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MODIFICATION OF FIDUCIARY DUTIES IN ALTERNATIVE ENTITIES

What We Will Discuss

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- ❑ **Background of Fiduciary Duties – what are they?**
- ❑ **Delaware Treatment in Alternative Entities**
 - ❑ **Applicable Statutes**
 - ❑ **Case Law – where is it headed?**
- ❑ **Maryland Treatment (limited guidance)**
- ❑ **Drafting Tips & Hypotheticals**
 - ❑ **Why Modify / Eliminate the Duties?**
 - ❑ **How to do so**

Overview Summary of DE Law

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- **GPs and controlling Members and Managers of LLCs have default FDs analogous to those of DE Corp Directors**
- **LP and LLC Acts and Courts give full effect to freedom of contract**
- **Drafters have full discretion to structure rights and obligations of parties**
- **Modification or Elimination must be unambiguous express which conflict with traditional duties**

Background of Fiduciary Duties in Delaware

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- ❑ **Corporate Law Ties – Courts have looked to duties traditionally imposed on Corporate Directors when determining the fiduciary duties owed by a person controlling an AE:**

“The fiduciary duty of fair dealing by a general partner to a limited partner is no less than that owed by a director to a shareholder. The form of the enterprise does not diminish the duty of fair dealing by those in control of the investments. As a result, Delaware law requires the general partners of limited partnerships to exercise due care and to act in the best interest of the partnership and the limited partners.”

In Re Boston Celtics Ltd. Partnerships Shareholder Litigation, C.A. No. 16511 (Del Ch. Aug. 6, 1999)

What are the Corporate Duties?

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- ❑ **Duty of Care**
- ❑ **Duty of Loyalty**
- ❑ **Duty of Disclosure**

The Duty of Care

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- ❑ **Director has the Duty to *Inform* self of all *Material Information***

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)

- ❑ **Directors generally protected by the Business Judgment Rule unless an “Interested Transaction” (see below)**

The Duty of Loyalty

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- ❑ **Directors' actions should be motivated solely the best interests of the corporation and its shareholders**
- ❑ **Decisions and actions may not be used to advance personal gain:**

“[C]orporate officers and directors are not permitted to sue their position of trust and confidence to further their private interests.”

Guth v. Loft Inc., 5 A.2d 503 (Del. 1939)

See *VGS, Inc. v. Castiel*, C.A. No. 17995 (Del. Ch. Aug. 31, 2000) (applying the Duty of Loyalty to controlling members and managers of an LLC)

Duty of Disclosure

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- ❑ **Directors must disclose fully all *material facts within control* to other directors and shareholders.**
- ❑ **Applies to LPs and LLCs**

In re Marriott hotel Properties II Limited Partnership Unitholders Litigation, C.A. No. 14961, slip op. (Del. Ch. Jan. 24, 2000) (Limited Partnership Context)

In re Bigmar, Inc., C.A. No. 19289, slip op. (Del. Ch. Apr. 5, 2002) (Limited Liability Company Context)

Business Judgment Rule

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- ❑ **Affords Directors the presumption that they acted in accord with the duties of care and loyalty – Allows flexibility in decision-making process**
- ❑ **Applies to AEs:**

“[T]he business judgment rule generally protects the actions of the general partners, affording them a presumption that they acted on an informed basis and in the honest belief that they acted in the best interest of the partnership and the limited partners.”

In Re Boston Celtics, slip op. at 10

Business Judgment Rule

- ❑ **Does not apply in Interested Transactions – any personal interest, interest of affiliates or self-dealing.**
- ❑ **If so, Delaware Courts apply the “Entire Fairness Test” – was there (1) Fair Dealing and (2) Fair Price?** See *Weinberger v. UOP, Inc.*, 457 A.3d 701 (Del. 1983)
- ❑ **Applies to LPs (*In re Boston Celtics*) and LLCs (*Solar Cells, Inc., v. True North Partners, LLC*, C.A. No. 19477 (Del. Ch. Apr. 25, 2002))**

How are LPs and LLCs Different?

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□ AEs are CREATURES OF CONTRACT

“[P]arties to contractual entities such as limited liability partnerships and limited liability companies should be free—given a full, clear disclosure paradigm—to adopt or reject any fiduciary duty obligation by contract. Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties, or the judicial scrutiny associated with them, where the parties have not contracted for those governance mechanisms in the documents forming their business entity . . . Interestingly, no relevant Delaware statute names, numbers, or defines any fiduciary duty or refers to the famous “triad”.”

