THE IMPACT OF ACT 170 ON LLCs, LLPs, LPs AND GPs

Duties

Duties

- Separate sections provide rules on the duties of:
  - members in a member-managed LLC (§ 8849.1)
  - managers in a manager-managed LLC (§ 8849.2)
- The duties in the two sections are largely the same, but the sections are tailored to the specific situations of members and managers.

1

General Rule

Members

- **§ 8849.1(a) General rule.** - A member of a member-managed limited liability company owes to the company and, * * * the other members the duties of loyalty and care stated under subsections (b) and (c).

Managers

- **§ 8849.2(a) General rule.** - A manager of a manager-managed limited liability company owes to the company and, * * * the members the duties of loyalty and care stated under subsections (b) and (c).

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Member Duties in a Manager Managed LLC

- Section 8849.1(i) provides that "a member does not have any duty to a manager-managed limited liability company or to any other member of the company solely by reason of being or acting as a member.

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Basic Duties

- **Duty of loyalty. (§§ 8849.1(b), 8849.2(b))**
- **Duty of care. (§§ 8849.1(c), 8849.2(c))**
  - The duty is "to refrain from engaging in gross negligence, recklessness, willful misconduct or knowing violation of law."
- **Contractual obligation of good faith and fair dealing. (§§ 8849.1(d), 8849.2(d))**
  - Is different from the corporate law concept of good faith which is an aspect of the duty of loyalty, as articulated in *Stone v. Ritter*, 911 A.2d 362 (Del. 2006).
  - Comment: "[T]he contractual obligation … is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a partner from acting in the partner's own self-interest … [T]he purpose … is to protect the arrangement the partners have chosen for themselves, not to restructure the arrangement under the guise of safeguarding it."

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Aspects of the Duty of Loyalty

1. Do not conduct the company's activities for personal gain.
2. Do not use company property for personal gain
3. Do not appropriate a company opportunity.
4. Do not engage in self-dealing.
5. Refrain from competing with the company.

These duties apply both during the life of the company and also during winding up.

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NEW: Duties Variable

- In a major change from prior law, the duties of members in a member-managed LLC and managers in a manager-managed LLC will be ***subject to variation*** by agreement of the members.
- Look to the operating agreement

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Varying Duties

- Duties other than care and loyalty may be altered or eliminated by the operating agreement, if not manifestly unreasonable.
- The operating agreement may alter the duty of care, if not manifestly unreasonable.
- The operating agreement may not vary the contractual obligation of good faith and fair dealing, but may prescribe the standards by which it is measured, if not manifestly unreasonable.

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These duties apply both during the life of the company and also during winding up.

- The operating agreement may **identify types of activities** that do not violate the duty of loyalty.
- The operating agreement may alter, but **not eliminate**, the aspects of the duty of loyalty stated in 1, 2, and 4.
- The operating agreement may freely alter, and may **eliminate entirely**, the aspects of the duty of loyalty stated in 3 and 5.

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STATUTORY DISCUSSION

- Under Subsection 8815(d) – The operating agreement governs the treatment of the matters described in subsection 8815(a), except as specifically limited by subsections 8815(c) and 8815(d)(3). However, subsections 8815(d)(1) and (2) list various arrangements often found in operating agreements. Subsection 8815(d)(3) lists permissible arrangements subject to the "not manifestly unreasonable" standard. Subsection 8815(e) delineates the manifestly unreasonable standard.
- Subsection 8815(d)(2) – is applicable only to member managed limited liability companies on the premise that: (i) managers are collectively responsible; and (ii) managers may properly delegate a duty but the delegation does not discharge the responsibility of the manager. However, subject to subsection 8815(d)(3) the operating agreement may alter or even eliminate fiduciary duties.
- Subsection 8815(d)(3) – Chapter 88 seeks to balance the virtues of "freedom of contract" against the dangers that inescapably exist when some have power over the interests of others, rejecting the notion that fiduciary duty within a business organization is merely a set of default rules.

