

IV. Delaware Supreme Court's Rulings Regarding Fiduciary Duties in Alternative Entities

A. Introduction

The Delaware Supreme Court recently decided two cases regarding the modification of fiduciary duties in alternative entities.¹ In *Gerber v. Enter. Prods. Holdings, LLC*, the Delaware Supreme Court confirmed that default fiduciary duties in such entities may be contractually modified, except the implied covenant of good faith and fair dealing (the “implied covenant”).² In *Allen v. Encore Energy Partners, L.P.*, the Delaware Supreme Court held further that operating agreements could properly modify fiduciary duties by replacing them with a subjective standard.³ Both cases turn on “significant nuanced substantive differences” in the language of the operating agreements,⁴ which limits the scope of the holdings, but provides clear precedent for practitioners.

This article will address the questions these cases raise about the future of fiduciary duties in alternative entities. Part B will explain the background law. Part C will summarize the cases leading up to *Gerber* and *Allen*. Part D will review *Gerber*, and Part E will discuss *Allen*. Part F analyzes what these cases mean for companies going forward.

B. Background and Applicable Law

1. Fiduciary Duties

Fiduciary duties generally arise when someone trusts and relies on another's judgment in certain circumstances or where one has a special duty to protect another's interests.⁵ Fiduciary duties,

¹ Thomas A. Mullen & Janine M. Salomone, *Delaware Insider: MLPs Take Center Stage in the Court*, BUS. L. TODAY, Aug. 2013, at 1, available at www.americanbar.org/publications/blt/2013/08/delaware_insider.html.

Limited liability companies and limited partnerships are examples of alternative entities: entities that are an alternative to the corporate form. *Id.*

² *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400, 419–20 (Del. 2013).

³ *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 95 (Del. 2013).

⁴ *DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chi., Ill.*, 75 A.3d 101, 106 (Del. 2013).

⁵ John J. Hanley & Austin D. Keyes, *Fiduciary Duties for Managers of*

important to corporate structure, protect members who lack control.⁶ The Delaware Court of Chancery has explained that corporate directors hold default “fiduciary responsibilities of care, loyalty, and ‘good faith.’”⁷

Limited liability company managers and limited partnership general partners are also subject to the duty of loyalty—requiring they act in the company’s best interests and avoid conflicts of interest—and the duty of care—requiring they act as a prudent individual would.⁸ These duties protect reasonably informed fiduciaries acting in good faith.⁹

2. Corporate Fiduciary Duties

Corporate fiduciary duties differ from the fiduciary duties in alternative entities. Under Delaware General Corporation Law section 102(b)(7), corporations may modify directors’ liability so that directors are not liable for monetary damages for breaches of the fiduciary duty of care.¹⁰ Section 102(b)(7) specifically states that directors may still be liable for certain acts, including breaching the duty of loyalty and acting in bad faith.¹¹ Corporate law, however, is “not automatically applicable” to alternative entities,¹² though the Delaware courts often analogize when the applicable Delaware law is similarly worded.¹³

Delaware Limited Liability Companies, CARTER LEDYARD & MILBURN LLP (June 28, 2013), <http://www.clm.com/publication.cfm?ID=444>.

⁶ Mullen & Salomone, *supra* note 1, at 3–4.

⁷ SIMON M. LORNE & JOY MARLENE BRYAN, ACQUISITIONS AND MERGERS: NEGOTIATED AND CONTESTED TRANSACTIONS § 2:6 (2013) (citing *Lynch v. Vickers Energy Corp.*, 383 A.2c 278 (Del. 1977)).

⁸ Hanley & Keyes, *supra* note 5. *See also* TAMAR FRANKEL, LEGAL DUTIES OF FIDUCIARIES: DEFINITIONS, DUTIES AND REMEDIES 135 (2012).

⁹ Hanley & Keyes, *supra* note 5.

¹⁰ DEL. CODE ANN. tit. 8, § 102(b)(7) (2013).

¹¹ *Id.*

¹² Vincent P. Schmeltz et al., *United States: Subjective vs. Objective: Beliefs Matter For Fiduciaries Of Delaware Limited Liability Partnerships And Limited Liability Companies*, MONDAQ (Aug. 5, 2013), <http://www.mondaq.com/unitedstates/x/255878/Corporate+Governance/Subjective+vs+Objective+Beliefs+Matter+For+Fiduciaries+Of+Delaware+Limited+Liability+Partnerships+And+Limited+Liability+Companies>.

