

December 3, 2012

Delaware Supreme Court Weighs in on Fiduciary Duties as Default Standard Under Limited Liability Company Act

In the recent decision *Gatz Properties LLC v. Auriga Capital Corporation*, the Delaware Supreme Court affirmed the Delaware Court of Chancery’s January 2012 decision in *Auriga Capital Corporation v. Gatz Properties*. In January of this year, the Court of Chancery held that a controlling member and manager of a limited liability company breached his fiduciary duties to the company’s minority members because the process by which he purchased the limited liability company from the minority members did not result in the payment of a fair price under the entire fairness standard of review. In affirming the decision, the Supreme Court stated that the question of whether the default standard under the Delaware Limited Liability Company Act is that a manager owes fiduciary duties to the members of a limited liability company remains unanswered and should not have been addressed by the lower court. Until this question is answered definitively, members of limited liability companies should clearly state in the limited liability company agreement whether and to what extent the company’s managers or controlling persons should have any fiduciary duties to the members.

Background

This case arose out of the 2009 sale of Peconic Bay, LLC, a Delaware limited liability company (“Peconic Bay”), an entity formed by Gatz Properties, LLC (“Gatz Properties”) and a number of minority investors (the “Minority Members”) for the purpose of leasing and developing a golf course on property owned by the Gatz family. The Amended and Restated Limited Liability Company Agreement (the “LLC Agreement”) for Peconic Bay designated Gatz Properties as the manager. Gatz Properties was in turn managed and controlled by William Gatz (“Gatz”). In 1998, Peconic Bay entered into a long-term sublease with a national golf course operator. By 2005, Gatz was aware that the golf course operator intended to exercise its early termination right in 2010 and hired an appraiser who valued the land at \$10.1 million with golf course improvements and at \$15 million as vacant land available for development. In 2007, Gatz was approached by RDC Golf Group, Inc. (“RDC”) with an offer to acquire the long-term sublease. Although Gatz refused to provide due diligence materials to RDC, RDC submitted two proposals, each of which was rejected by the Peconic Bay members. In response to a request from the Minority Members that Gatz determine RDC’s interest in a deal at \$6 million, Gatz told RDC that an offer “well north of \$6

million” would be required to continue discussions. RDC indicated it was willing to proceed on those terms, but Gatz failed to respond and told the Minority Members that negotiations had broken off without informing them of RDC’s continued interest. Gatz then offered the Minority Members approximately \$700,000 for their interests in Peconic Bay, which the Minority Members rejected. For the next year, Gatz pursued a course of action that led to a sale of Peconic Bay as a distressed asset in a poorly run auction. Gatz was the only bidder at the auction and purchased Peconic Bay for \$50,000 cash plus assumption of its debt, yielding proceeds to the Minority Members well below what they would have received had Peconic Bay been sold to RDC in the previously proposed transactions. The Minority Members sued for money damages based on, among other things, breach of fiduciary and contractual duties.

Analysis

The Supreme Court upheld the Chancery Court’s decision regarding Gatz’s liability for breach of fiduciary duty; however, it based its decision “exclusively on contractual grounds” and not on the existence of any “‘default’ fiduciary duties” under Delaware’s limited liability company statute.

In determining that Gatz owed fiduciary duties to the Minority Members of Peconic Bay, the Supreme Court reviewed *de novo* the contract interpretation issues. The Supreme Court interpreted the relevant LLC Agreement provision, which required agreements between Peconic Bay and related parties to be on terms and conditions no less favorable than those that could be obtained from “arms-length third parties”, to be the “contractual equivalent of the entire fairness equitable standard of conduct.” Under this standard, Gatz was required to establish the fairness of the transaction since his acquisition of Peconic Bay had not been approved by the informed vote of the holders of two-thirds of the interests in Peconic Bay held by unconflicted members, as required under the LLC Agreement. After reviewing the Chancery Court’s factual findings and the trial proceedings, the Supreme Court was satisfied that Gatz had failed to carry his burden of proof and held that Gatz had violated his contractual fiduciary duties based on, among other things, his refusal to negotiate with RDC and his subsequent sale of Peconic Bay “to himself at an unfair price in a flawed auction.” The Supreme Court also upheld the Chancery Court’s finding that Gatz was not entitled to the benefit of the exculpation and indemnification provisions in the LLC Agreement because he acted in bad faith and made willful misrepresentations to the Minority Members.

Notably, the Supreme Court stated that whether the managers and controllers of a limited liability company are subject to “default” fiduciary duties under the Delaware Limited Liability Company Act is an issue about which “reasonable minds could differ.” The Supreme Court also noted that it was unnecessary for the Chancery Court to decide “*sua sponte*, the default fiduciary duty issue” in this case because dispute over the application of fiduciary standards was determinable “solely by reference to the LLC Agreement” and no litigant had asked the Chancery Court to decide this issue as a matter of statutory law. For these reasons, among others, the Supreme Court held that the Chancery Court’s “statutory pronouncements must be regarded as dictum without any precedential value.”

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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