Challenging Traditional Thought: No Default Fiduciary Duties in Delaware Limited Liability Companies After Auriga

Peter I. Tsoflias
Ann E. Conaway

Available at: https://works.bepress.com/peter_tsoflias/1/
CHALLENGING TRADITIONAL THOUGHT: NO DEFAULT FIDUCIARY DUTIES IN DELAWARE LIMITED LIABILITY COMPANIES AFTER AURIGA

Professor Ann E. Conaway

Peter I. Tsoflias
I. Background: Chief Justice Myron T. Steele on Default Fiduciary Duties .......... 4

II. The Infrastructure of the DLLCA .......................................................................................... 5
  A. Freedom of Contract ........................................................................................................... 5
  B. Linkage and the Common Law .......................................................................................... 8
  C. Section 18-1101(c) – The Modification or Elimination of Duties in a Delaware LLC Agreement ............................................................................................................................... 10

III. When are Fiduciary Duties Necessary? ............................................................................ 12
  A. General Rule ....................................................................................................................... 12
  B. No Default Duties are Warranted in a Delaware LLC ................................................. 13

IV. Saving Unsophisticated, Unrepresented and Ignorant Parties From the Bargains They Make ................................................................................................................................... 15

V. The “Contractarian” View Applied: *Auriga Capital Corp. v. Gatz Props., LLC* ............. 18
  A. Facts ..................................................................................................................................... 18
  B. Court of Chancery’s Holding & Analysis ........................................................................ 22
     1. Legal Analysis .................................................................................................................. 22
     2. Gatz Breached His Fiduciary and Contractual Duties .................................................. 24
  C. Evaluating the Auriga Decision ....................................................................................... 26
     1. The Court Committed Legal Error by Failing to Interpret the Plain Language of the Agreement Under Clear Standards of Delaware Law .......... 26
     2. The Court Committed Legal Error by Resolving an Issue of Default Fiduciary Duties Where the Limited Liability Company Before the Court Had Modified the Default Form for Delaware LLCs .................................................. 29
        i. Reliance Upon the Catch-all "Law and Equity" Phrase............................................. 30
        ii. Chancellor Strine’s Remaining Justifications ......................................................... 31
     3. Summary ......................................................................................................................... 34

VI. Summation ........................................................................................................................... 34
CHALLENGING TRADITIONAL THOUGHT: NO DEFAULT FIDUCIARY DUTIES IN DELAWARE LIMITED LIABILITY COMPANIES AFTER AURIGA

Professor Ann E. Conaway*
Peter I. Tsoflias ∞

We agree with Chief Justice Myron T. Steele in his article, Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies,1 that the proper default rule for Delaware limited liability companies (“LLCs”) formed under the Delaware Limited Liability Company Act (“DLLCA” or “Act”) is the contractual duty of good faith and fair dealing.2 In this article we invite each reader to set aside bias, pre-conceived legal opinions, and rote legal training and to listen. Hearing each legal argument and searching for— not assuming – the most appropriate answer to the question of default duties is our quest.

To provide context, this article begins by examining Chief Justice Steele’s position on default fiduciary duties. Next, this article analyzes the DLLCA, discussing its objective to give maximum effect to the principle of freedom of contract3 and its lack of linkage to the common law of fiduciary duties.4 This article also posits that, after a reasoned statutory construction of § 18-1101, no default fiduciary duties obviously existed in the DLLCA at the time of its enactment or now.5 This article asserts that

1 See Myron T. Steele, Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies, 46 AM. BUS. L.J. 221 (Summer 2009).
2 See id; discussed infra Part I.
3 See infra Part II.A.
4 See infra Part II.B.
5 See infra Part II.C.
fiduciary duties are unnecessary in the LLC business form, concluding that contract
law is principled upon free bargaining, negotiation of unequal terms in light of market
conditions and bartering in self-interest by all parties. In addition, contract law offers
ample policing tools to account for unsophisticated, unrepresented, and ignorant
parties. Finally, the article examines these principles under the recent Delaware
Chancery Court opinion of Aurga v. Gatz; concluding that the court erred in holding
that fiduciary duties apply by default in a manager-managed LLC.

I. BACKGROUND: CHIEF JUSTICE MYRON T. STEELE ON DEFAULT FIDUCIARY DUTIES

In his article, Freedom of Contract and Default Duties in Delaware Limited Partnership
and Limited Liability Companies, Chief Justice Steele ostensibly concludes that the
contractual duty of good faith and fair dealing is the proper default rule for Delaware
LLCs. In so concluding, Chief Justice Steele focuses his arguments on the Delaware
legislature’s public policy favoring freedom of contract as well as economic rationales
underlying fiduciary duties.

First, the Chief Justice emphasizes that, pursuant to the 2004 amendment to the
Act, the Delaware legislature instructed courts to give full effect to the policy of
freedom of contract. To this end, Chief Justice Steele asserts that, rather than applying
default fiduciary duties (which runs contrary to the general principle of freedom of
contract), courts should apply the contractual duty of good faith and fair dealing.
Doing so, inter alia, promotes contractual customization- a feature that attracts
sophisticated parties to the LLC business form.

Next, Chief Justice Steele analyzes default fiduciary duties from an economic
perspective, concluding that the added costs associated with such duties outweigh the

---

6 See infra Part III.
7 See infra Part IV.
8 See Steele, supra note 1, at 221.
9 See id. at 223-24.
10 See id. at 233-34 (noting that although the legislature has not resolved the issue of default
fiduciary duties, it has apprised courts to give full effect to the principle of freedom of contract).
11 See id. at 234 (“this general principle of freedom of contract announced by the legislature
indicates that courts should not assume that default fiduciary duties apply.”).
12 See Steele, supra note 1, at 222. Chief Justice Steele also expressed concern that courts may look to
fiduciary duties rather than undergo a meticulous contractual interpretation; thereby disregarding the
statutory requirement “to maximize effect to the principle of freedom of contract.” See id. at 235-36.
minimal benefit that they provide. More specifically, the Chief Justice asserts that default fiduciary duties add unnecessary contracting costs to the drafting of LLC agreements. For example, the Chief Justice notes the complexities that arise when parties seek to eliminate some, but not all, fiduciary duties. Such added complexities, Chief Justice Steele argues, frustrate parties’ deliberate choice to use the LLC form, “a highly customizable vehicle.” Further, the Chief Justice acknowledges the unexpected litigation costs that default fiduciary duties often impose upon parties. Notably, Chief Justice Steele asserts that, rather than litigating claims based on contractual interpretation, parties may be forced to focus on rights not provided for in the LLC agreement, namely, unbargained for fiduciary duties.

The Chief Justices’ position-- applying the contractual duty of good faith and fair dealing-- has been referred to as the “contractarian” view. The remainder of this article expands upon the contractarian view and asserts sound justifications for it application.

II. The Infrastructure of the DLLCA

A. Freedom of Contract

The DLLCA is unique among Delaware’s unincorporated entity acts. The Delaware General Assembly adopted the Act in 1992 as the last of Delaware’s preeminent unincorporated acts. Like the Delaware Revised General Partnership Act (“DRUPA”), and the Delaware Revised Limited Partnership Act (“DRULPA”), DLLCA contains the signature Delaware provision that provides: “It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the

---

13 See id. at 236.
14 See id. at 240.
15 See Steele, supra note 1 at 240 (recognizing that, if courts impose default fiduciary duties, contractual provisions providing for some, but not all duties, will appear contradictory; further complicating the contracting of LLC agreements).
16 See id. at 241.
17 See id.
18 See id.
enforceability of limited liability agreements.”

At the time of the enactment of this contractarian provision, the Delaware General Assembly made clear that: (1) limited liability companies were contractual in nature; and (2) contractual principles were to be given dominance above tort-based, fiduciary principles like those applied by the Delaware Court of Chancery for almost one hundred years in the corporate domain. Otherwise, the statutory language, “freedom of contract,” coupled with “maximum enforceability of limited liability agreements” is unnecessary to the Act. In other words, unlike any other Delaware act, “freedom of contract” has a clear and intended meaning within DLLCA.

