the absence of magic language regarding "fiduciary duties" or "entire fairness," imprecise language in an LLC agreement may be construed as a contractual assumption by the LLC manager to abide by traditional fiduciary duties. Thus, while we do not expect that Vice Chancellor Laster's *Feeley* decision represents the last word in the default fiduciary duty debate, the lesson is the same: LLC agreements should be drafted to expressly address the nature and scope of the LLC managers' fiduciary duties, or to specifically eliminate fiduciary duties altogether.

¹ The Supreme Court also affirmed the Court of Chancery's determination that the LLC Agreement did not exculpate or indemnify the LLC's manager due to his bad faith and willful misrepresentations, as well as its awards of damages and attorneys' fees.