

State Law & State Taxation Corner

By *Thomas E. Rutledge*

Waiving Fiduciary Obligations



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In *Gotham Partners*,¹ the Delaware Supreme Court held that the then-existing language in the Delaware Limited Partnership Act providing that fiduciary duties may, in a limited partnership agreement, be “expanded or restricted” was not sufficient to permit the elimination of fiduciary duties.² Subsequently, in 2004, the Delaware General Assembly amended the Delaware LLC, Limited Partnership and the General Partnership Acts to provide expressly that the organic agreement between the participants may “eliminate” fiduciary obligations.³ Since then, we have been advised that it is the Court’s expectation that any waivers of fiduciary duties must be carefully crafted,⁴ and as well that, if the transaction is sufficiently specific, parties thereto should not thereafter seek to undo the deal to which they have entered.⁵

A recent pair of decisions highlights the issues that arise when a waiver of fiduciary obligations is the desired outcome. The first of these decisions was rendered in *Faulkner v. Kornman (in re The Heritage Organization, L.L.C.)*,⁶ where the question presented was how to interpret a waiver of fiduciary duties set forth in an operating agreement. In this instance, the operating agreement was specific that the manager of the Heritage Organization, L.L.C. owed no fiduciary obligations to either that business organization or to its members. Heritage Organization, L.L.C. is a Delaware L.L.C. formed in 1994 that, in May 2004, filed a voluntary petition for bankruptcy under Chapter 11.

The Heritage operating agreement provided:

The manager should not be required to exercise any particular standard of care, nor shall he owe



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any fiduciary duties to the Company or the other Members. Such excluded duties include, by way of example, not limitation, any duty of care, duty of loyalty, duty of reasonableness, duty to exercise proper business judgment, duty to make business opportunities available to the company, and any other duty which is typically imposed upon corporate officers and directors, general partners or trustees. The Manager shall not be held personally liable for any harm to the Company or the other Members resulting from any acts or omissions attributed to him. Such acts or omissions may include, by way of example but not limitation, any act of negligence, gross negligence, recklessness, or intentional misconduct.

In this bankruptcy proceeding, one argument of the Trustee was that, *inter alia*, the managers of Heritage⁷ owed common law fiduciary duties in addition to those detailed in the operating agreement. In response, the Court noted that, under

Delaware law, a limited liability company is a creature of contract, citing as authority, *Bernstein v. TractManager, Inc.*⁸ and *Douzinias v. Am. Bureau of Shipping, Inc.*⁹ for the proposition that whether such rights or duties as existed were those as detailed in the operating agreement. On that basis, the Defendants' Motion for Summary Judgment as to allegations of breach of fiduciary duties and gross negligence was granted as:

The Trustee has still to demonstrate the existence of any fiduciary duties owed Without a duty, there can be no breach of duty or resulting harm.

Conversely, the ultimate outcome of the decision rendered in *Kahn v. Portnoy*¹⁰ was highlighted by the lead-in paragraph of the opinion, which states:

Limited liability companies are primarily creatures of contract and the parties have broad discretion to design the company as they see fit in an LLC agreement. With this discretion, however, comes the risk—for both the parties and this Court—that the resulting LLC agreement will be incomplete, unclear or even incoherent.

A recent pair of decisions highlights the issues that arise when a fiduciary waiver is sought when a waiver of fiduciary obligations is the desired outcome.

In this instance, the LLC agreement at issue specifically imported, and then sought to modify, the fiduciary duties imposed under Delaware Corporate Law. The Court found that the agreement failed “to clearly articulate the contours of these contractual fiduciary duties,” provided an ambiguous definition of fiduciary duties and was open to more than one reasonable interpretation, thereby precluding the award of a motion to dismiss.

While these cases are helpful illustrations of what does and does not constitute the obligation to scriven with precision, as applied outside of Delaware there is begged a crucial question, namely whether it is permissible to even so scriven. As noted above, the Delaware LLC, limited partnership and general partnership acts expressly permit

the elimination of the fiduciary duties, including the duty of care and the duty of loyalty.¹¹ Certain other states, at least in individual statutes, similarly permit elimination of either duties or culpability for their violation.¹²

It is incumbent upon the drafter to be sure that statutory limitations upon the modifiability/elimination of fiduciary duties are satisfied. An exactly precise modification or elimination may not be enforced when the statute does not expressly permit such modification/elimination, and will of course be a nullity if it extends beyond the degree to which a statute expressly permits modification/elimination. For example, the Uniform Limited Partnership Act (2001), at Section 110 thereof,¹³ provides *inter alia*, that an agreement of limited partnership may not eliminate the duty of loyalty, may provide exceptions to the duty of loyalty only if not “manifestly unreasonable,” or may not “unreasonably” reduce the duty of care. In the context of a limited liability company governed by the Uniform Limited Liability Company Act (2006),¹⁴ a different formulation is used as to the degree to which either the duty of loyalty or the duty of care may be modified, but again, it is not permitted that either obligation be eliminated.