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STATUTORY DISCUSSION

- A properly drafted operating agreement may substantially alter and even eliminate fiduciary duties, subject to two important limitations:
  - First, arrangements subject to this subsection ***may not*** be "manifestly unreasonable" as that concept is delineated in subsection 8815(e).
  - Second, the operating agreement ***may not*** transform the relationship among the members, managers, and the limited liability company into an entirely arm's length arrangement. For example, displacement of fiduciary duties is effective only to the extent that the displacement is stated clearly and with particularity. See, e.g., Paige Capital Management, LLC v. Lerner Master Fund, LLC, Civ. A. No. 5502–CS, 2011 WL 3505355 at *31 (Del.Ch. Aug. 8, 2011) (even under a statute that permits complete waiver of fiduciary duty, such waivers must be set forth clearly").

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STATUTORY DISCUSSION

Determination of manifest unreasonableness. – Section 8815(e) provides that the ***court*** shall decide as a matter of law whether a term of an operating agreement is manifestly unreasonable under subsection (d)(3). The court:

(1) makes its determination as of the time the challenged term became part of the operating agreement and by considering only circumstances existing at that time; and

(2) may invalidate the term only if, in light of the purposes, activities and affairs of the limited liability company, it is readily apparent that:

(i) the objective of the term is unreasonable; or

(ii) the term is an unreasonable means to achieve the term's objective.

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Variations: Sample Language – General Waiver

This Agreement is not intended to, and does not, create or impose any fiduciary duty on any Member, [Manager], [Director, or Officer] *[insert appropriate positions]*. Each of the Members and the Company hereby waives any and all fiduciary duties that, absent that waiver, may be implied or imposed by applicable law, and in doing so, acknowledges and agrees that the duties and obligations of each Member, [Manager], [Director, and Officer] to each other and to the Company are only as expressly set forth in this Agreement. The Members hereby acknowledge and agree that the provisions of this Agreement, to the extent that they restrict the duties and liabilities of a Member, [Manager] [Director, or Officer] otherwise existing at law or in equity, expressly replace such other duties and liabilities of such Member, [Manager], Director, or Officer. Each Member expressly waives, to the fullest extent permitted by applicable law, any rights to assert any claim based on any matter arising out of or in connection with any fiduciary duty owed to the Company or any Member.

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Variations: Sample Language – General Waiver Discussion

- The previous slide purports to limit fiduciary duties to those set expressly set forth in the Agreement – although on its face, with nothing more, this language would serve to eliminate such duties in their entirety. See Section 8815(d)(3)(v). Any such waiver must be express and stated with particularity. See comment to subsection 8815(d)(3). The acknowledgement and consent language in the last two sentences support the hallmark determinations of enforceable waivers: knowing, voluntary and intelligent.

- **Discussion**: is such a broad limitation "not manifestly unreasonable"?

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Variations: Sample Language – Limitation on Duty of Loyalty (ex. 1)

Each Member hereby agrees that in the event it becomes aware of any bona fide opportunity [***within a specified category aligned to the Company's function***] (each, a "***Subject Opportunity***"), it shall be first be offered to the Company. Such Member shall provide information to the [Manager] [Members] sufficient for the [Manager][Members] to properly evaluate the Subject Opportunity, or sufficient to permit the Manager to obtain such relevant information to enable such evaluation. ***[insert mechanism for time frame and consideration of transaction]***. In the event the Company does not pursue such Subject Opportunity [***within time frame***] or does not consummate such Subject Opportunity, the introducing Member shall be free to so pursue. Other than with respect to Subject Opportunities, each Member is otherwise free to engage in any venture or activity in any fashion, and the independent pursuit of other ventures and activities by Members or Managers is hereby consented to by the Members and shall not be deemed wrongful or improper."

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Variations: Sample Language – Limitation on Duty of Loyalty Discussion

- The previous slide highlights the level of detail necessary to create a limitation that is both properly expressed and not manifestly unreasonable.
- In certain circumstances, it may be reasonable to permit full competition with no restrictions. In others, it may be reasonable to permit no such latitude.
- A proper, focused description of Subject Opportunity is critical.
- The obligations of good faith and fair dealing continue to be applicable to the actions of the parties notwithstanding the permissions in the above language.