¹³ *Sanders v. Ohmite Holdings, LLC*, 17 A.3d 1186 (Del. Ch. 2011) (“Delaware courts have interpreted Section 18-305 by looking to cases

3. The Delaware Limited Liability Company Act

Under the Delaware Limited Liability Company Act, parties may provide for fiduciary duties in the entity's governing document.¹⁴ This flexibility follows one of the Act's main objectives: to "give maximum effect to the principle of freedom of contract and to the enforceability of" agreements.¹⁵ Courts first look to the entity's governing document to determine what fiduciary duties apply.¹⁶ The Act grants wide latitude to contracting parties, specifically providing that fiduciary duties may be expanded, limited, or eliminated,¹⁷ while explicitly stating that parties cannot eliminate the implied covenant of good faith and fair dealing.¹⁸

C. Early Delaware Supreme Court Decisions

The Delaware Limited Liability Company Act left open the question of default fiduciary standards open, meaning that parties must "specifically provide[]" in the governing document what default duties the controlling members or managers owe.¹⁹ Several recent cases interpreting Delaware's Limited Liability Company Act and Revised Uniform Limited Partnership Act have clarified that alternative entities can "contractually modify or eliminate" the

interpreting similar Delaware statutes concerning corporations and partnerships.") (internal quotes and citation omitted).

¹⁴ DEL. CODE ANN. tit. 6, § 18-1101 (2013); *see also* Hanley & Keyes, *supra* note 5 ("While the Delaware Limited Liability Company Act ('LLC Act') does not impose fiduciary duties of loyalty and care on a manager, it does allow parties to contract for these fiduciary duties in an LLC operating agreement.").

¹⁵ Hanley & Keyes, *supra* note 5; *see also* DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chi., Ill., No. 547, 2012, 2013 Del. Lexis 430, at *13 (Del. Aug. 26, 2013) ("[T]he Delaware Revised Uniform Limited Partnership Act is intended to give 'maximum effect to the principle of freedom of contract.'" (quoting Allen v. Encore Energy Partners, L.P., 72 A.3d 93, 95 (Del. 2013))).

¹⁶ Hanley & Keyes, *supra* note 5.

¹⁷ *Id.* (citing § 18-1101(c)).

¹⁸ § 18-1101(c) ("[T]he limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.").

¹⁹ Schmeltz et al., *supra* note 12.

default fiduciary “duties of loyalty, care and candor.”²⁰ However, these cases also confirmed that, as the Act explicitly states, parties cannot modify the implied covenant of good faith and fair dealing.²¹

These cases demonstrate an increasing leniency from courts addressing alternative entities’ modifications of default fiduciary duties, with the Delaware Supreme Court reading governing documents more and more broadly. In *Gatz Properties, LLC v. Auriga Capital Corp.*, the Delaware Supreme Court held that no “magic words” were required in governing documents, but rather the “operative language” must be “[v]iewed functionally.”²² In *Brinckerhoff v. Enbridge Co., Inc.*, the Delaware Supreme Court accepted a limited partnership agreement’s provisions eliminating the general partner’s personal liability if the general partner and affiliates acted in good faith.²³ The *Brinckerhoff* court further held that the standard for bad faith, requires the actor to “have been ‘so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.’”²⁴ In *Norton v. K-Sea Transp. Partners L.P.*, the Delaware Supreme Court held that a partnership agreement imposing a good faith standard was satisfied by the general partner’s reliance on a fairness opinion from the conflicts committee.²⁵ The plaintiffs had no reasonable contractual basis to expect anything further from the general partner as a fiduciary.²⁶ The *Norton* court “declined to address any implied covenant claims based upon the plaintiff’s abandonment of such claims on appeal.”²⁷

D. *Gerber v. Enterprise Products Holdings, LLC*

In *Gerber*, limited partners alleged that the general partner had breached contractual and fiduciary duties by agreeing to transactions that were “neither fair nor reasonable” for the entity.²⁸

²⁰ *Id.*

²¹ *See, e.g., Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400, 417–23 (Del. 2013).

²² 59 A.3d 1206, 1213 (Del. 2012).

²³ 67 A.3d 369, 370 (Del. 2013).

²⁴ *Id.* at 373.

²⁵ 67 A.3d 354, 356 (Del. 2013).

