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## Fiduciary Liability of LLC Managers and Members

A limited liability company (“LLC”) is a business entity form that combines the features of a corporation and a partnership. LLCs are generally viewed as a more flexible alternative to the corporate form, with operations and management that can be freely structured by its members, including the ability to limit or eliminate the types of fiduciary duties imposed upon corporate directors and controlling stockholders.

Section 18-1101 of the Delaware Limited Liability Company Act provides that the duties (including fiduciary duties) of a member or manager of a limited liability company “. . . may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.” Recent Delaware opinions, as well as New York opinions applying Delaware law, have taken the position that, in order to limit or eliminate the traditional fiduciary duties of care and loyalty, a limited liability company agreement provision must be clear and comprehensive.

### Delaware Opinions

In *Bay Center Apartments Owner LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS (Del. Ch. 2009), the plaintiff and defendant were the sole members of an LLC that was created to develop a condominium project. The plaintiff alleged that the defendant’s mismanagement of the project led to the project’s eventual failure and the plaintiff brought suit against the defendant for breach of contract and fiduciary duties. Despite the defendant’s claim that the LLC agreement did not provide for any fiduciary duties, the Court refused to dismiss the claims. The Court stated: “The Delaware LLC Act gives members of an LLC wide latitude to order their relationships, including the flexibility to limit or eliminate fiduciary duties. But, in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC.” The Court noted that the “LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation.”

In *re Atlas Energy Resources, LLC Unitholder Litigation*, C.A. No. 4589-VCN (Del. Ch. 2010) involved a merger arranged by a corporate controlling member of an LLC with the LLC. The minority members of the LLC complained that the merger was unfair as to them and that the controlling member breached its fiduciary duties to them. The controlling member moved to dismiss the suit on the grounds that the LLC operating agreement contained provisions regarding dealings between the controlling member and the LLC and that the controlling member had complied with those provisions.

The Court stated:

“Limited Liability Companies are creatures of contract, designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved. One aspect of this flexibility is that parties to a limited liability agreement can contractually expand, restrict, modify, or fully eliminate the fiduciary duties owed by the company or its members, subject to certain limitations. By contrast, in the absence of explicit provisions in a limited liability company agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the limited liability company context.”

The Court then reviewed the provisions of the LLC agreement which provided a methodology for dealing with conflicts of interest between a member of the LLC and the LLC itself. The Court determined, however, that the conflict was not between a member and the LLC, but between the controlling member and the minority members. As this latter conflict was not addressed in the LLC agreement, the Court determined that there was no preclusion to the minority members' fiduciary breach suit and that the merger needed to be treated under the entire fairness standard.

## New York Opinions

In *Melcher v. Apollo Medical Fund Management, LLC*, 923 N.Y.S.2d 92 (1st Dept 2011), the plaintiff, a member of a Delaware LLC, argued that the defendant breached his fiduciary duties by diverting fees from the LLC to his own investment advisory firm. The defendant manager contended that he did not owe the plaintiff any fiduciary duties because there was no reference to any fiduciary duties in the LLC agreement. The Melcher court rejected the defendant's argument and instead applied the default rules of fiduciary duties affirmed in *Bay Center*. The Court applied Delaware law in determining that because the LLC agreement did not explicitly contain language limiting the fiduciary duties of the managing member of the LLC, the defendant owed the plaintiff the fiduciary duties of care and loyalty.

Despite the willingness of the courts to impose fiduciary duties on managers, the question remains as to whether such fiduciary obligations extend to anyone else. In *Coventry Real Estate Advisors, LLC v. Developers Diversified Realty Corporation*, 923 N.Y.S.2d 476 (1st Dep't 2011), the New York Appellate Court, applying Delaware law, attempted to resolve this question. In *Coventry*, the plaintiff alleged that the defendant, in an effort to maximize personal profits, mismanaged several real estate properties that belonged to the LLC and took advantage of the LLC's weak financial position. According to the LLC agreement, the plaintiff was the sole managing member of the LLC and the defendant was only a non-managing minority member. The plaintiff claimed that in spite of the LLC agreement, the defendant was a de facto managing member and therefore the defendant was bound by and in breach of its fiduciary duties. While the Court reiterated that managers and majority members of LLCs have certain fiduciary duties, the Court rejected the plaintiff's claim that the defendant's conduct could make it a “de facto manager.” The Court determined that fiduciary duties only apply to actual “managers and those designated as controlling members of an LLC,” and that the defendant, as a non-managing minority member, did not have any fiduciary duties and thus dismissed the plaintiff's claims.