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Variations: Sample Language – Limitation on Duty of Loyalty (ex. 2)

Nothing herein shall prevent the Manager or any Member from conducting any other business, including any business with respect to securities, regardless of whether such business is in competition with the Company. Without limiting the generality of the foregoing, the Member, its members, officers, affiliates and employees may act as [manager] [advisor] for others, may manage businesses, operations, investments or capital for others, may have, make and maintain investments in its own name or through other entities, and may serve as a consultant, member, partner or stockholder of one or more businesses engaging in the same or similar businesses as the Company and may act as a director, officer and/or employee of any corporation, or other business organization, a trustee of any trust, an executor or administrator of any estate, or an administrative official of any other business entity.

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Variations: Sample Language – Limitation on Duty of Loyalty Discussion

- The previous slide is a typical broadly constructed grant of permission in the investment industry for managers and advisors to act for other investment vehicles and their affiliates.
- Given its context, it is rarely challenged.
- Quaere whether it would survive the "not manifestly unreasonable" for more general operating company managers.

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Variations: Sample Language – Limitation on Duty of Loyalty (ex. 3)

- No Exclusive Duty to Company. No Member or Manager shall be required to manage, or act on behalf of, the Company as his or its sole and exclusive function. Subject to the fulfillment of any Member's or Manager's obligations pursuant to this Agreement, each Member and Manager may have other business interests and may engage in other businesses, investments and activities in addition to those relating to the Company even if such other businesses, investments and/or activities compete with the business of the Company. Neither the Company, nor any other Member, shall have any right, by virtue of this Agreement, to share or participate in such other businesses, investments or activities of any Member or Manager or to the income or proceeds derived therefrom. No Member or Manager shall incur any liability to the Company or to any of the other Members as a result of engaging in any such other business, investment or activity.

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Variations: Sample Language – Limitation on Duty of Loyalty Discussion

- The previous slide reflects a more moderate expression of permission for a manager to engage in activities other than managing the subject company.

- ***Key drafting consideration***: where to draw the line in order to optimize a conclusion (in an action attacking a Manager's conduct) that the contractual provision is "not manifestly unreasonable" and therefore should be honored.

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Variations: Sample Language – Limitation on Duty of Loyalty/Self-Dealing

No Member and no Person which is an Affiliate of any Member, (a) may be employed by the Company or any Affiliate of the Company or otherwise deal with the Company, any Affiliate of the Company or any Property, or (b) may be paid any compensation, fees or other remuneration, directly or indirectly, by the Company or any Affiliate of the Company, except in either such case with the prior written consent of all Members. Notwithstanding the foregoing, the Company or any Affiliate of the Company may enter into a written management agreement with ABC Management Services, Inc., an affiliate of [Member X] or an Affiliate thereof, to provide property management, leasing and brokerage services with respect to any Property acquired by the Company, subject to the written approval of [Member Y] in each instance. The enforcement of any such agreement by or on behalf of the Company and/or any Affiliate of the Company shall be controlled exclusively by [Member Y].

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Variations: Sample Language – Duty of Loyalty/Self-Dealing Discussion

- The language in the previous slide reflects specific negotiated consent to engage in a limited form of self-dealing for affiliates of Member X, subject to the consent of Member Y (in reality, there were 10 additional members, but all with significantly more modest involvement).

- Other "not manifestly unreasonable" governors could include a statement that the compensated services to the company would be at a price not exceeding market price, or that the manager may pursue certain categories of opportunities that otherwise would be company opportunities. Such arrangements are commonplace and permissible.

- Consider appropriate limitations to address the "not manifestly unreasonable" standard (in the example, governors imposed by a non-affiliate member consent, in the alternative, market price).

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Variations: Sample Language – Method of Ratification: § 8815(d)(i)(1)

[A]NY resolution or course of action by the [Manager] or its Affiliates in respect of such conflict of interest shall be permitted and deemed approved by all Members, and shall not constitute a breach of this Agreement … or of any duty stated or implied by law or equity, if the resolution or course of action in respect of such conflict of interest is (i) approved by Special Approval, (ii) approved by the vote of a majority of the Common Units (excluding Common Units owned by the Manager and its Affiliates), (iii) on terms no less favorable to the Company than those generally being provided to or available from unrelated third parties, or (iv) fair and reasonable to the Company, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable or advantageous to the Company).