²⁶ *Id.*

²⁷ Mullen & Salomone, *supra* note 1, at 2.

²⁸ *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400, 408–09 (Del. 2013).

The partnership agreement had replaced the default fiduciary duties with a good faith standard.²⁹ The Court of Chancery dismissed the claims arising under the good faith standard and under the implied covenant of good faith and fair dealing, relying on the conflicts committee's special approval of each transaction in accordance with the governing document.³⁰

The Delaware Supreme Court affirmed the dismissal of the good faith claims but reversed the dismissal of the implied covenant claims.³¹ The Delaware Supreme Court held that the limited partnership agreement's "conclusive presumption of good faith" did not "bar a claim under the implied covenant."³² Furthermore, the *Gerber* court found that the limited partners had adequately pled breaches of the implied covenant by alleging a "manifestly unfair transaction" with "the type of arbitrary, unreasonable conduct that the implied covenant prohibits."³³

In earlier decisions, the Delaware Supreme Court gave broad effect to alternative entities' governing documents by viewing the actual effect of such agreements, rather than requiring specific words to trigger fiduciary duties.³⁴ The Delaware Supreme Court gave effect to the duties and levels of such duties as altered in the governing documents.³⁵ In *Gerber*, the Delaware Supreme Court expanded the contractual freedom of alternative entities by holding

²⁹ Mullen & Salomone, *supra* note 1, at 2.

³⁰ *Gerber*, 67 A.3d at 410 ("[A] provision created four 'safe harbors' within which the general partner and its 'Affiliates' could effectuate a conflict of interest transaction free of any claim that they breached. . . . The first of those four enumerated safe harbors—"Special Approval" is implicated in this case.").

³¹ Mullen & Salomone, *supra* note 1, at 2.

³² *Gerber*, 67 A.3d at 418; *see also* Mullen & Salomone, *supra* note 1, at 2 ("The Court reasoned that the contractual good faith standard was distinct from the implied covenant of good faith and fair dealing, and that the conclusive presumption provision applied only to the contractual good faith standard. In addition, the Court concluded that the conclusive presumption provisions could not eliminate the implied covenant because the Delaware limited partnership statute expressly provides that a partnership agreement may not do so.").

³³ Mullen & Salomone, *supra* note 1, at 2.

³⁴ *See* *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1213 (Del. 2012).

³⁵ *Brinckerhoff v. Enbridge Co., Inc.*, 67 A.3d 369, 370 (Del. 2013); *Norton v. K-Sea Transp. Partners L.P.*, 67 A.3d 354, 356 (Del. 2013).

that such entities may modify or eliminate any fiduciary duties other than the implied covenant.³⁶

E. *Allen v. Encore Energy Partners, L.P.*

The *Allen* case arose from the merger of a publicly traded Delaware limited partnership.³⁷ William Allen, a limited partner, alleged that the general partner, its controller, and its directors had breached their fiduciary duties.³⁸ The Delaware Court of Chancery dismissed the complaint, and the Delaware Supreme Court affirmed, because the governing document had modified the fiduciaries' duties.³⁹

The Delaware Supreme Court affirmed the Delaware Court of Chancery's dismissal, finding that fiduciary duties in limited liability partnerships may be held to a subjective standard if the governing document clearly declares such a standard.⁴⁰ Relying on the document's clear wording, the Delaware Supreme Court found that the agreement's contractual "good faith" standard was satisfied by a subjective belief that one was acting in the company's best interest.⁴¹ Allen failed to meet the pleading burden, which he could have met only by pleading that either (1) "the conflicts committee believed it was acting against [the company's] best interest," or (2) "the conflicts committee consciously disregarded its duty" to form an opinion that the actions were in the company's best interest.⁴²

The *Allen* decision confirms that Delaware courts will accept contractually modified fiduciary duties in governing documents and will not use corporate or tort law standards of conduct when the agreement properly modifies the default duties.⁴³ This effectively lowers the standard to which fiduciaries of alternative entities are held.⁴⁴

³⁶ Mullen & Salomone, *supra* note 1, at 4.

³⁷ *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 95–96 (Del. 2013).

³⁸ *Id.* at 96.

³⁹ *Id.* at 110.

⁴⁰ *Id.* at 100.