Freedom of contract in the context of a member-managed LLC, the default organization under DLLCA, is reasonable since a member must enter into an LLC agreement in order to form a Delaware LLC. Contract law does not impose fiduciary duties between parties to a bargain. The suggestion/assumption by academics and practitioners that every business organization is formed with fiduciary duties is nonsensical. This legal position reflects rote application of business governance principles and ignores the unique structure of Delaware’s Act. Just as parties negotiating the purchase and sale of a business may bargain in self-interest, so may investors. The obvious benefit of a contractual, rather than a statutory, entity is that the bargained-for entity does not presumptively require fiduciary duties in a contractarian jurisdiction. To the contrary, no “contract or agreement” among the owner/s of a

---


24 See, e.g., In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).


27 Del. Code Ann. tit., 6, § 18-201(a) (2011) (“In order to form a limited liability company, 1 or more authorized persons must execute a certificate of formation. The certificate shall be filed in the office of the Secretary of State.”); Del. Code Ann. tit., 6, § 18-201(d) (2011) (“A limited liability company agreement shall be entered into or otherwise existing either before, after or at the time of the filing of a certificate of formation”).


30 See Conaway, supra note 21, at 796-801 (examining the unique characteristics of the LLC as compared to other business entities).


32 See Steele, supra note 1 (arguing that bargained for entities should not require default fiduciary duties).
corporation is necessary to form a corporate entity – only the filing of a certificate of incorporation.\textsuperscript{33} Thus, the statutory language of DLLCA, as well as that in DRUPA and DRULPA is clearly differentiated from any statutory, or common, law in the realm of corporations.\textsuperscript{34}

In addition, the provision for “freedom of contract” does not exist as a Delaware statutory corporate governance policy.\textsuperscript{35} Tort-based fiduciary duties that drive corporate internal affairs reflect the separateness between corporate managers and the accountability the managers owe to their indirect residual owners.\textsuperscript{36} These corporate fiduciary duties derive their authority from the common law as interpreted under general authority provisions of the Delaware General Corporation Law (“DGCL”).\textsuperscript{37}

The Delaware statutory provision enabling “freedom of contract” manifested clear legislative intent and signaled a unique beacon for Delaware.\textsuperscript{38} Foremost, in an entity context, “freedom of contract” signifies to a reviewing court that a Delaware LLC is a bargained-for, contractual entity where terms are not uniformly set by statute, but rather are dictated by the parties and the marketplace.\textsuperscript{39} In this sense, parties may choose a lesser bargain in a difficult market in the hope that the first bargain will lead to a second on better terms in the future. Second, freedom of contract also represents that parties may bargain in self-interest or freely waive self-interest, if desired.\textsuperscript{40} Third, contractual freedom and its duty of good faith and fair dealing (that attaches to the performance of \textit{actual and not missing terms}) most importantly permit parties to determine for themselves whether to contract or to walk away from the bargaining table due to unfair or untenable terms.\textsuperscript{41} This latter contractual tenet is known as “freedom from [judicial] contract.”\textsuperscript{42} Finally, “freedom of contract” does not impose fiduciary

\textsuperscript{33} \textsc{Del. Code Ann.} tit., 8, § 102(a), (b) (2006) (No shareholders/owners exist at the time of the filing of a certificate of incorporation).
\textsuperscript{34} See Steele, \textit{supra} note 1.
\textsuperscript{35} See Conaway, \textit{supra} note 21, at 814 (recognizing that one of the features missing from the DGCL is the statutory policy of freedom of contract).
\textsuperscript{37} \textsc{Del. Code Ann.} tit. 8, §§ 141(a) (2006) (general authority of the board of directors); \textit{id.} § 142 (officers); § 144 (interested transactions).
\textsuperscript{39} See, e.g., Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 WL 1961156, *8 (Del. Ch. May 7, 2008) (indicating that LLCs are creatures of contract).
\textsuperscript{40} See, e.g., 16B AM. JUR. 2D Constitutional Law § 641 (2012) (discussing the policy of freedom of contract).
\textsuperscript{41} See \textit{id}. (indicating that the freedom of contract entails the freedom not to contract).
\textsuperscript{42} See \textit{id}.
duties except in the instance of the unusual relationship where one party reposes trust and confidence in another and the other party knows of this special reliance. In the aggregate, statutory “freedom of contract” clearly calls for default contractual duties.

B. Linkage and the Common Law

In addition, DRULPA specifically “links” to the Delaware Uniform Partnership Act (“DUPA”) which, when enacted, “dragged along” the common law of general partnerships. Therefore, a court faced with the issue of whether tort-based fiduciary duties exist under DRULPA is required to interpret the “linkage” provision in DRULPA that provides:

“In any case not provided for in this chapter, the Delaware Uniform Partnership Law in effect on July 17, 1999 and rules of law and equity, including the Law Merchant, shall apply.”

The essential common law of general partnerships that transferred into DUPA, and thus into the “linkage” provisions, was that pronounced in the seminal case of Meinhard v. Salmon. In the Meinhard case, the defendant, approximately four months before the expiration of a 20-year lease, executed a new lease with the lessor without first disclosing the new lease to his “coadventurer.” Justice Cardozo, writing for the majority, found the non-disclosure to be a breach of “the duty of finest loyalty.” Justice Cardozo seemed not to care for the fact that the defendant managed the venture and had bargained for day-to-day control of the leased property. Importantly, Justice Cardozo states that he need not decide if defendant had disclosed the opportunity for the new lease and then competed and won the opportunity whether a breach would have occurred.

---

43 See, e.g., Steele, supra note 39, at 16-17 (indicating that the covenant of good faith and fair dealing prohibits a contracting party to take advantage of his/her position of control).
44 See Steele, supra note 39, at 14.
45 DEL. CODE ANN. tit., 6, § 17-1105 (2011) (internal citations omitted).
46 164 N.E. 545 (N.Y. 1928)(Not applying UPA).
47 See id. at 546.
48 Id.
49 Id. at 547.
50 Id. (stating that if Salmon had told Meinhard about the offered lease, “we do not need to say whether he would have been under a duty, if successful in the competition, to hold the lease so acquired for the benefit of a venture then about to end.”).
As examined in a prior writing,\textsuperscript{51} the “duty of loyalty” in Meinhard did not arise under the existing statute at the time – UPA (1914).\textsuperscript{52} However, a reference in the case notes the actions of the defendant in his capacity as an agent.\textsuperscript{53} Under the Restatement (Second) of Agency, however, the duty of care is not the same as a corporate fiduciary duty of care.\textsuperscript{54} The Restatement (Second) of Agency does, however, articulate a duty of loyalty. If the Restatement (Second) of Agency is the source of Justice Cardozo’s “duty of finest loyalty” then the duty’s application is limited to actions by a partner with third parties – as were the facts in the case that so held. The duty of loyalty would not attach to partners or co-venturers inter se. Yet, without any serious examination of Meinhard or the foundation of its holding, subsequent courts have applied the “duty of finest loyalty” with unrestrained judicial abandon for decades.\textsuperscript{55}

The DLLCA, however, has no linkage provision. All answers regarding “fiduciary duties” are contained in the Act. The DLLCA includes no standards of conduct within its provisions. However, DRUPA clearly provides standards of conduct for partners in a Delaware general partnership.\textsuperscript{56} Thus, when the Delaware General Assembly saw fit to incorporate standards of conduct within an unincorporated act, it did so in an obvious and unmistakable manner. Standards of conduct, or tort-based fiduciary duties, are wholly absent within DLLCA.

In addition to the nonexistence of fiduciary standards in DLLCA, at the time of its enactment, there was no extant common law of fiduciary duties for limited liability companies. The DLLCA is a hybrid entity and is unique in this respect from all Delaware unincorporated organizations.\textsuperscript{57} The only provision of DLLCA that raises a hint of duties is § 18-402 that provides:

\begin{itemize}
\item[52] Id. at 110, 111.
\item[53] Meinhard, 164 N.E. at 547.
\item[54] \textit{Compare} RESTATEMENT (SECOND) OF AGENCY § 1 (1958) (discussing the duty of care in the agency context) \textit{with In re Walt Disney Co.} Derivative Litig., 907 A.2d 693, 746 n.402 (Del. Ch. 2005) (examining the duty of care in the corporate context).
\item[55] See, e.g., Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981) (indicating that the general partner in a limited partnership must “exercise the utmost good faith, fairness, and loyalty.”) (citing Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928)).
\item[56] DEL. CODE ANN. tit. 6, § 15-404 (2011).
\item[57] See, e.g., Carter G. Bishop & Daniel S. Kleinberger, Overview of the Delaware Statute and Delaware LLCs ¶ 14.01 (Thomson/RIA 2011).
\end{itemize}
“Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.”

Section 18-402 does not use the term “agent” to describe the authority of the member and manager. However, it seems logical that the “authority to bind the limited liability company” refers to acts regarding third parties and thus can be assumed to relate to agency authority. The Restatement (Third) of Agency imposes fiduciary duties on agents with respect to their principals – here, the LLC. However, even in its broadest interpretation, this single reference to “binding” the entity cannot bootstrap itself into a general argument for default fiduciary duties inter se.

