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Delaware Court of Chancery Reaffirms Default Fiduciary Duties in the Limited Liability Company Context Absent Contractual Modifications

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In its January 27, 2012 decision in *Auriga Capital Corp. et al v. Gatz Properties LLC et al*, C.A. 4390-CS (Del. Ch. Jan. 27, 2012), the Delaware Court of Chancery reaffirmed that limited liability company managers and other fiduciaries are charged with the equitable fiduciary duties of care and loyalty, similar to the obligations of officers and directors of a corporation, and that, in order to eliminate or limit those duties, the parties to the limited liability agreement must so agree in the agreement itself.

In *Auriga*, the Court found that the defendant manager and majority owner of Peconic Bay LLC, a Delaware limited liability company holding a long-term lease on land used as a golf course, repeatedly breached the default fiduciary duties it owed to the company's minority members in the absence of language in the operating agreement clearly modifying or waiving such duties. The Court firmly rejected the manager's position that, as the owner of the controlling interest in Peconic Bay, it owed no fiduciary duties to the company's minority investors, noting that "[t]he purpose of the duty of loyalty is in large measure to prevent the exploitation by a fiduciary of his self-interest to the disadvantage of the minority."

The Court of Chancery likewise dismissed the manager's contention that he acted in good faith and with due care. Though the company's operating agreement contained an exculpatory provision for fiduciary duty breaches other than those resulting from bad faith action, willful misconduct and gross negligence, the Court found that the defendant's actions and omissions — including self-dealing, deceit and "hardball" tactics calculated to coerce minority investors in the LLC to sell their interests to the manager at an unfair price — exemplified bad faith "fiduciary infidelity of a classic variety."

Background

Peconic Bay's manager, Gatz Properties, LLC, was solely managed by William Gatz, whose family owned the land leased to Peconic Bay for use and development as a golf course. Peconic Bay, in turn, subleased the property to American Golf Corporation, a golf management company. The term of the Peconic Bay-American Golf sublease was 35 years, with American Golf having the option to terminate the contract in 2010 after the first 10 years of its operation of the golf course. In the early 2000s, investors with little interest in maintaining the golf course acquired American Golf, and the course quickly fell into disrepair. Revenues rapidly declined, and it soon became evident that American Golf would take advantage of the early termination option under its sublease with Peconic Bay.

Rather than taking actions consistent "with those of someone whose duty it was to seek out ways to preserve value for Peconic Bay's investors," however, during this time, Gatz made decisions that one would expect from "someone who was hoping that…Peconic Bay would simply revert back to his family's ownership once [American Golf terminated the sublease and] Peconic Bay's primary source of revenue ran dry, without regard for the interest of the [m]inority [m]embers." When it became clear in 2004-2005 that American Golf would not renew the sublease, Gatz did nothing to seek — and actively avoided — strategic alternatives for the company. For example, in 2007, Gatz learned from a bank appraiser's report that his family's property could be used more profitably for residential development; when a bidder approached Gatz about selling Peconic Bay the same year at a price that would have earned the minority members a full return on their investment in the company, Gatz refused to provide diligence materials to, or negotiate in good faith with, the bidder and misled the minority members about the potential buyer's proposed terms. Then, "using the leverage obtained by his own loyalty breaches," Gatz played "hardball" with the minority members by offering to purchase the company at an unfair price. Gatz ultimately bought Peconic Bay in what the Court called a "bad faith sham" auction designed to deter third-party buyers so that Gatz could cheaply acquire the minority investors' interests in the company.

Damages

Finding that Gatz's course of conduct constituted clear breaches of both his contractual duties and his default fiduciary duties of care and loyalty, the Court awarded damages in the amount of $797,500 to the plaintiffs — i.e., their entire capital contribution of $725,000, plus a 10% return on that figure. Further, because the defendant manager and his counsel made the "litigation far more cumbersome and inefficient than it should have been by advancing certain frivolous arguments," Chancellor Strine invoked the bad faith exception to the American Rule and ordered the manager to pay one-half of the plaintiffs' reasonable attorneys' fees. In the Court's words, the remedy was "modest," and the record could have supported a higher one.

Significance

The *Auriga* opinion, delivered in Chancellor Strine's characteristically colorful prose, contributes an extensive examination of Delaware statutory provisions, legislative history and precedent case law supporting the default application of traditional fiduciary duties in the absence of contractual carve-outs.

In *Auriga*, Chancellor Strine catalogues a "consistent line of decisions" by the Supreme Court and the Court of Chancery that affirm the principal that traditional fiduciary duties of loyalty and care apply unless the parties to an operating agreement "expressly modify or eliminate those duties" and explains that, although the Delaware Limited Liability Company Act "does not plainly state that the traditional fiduciary duties of loyalty and care apply by default as to managers or members of a limited liability company," the conclusion that such duties are implicit in the limited liability context absent contractual modification is strongly confirmed by a review of the Act's history.

Having described the 2004 amendments to the Delaware Limited Liability Company Act that permitted the waiver of fiduciary duties and full exoneration for breaches of contractual and fiduciary duties, other than the implied contractual covenants of good faith and fair dealing, Chancellor Strine reasons that it would have been pointless for the General Assembly to have amended the Act

> to provide for the elimination of (and the exculpation for) 'something' if there were no 'something' to eliminate (or exculpate) in the first

> place[.] The fact that the legislature enacted these liability-limiting measures against the backdrop of case law holding that default fiduciary duties did apply in the LLC context, and seemed to have accepted the central thrust of those decisions to be correct, provides further weight to the position that default fiduciary duties do apply in the LLC context to the extent they are not contractually altered.

In *Auriga*, Chancellor Strine likewise reaffirms that, like corporate directors, general managers and trustees, limited liability company managers fall within the definition of "fiduciary," since, under Delaware law, "'[a] fiduciary relationship is a situation where one person reposes special trust in and reliance on the judgment of another, or where a special duty exists on the part of one person to protect the interests of another.'" He notes that, unlike straightforward commercial arrangements, fiduciary relationships create an expectation that "one party will act in the interests of the other."

As Chancellor Strine emphasizes in *Auriga*, Delaware law creates the expectation in investors that managers and other fiduciaries of limited liability companies owe "enforceable fiduciary duties" absent an express disclaimer of such duties in the company's operating agreement. Practitioners, fiduciaries and minority investors of limited liability companies should review existing limited liability company agreements, and create new operating agreements, with an eye toward this expectation and the requirements or wishes of the parties with respect to the applicability of default fiduciary duties. Where limitations or waivers of the traditional fiduciary duties of loyalty and care are desirable in the limited liability company context, the governing documents should expressly modify or eliminate such duties.

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