⁴¹ *Delaware LLC & Partnership Law Update: Allen v. Encore Energy Partners, L.P.*, RICHARDS LAYTON & FINGER (July 23, 2013), <https://www.rlf.com/KnowledgeCenter/EAlertsNewsletters/4744> [hereinafter RICHARDS LAYTON & FINGER].

⁴² *Id.*

⁴³ *Id.*

⁴⁴ Schmeltz et al., *supra* note 12.

F. Moving Forward

1. What Do These Decisions Mean for Companies?

Together, these cases explain that alternative entity governing agreements can contractually modify fiduciary duties and replace them with subjective standards, but they cannot eliminate the implied covenant.⁴⁵ Moreover, since many concepts from corporate law are not “automatically applicable” in the alternative entity context, parties must specifically draft any desired rights into the governing document.⁴⁶ Members of alternative entities can rely on the agreement to be enforced as written, including additions, limitations, and eliminations of duties except the implied covenant.⁴⁷ This flexibility in forming contractual duties may provide significant protections for fiduciaries,⁴⁸ but potentially less protection for members.⁴⁹ On the other hand, the *Gerber* decision has made some practitioners wary that Delaware courts may use the implied covenant to impose traditional fiduciary duties otherwise contractually supplanted.⁵⁰

One common way governing documents contractually modify fiduciary duties is by requiring that the fiduciary act as he or she believes is in the company’s best interests.⁵¹ Whether or not such beliefs are ultimately held to an objective or subjective standard can drastically impact whether the fiduciary is liable for a breach.⁵² In *Allen*, the Delaware Supreme Court clarified that the fiduciary’s belief should be reviewed under a subjective standard unless it is qualified in the governing agreement by a reasonableness requirement.⁵³ However, the objective reasonableness of actions may be relevant in determining whether

⁴⁵ Mullen & Salomone, *supra* note 1, at 3.

⁴⁶ Schmeltz et al., *supra* note 12.

⁴⁷ Mullen & Salomone, *supra* note 1, at 3.

⁴⁸ RICHARDS LAYTON & FINGER, *supra* note 41.

⁴⁹ Mullen & Salomone, *supra* note 1, at 3–4.

⁵⁰ *Id.* (“[*Gerber*] suggests that a Delaware court may use the implied covenant as a means to import a contract-based duty (and to ‘do equity’) when traditional fiduciary [sic] duties have otherwise been effectively eliminated or replaced by contractual standards.”).

⁵¹ Schmeltz et al., *supra* note 12.

⁵² *Id.*

⁵³ *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 107 (Del. 2013).

the subjective standard is met, such as where actions are so unreasonable they constitute subjective bad faith, or where the defendant knows objective facts indicating the actions are not in the company's best interests.⁵⁴

The *Gerber* and *Allen* decisions are likely to affect the drafting of governing documents, depending on whether the drafter favors protection for fiduciaries or for the entity and unaffiliated participants.⁵⁵ The holdings may also affect litigation, as plaintiffs must plead based on the governing agreement.⁵⁶ Furthermore, pleading a breach of subjective good faith is a high bar, and thus more cases may be dismissed.⁵⁷

2. Are Differences Between Corporations & Alternative Entities Disappearing?

In the past, businesses found alternative entities attractive due to the higher level of protection these entities provide compared to corporations, but these cases call that preference into question.⁵⁸ Safe harbor provisions, such as the one in *Gerber*, may encourage board members to rely on experts and allow independent directors to make decisions in a manner similar to how corporations protect themselves from liability.⁵⁹ However, alternative entities, unlike corporations, have the additional burden of the implied covenant, and *Gerber* clarified that reliance on safe harbor provisions is still subject to the implied covenant.⁶⁰ This may result in drafters attempting to avoid the implied covenant by adopting provisions that are less protective of investors.⁶¹ *Gerber* might even “have the unintended effect of

⁵⁴ Mullen & Salomone, *supra* note 1, at 3.

⁵⁵ Schmeltz et al., *supra* note 12.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Mullen & Salomone, *supra* note 1, at 4.

⁵⁹ *Id.* (“One way to view the safe harbors contained in MLP agreements is as an attempt to achieve the functional equivalent of the business judgment rule for conflict transactions.”). See *supra* note 30 and accompanying text.

⁶⁰ Mullen & Salomone, *supra* note 1, at 2.