C. Section 18-1101(c) – The Modification or Elimination of Duties in a Delaware LLC Agreement

In the 1992 version of the DLLCA, parties to a Delaware LLC agreement could:

“[E]xpand or restrict duties (including fiduciary duties) owed by a person or member to each other or the entity or to another person, provided that the limited liability agreement did not eliminate the implied contractual covenant of good faith and fair dealing.”

In 2004, the General Assembly amended the language “expand or restrict,” when used to describe the contractual parameters of duties, to make clear that “restrict” included “eliminate.”

Some commentators may suggest that the parenthetical language of § 18-1101(c) is conclusive evidence that fiduciary duties were intended by the General Assembly as default fiduciary obligations. This conclusion is presumptive and incorrect for three reasons.

First, the structure of the opening sentence to § 18-1101(c) suggests that duties do

59 Restatement (Third) of Agency § 1.01 (2006).
61 Id. (2005).
not exist.\textsuperscript{63} For example, § 18-1101(c) provides: “to the extent that duties exist,” they may be modified or eliminated.\textsuperscript{64} In the DGCL at § 102(b)(7), the Delaware General Assembly stated that a corporation could amend its certificate of incorporation to include:

“A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders”\textsuperscript{65}

As evidenced by the language of § 102(b)(7) of the DGCL, when the Delaware General Assembly intended to refer to extant fiduciary duties, it clearly knew how to do so. By comparison, the language of the DLLCA § 18-1101 does not refer to any fiduciary duties owed by or to any person.

Second, at § 18-402 of the DLLCA, each member or manager of a Delaware LLC may “bind” the limited liability company.\textsuperscript{66} To the extent the member or manager exercises “agency” authority in “binding” the LLC, agency law imposes certain fiduciary duties upon the agent to the principal—here, the LLC.\textsuperscript{67} At the enactment of § 18-1101(c), as now, fiduciary duties arise under agency principles unless modified, expanded or eliminated - not LLC law.

Finally, contract law recognizes one exception to the rule that no fiduciary duties exist in a bargained-for exchange.\textsuperscript{68} That exception arises where one party reposes special trust and confidence in another, and the other party knows and accepts this special relationship.\textsuperscript{69} Again, in the circumstance of full knowledge and consent by contracting parties, § 18-1101(c) permits the modification, and possible elimination, of a “special” contractual fiduciary duty.\textsuperscript{70}

\textsuperscript{64} \textit{Del. Code Ann.} tit. 6, § 18-1101(c) (2011) (emphasis added).
\textsuperscript{67} See \textit{Restatement (Third) of Agency} § 1.01 (2006).
\textsuperscript{68} See, e.g., Steele, \textit{supra} note 39, at 16-17.
\textsuperscript{69} See, e.g., \textit{id}. (indicating that the covenant of good faith and fair dealing prohibits a contracting party to take advantage of his/her position of control).
\textsuperscript{70} See \textit{Del. Code Ann.} tit. 6, § 18-1101(c) (2011).
In each of these examples, the language of § 1101(c) illustrates that no fiduciary duty is *created* between and among members and managers *inter sese* or between members and managers and the LLC. The statutory provision merely provides that, to the extent that *duties (including fiduciary duties)* exist by way of other law, those duties are subject to modification and elimination.\textsuperscript{71} Section 1101(c) does not enable fiduciary duties. If the statutory provision were meant to be enabling, the General Assembly was quite knowledgeable in 2004 as to how to draft standards of conduct as it did in 2001 in DRUPA at § 15-404.\textsuperscript{72} The General Assembly obviously chose not to do so in § 18-1101(c).\textsuperscript{73}

### III. WHEN ARE FIDUCIARY DUTIES NECESSARY?

#### A. General Rule

Common law fiduciary duties are imposed where parties are in a special relationship and one party has superior knowledge or control over another.\textsuperscript{74} A classic example is that of a trustee over the res of a trust with residual beneficiaries who cannot either control the trustee or safeguard trust res.\textsuperscript{75} In this case, the trustee is held to a very strict standard of safeguarding trust assets for the benefit of trust beneficiaries.\textsuperscript{76}

\textsuperscript{71} See id.


\textsuperscript{73} The other issue posed by any argument suggesting default fiduciary duties is *what fiduciary duties would apply?* The LLC is a hybrid entity with the default organization being member-managed. If *default duties* are being sought, then partnership duties such as those set forth in DRUPA § 15-404 are the logical default choice. See also Steele, *supra* note 1, at 242 (“Surely corporate fiduciary principles do not fit a bargained-for contractual venture where parties have structured their rights and duties, including management, voting, distribution, exist, and other rights.”). However, there is presently in Delaware’s Court of Chancery cases in which the court has applied corporate duties without any reasoning or explanation. As noted by the Delaware Supreme Court in *CML V v. Bax*, 28 A.3d 1037 (Del. 2011), corporations and LLCs are different types of entities and operate under different sets of rules. This reasoning by the Delaware Supreme Court should apply equally to any attempted application of fiduciary principles in the context of LLCs or other alternative entities.

\textsuperscript{74} See, e.g., Steele, *supra* note 39, at 16-17.

\textsuperscript{75} See, e.g., Restatement (Third) of Trust § 2 (2003).

\textsuperscript{76} See id.
Another example is that developed by the common law of publicly-traded corporations.\(^77\) In a publicly-owned corporation, shareholders/owners exercise their right to elect directors at an annual meeting.\(^78\) In general, directors will thereafter manage the business and affairs of the corporation until the next annual election of directors.\(^79\) In order to assure that directors are accountable to shareholders during the course of each year, corporate common law developed tort-based fiduciary duties that directors must satisfy or suffer litigation at the hands of shareholders.\(^80\) These fiduciary duties are the duties of care and loyalty – recognizing that good faith is a component of these duties.\(^81\)

### B. No Default Duties are Warranted in a Delaware LLC

In the scheme of corporate governance, fiduciary duties are logical. A corporation is a creature of statute and is formed by a filing and not by filing and an agreement of owners.\(^82\) As noted before, a Delaware corporation does not operate under a philosophy of “freedom of contract” - especially in the context of Fortune 500 corporations where an “agreement of shareholders” would be nonsensical.\(^83\) Recognizing, then, that corporations and LLCs exist as diverse paradigms and seek to achieve divergent legal stratagems, to argue that fiduciary duties exist in corporations and therefore should survive in all other limited liability entities is irrational and lacks a searching inquiry. The presumption that all business entities necessarily exist with fiduciary duties ignores DLLCA, its legislative purpose, and the absence of any common law for the LLC.

In a general partnership, fiduciary duties were deemed necessary since partners could create vicarious liability against other partners even though innocent partners rarely had knowledge of the misconduct of the tortfeasor partner.\(^84\) Standards of conduct were adopted by Delaware in the DRUPA.\(^85\) Similarly, in a limited partnership,

---

\(^77\) See e.g., Smith v. Van Gorkom 488 A.2d 858 (Del. 1985).
\(^80\) See, e.g., In re Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005).
\(^83\) See supra Part II.A.
the common law developed fiduciary duties based upon the *statutory structure* of a limited partnership. \(^86\) Unlike the general partnership, the Delaware limited partnership, by statute, requires two persons - at least one general partner and one limited partner. \(^87\) The general partner has the same powers as a general partner in a general partnership \(^88\) and the limited partner may not participate in control of the limited partnership. \(^89\) Therefore, like the corporation with separation of control and management, the limited partnership common law imposed a fiduciary duty upon the general partner as the statutory person in control of the entity to the exclusion of the limited partner. \(^90\)

The Delaware LLC, on the other hand, is unlike both the Delaware general and limited partnerships. Statutorily, then, by far the most compelling reason against imposing a *default* fiduciary duty is that one is not needed. In a Delaware LLC, the *default entity* is member-managed. \(^91\) In a member-managed LLC, no member has liability for LLC obligations and no member can create vicarious liability for other members. \(^92\) Thus, unlike a general partnership where partners can create vicarious liability against other partners, the parallel is not true for a member-managed LLC. \(^93\) In addition, in an LLC each member bargains for whatever economic and voting rights the deal dictates. \(^94\) Those rights range from non-economic rights, non-voting rights, and economic rights based upon capital contributed, to per capita voting rights. It is an inaccurate assumption that every member-managed Delaware LLC is organized and capitalized in the same manner. Without some compelling evidence of a default legal infrastructure in DLLCA that indicates that members who, under a scheme of freedom of contract, always find themselves in an undesired, “frozen-out” situation, imposition of fiduciary duties *necessarily alters the parties’ bargain*. Even in the context of a manager-managed LLC, managers are often not parties to the limited liability company agreement. For example, members owning an apartment or condominium complex may hire a “manager” who is tasked with the obligations to “manage and supervise” the LLC’s property. In this context, the “manager” of the LLC is subject to the members’ direction and control and is not a party to the LLC agreement. It is therefore a misnomer in the LLC lexicon to assume that every “manager” controls an LLC.