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Variations: Sample Language – Method of Ratification: § 8815(d)(i)(1)

- Special Approval" means approval by a majority of the members of the Conflicts Committee.
- The Conflicts Committee must be: [A] committee of the Board of Directors of the Manager composed entirely of two or more directors who are not (a) security holders, officers or employees of the Manager, (b) officers, directors or employees of any Affiliate of the Manager, (c) holders of any ownership interest in the Company other than Common Units and who also meet the independence standards required of directors who serve on an audit committee of a board of directors established by the Securities Exchange Act of 1934, as amended, and the rules and regulations of the Commission thereunder and by the National Securities Exchange on which the Common Units are listed or admitted to trading.

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Variations: Sample Language – Method of Ratification Discussion

- The above language was “borrowed” from the recent Delaware Supreme Court decision in *Dieckman v. Regency GP LP*, C.A. No. 11130 (Del. Jan. 20, 2017), which confirms that, although Delaware courts will enforce clear, express and unambiguous language modifying or eliminating default fiduciary duties, a conflict of interest transaction may still run afoul of implied contractual standards. (while a limited partnership case, the law is substantially similar to that governing LLCs)
- The *Dieckman case* involved a merger of Regency Energy Partners LP, a publicly traded Delaware limited partnership (the "MLP"), with an affiliated entity. To reconcile this inherent conflict of interest, the general partner (GP) of the MLP attempted to satisfy two safe harbor mechanisms set forth in the partnership agreement, either of which could be used to insulate the transaction from legal challenge—"Special Approval" by an independent Conflicts Committee and "Unaffiliated Unitholder Approval."

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Variations: Sample Language – Method of Ratification Discussion

- The plaintiff, a common unitholder of the MLP, alleged that (1) the GP failed to satisfy the Special Approval safe harbor because there was a conflicted member on the Conflicts Committee, and (2) the GP failed to satisfy the Unaffiliated Unitholder Approval safe harbor because the GP made false and misleading statements in a proxy statement to secure such approval.
- The Chancery Court did not address the defendants' Special Approval defense, but found that the Unaffiliated Unitholder Approval safe harbor had been satisfied because (i) the partnership agreement had eliminated all fiduciary duties, including the duty of disclosure, and (ii) the disclosures expressly required by the partnership agreement had been made. The Chancery Court therefore granted the defendants' motion to dismiss.

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Variations: Sample Language – Method of Ratification Discussion

- On appeal, the Delaware Supreme Court noted that even when a partnership agreement waives fiduciary duties, investors still have, *inter alia,* protections afforded to them through the implied covenant of good faith and fair dealing.
- The Supreme Court focused on the safe harbor process in its entirety and found that the language in the partnership agreement's conflict resolution provision implicitly required the GP to act in a manner that would not undermine the protections afforded to the unitholders in connection with the safe harbor process.
- The Supreme Court analyzed aspects of ***both*** the Special Approval Defense and the Unaffiliated Unitholder Approval Defense

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Variations: Sample Language – Method of Ratification Discussion

- In analyzing the Unaffiliated Unitholder Approval defense, the Supreme Court noted that the GP had issued a comprehensive proxy statement, which went far beyond the minimal disclosures required by the express terms of the partnership agreement, to induce the unitholders to approve the merger transaction, but then held that once the GP determined to go beyond the minimal disclosure requirements under the partnership agreement, then—pursuant to the implied covenant of good faith and fair dealing—the GP had an obligation not to mislead investors.
- The Supreme Court found that the plaintiff pled facts raising sufficient doubt concerning whether the proxy statement misled investors by creating the false appearance that the Conflicts Committee, which had approved the transaction, was composed solely of unaffiliated and independent persons.