⁶¹ *Id.* at 4 (“After *Gerber*, not only may general partners be inclined to think twice before referring matters to an independent committee, but drafters of MLP agreements and other partnership and LLC agreements may look to other contractual methods that are less protective of the unaffiliated investors but more likely to avoid scrutiny under the implied covenant.”).

encouraging deal planners to use corporations when alternative entities would otherwise be more appropriate.”⁶²

3. Remaining Open Questions

a. Are There Default Fiduciary Duties in Alternative Entities?

The Delaware Limited Liability Company Act does not specify whether default fiduciary duties other than the implied covenant exist where an agreement is silent.⁶³ In *Auriga*, the Chancery Court found default fiduciary duties by referencing the principles behind the Act and by analogizing to the Delaware General Corporations Law, where the statute is similarly silent and courts apply default fiduciary duties.⁶⁴ The Delaware Supreme Court described the Chancery Court’s discussion as “improvident and unnecessary.”⁶⁵ Despite this, the Chancery Court held again that default fiduciary duties exist in *Feeley v. NHAOCG, LLC*.⁶⁶ The Delaware State Bar Association drafted an amendment, introduced to the legislature in May 2013, stating that “managers owe default fiduciary duties of loyalty and care, absent an express agreement to the contrary.”⁶⁷ This amendment would resolve the uncertainty without changing parties’ ability to modify duties.⁶⁸

⁶² *Id.*

⁶³ DEL. CODE ANN. tit. 6, § 18-1101 (2013). Other states (including California, the District of Columbia, Idaho, Iowa, Nebraska, New Jersey, and Wyoming) do include default fiduciary duties in their LLC statute. Moreover, similarly vague LLC acts in other states, including New York and Connecticut, tend to be interpreted by the courts as including default fiduciary duties. See Hanley & Keyes, *supra* note 5.

⁶⁴ Hanley & Keyes, *supra* note 5.

⁶⁵ Gatz Properties, LLC v. Auriga Capital Corp., 59 A.3d 1206, 1218 (Del. 2012).

⁶⁶ 62 A.3d 649 (Del. Ch. 2012).

⁶⁷ Hanley & Keyes, *supra* note 5.

⁶⁸ *Id.*

b. Does Secondary Liability for Breach of the Implied Covenant Exist?

Whether one can aid and abet a breach of the implied covenant is another open issue.⁶⁹ The Court of Chancery has recognized secondary liability in a breach of contractual fiduciary duty.⁷⁰ In *Gerber*, the Delaware Supreme Court remanded the question of secondary liability.⁷¹ The answer will be especially important for limited partnerships, where the general partner may be a shell company that is immune from liability, and the true actors are the directors and parent company.⁷²

c. Can Directors be Contractually Exculpated?

Gerber made it clear that fiduciaries are “subject to monetary damages claims” if they breach the implied covenant.”⁷³ Thus, these cases also opened the issue of whether directors could be contractually exculpated for breaches of the implied covenant, or from secondary liability claims arising from such actions.⁷⁴

G. Conclusion

The cases clarify the extent to which fiduciaries owe default duties in an alternative entity. In *Allen*, the Delaware Supreme Court held that “clear, express and unambiguous language modifying default fiduciary duties will be enforced,” even if it is a subjective standard.⁷⁵ In *Gerber*, the Delaware Supreme Court confirmed that the implied covenant cannot be contractually modified, though other fiduciary duties may be.⁷⁶ With these clarifications, alternative entities must be “explicit and unambiguous” in governing documents regarding what contractual duties are owed by the managers and

⁶⁹ Mullen & Salomone, *supra* note 1, at 4.

⁷⁰ *Id.*

⁷¹ *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400, 416 (Del. 2013).

⁷² Mullen & Salomone, *supra* note 1, at 4.

⁷³ *Id.*

⁷⁴ *Id.*; see also *Gerber*, 67 A.3d at 425–26.

⁷⁵ RICHARDS LAYTON & FINGER, *supra* note 41.

⁷⁶ *Gerber*, 67 A.3d at 417–18.

controlling partners in order to overcome the default duties.⁷⁷ Despite several open issues, alternative entities still provide more flexibility in drafting contractual duties, offering significant protections to fiduciaries,⁷⁸ albeit possibly at the expense of the other members.⁷⁹

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⁷⁷ Hanley & Keyes, *supra* note 5.

⁷⁸ RICHARDS LAYTON & FINGER, *supra* note 41.

⁷⁹ Mullen & Salomone, *supra* note 1, at 3–5.

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