---

\(^{86}\) For a discussion on the fiduciary duties owed in a limited partnership see Sonet v. Timber Co., L.P., 722 A.2d 319, 322-23 (Del. Ch. 1998).


\(^{90}\) See Sonet, 722 A.2d at 322-23.


\(^{94}\) See 16B Am. Jur. 2d *Constitutional Law* § 641 (2012) (noting that a fundamental principle underlying the concept of freedom of contract is a parties right to bargain freely).
Therefore, reading the clear intent of the Delaware General Assembly’s provision for “freedom of contract,” the only appropriate conclusion is that adoption of default fiduciary duties counteracts free will as well as parties’ ability to tailor their deals according to specific desires, businesses, internal operations, and niche ventures, including self-dealing transactions. The application of default fiduciary duties affronts an obvious State policy of contractual freedom and will result in rampant judicial interference in bargained-for exchanges, market inefficiency, increased agency costs, and the loss of Delaware’s preeminence in the field of LLCs.

IV. SAVING UNSOPHISTICATED, UNREPRESENTED AND IGNORANT PARTIES FROM THE BARGAINS THEY MAKE

Some commentators allege that fiduciary duties are necessary in every business organization that potentially involves unsophisticated or unrepresented parties who are unable to “bargain” for “fair” contract terms.95 There are several reasons why this argument fails.

First, in the seminal Delaware case of Nixon v. Blackwell,96 involving the application of the “entire fairness” doctrine, the Delaware Supreme Court succinctly stated:

“[The plaintiffs’] argument takes the following form: fiduciary principles require fair conduct; equal treatment is fair conduct; hence, fiduciary principles require equal treatment. The conclusion does not follow. The argument depends on equivalence between equal and fair treatment. To say that fiduciary principles require equal treatment is to beg the question whether investors would contract for equal or even equivalent treatment.”97

For the same reason stated in Nixon, it is a faulty assumption that even unsophisticated investors would bargain for “fair” or even “equal” treatment if a prior “unfair” agreement placed them in an improved position for a second “fair” agreement.

97 Id. at 1377.
Next, as noted in *Nixon*, contract principles do not impose a “fairness” or “equality” standard for parties to a bargain. Just as in the above example, to require a “fair” bargain between arm’s length parties nullifies each party’s ability to negotiate for those terms that are most advantageous to one party and to “give up” those terms that have lesser significance. In a down economy, many investors are willing to negotiate on terms today that they would not have accepted three years ago – does this fact make the contract unfair? A contract is a bargain sought and returned; each promise exchanged in return for the other. If both parties seek a bargained-for exchange, the courts should enforce the exchange without reference to “equality” or “fairness” - the contract is the parties’ deal.

In the event a sophisticated party uses sharp practices against a party of lesser mental agility, contract law offers policing techniques to unwind the damage. For example, if economic duress is present, a court may reform the contract. Unconscionability is another judicial device for not enforcing terms that are shocking to the judicial conscience. Other policing devices include failure of assent, interpretation against the drafter, adhesion contracts, mutual mistake, impracticability, or frustration of purpose.

The contractual duty of good faith and fair dealing is available for the enforcement and performance of agreed to terms – not the implication of missing terms. The duty of good faith and fair dealing is also *not a freestanding, independent* duty separate from a breach of underlying contract terms. Where the duty of good faith and fair dealing consistently arises in entity law is typically in the interpretation of “satisfaction” or “discretion” clauses. Thus, parties may choose to bargain for one side to have “full discretion” in managing the business except to the extent the “discretion”

---

98 See *id.*
99 As previously noted, this runs contrary the policy of freedom of contract. See 16B AM. JUR. 2D Constitutional Law § 641 (2012) (noting that a fundamental principle underlying the concept of freedom of contract is a parties right to bargain freely).
100 RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981).
impacts the withdrawal of the other party’s funds after a specified interval.\textsuperscript{109} In this circumstance, the parties have shifted all managerial decisions to one person with the limited exception noted.\textsuperscript{110} In the same manner, an investor could bargain for the payment of specific management fees if a fund is performing to the investor’s “satisfaction.”\textsuperscript{111} In the latter example, the investor holds no management power, but does retain all authority over the payment of management fees.\textsuperscript{112} Historically, “satisfaction” and “discretion” clauses shift the balance of control absolutely from one side to another unless exceptions are drafted.\textsuperscript{113} Parties bargain for these “control” devices and may enforce them in self-interest – just as they were negotiated.

Finally, parties are free to intentionally breach a contract – especially a losing contract and not pay punitive damages.\textsuperscript{114} The breach may be willful, intentional, and thus arguably in “bad faith.” However, because contract law compensates the injured party with a suit for damages, no “extra” reparation will be awarded for the “bad faith” breach.\textsuperscript{115} The economics of the rules are sound. If a party finds itself in a 15-year contract at a market price that is now increasing at an unforeseen rate, the losing party should be free to breach the contract, cut its losses, and pay the contract damages owed to the non-breaching party. Even though the breach is intentional, the non-breaching party is fully compensated by a money award and the losing party has mitigated its losses.\textsuperscript{116} The “bad faith” breach is paid. No punitive damages are necessary since the breach was economically sound and “societal penance” or “moral reforms” are illogical concepts in contract law absent an accompanying tort. Courts should modernly recognize that contractual “bad faith” results in monetary awards – not the imposition of “fiduciary duties” under the rubric that one party’s “expectation” has failed. The most fundamental tenet of contract law asserts that any party may be deprived of her “expectation” by an intentional breach by the other contracting party under any circumstance with the result that the breaching party will compensate the non-breaching party for the loss of her “expectation” interest. A breach of the duty of good faith and fair dealing anticipates actions by one party that prevents performance by another or the utter failure of a party’s expectation under the contract due to another’s conduct – not the mere breach of an agreement that is compensable in damages.\textsuperscript{117}

\textsuperscript{110} See Bay Center Apartments Owner, LLC, 2009 WL 1124451.
\textsuperscript{111} See Rohn Indus., Inc. v. Platinum Equity, LLC, 911 A.2d 379, 384 (Del. 2006).
\textsuperscript{112} See id.
\textsuperscript{113} See id.
\textsuperscript{114} See Restatement (Second) of Contracts ch. 16 (1981).
\textsuperscript{115} See Restatement (Second) of Contracts § 344 (1981).
\textsuperscript{116} See Restatement (Second) of Contracts § 344 (1981).
\textsuperscript{117} See Restatement (Second) of Contracts § 205, Comment (1981).
V. THE “CONTRACTARIAN” VIEW APPLIED: AURIGA CAPITAL CORP. V. GATZ PROPS., LLC

In a recent decision by the Court of Chancery, Auriga Capital Corp. v. Gatz Props., LLC, Chancellor Strine held that fiduciary duties apply by default in a manager-managed LLC.\(^{118}\) This section examines the Auriga decision and concludes that the contractarian view, as articulated in this article, is the more logical approach to deal with fiduciary duties in the LLC context.

A. Facts

Peconic Bay, LLC (“Peconic Bay” or the “Company”) was formed by defendant Gatz Properties, LLC (“Gatz Properties” or “Gatz”)\(^ {119} \) and plaintiffs, the “Minority Members”,\(^ {120} \) for the purpose of developing and operating a golf course (the “Course”). To this end, Gatz Properties leased Property (the “Property”) to Peconic Bay under a “Ground Lease,” restricting the Property’s use to a public golf course.\(^ {121} \) Peconic Bay was governed by an Operating Agreement (the “Agreement”) that created two classes of membership interests; both of which were controlled by the “Gatz Members.”\(^ {122} \) This control meant that the Gatz Members had veto power over many of Peconic Bay’s decisions.\(^ {123} \)

Although Peconic Bay was formed for the purpose of developing and operating a golf course, the Company acted merely as a passive entity and the Course was to be run


\(^{119}\) Gatz Properties is managed and partially owned by William Gatz, who was the primary actor in this case. See id. at *4. Therefore, this article refers to Gatz Properties and Gatz as one in the same.

\(^{120}\) The plaintiffs, minority investors in Peconic Bay, consist of Auriga Capital Corporation, Paul Rooney, Hakan Sokmenseur, Don Kyle, Ivan Benjamin, and Glen Morse. See id.