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Variations: Sample Language – Method of Ratification Discussion

- The Court, in analyzing the Special Approval defense, found that the GP had an obligation to form a conflicts committee as required by the partnership agreement (committee members independent from and unaffiliated with the GP). The plaintiff alleged the GP created a two-member committee that included an individual who began reviewing the merger transaction while still a member of an affiliate board, which contravened the independent status requirement of the Conflicts Committee members. The Court concluded that the plaintiff raised sufficient doubt as to whether the Conflicts Committee was properly constituted, which called into question whether the GP could use the partnership agreement's safe harbor provisions agreement to preclude judicial review of the merger transaction.
- *Dieckman* illustrates the tension between contractual flexibility afforded to Delaware limited partnerships and general good faith requirements to perform obligations imposed by contractual responsibilities in the partnership agreement.

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Recent Case Law Trends – Ratification

In re Energy Transfer Equity, L.P. ("ETF") Unitholder Litigation C.A. No. 12197-VCG (Del. Ch. May 17, 2018)

- Soon after ETF entered into an agreement to merge with the Williams Companies, Inc. ("Williams Co."), the energy sector experienced a sharp decline. Facing a credit downgrade, ETF explored alternatives to deleverage its balance sheet. The Board of ETF approved a public offering of convertible preferred units. The offering required the consent of Williams Co. Williams Co. refused consent. The Board then approved a private placement of securities. Over 70% of the individuals invited to participate in it were either affiliated with ETF or related to affiliated individuals.
- Litigation ensured. One of the key theories advanced by the plaintiffs was that the private placement violated the Partnership Agreement provisions governing conflict transactions. Plaintiff sought cancellation of the securities issued in the private placement and a permanent injunction to prevent conversion or transfer of the issued securities.

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Recent Case Law Trends – Ratification

The Partnership Agreement provided four safe harbors to demonstrate that the private issuance of securities was fair and reasonable. ETF relied primarily on the use of a Conflicts Committee.

The Conflicts Committee appointed by the Board was subject to certain "flaws".

- One - two of the three proposed members were affiliated with ETF.
- Two – upon notification that two proposed members were affiliates, the Board received advice to reconstitute the Conflicts Committee (a committee of one) but failed to do so.
- Three – the unaffiliated member (a highly regarded engineer and former VP at ETF) was simply out of his league and had little or no experience in financial matters.
- Four – poor process – minutes reflected substantive telephonic meetings but phone records indicated only brief calls. Written records indicated that key written materials were distributed at or near the end of meetings rather than in advance of meetings.

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Spectra Energy

Morris v. Spectra Energy Partners (DE) GP, LP, C.A. No. 12110-VCG (Del. Ch. June 27, 2017)

Represents another foray into an interested party transaction. Basic takeaways:

The terms of the partnership or operating agreement matter;

The facts matter; and

The narrative of the Conflicts Committee process matter.

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Spectra Energy

The Partnership Agreement provided that the approval of a Conflicts Committee created a rebuttable presumption that the general partner acted in good faith. The Partnership Agreement also contained a general provision that provided for a conclusive presumption of good faith where the Conflicts Committee acts in reasonable reliance on certain professional opinions.

The Court in Spectra held that statutory construction provides that the specific partnership provisions dealing with rebuttal presumption control over the more general conclusive presumption partnership provision.

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Spectra Energy

The facts at first blush indicated that Spectra Corp. would transfer approximately $1.0 billion in value to Spectra Energy Partners ("SEP") in exchange for SEP's rights held in certain pipelines.

Spectra Corp. would then transfer the rights in said pipelines to a newly formed 50/50 joint venture with the other joint venture partner contributing $1.5 billion in cash.

The record suggests that under the distribution waterfall in the Partnership Agreement, Spectra Corp. was entitled to certain distributions related to the pipeline and that as a result the value of the rights in the pipeline were perhaps $1.5 billion in the hands of Spectra Corp. but only $1.0 billion in the hands of the Partnership.

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Spectra Energy

The Conflicts Committee and its experts did not sufficiently develop the facts regarding the distribution waterfall, or the basis on which the valuation expert rendered its opinion to adequately address the discrepancy in the perceived value to Spectra Corp ($1.5 billion) and the Partnership ($1.0 billion).

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