Working against these statutory limitations may be more difficult than is the situation in Delaware where, assuming the parties to the transaction are agreeable to such, a complete waiver of the duties is permissible. It is rather more difficult within the scope of

indefinite statutory formations and distinctions such as between “unreasonable” and “manifestly unreasonable,”¹⁵ to craft a modification of the obligations imposed. Absent guidance, which guidance has not to date been forthcoming, as to how these limitations on modifiability will be applied, there will exist questions regarding whether any particular language is or is not going to be enforceable. This risk should be communicated to those persons who are seeking an operating or partnership agreement that departs, especially if the departure is significant, from the default standards.

With the language sanctioned in *Faulkner*, we have a benchmark as to what, at least with respect to partnerships, limited partnerships and LLCs organized in Delaware, is sufficient specificity for the elimination of fiduciary obligations. This guidance, however, is certainly not controlling outside of Delaware and especially in those jurisdictions that do not provide an express authorization for the elimination of fiduciary duties or, more importantly, in those jurisdictions that have imposed limitations on the degree to which the default of fiduciary obligations of care and loyalty may be modified.

ENDNOTES

- ¹ *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, Del. SCT, 817 A2d 160 (2002).
- ² DEL. CODE ANN. tit. 6, §17-1102(d)(2) (prior to amendment in 2004).
- ³ See, e.g., DEL. CODE ANN. tit. 6, §18-1101(c) (“To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealings.”); DEL. CODE ANN. tit. 6, §18-1101(e) (“A limited liability company agreement may provide for the elimination of any and all liabilities for breach of contract or breach of duty (including fiduciary duties) of a member, manager, or other person to a limited liability company.”)
- ⁴ *Willie Gary LLC v. James & Jackson LLC*, Del. Ch., 2006 Del. Ch. LEXIS 3 (Jan. 10, 2006); *aff’d*, *James & Jackson, LLC v. Willie Gary, LLC*, Del. SCT, 906 A2d 76 (Mar. 14, 2006).
- ⁵ *Miller v. American Real Estate Partners, L.P.*, 2001 Del. Ch. LEXIS 116 at *26 (“This court has made clear that it will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties”) (citations omitted). (Del. Ch. 2001).
- ⁶ *Faulkner v. Kornman (in re The Heritage Organization, L.L.C.)*, BC-DC Tex., 2008 Bankr. LEXIS 3230 (Dec. 12, 2008).
- ⁷ Another interesting aspect of this case is that the Heritage operating agreement expressly provided for the delegation of certain functions to persons other than parties to the operating agreement, giving rise to a question of whether, in those delegated roles, those persons were protected by the fiduciary waiver language of quoted. Ultimately, the Court determined that they were.
- ⁸ *Bernstein v. TractManager, Inc.*, Del. Ch., 953 A2d 1003, 1007-08 (2007).
- ⁹ *Douzinis v. Am. Bureau of Shipping, Inc.*, Del. Ch., 888 A2d 1146, 1150 (2006).
- ¹⁰ *Kahn v. Portnoy*, Del. Ch., 2008 Del. Ch. LEXIS 184.
- ¹¹ DEL. CODE ANN. tit. 6, §§18-1101(c) (LLC), 17-1101(d) (LP), 15-103(c) (general partnership) and tit. 12, §§3806(c), (e) (statutory trust).
- ¹² For example, the Kentucky LLC Act, since its adoption in 1994, has provided that a written operating agreement may eliminate culpability for breaches of fiduciary duty. See KY. REV. STAT. ANN. §275.180(1). Kentucky is a clear example, however, of why this statutory review must be done on an entity-by-entity basis. Neither the Kentucky adoption of the Revised Uniform Partnership Act (1997) nor its adoption of the Uniform Limited Partnership Act (2001) permit either the elimination of the duty of care or the duty of loyalty nor expressly provide that culpability for any breach thereof may be eliminated.
- ¹³ 6A U.L.A. 378 (2008).
- ¹⁴ 6B U.L.A. 442 (2008).
- ¹⁵ Compare RUPA §103(b)(4) with §103(b)(3)(i).

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