\(^{121}\) See id. Using the Property as collateral, Peconic Bay acquired a note valued at approximately $6 million to finance the Course’s construction. See id.


\(^{123}\) Id. at *5. The most relevant decisions include: “the decision to sell the company; enter into a long-term sub-lease with a golf course operator; or ‘otherwise deal with the [Course] in such manner as may be determined by Majority Approval of the Members,’ such as choosing to run the Course itself.” Id. (internal citations omitted).
by a third-party operator.\textsuperscript{124} Thus, Gatz’s role as manager of the Company under the terms of the Agreement was limited to collecting rent, making payments on the Company’s debt obligations, and distributing funds in accordance with the terms of the Agreement.\textsuperscript{125}

Peconic Bay subsequently subleased the Property (the “Sublease”) to American Golf Corporation (“American Golf”), the third-party operator.\textsuperscript{126} American Golf, however, never operated the Course at a profit and began neglecting the Property.\textsuperscript{127} By 2004, it became clear that American Golf was going to exercise its option to terminate the Sublease in 2010.\textsuperscript{128} In anticipation of American Golf’s termination of the Sublease, Gatz set aside approximately $1.6 million to satisfy the Company’s present and future obligations.\textsuperscript{129}

Despite American Golf’s shortcomings, Matthew Galvin, on behalf of RDG Golf Corp, Inc. (“RDC”), contacted Gatz to express interest in acquiring Peconic Bay’s long-term lease.\textsuperscript{130} Rather than providing Galvin with Peconic Bay’s records, Gatz asked for

\textsuperscript{124}See id.

\textsuperscript{125}See Auriga Capital Corp. v. Gatz Props., LLC, 2012 WL 361677, at *5 (Del. Ch. Jan. 27, 2012). Gatz was authorized “to do all things necessary or convenient to carry out the day-to-day operation of the Company.” Id. (internal quotation marks and citations omitted). It is important to note, however, that Gatz Properties was to receive no management fee. See id. Rather, Gatz Properties was to be compensated through its membership interest in Peconic Bay and through rent earned from the Property. See id. The LLC Agreement “called for payment of 95% of all cash disbursements to go to the Class B members until they received a full return of their investment. After that point, the distributions were to be made pro rata.” Id. (internal citations omitted).

\textsuperscript{126}See id. at *6. The sublease entered into between Peconic Bay and American Golf Corporation was for a term of 35 years; giving the sub-lessee the right to terminate without penalty after 10 years of operation. See id. The sublease also required American Golf Corporation to pay minimum rent as well as ground lease rent that amounted to 5% of its revenue from operations. See id. The ground lease rent was retained by Gatz Properties pursuant to an agreement between Peconic Bay and Gatz Properties. See id.

\textsuperscript{127}See id. “[A]t trial, both sides repeatedly referred to American Golf as a ‘demoralized operator.’ That is to say, American Golf was not managing the Course as a fully motivated operator would have. It neglected maintenance items and allowed the Course to become rundown.” Id. at *14 (internal citations omitted). Such neglect was attributable to a host of reasons including, inter alia, American Golf’s new owners’ focus on cutting expenses rather than growing the top-line. See id.


\textsuperscript{129}See id. at *15. Gatz withheld such funds pursuant to § 11 of the LLC Agreement that “allowed him to withhold from distribution to Peconic Bay’s members those funds that he reasonably determine[d] [were] necessary to meet the Company’s present or future obligations.” Id. (internal quotation marks and citations omitted).

\textsuperscript{130}See id. at *17.
Galvin’s projections for the Course.131 Such projections, Gatz noted, were overly optimistic.132

Galvin insisted, however, on purchasing the Company’s leasehold for $3.75 million.133 This offer was well below Peconic Bay’s debt and was consequently rejected by the Company’s members.134 Without knowledge of Peconic Bay’s debt, Galvin submitted another offer in the amount of $4.15 million.135 This offer was also rejected by the Company.136 Gatz effectively forestalled subsequent negotiations with Galvin until Galvin abandoned efforts to acquire the leasehold.137

Notwithstanding Peconic Bay’s failed negotiation attempts with RDC, the Minority Members voted to make RDC a counter-offer in the amount of $6 million. The Minority Members, however, lacked the contractual authority to make this offer.138 Although the Gatz Members voted against making such a counter-offer, Gatz offered to purchase the Minority Members’ interests for $5.6 million.139 Such an offer would have returned to each of the Minority Member’s their initial capital investment.140 The Minority Members rejected this offer.141

After the Minority Members rejected Gatz’s offer, Gatz hired Laurence Hirsh to appraise the Property.142 Gatz, however, failed to provide Hirsh with certain information that would affect the appraisal.143 Specifically, Gatz did not mention- (1) that Gatz Properties sought to acquire the Property (as opposed to a third-party); (2)
that RDC had offered to purchase the Company’s assets for $4.15 million; and (3) Galvin’s purportedly inflated projections.\textsuperscript{144} Without this information, Hirsh appraised the Company’s leasehold at a value between $2.8 and $3.9 million.\textsuperscript{145}

In light of Hirsh’s appraisal, Gatz lowered his offer to 25\% of each Minority Member’s capital account balance.\textsuperscript{146} After this offer was rejected, Gatz threaded litigation in order to enforce his contractual rights.\textsuperscript{147}

Gatz subsequently put Peconic Bay up for auction (the “Auction”).\textsuperscript{148} To satisfy the arms-length requirement of § 15 of the LLC agreement, Gatz hired Richard Maltz, an independent third-party auctioneer.\textsuperscript{149} Gatz and Maltz conducted a 90-day marketing campaign consisting of newspaper advertisements and direct mailings.\textsuperscript{150} Gatz also compiled a due diligence package, which was made available one month prior to the Auction.\textsuperscript{151} Lastly, the Auction terms indicated, \textit{inter alia}, that Peconic Bay would be sold “as-is,”\textsuperscript{152} and that Gatz “reserved the right to cancel the [a]uction at any time before bidding.”\textsuperscript{153}

As the sole bidder at the Auction, Gatz purchased Peconic Bay for $50,000 over the Company’s debt.\textsuperscript{154} Gatz is currently running the Course himself and is paying the debt.\textsuperscript{155}

\begin{flushleft}
\textsuperscript{144} See id.
\textsuperscript{145} See id. Hirsh determined that the Company’s leasehold was valued at “$2.8 million as a daily fee course and $3.9 million as a private course.” Id.
\textsuperscript{146} See Auriga Capital Corp. v. Gatz Props., LLC, 2012 WL 361677, at *21 (Del. Ch. Jan. 27, 2012). “Gatz told the Minority Members that he was willing to make the Hirsh report available to any of them for the ‘refundable’ fee of $250, plus shipping. According to Gatz, this second buyout offer was a ‘more than fair and equitable’ way to ‘resolve’ the Minority Member problem.” Id. (internal citations omitted).
\textsuperscript{147} See id. at *22.
\textsuperscript{148} See id. The Gatz Members voted in favor of this proposal, thereby approving the auction. See id.
\textsuperscript{149} See id.
\textsuperscript{151} See id.
\textsuperscript{152} “The [auction terms] stated that Peconic Bay would be sold ‘as-is,’ ‘where-is,’ and ‘with all faults,’ without any representations or warranties.” Id. (citations omitted).
\textsuperscript{153} Id.
\textsuperscript{154} See Auriga Capital Corp. v. Gatz Props., LLC, 2012 WL 361677, at *24 (Del. Ch. Jan. 27, 2012).. It is important to note that Gatz was the guarantor of Peconic Bay’s debt. See id. at *2.
\textsuperscript{155} See id.
\end{flushleft}
B. Court of Chancery’s Holding & Analysis

In Auriga the Minority Members argued that Gatz breached his contractual and fiduciary duties.156 In response, Gatz claimed, *inter alia*, that no fiduciary duty analysis was warranted and that his actions fell under the exculpation clause of the Agreement because they were taken in good faith and with due care.157

1. Legal Analysis

Chancellor Strine, writing for the court, held for the plaintiffs; reasoning that “the LLC Agreement here [did] not displace the traditional duties of loyalty and care that are owed by managers of Delaware LLCs to their investors in the absence of a contractual provision waiving or modifying those duties.”158 In so holding, the court noted that fiduciary duties apply by default in the LLC context.159

In concluding in this manner, the court stated that, although the Delaware LLC Act (“Act”) does not explicitly apply default fiduciary duties to managers or members of an LLC, the Act plainly states that “law and equity” govern cases not covered by the Act.160 In light of this, the Chancellor stated that fiduciary duties grounded in equity

---

156 See *id.* at *6. The Minority Members claim that Gatz breached his contractual and fiduciary duties by:

(1) failing to take any steps for five years to address in good faith the expected loss of American Golf as an operator; (2) turning away a responsible bidder which could have paid a price beneficial to the LLC and its investors in that capacity; (3) using the leverage obtained by his own loyalty breaches to play “hardball” with the Minority Members by making unfair offers on the basis of misleading disclosures; and (4) buying the LLC at an auction conducted on terms that were well-designed to deter any third-party buyer, and to deliver the LLC to Gatz at a distress sale price.

