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Private Equity Alert

When Fiduciary Duty Calls

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In the private equity world, deal lawyers and professionals often face the question of whether companies should be set up as a traditional corporation or an alternative entity, such as a limited liability company or limited partnership. The choice of entity is often made by weighing various factors related to structuring, management, governance, and taxation. One of the considerations that should be taken into account is whether those who are in charge of overseeing or running the operations of the business (i.e., the Board or the officers) should be subject to fiduciary duties to the equity holders of the enterprise. For example, in a deal where there exists two equity holders in a new venture (one is the majority holder and will control the Board and the other is the minority holder with no Board rights), will the Board designees of the majority holder owe fiduciary duties to the minority holder? Unlike a Delaware corporation, which has clearly established fiduciary duties for directors and officers (i.e., the duty of care and the duty of loyalty) that cannot be amended, modified, or eliminated by contract, Delaware law does permit such flexibility for alternative entities. Although most deal lawyers and professionals are aware of this flexibility, there exists a trap for the unwary. What happens if the operating documents of a Delaware limited liability company do not expressly address whether such fiduciary duties exist or, if they do exist, to what extent?[1] Unfortunately, as demonstrated in the recent Delaware case of *Gatz Properties, LLC v. Auriga Capital Corp.*, and contrary to the prior beliefs of many deal lawyers and professionals alike, the contracting parties in this scenario will be left in a state of ambiguity as there is no "default" rule of whether or not fiduciary duties apply. If not careful to address this issue head-on, the flexibility that the Delaware Limited Liability Company Act allows for contracting parties could result in ambiguity and potential personal liability risk for the unwary private equity professional.

The Delaware Limited Liability Company Act makes clear that the members of a limited liability company can tailor the requisite fiduciary duties in any number of ways: they can contractually agree to the same fiduciary duties as directors in a corporation, they can eliminate such duties altogether, or they can choose to modify or expand the duties as they see fit.[2] The decision of whether to exercise this flexibility is often heavily negotiated among contracting parties and focuses on the central question of what is the appropriate level of protection for minority equity holders. For example, a new platform company may be formed by a sponsor majority holder and minority co-investors as a Delaware limited liability company. The sponsor may have the right to appoint a majority of the Board. Should the sponsor's designees have the same fiduciary duties as directors

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- Weil advised Advent International in its acquisition of a majority interest in AOT Bedding Super Holdings, the parent company of National Bedding Company and Simmons Bedding Company
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of a corporation? This would create additional liability on the part of the sponsor designees, but at the same time provide additional protection to the other members. Alternatively, should all fiduciary duties be eliminated and the other members rely on negotiated-for contractual rights (i.e., vetoes on enumerated actions by the Board and/or management)? In this scenario, the liability of the sponsor designees is removed, but the minority members may have concerns about whether the enumerated vetoes are substantial enough to adequately protect their interests. Furthermore, it may be difficult for parties to accurately foresee all potential issues down the road for which to provide contractual remedy. Fiduciary duty requirements focus on principles rather than precise scenarios. Majority equity holders prefer to exercise the flexibility and eliminate fiduciary duties, oftentimes arguing that the parties are sophisticated and should specifically negotiate the rights and obligations of the parties in a closely held company (including potentially minority protections such as veto rights or preemptive rights). Further, they are likely to argue that the imposition of fiduciary duties only serves as a second bite at the apple for a potential disgruntled minority holder. This line of thinking argues that sophisticated parties can provide more precisely for the necessary protections through contractual means. Minority equity holders often argue that the choice of entity should in no way result in granting the majority holder the ability to control the enterprise in a manner that might not be in the best interests of all equity holders (i.e., the decision to use a limited liability company is based on primarily tax or other structural considerations, but that decision should not affect the fiduciary duties that would otherwise exist if a corporation was chosen).

The question of whether fiduciary duties apply in a limited liability company is often front and center in negotiations. However, sometimes parties either never address the issue or affirmatively decide to remain silent in the definitive legal agreements as a result of a stalemate in the negotiations or otherwise. For many years, the commonly held belief has been that traditional fiduciary principles apply in a limited liability company by "default" if the members did not take such action to explicitly eliminate, modify, or expand such fiduciary duties. This position was most recently supported in January 2012 by Judge Strine's opinion in *Auriga*. Although the issue of default fiduciary duties was not the crux of the case, Judge Strine stated that limited liability company managers are charged with the fiduciary duties of a corporate board, and, to eliminate such duties, the parties must contractually agree otherwise. However, on appeal, the Delaware Supreme Court this month has thrown this line of thinking into doubt. The court indicated that the question of whether the Delaware Limited Liability Company Act has default fiduciary duties has not been answered to date in Delaware, and that any prior Chancery or other Delaware court decisions to the contrary shall have no precedential value.

The key takeaway from *Auriga* is that silence in a limited liability company agreement will only result in ambiguity. Deal professionals and lawyers would be well advised to affirmatively provide in the applicable contract whether fiduciary duties exist or not, and if they do exist, to what extent. Each deal will have its own particular facts and circumstances, but majority and minority members alike would be well advised to address the issue head-on. As a second takeaway, deal lawyers and professionals are reminded to consider whether certain customary provisions in a limited liability company agreement (i.e., veto rights, preemptive rights on new equity issuances, corporate opportunity clauses, etc.) create or affect fiduciary duties or at the very least consider how the existence of such provisions impact any general statements about the existence, lack, or modification of fiduciary duties. In every transaction involving a Delaware limited liability company, it is imperative for private equity professionals to consider if and to what extent fiduciary duty calls.

1 It is important to note that Delaware partnership law provides "default" fiduciary duties similar to a corporation, although they can be modified, expanded or eliminated. This is unlike the Delaware LLC Act which does not provide for such "default" fiduciary duties in any express fashion, although many practitioners have operated under the belief that a similar result applies with respect to Delaware limited liability companies.

2 It is important to note the one exception: under Delaware law, a contract cannot modify or eliminate the implied covenants of good faith and fair dealing.

If you would like more information about the contents of this issue, or about Weil's Private Equity practice, please speak to your regular contact at Weil or to the editors or authors.

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