-- Delaware Chief Justice Myron Steele

DRULPA

6 DEL. C. §§ 17-1101, *et seq.*

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(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

DRULPA

6 DEL. C. §§ 17-1101, *et seq.*

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(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or ELIMINATED by provisions in the partnership agreement; provided that the partnership agreement may *not* eliminate the implied contractual covenant of good faith and fair dealing.

DRULPA

6 DEL. C. §§ 17-1101, *et seq.*

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(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.

DRULPA

6 DEL. C. §§ 17-1101, *et seq.*

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(f) A partnership agreement may provide for the LIMITATION OR ELIMINATION of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

DLLCA

6 DEL. C. §§ 18-1101, *et seq.*

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(b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

DLLCA

6 DEL. C. §§ 18-1101, *et seq.*

17

(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be EXPANDED OR RESTRICTED OR ELIMINATED by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

DLLCA

6 DEL. C. §§ 18-1101, *et seq.*

18

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.

DLLCA

6 DEL. C. §§ 18-1101, *et seq.*

(e) A limited liability company agreement may provide for the **LIMITATION OR ELIMINATION of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing**

2004 Amendments

- Added provisions permitting the **FULL ELIMINATION** of fiduciary duties in both the **DRULPA** and **DLLCA**
- Legislative Response to *Gotham Partners v. Hallwood Realty Partners*, **817 A.2d 160 (2002)**

DRULPA and DLLCA



- ❑ No specific fiduciary duties mentioned or required
- ❑ Primacy of Governing Document terms
- ❑ Application of corporate / common law fiduciary duties only as “Gap Fillers” where parties have not made clear their intent.
- ❑ Poor or incomplete drafting permits judicial interference

Delaware Supreme Court Overview



Delaware Supreme Court Chief Justice Steele argues that parties forming limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in LLC fiduciary duty cases.

Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007)

Chancery Court Overview

□ Chancery Court has strong preference toward primacy of LP/LLC Agreement language over common law duties

□ Chancery Court will make every effort to enforce the terms actually bargained for and negotiated in parties' agreement:

“Courts should recognize the parties’ freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties ... [no provision in the LLC Agreement] create[d] a code of conduct for all members; on the contrary, most of those sections expressly claim to limit or waive liability. . . There is no basis in the language of the LLC Agreement [indicating] that all members were bound by a code of conduct.”

Fisk Ventures, LLC v. Segal, C.A. No. 3017-CC, 2008 WL 1961156, at *9 (Del. Ch. May 7, 2008)

Delaware Courts Uphold Contractual Modification

“Principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intention to do so plain” *Sonet v. Timber Co., L.P.*, 722 A.2d 319, 322 (Del. Ch. 1998)

The “[B]asic approach [of the LLC Act] is to provide members with broad discretion in drafting the Agreement and to enforce such terms.” *Elf Atochem North America, Inc., v. Jaffari*, 727 A.2d 286, 291 (Del. 1999)

Delaware Courts Uphold Contractual Modification

“[U]nder Delaware limited partnership law a claim of breach of fiduciary duty must first be analyzed in terms of the operative governing instrument – the partnership agreement – and only where that document is silent or ambiguous . . . Will a Court begin to look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence.”

Sonet, 722 A.2d at 324

How Explicit Must a Modification Be?

As a result of the 2004 Amendments and Chancery Court rulings, it is clear that Delaware LPs and LLCs may limit or eliminate traditional fiduciary duties by contract

BUT

Delaware courts **WILL** imply traditional corporate-like fiduciary duties in the absence of **EXPRESS AND UNAMBIGUOUS** agreement provisions eliminating those duties.

THUS

Precise drafting is essential!

Do Modifications Conflict or Complement Common Law Duties?

[W]here the use of default fiduciary duties would intrude upon the contractual rights or expectations of the general partner or be insensible in view of the contractual mechanisms governing the transaction under consideration, the court will eschew fiduciary concepts and focus on a purely contractual analysis of the dispute.

Put somewhat differently, *the irreconcilability of fiduciary duty principles with the operation of the partnership agreement can itself be evidence of the clear intention of the parties to preempt fiduciary principles.*

In *R.S.M. Inc. v. Alliance Capital Management Holdings L.P.*, 790 A.2d 478, 497-98 (Del. Ch. 2001)

Good Faith and Fair Dealing – when does the implied covenant come into play?



