

Delaware Supreme Court Addresses Default Fiduciary Duties

Gatz Properties, LLC v. Auriga Capital Corporation

The Delaware Supreme Court recently released its *per curiam* opinion in the *Gatz Properties, LLC v. Auriga Capital Corporation* case. The opinion has garnered significant attention for its position on default fiduciary duties, that is, the duties that apply in the absence of applicable contract provisions. In this regard, the Court stated that the issue of whether the Delaware Limited Liability Company Act “does – or does not – impose default fiduciary duties is one about which reasonable minds could differ.” And it described the statute as “consciously ambiguous” on this point indicating that the Court did not consider the issue to be settled as a matter of Delaware law. However, the more lasting impact of the case may be its holding respecting fairly common language in the LLC agreement requiring a disinterested member vote for any affiliate transaction that was on terms and conditions “less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arm’s-length third parties.” This language, the Court held, constituted a contractually adopted “fiduciary duty standard of entire fairness, and the ‘fair price’ obligation which inheres in that standard.” Click [here](#) to download the Court’s opinion.

The *Auriga* case involved Peconic Bay, LLC, a Delaware limited liability company (the “LLC”), in which both the manager and the majority member of the two outstanding classes of membership interests were controlled by the Gatz family and their affiliates. The primary asset of the LLC was a ground lease for a property that was used as a golf course and owned by the Gatz family. The LLC entered into a sublease with a national golf course operator. The sublease ran for a term of 35 years, but granted the operator an early termination right after the 10th year of operation. By the 7th year of operation, the Court found that the manager

knew that the golf course operator would elect to terminate the sublease in 2010. Anticipating that, the manager commissioned an appraisal and also began setting aside cash to meet present and future obligations. The dispute in the case centered around the disposition of the assets of the LLC, principally the ground lease. Although the manager hired an appraiser to appraise the property, the Court found that the manager gave the appraiser incomplete information – leading to an artificially low appraisal. In addition, the manager purported to run an auction – often a vehicle for establishing fair market value. However, both the Court of Chancery and the Supreme Court found that only minimal, inadequate marketing efforts were undertaken prior to the auction and, consequently, the only bidder at the auction was the manager who also represented the controlling member. As a result, the Court of Chancery found that the auction was a “sham” and the Supreme Court agreed.

At the conclusion of the “auction,” the managing member purchased the LLC for \$50,000 cash plus assumption of its debt. The minority members collectively received \$20,985 and the “auctioneer” received \$80,000 for his services. The principal legal question before the Court was the construction of a provision in the LLC agreement relating to affiliate transactions. The provision in question prohibited the manager or any other member from causing the LLC to enter into any affiliate transaction “on terms and conditions which are less favorable to the [LLC] than the terms and conditions of similar agreements which could then be entered into with arm’s-length third parties, without the consent of a majority of the non-affiliated Members.” The Court recognized that this contractual language did not use the words “entire fairness” or “fiduciary duties.” The Court nonetheless construed the language “as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons.” “Viewed functionally,” the Court continued “the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.” The Court concluded by stating that the LLC agreement “by its plain language, contractually adopts the fiduciary duty standard of entire

fairness, and the ‘fair price’ obligation which inheres in that standard.”

The Court noted that had the manager conditioned the transaction upon the approval of an informed majority of the non-affiliated members, the sale of the LLC would not have been “subject to, or reviewed under, the contracted-for entire fairness standard.” However, the Court found that there was no majority-of-the-minority approval of the transaction, and, therefore, determined that the burden of establishing the fairness of the transaction fell upon the manager – just as it would under the traditional entire fairness test as developed under Delaware corporate law. This burden shift contrasts with the standard requirements in a breach of contract claim where the plaintiff bears the burden of establishing all of the elements of its claim for breach. Had the Court applied standard breach of contract requirements of pleading and proof, it could have required the plaintiff to demonstrate that the sale transaction was with an affiliate, did not receive disinterested member approval and was on less favorable terms than would be entered into with arm’s-length third parties. Based on the record, it would seem this showing could easily have been made.

The case provides several important lessons to drafters of LLC agreements and possibly other contracts as well. In

the first instance, as the Court has indicated that whether managers and controlling members of a Delaware LLC owe default fiduciary duties is an open question under Delaware law, drafters of LLC agreements should specifically address this issue, providing the contours of any duties they wish to have or indicating their intention to have no fiduciary duties. Perhaps even more significantly, however, drafters of LLC agreements that require affiliate transactions to be on third party terms should make clear whether or not they intend that standard to be a contractual adoption of the entire fairness standard. In particular, drafters of such provisions may wish to address which party bears the burden of proof on the issue of whether an affiliate transaction is on third party terms. In addition, drafters may wish to address specifically the “fair process” prong of the entire fairness test, specifying that it does or does not apply. Finally, it remains to be seen whether the Court’s interpretation of an affiliate transaction provision as a contractual adoption of the entire fairness standard will be applied to contracts beyond the context of LLC agreements and limited partnership agreements.

If you would like to discuss the implications of this decision, please feel free to call a member of the Commercial Law Counseling Group.

Morris Nichols Commercial Law Counseling Group

David Ley Hamilton
(302) 351-9207
dhamilton@mnat.com

David A. Harris
(302) 351-9351
dharris@mnat.com

Tarik J. Haskins
(302) 351-9120
thaskins@mnat.com

Louis G. Hering
(302) 351-9213
lhering@mnat.com

Michael Houghton
(302) 351-9215
mhoughton@mnat.com

Donald Nelson Isken
(302) 351-9222
disken@mnat.com

Walter C. Tuthill
(302) 351-9204
wtuthill@mnat.com

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