*Id.* at *13.

157 See *id.* at *7.

158 Id. at *2. (emphasis added).

159 See *id.* at *8.

160 See *Auriga Capital Corp. v. Gatz Props., LLC, 2012 WL 361677, at *7-8 (Del. Ch. Jan. 27, 2012).* Chancellor Strine proceeded to compare the Act to its corporate counter-part, the DGCL, which also fails to explicitly apply fiduciary duties by default. *See id.* The court noted, however, that unlike the Act, the DGCL judicially mandates such equitable duties. *See id.* at *8. (citing *Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971)* holding that the DGCL is to be interpreted to include equitable fiduciary duties). The court also indicated that, unlike the DGCL, the Act statutorily mandates application of equitable principles. *See id.*
should apply to managers of LLCs. Further, the court held that “it seems obvious that . . . a manager of an LLC would qualify as a fiduciary of that LLC and its members.”
The court reasoned that a manager of an LLC, an entity sharing many of the same characteristics of a corporation, is empowered to manage the LLC’s business. As such, “[t]he manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC.”

In seeking further justification for applying default fiduciary duties, the court turned to the history of the Act. Notably, the court relied upon the 2004 amendment of the Act, permitting an LLC agreement to modify or eliminate fiduciary duties (other than the contractual duty of good faith and fair dealing) to the extent that such duties exist. In light of this amendment, Chancellor Strine asserted that the Act cannot allow for the elimination of a duty if there was no duty to eliminate in the first place.

Next, Chancellor Strine argued that the implied covenants of good faith and fair dealing cannot adequately protect investors in the LLC context. The court reasoned that the implied covenant must be narrowly interpreted so as to avoid overreaching judicial oversight. To this effect, the implied covenant applies only “when the express terms of the contract indicate that the parties would have agreed to the obligation had they negotiated the issue.” In light of this narrow interpretation, the court asserted

---

161 See id. (internal citations omitted).
162 Id. (emphasis added) (noting that “[e]quit distinguishes fiduciary relationships from straightforward commercial arrangements where there is no expectation that one party will act in the interest of the other.”).
164 Id. In summation, Chancellor Strine held that “because the LLC Act provides for principles of equity to apply, because LLC managers are clearly fiduciaries, and because fiduciaries owe the fiduciary duties of loyalty and care, the LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties.” Id.
165 See id. at *9.
168 See id.
169 See id. at *10.
170 See id.
that the implied covenant is not designed to govern a manager’s decisions made pursuant to an LLC agreement.\textsuperscript{172}

Finally, the court recognized two policy concerns which tip the balance in favor of default fiduciary duties.\textsuperscript{173} First, if fiduciary duties were not applied by default, current LLC agreements purportedly drafted in reliance upon such equitable default duties would be deleteriously altered.\textsuperscript{174} Further, such a holding would erode Delaware’s credibility amongst alternative entity investors.\textsuperscript{175}

2. Gatz Breached His Fiduciary and Contractual Duties

With default fiduciary duties in place, the court turned to the facts of the case at bench.\textsuperscript{176} The court began by examining the pertinent provisions of the Agreement.\textsuperscript{177} The court noted that the Agreement did not eliminate the fiduciary duties of care and loyalty; therefore, such duties are applied by default.\textsuperscript{178} Further, the court interpreted § 15 of the Agreement to require the “entire fairness” standard for reviewing self-dealing transactions, a principle derived from corporate law.\textsuperscript{179} Thus, in order to seek protection under § 15, the court held that Gatz bore the burden of proving, in good faith, that the price he paid for Peconic Bay was fair.\textsuperscript{180} The court also observed that § 16 of the Agreement contained an exculpatory provision akin to § 102(b)(7) of the DGCL.\textsuperscript{181} The

\begin{itemize}
\item \textsuperscript{172} See id.
\item \textsuperscript{173} See id.
\item \textsuperscript{174} See id.
\item \textsuperscript{176} See id. at *11.
\item \textsuperscript{177} See id.
\item \textsuperscript{178} See id.
\item \textsuperscript{179} See Auriga Capital Corp. v. Gatz Props., LLC, 2012 WL 361677, at *11 (Del. Ch. Jan. 27, 2012). § 15 of the LLC Agreement provides, in pertinent part:
\begin{quote}
15. Neither the Manager nor any other Member shall be entitled to cause the Company to enter . . . into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).
\end{quote}
\item \textsuperscript{180} See id. at *12.
\item \textsuperscript{181} See id. § 16 of the LLC Agreement provides:
\end{itemize}
court noted, however, that § 16 only eliminated liability for the breach of the duty of loyalty where such a breach was committed in good faith without a showing of willful misconduct.\textsuperscript{182}

After analyzing the terms of the Agreement, the court examined Gatz’s conduct; holding that Gatz breached his contractual and fiduciary duties.\textsuperscript{183} First, the court held that Gatz did not act as a reasonable fiduciary would by failing to search for a new buyer once he knew that American Golf would not be renewing its sublease.\textsuperscript{184} By the same token, the court held that Gatz breached his fiduciary duty to maximize value for Peconic Bay’s investors by forestalling negotiations with Galvin.\textsuperscript{185} The court noted that by providing Galvin with incomplete information Gatz did not act like a motivated seller would.\textsuperscript{186}

To the contrary, the court held that Gatz used Galvin’s low offers to initiate negotiations of his own with the Minority Members.\textsuperscript{187} The court termed such negotiation techniques as playing “hardball” with the Minority Members.\textsuperscript{188} By negotiating as such, the court held that Gatz breached his contractual and fiduciary duties.\textsuperscript{189}

\begin{footnotesize}
\textsuperscript{16} No Covered Person [defined to include “the Members, Manager and the officers, equity holders, partners and employees of each of the foregoing”] shall be liable to the company, [or] any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person’s gross negligence, willful misconduct or willful misrepresentation.

\textit{Id.}(emphasis in original) (citations omitted).
\end{footnotesize}
Lastly, the court took concern with the Auction conducted by Gatz. More specifically, the court held that Gatz’s broker was inexperienced, Gatz’s advertising was insufficient, and the Auction terms were partial to Gatz. In light of such concerns, the court rejected Gatz’s argument that Peconic Bay was not worth more than its debt, and held that Gatz breached his contractual and fiduciary duties.

In finding for the plaintiffs, the court held that Gatz’s conduct was not protected by § 15 or § 16 of the Agreement. The court therefore awarded the plaintiffs damages plus partial attorney’s fees.

C. Evaluating the Auriga Decision

1. The Court Committed Legal Error by Failing to Interpret the Plain Language of the Agreement Under Clear Standards of Delaware Law

In analyzing Gatz's conduct, the Court in *Auriga* was required under Delaware’s clearly stated law of "freedom of contract and the enforceability of limited liability company agreements" to interpret the contractual provisions of the Agreement. Simply stated, the issue before the Chancellor was one of contract law, i.e., whether Gatz’s conduct conformed to his contractual obligations as set forth in the Agreement. By adding a fiduciary duty element to the analysis, the Court clearly erred as a matter of law. The

---

190 See *id.* at *24.
192 See *id.* at *25.
193 See *id.* at *26-*27.
194 See *id.* at *27-*29.
196 See *In re NextMedia Investor, LLC, 2009 WL 1228665, at *6 (Del. Ch. May 6, 2009) (Chancellor Strine (then Vice Chancellor) stated that "[t]he plain meaning of a contract, as it would be understood by a reasonable person reading the contract, is controlling in disputes over contract interpretation."). Additionally, in *Bank of New York Mellon v. Commerzbank Capital Funding Trust II*, the Court indicated that, when interpreting LLC agreements:

> [t]he true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant. The Court "must construe the agreement as a whole, giving effect to all provisions therein. The Court must give unambiguous language its plain meaning; it must not twist language to create ambiguity where none exists, because doing so could, "in effect, create a new contract with rights, liabilities and duties to which the parties had not assented."

result of the Chancellor’s analysis was both the imposition upon Gatz of a heightened standard of conduct to which no member in the LLC either bargained or paid for as well as the transformation of a bargained contract into a trust document.

