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Delaware Supreme Court Interprets Contractual Fiduciary Duties of LLC Manager as Requiring Entire Fairness Review

In *Gatz Properties, LLC v. Auriga Capital Corp.*, the Delaware Supreme Court affirmed the Court of Chancery's decision that a limited liability company's controlling member-manager breached his contracted-for fiduciary duties when he refused to negotiate with a third party bidder and caused the company to sell itself to him at an unfair price via a faulty auction process. The Court declined to consider whether fiduciary duties are imposed by default on managers or members of Delaware LLCs where the operating agreement of the entity fails to address the issue.

The limited liability company in *Gatz* was formed to finance and develop a golf course on a property belonging to the company's member-manager, which was controlled by William Gatz, who along with his family owned a controlling interest in the LLC. The company held a 40-year lease on the property, which it in turn subleased to a third party who operated the course, but was unable to generate a profit.

Knowing that the golf course was unprofitable and that the sublessee was going to exercise its termination option under the sublease, Gatz commissioned an appraisal that showed that the land was worth more as vacant land available for development than as a golf course. Gatz, therefore, had an incentive to squeeze out the LLC's minority members so that he could re-acquire the property.

During this time, a third party made multiple overtures of interest in taking over the lease and sublease, but Gatz refused to engage in meaningful negotiations. Gatz instead offered to buy out the minority investors' interests at a price less than the third party indicated that it would consider offering. Gatz also failed properly to inform the minority investors about the extent of the third party's offer.

The minority investors rejected Gatz's offer, and he then exercised his majority voting power to approve a proposal for the company to auction off its assets. Gatz hired an auctioneer who specialized in "debt related" sales and had no experience with golf course auctions. The record indicated that the auctioneer did not contact any golf course brokers, managers or operators, but instead relied on a series of small-print classifieds in newspapers and magazines and online advertisements to publicize the auction. Moreover, Gatz failed to tell the auctioneer about the third party's previous offers to purchase the lease and sublease, or suggest that the third party may still be interested. As a result, Gatz was the auction's only bidder and he purchased the company for less than 3% of the amount that he and the third party had previously indicated that they were willing to offer.

The Supreme Court affirmed the Court of Chancery's holdings that the LLC agreement imposed contractually-agreed-to fiduciary duties on Gatz, which duties had been violated by

Gatz's various bad faith actions and misrepresentations to the minority holders during the sale process. The "operative language" of the LLC agreement provided that Gatz, without majority-of-the-minority consent, could not cause the LLC to enter into any transaction with affiliates on terms and conditions which were "less favorable to the [c]ompany than the terms and conditions of similar agreements which could then be entered into with arms-length third parties." Noting that Delaware law does not mandate "that an LLC agreement use magic words, such as 'entire fairness' or 'fiduciary duties'" to "impose fiduciary standards of conduct as a contractual matter," the Supreme Court held that the LLC provision described above contained "an explicit contractual assumption" that required the manager to "obtain a fair price for the LLC in transactions between the LLC and affiliated persons."

The Supreme Court decided, therefore, that the LLC agreement contained the contractual equivalent of the "entire fairness" standard found in Delaware corporation law and that Gatz had the burden of showing fair dealing and fair price. If Gatz had conditioned the transaction upon the approval of an informed majority-of-the-minority vote, the Supreme Court said that "the sale of the LLC would not have been subject to, or reviewed under, the contracted-for entire fairness standard." Notably, this result would differ from the outcome under Delaware corporate law where a similar vote would only shift the burden of proof and an aggrieved stockholder would then be required to show that the transaction was not entirely fair.

Following the decision of the Supreme Court, the question of whether the Act imposes fiduciary duties on parties to an LLC agreement by default remains an open issue under Delaware law.

For the Gatz opinion, see <http://www.paulweiss.com/media/1320928/gatzopinion.pdf>.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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