❑ Remember – Under the DRULPA and DLLCA, FDs can be modified or eliminated *subject* to the implied covenant of Good Faith and Fair Dealing

❑ Exhaustive Debate over what GF & FD constitutes

Good Faith and Fair Dealing – when does the implied covenant come into play?

□ What you need to know – For purposes of Sections 17 and 18-1101, Good Faith is interpreted in a contract law context, *not* a fiduciary law context

See R.S.M. Inc. v. Alliance Capital Mgmt. Holdings L.P., 790 A.2d 478, 497 (Del. Ch. 2001) (“[W]here the use of default fiduciary duties would intrude upon the contractual rights or expectations of the general partner or be insensible in view of the contractual mechanism governing the transaction under consideration, the court will eschew fiduciary concepts and focus on a purely contractual analysis of the dispute.”)

Good Faith and Fair Dealing – when does the implied covenant come into play?



Thus, parties need only abide by the terms negotiated – this permits acting in self-interest if the contract terms so provide

Where are We Now?: Recent Cases

❑ **LLC/LP Agreements must expressly modify or negate common law duties**

❑ **Good Faith is viewed through in a contractual context to honor the negotiated and bargained for terms of an entity agreement**

❑ **Courts will NOT use the implied covenant of GF to override Express terms of an entity agreement (in effect creating a new right)**

❑ **In absence of express unambiguous language modifying or eliminating FDs, corporate/common law FDs WILL apply**

Where are We Now?: Recent Cases

LLC Agreement:

Performance of Duties; no Liability of Officers. No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements. No Member, Representative, or Officer of the Company shall be liable to the Company or to any Member for any loss or damage sustained by the Company or to any Member, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the Member, Representative, or Officer in question....

Fisk Ventures, LLC v. Segal, 2008 WL 1961156 (May 7, 2008)

Fisk Ventures, LLC v. Segal

2008 WL 1961156 (May 7, 2008)

- ❑ **Claim of breach of fiduciary duty dismissed**
- ❑ **The language in the agreement was sufficient to negate common law FDs**
- ❑ **Inappropriate to use common law FDs as “gap fillers” when the intent of the parties is expressly and unambiguously stated in the agreement**
- ❑ **Courts will not use the implied covenant of Good Faith to “create” a new duty**

Kelly v. Blum (2010)

CA No. 4516-VCP (Del. Ch. Feb. 24, 2010)

LLC Agreement:

[t]he Board of Managers shall manage the affairs of the Company in a prudent and businesslike manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs.

Kelly v. Blum (2010)

❑ NO express modification or elimination of FD.
Ambiguous language used in the agreement

❑ Thus, interpreted to mean that the parties intended common law fiduciary duties to apply – burden on drafter

“Having been granted great contractual freedom by the LLC Act, drafters and parties to an LLC agreement should be expected to provide parties and anyone interpreting the agreement with clear and unambiguous provisions when they desire to expand, restrict, or eliminate the operation of traditional fiduciary duties.”

Lonergan v. EPR Holdings LLC, et al.

C.A. No. 5856-VCL Del. Ch. Oct. 11, 1010)



LLC Agreement:

Except as expressly set forth in this Agreement, neither [Holdings GP] nor any other Indemnatee shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner and the provisions of this Agreement, to the extent that they restrict or otherwise modify the duties and liabilities, including fiduciary duties, of [Holdings GP] or any other Indemnatee otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of [Holdings GP] or such other Indemnatee.

Lonergan v. EPR Holdings LLC, et al.

C.A. No. 5856-VCL (Del. Ch. Oct. 11, 2010)

Clear and unambiguous elimination of the duty

Plaintiff's attempt to use the implied covenant of good faith fails in the face of such explicit contract terms:

“The implied covenant is not a substitute for fiduciary duty analysis. The covenant is ‘best understood as a way of implying terms in the agreement’ Existing contract terms control, however, such that implied good faith cannot be used to circumvent the parties’ bargain, or to create a free-floating duty unattached to the underlying legal documents.”

See also, In re Atlas Energy Resources, LLC, Unitholder Litigation, C.A. No. 4589-VCN (Del. Ch. Oct. 28, 2010)

The Bottom Line in Delaware



“In large measure, the DRULPA [and LLC Act] reflect[] the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships [and LLCs] have countless other investment opportunities available to them that involve less risk and/or more legal protection.”

Miller v. Am. Real Estate P’rs, L.P., 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001)

Maryland LP and LLC Acts



No express provisions on point regarding fiduciary duties of partners / members in either statute.