First, the Court had before it a Delaware limited liability company agreement negotiated by sophisticated parties. The parties bartered for a manager - Gatz Properties. In section seven of the Agreement, the parties agreed as follows:

(a) The management of the day-to-day operations of the Company shall be the responsibility of the manager (the “Manager”) who may, but need not be, a member. The initial Manager of the Company shall be Gatz Properties. The Manager shall act as the “tax matters partner” for the Company. The Manager shall have the power, on behalf of the Company, to do all things necessary or convenient to carry out the day-to-day operations of the Company.

Strikingly, unlike most limited liability company agreements today, the Gatz Agreement is utterly silent as to any standard of conduct or statement of duty upon the Manager in the exercise of its authority or power in the conduct or operation of the Company. Most LLC agreements modernly either require that managers exercise their authority in "good faith and in the best interest of the LLC" or the agreement articulates more specific standards of conduct to which managers must adhere. The Agreement before the Chancellor was extremely unusual in that no language of any standard of any nature was articulated – a fact that the Chancellor ignored as a matter of law.

In addition, section fifteen of the Agreement clearly addresses conflicting interest transactions. Section fifteen provides in pertinent part:

Agreements with Affiliates. Each of Members acknowledge and agree that the Company has entered into the following agreements with affiliates of certain Class A Members as of the date hereof (“the Initial Affiliate Agreements”):

---

198 Peconic Bay, LLC Operating Agreement at § 7(a).
199 See Peconic Bay, LLC Operating Agreement at § 15.
(i) the Financing and Project Management Agreement, dated February 18, 1997 between Auriga and the Company;

(ii) the Ground Lease; and

(iii) the Gatz Loan.\(^{200}\)

Notwithstanding the Agreement’s express provisions for approving conflicting interest transactions, the Chancellor indicated that the failure to include a "general provision stating that the only duties owed by the managers to the LLC and its investors are set forth in the Agreement itself," meant that managers are left with default fiduciary duties.\(^{201}\) Under this interpretation then, in the absence of a general fiduciary duty provision in an LLC agreement, all Delaware LLC agreements will, in essence, be construed as a trust document and will contain “terms” to which they clearly did not barter or intend.

Finally, the Court had recourse to section sixteen of the Agreement that provided indemnification and exculpation for "Covered Persons."\(^{202}\) Pursuant to section sixteen:

\[\text{[N]}o \text{ "Covered Person," shall be liable to the Company, any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any loss, damage, or claim incurred by reason of such Covered Person’s gross negligence, willful misconduct, or willful misrepresentation.} \]

Viewing provision seven in tandem with that of sections fifteen and sixteen, the Court was obligated, under basic principles of contract law,\(^{204}\) to interpret these

\(^{200}\) Peconic Bay, LLC Operating Agreement at § 15.


\(^{202}\) The term "Covered Person" is defined to include any Member or Manager (or officers, equity holders, partners or employees of the foregoing). See Peconic Bay, LLC Operating Agreement.

\(^{203}\) Peconic Bay, LLC Operating Agreement at § 16.

\(^{204}\) See In re NextMedia Investor, LLC, 2009 WL 1228665, at *6 (Del. Ch. May 6, 2009) (Chancellor Strine (then Vice Chancellor) stated that, when interpreting LLC agreements, "[t]he plain meaning of a contract, as it would be understood by a reasonable person reading the contract, is controlling in disputes
provisions consistently. A coherent contractual analysis logically leads the reader to the parties' deal—a manager with no fiduciary duties but with a carefully brokered standard for affiliate agreements and exculpation and indemnification.

The Court committed legal error by ignoring the plain language of the parties' contract. The Agreement before the Court contained no ambiguity; therefore, the Court could not reach outside the contract to create terms and claims that did not exist.

2. The Court Committed Legal Error by Resolving an Issue of Default Fiduciary Duties Where the Limited Liability Company Before the Court Had Modified the Default Form for Delaware LLCs

From the outset, Chancellor Strine most regrettably phrased the legal issue in *Auriga* as whether default fiduciary duties existed in a Delaware manager-managed LLC, which is not the default form for a Delaware LLC. As provided at 6 Del. Code § 18-101(6), a Delaware limited liability company is defined as "a limited liability company formed under the laws of the State of Delaware and having 1 or more members." Thus, in the first instance, for the Court to attempt to resolve the important question of the existence of default fiduciary duties for members or managers of Delaware LLCs upon the facts of this case must necessarily muddy the waters of any judicial analysis.

With the waters of judicial analysis clouded by a misapplication of the default LLC form, Chancellor Strine premised his justification for applying default fiduciary duties to LLCs on four principles. This section evaluates each of Chancellor Strine's arguments; concluding that default fiduciary duties in the LLC context are unwarranted. Next, this section turns to the facts of *Auriga*, focusing on Gatz’s conduct, as the Court of Chancery should have, through the lens of the Agreement—the agreement upon which all of the Peconic Bay members bargained and ultimately agreed.

---

over contract interpretation.”); see also Bank of New York Mellon v. Commerzbank Capital Funding Trust II, 2011 WL 3360024, at *7 (Del. Ch. Aug. 4, 2011) (“The Court must give unambiguous language its plain meaning; it must not twist language to create ambiguity where none exists, because doing so could, 'in effect, create a new contract with rights, liabilities and duties to which the parties had not assented.'”)(citations omitted).


207 Discussed *supra* Part V.
i. Reliance Upon the Catch-all "Law and Equity" Phrase

Despite recognizing that the Act does not explicitly apply fiduciary duties by default to managers or members of an LLC, Chancellor Strine sought justification for applying these default duties by relying upon the well-known "catch-all" phrase originally found in UPA (1914) as crafted by the drafters of the Uniform Law Conference.\(^\text{208}\) The Chancellor's interpretation of this principle missed the mark for two reasons.

First, in the Comment to § 104 of the Revised Uniform Partnership Act (1997) from which all the ULC alternative entity Acts derive the same "law and equity" clause, the following is noted:

The principles of law and equity supplement RUPA unless displaced by a particular provision of the Act . . . Those supplementary principles encompass not only the law of agency and estoppel and the law merchant in the UPA, but all of the other principles listed in UCC Section 1-103: the law relative to capacity to contract, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, and other common law validating or invaliding causes, such as unconscionability. \textit{No substantive change from either the UPA or the UCC is intended.}\(^\text{209}\)

From this Comment, it is clear that the phrase, "Unless displaced by particular provisions of this [Act], the principles of law and equity supplement this Act," was never intended to address, much less impose, fiduciary duties on owners or managers in partnerships or LLCs.

The second, and most compelling, error in the Court's line of reasoning is the Chancellor's failure to address the preamble to § 18-1104 that states: \textit{"In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern."}\(^\text{210}\) According to the prefatory language of § 18-1104, if any provision in the Delaware LLC Act speaks to fill the void of "law and equity," then § 18-1104 is rendered moot as to that issue. The Delaware LLC Act uniquely, clearly and concisely—since its adoption in 1992—has specifically expressed the position of the Delaware

\(^{208}\) See Auriga Capital Corp., 2012 WL 361677, at *7-*8.
\(^{209}\) DEL. CODE ANN. tit. 6, § 104 (2005) (emphasis added).
\(^{210}\) DEL. CODE ANN. tit. 6, § 18-1104 (2011) (emphasis added).
General Assembly on the policy to be followed for all Delaware LLCs. That policy is established at § 18-1101(b) that unambiguously provides: "It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."211

Thus, if the Court of Chancery were to find that a contractual legal issue could not be answered within the tenets of contract law, only then would the language of § 18-1104 have any legal meaning.

ii. Chancellor Strine’s Remaining Justifications

As discussed above, Chancellor Strine sought further justification for applying default fiduciary duties to LLCs by focusing on: (1) the 2004 amendment to the Act; (2) the implied covenant of good faith and fair dealing; and (3) policy concerns.212

First, Chancellor Strine determined that, in light of Delaware’s 2004 amendment, the Act couldn’t allow for the elimination of a duty if there was no duty to eliminate in the first place.213 This argument has been repeated around the country by academics and practitioners alike, yet the legal basis of the argument alarmingly disregards two vitally significant structural themes of the Delaware Act. First, the Delaware Act lacks linkage to the Common Law of any "fiduciary duty" among members. Since the Delaware Act stands alone without linkage, query either the need or “common law” motivation for a fiduciary duty in the initial instance in any business organization—control by one party that is superior in quality and quantity214 and/or the ability of one person to impose vicarious liability upon another.215 The Delaware LLC lacks both these

211 DEL. CODE ANN. tit. 6, § 18-1101(b) (2011) (emphasis added) (this same language of usurpation over the "catch all" provisions referencing equity appears in each Delaware partnership act as well as the Delaware LLC Act).