## Fiduciary Duties of Controlling Persons

Although the *Coventry* decision suggests that, absent limiting language in the LLC operating agreement, New York courts will only impose traditional fiduciary duties on managers and majority members of an LLC, the Delaware Court's approach to this question is not as clear. In *Bay Center*, the plaintiff alleged a breach of fiduciary duties claim against a defendant who was neither a manager nor a majority member of the LLC. The Court recognized that the defendant fell outside the traditional scope of

those who owe a fiduciary duty to the members of an LLC but refused to dismiss the plaintiff's claim. The Court began its analysis by looking at *In re USACafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1999), a Delaware case holding that affiliates of a general partnership who exercise control over the partnership also owe fiduciary duties to both the partnership and its limited partners. The Court in *Coventry* extended the ruling of *USACafes* regarding a controlling affiliate's duties, holding that because the defendant exercised control over entities that were in fact managing members of the LLC, the defendant himself was also subject to fiduciary duty responsibilities. The Court reasoned that its decision of extending *USACafes* to this case was a "rational and disciplined way of protecting investors in alternative entities . . ."

## Conclusion

These cases illustrate that, in order to contractually limit or eliminate traditional fiduciary duties, the provisions of the LLC agreement must precisely set forth language reflecting the intention to do so. Otherwise, the courts will readily impose the traditional fiduciary duties upon LLC controlling members and managers and, in the circumstances described in *Bay Center* and *USACafes*, may also hold controlling persons of managers liable.

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### Corporate

#### ***New York***

Carlos T. Albarracín  
+1 (212) 408-1081  
[calbarracin@chadbourne.com](mailto:calbarracin@chadbourne.com)

Lara Aryani  
+1 (212) 408-5243  
[laryani@chadbourne.com](mailto:laryani@chadbourne.com)

Marc A. Alpert  
+1 (212) 408-5491  
[malpert@chadbourne.com](mailto:malpert@chadbourne.com)

A. Robert Colby  
+1 (212) 408-5571  
[rcolby@chadbourne.com](mailto:rcolby@chadbourne.com)

William Greason  
+1 (212) 408-5527  
[wgreason@chadbourne.com](mailto:wgreason@chadbourne.com)

Morton E. Grosz  
+1 (212) 408-5592  
[mgrosz@chadbourne.com](mailto:mgrosz@chadbourne.com)

Charles E. Hord, III  
+1 (212) 408-5353  
[chord@chadbourne.com](mailto:chord@chadbourne.com)

Peter K. Ingerman  
+1 (212) 408-5422  
[pingerman@chadbourne.com](mailto:pingerman@chadbourne.com)

Sey-Hyo Lee  
+1 (212) 408-5122  
[shlee@chadbourne.com](mailto:shlee@chadbourne.com)

Jonathan M.A. Melmed  
+1 (212) 408-1002  
[jmelmed@chadbourne.com](mailto:jmelmed@chadbourne.com)

J. Allen Miller  
+1 (212) 408-5454  
[amiller@chadbourne.com](mailto:amiller@chadbourne.com)

Marc M. Rossell  
+1 (212) 408-1057  
[mrossell@chadbourne.com](mailto:mrossell@chadbourne.com)

Edward P. Smith  
+1 (212) 408-5371  
[esmith@chadbourne.com](mailto:esmith@chadbourne.com)

Kevin C. Smith  
+1 (212) 408-1092  
[ksmith@chadbourne.com](mailto:ksmith@chadbourne.com)

#### ***London***

Claude S. Serfilippi  
+44 (20) 7337-8030  
[cserfilippi@chadbourne.com](mailto:cserfilippi@chadbourne.com)

#### ***Washington***

Dana Frix  
+1 (202) 974-5691  
[dfrix@chadbourne.com](mailto:dfrix@chadbourne.com)

Sean P. McGuinness  
+1 (202) 974-5680  
[smcguinness@chadbourne.com](mailto:smcguinness@chadbourne.com)

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