Maryland Revised Uniform Partnership Act

A Partnership Agreement may *not*:

(3) Eliminate the duty of loyalty under § 9A-404(b) or § 9A-603(b)(3) of this title, but:

- (i) The partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty; however, the partnership agreement may not be amended to expand or add any specific types or categories of activities that do not violate the duty of loyalty without the consent of all partners after full disclosure of all material facts; or**
- (ii) All of the partners or a number or percentage of not less than a majority of disinterested partners specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;**

Maryland Revised Uniform Partnership Act



(4) Unreasonably reduce the duty of care under § 9A-404(c) or § 9A-603(b)(3) of this title;

(5) Eliminate the obligation of good faith and fair dealing under § 9A-404(d) of this title, but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable;

Judicial Preference for Contract?

“The general rule is that the partnership agreement governs the relations among the partners and between the partners and the partnership.”

Della Ratta v. Larkin, 856 A.2d 643, 649 (2004)

Clancy v. King

954 A.2d 1094 (2008)

- ❑ Clancy's actions would have been a breach of fiduciary duty of loyalty under typical circumstances
- ❑ However, no breach in this instance because the language of the partnership agreement **LIMITED** Clancy's fiduciary duties and permitted self-dealing
- ❑ Parties to a partnership can agree to limit their duties to each other and the partnership
- ❑ Partnership agreement will be analyzed under contract law and not fiduciary law

Clancy v. King

954 A.2d 1094 (2008)

LP Agreement:

“Nothing herein shall limit the General Partners or their Affiliated Persons from engaging in any such business activities, or any other activities which may be competitive with the Partnership . . . And the General Partners . . . shall not incur any obligation, fiduciary or otherwise . . . because of such activities.”

Clancy v. King

Court's Analysis

- ❑ **First step is to examine the Partnership Agreement.**
- ❑ **Court will give effect to the clear terms of the parties**
- ❑ **Fiduciary Duties understood as Gap Fillers**
- ❑ **Delaware cases (*Sonet, Kahn v. Ichan*) cited with approval**

Clancy v. King

Good Faith Analysis

- ❑ Good Faith cannot be waived - § 9A-103(b)(5); exists as an implied covenant in the contract.
- ❑ Again cites Delaware cases as authority (*Desert Equities, Arvida/JMB, Fitzgerald*)
- ❑ Partnership Agreement Terms can disadvantage the Partnership or other Partners if not exercised in Bad Faith
- ❑ What is “Bad Faith”? Subjective standard will apply

Clancy v. King

Jerry: Excuse me, I'd like to return this jacket.

Clerk: Certainly. May I ask why?

Jerry: For spite.

Clerk: Spite?

Jerry: That's right. I don't care for the salesman that sold it to me.

Clerk: I don't think you can return an item for spite.

Jerry: What do you mean?

Clerk: Well, if there was some problem with the garment. If it were unsatisfactory in some way, then we could do it for you, but I'm afraid spite doesn't fit into any of our conditions for a refund.

Jerry: That's ridiculous, I want to return it. What's the difference what the reason is?

Clerk: Let me speak with the manager . . . excuse me . . .
Bob!

(walks over to the manager and whispers)

Bob: What seems to be the problem?

Jerry: Well, I want to return this jacket and she asked me why and I said for spite and now she won't take it back.

Bob: That's true. You can't return an item based purely on spite.

Maryland Post-Clancy

Follow Delaware trend? *Clancy* expresses strong favor for that line of reasoning

But . . . Underlying statutes are significantly different. Dubious to rely on *Clancy* alone as authority

When to Modify Fiduciary Duties

- ❑ Allow firm members to compete with the firm (*Clancy*)
- ❑ Allow parties to take business opportunities that were available to the firm (*Clancy; Affiliates*)
- ❑ Permit Self-Interested Transactions (*Sonet*; sole discretion language)
- ❑ Limit Duties of Disclosure (trade secrets in joint ventures)
- ❑ Induce participation by certain necessary firm members (venture capital funds)

Good Policy?



- Modification of FD places onus for establishing standards of conduct on the marketplace reflecting true intent**
- If done correctly, can greatly reduce uncertainty and risk in transactions stemming from judicial intervention contrary to parties' intent**
- Contractual freedom places partners and members on notice as to how they will be governed. Objections raised during drafting stage**
- Race to the bottom / Moral Hazard?**