212 Discussed supra Part V.


214 For example, a fiduciary duty exists under the common law of corporations due to the separation of ownership from centralized management. In the context of limited partnership law, the duty was said to arise due to the control by the general partner and the inability to participate in management by limited partners. The latter scenario is less real in many cases than that of the corporation.

215 Consider the original general partnership in which one partner had the ability to bind not only the partnership but all partners personally by unauthorized acts. In the latter situation, although partners may have "default equal authority," the ability of a rogue partner to create personal liability upon innocent partners justified the imposition of agency fiduciary duties. Under the Harmonized Uniform Partnership Act 2011, only the fiduciary duty of loyalty remains—no fiduciary duty of care exists.
justifications for a fiduciary duty since members are equal and have no liability. Lacking a common law motivation for imposition of a fiduciary duty, the hybrid limited liability company may obviously be enacted in any jurisdiction without default fiduciary duties.

Second, the argument put forth by the Chancellor regarding default fiduciary duties in all business entities misinterprets the Delaware General Assembly’s intent to give "maximum effect to freedom of contract.” As previously discussed in this article, the "majority" argument ignores the structure of the opening sentence to § 18-1101(c) that provides: "to the extent that duties exist . . . they may be modified or eliminated.”216 Such language refers not to the extant fiduciary duties of loyalty and care applied in corporate law where ownership and management are separated by law; rather, this provision refers to the “agency law” duties imposed upon a member or manager when that person exercises "agency” authority in "binding" the LLC.217 As with any other entity, an LLC must act through its agents. Under the Restatement (Third) Agency, agency is a "fiduciary” relationship between the agent (member or manager of the LLC) and the principal (Company).218 The Delaware Act makes transparent that both members and managers are agents of the LLC.219 Thus, at the passage of § 18-1101(c), the fiduciary duties of agents existed unless modified or eliminated. Agency law, and its associated fiduciary duties, has walked in tandem with business entity law since its inception – a concept well understood by business law academics and practitioners.

Chancellor Strine’s further indicated that the implied covenant of good faith and fair dealing inadequately protects investors in the LLC context.220 This argument, however, is based upon an incorrect reading of the implied covenant. First, contracting parties, especially in a down economy, often purposely leave terms silent, negotiate negative terms, or bargain for "unfair" terms in order to "get themselves in the door.” While contracting parties are free to barter for any terms or self-dealing provisions, they certainly have no desire for courts to intervene by adding terms that neither party

216 DEL. CODE ANN. tit. 6, § 18-1101(c) (2011) (emphasis added).
217 Discussed supra Part II.B.
218 RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006). For the fiduciary duties of agents to their principals see Article 8 of the Restatement (Third) Agency.
219 See DEL. CODE ANN. tit. 6, § 18-402 (2011) (emphasis added) (Management of Limited Liability Company: “Unless otherwise provided in a limited liability company agreement each member and manager has the authority to bind the limited liability company.”)
wishes. The implied covenant was never intended to serve as a "gap filling" function; rather, it is meant to be used as tool to enforce the agreed upon terms in any party’s deal.\textsuperscript{221} The contractual duty of good faith and fair dealing also should not be judicially “transformed” into a fiduciary duty through the use of “equity.” Where parties have negotiated specific terms and left others silent and then a deal turns sour for one party, the contractual duty of good faith and fair dealing does not require judicial examination of the contract based upon “entire fairness” simply because one party “managed” the deal – that was the parties’ bargain. Clearly one party’s “expectation” has not resulted in the outcome desired; however, every person negotiating a contract today understands that risk follows as the night does the day. That a contract may result in risk or loss does not leave the unsophisticated unprotected. The fundamental tenet of contract law is that parties have a suit for damages for loss of their expectation interest where there is a breach of contract. Parties may also conclude that the element of risk is greater than the chance of profit and thus not enter a bargain at all. In addition, parties may still turn to basic contract policing techniques such as unconscionability, coercion and duress.\textsuperscript{222} In the final analysis, freedom of contract includes freedom from interference by courts “doing equity” – especially in a jurisdiction where “freedom of contract” is stated policy.

Lastly, Chancellor Strine expressed concern for Delaware’s credibility amongst alternative entity investors.\textsuperscript{223} The Chancellor also feared that LLC agreements purportedly drafted in reliance upon default fiduciary duties would be deleteriously altered if the court did not apply such duties by default.\textsuperscript{224} Such concern is misplaced. Turning once again to Chief Justice Steele’s article, \textit{Freedom of Contract and Default Contractual Duties in Delaware Limited Partnership and Limited Liability Companies}, it is the Delaware LLCs' unique flexibility and policy of contractual customization that attracts sophisticated parties to use this form.\textsuperscript{225} By applying fiduciary duties by default, and the added costs that attach to such duties, the Court effectively erodes parties' reliance upon the Act's providing for the "maximum effect to the principle of freedom of contract." The \textit{Auriga} opinion is a perfect case in point – the Chancellor “created” duties

\textsuperscript{221} See Conaway, \textit{supra} note 52 (Delaware courts have mistakenly interpreted the implied covenant of good faith and fair dealing to permit the addition of terms to a contract).

\textsuperscript{222} Discussed \textit{supra} Part IV.

\textsuperscript{223} See \textit{Auriga Capital Corp.}, 2012 WL 361677, at *10.

\textsuperscript{224} See \textit{id}.

\textsuperscript{225} Discussed \textit{supra} Part I.
that the parties intentionally left silent and then held one party in violation of the duty the Chancellor created. Decisions like Auriga will result in the loss of sophisticated US and foreign investors to Delaware who will fear imposition of additional terms by judicial fiat.

3. Summary

Removing default fiduciary duties (including any Revlon-type duty) from the equation, the parties in Auriga are solely obligated to satisfy that they performed the terms of the Agreement in contractual good faith—a concept emphasized by Chief Justice Steele.226 Turning to the facts of Auriga, the plain terms of the Agreement impose no duties on the manager and clearly eliminated conflicts of interest—typical in duty of loyalty transactions.227 In addition, the Agreement provided exculpation for good faith reliance on the Agreement that allowed the manager, as a member, to vote its interests to sell the company.228 Lastly, pursuant to the Agreement, the Minority Members have no authority to pursue a counter offer.229

Gatz’s conduct conformed to the terms expressly provided for in the Agreement. The implied duty of good faith and fair dealing does not permit the court to interject any additional requirements upon Gatz – only those already bargained for by the parties in Auriga. By the same token, allowing Peconic Bay’s members to sue for breach of fiduciary duty provides Members with rights not provided for in the Agreement—rights for which the Members neither bargained nor paid.

VI. Summation

There is no historical or common law that suggests fiduciary duties arise in member managed LLCs – the default entity under DLLCA. This fact is true around the United States as well. But the Delaware Act is extremely unique. The DLLCA was drafted to include a STATE policy of “freedom of contract.” Only two other Delaware acts embody this policy. In one of those acts, DRUPA, the Delaware General Assembly codified standards of conduct for general partners possibly due to the issue of vicarious liability; possibly due to the extant common law of partnerships. In the second act, DRULPA, a linkage provision which sends a reviewing court to DUPA and the

226 Discussed supra Part I.
228 See id.
229 See id.
common law of general partnerships.

Structurally, only DLLCA has: (1) freedom of contract; (2) no linkage to another act with pre-existing common law; (3) no standards of conduct; and (4) no common law. The DLLCA is a hybrid act that must be interpreted by Delaware jurists, academics and practitioners as an independent act, linked to no other Delaware entity legislation either by way of common law or statutory device.

In addition, due to the flexible nature of the Delaware LLC, there is no “default” organizational infrastructure that warrants the imposition of fiduciary duties. Even in a manager-managed LLC, the manager may well be an employee and not a party to the LLC agreement. The term “manager” in an LLC may cover many forms of “management.” Without a default statutory structure that requires investor protection, default fiduciary duties undercut parties’ bargained-for agreements. Sophisticated deals will leave Delaware if courts can reform transactions on an ad hoc basis.

As for ignorant and unsophisticated parties, neither entity nor contract law requires “equal” nor “fair” deals since investors likely don’t bargain in this manner. In the event foul play or “inequity” arises in the context of a contract, courts have an arsenal of equitable contract remedies to reform, unwind, assess damages or enter a judgment suitable to the circumstances. The contractual duty of good faith and fair dealing, however, is not a “contractual fiduciary duty” in disguise and should not be used by courts as shorthand for a fiduciary duty.