Approval of Conflicted Transaction by a Majority of LLC Members Does Not Disclaim Fiduciary Duties

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The Delaware Court of Chancery reaffirmed a manager's fiduciary duties of loyalty and care to members of a Delaware limited liability company in the absence of a clear and unambiguous disclaimer of fiduciary duties in the operating agreement. Under *Largo Legacy Grp., LLC,* a manager may be held accountable for a breach of its fiduciary duties, even though the operating agreement sanctions or provides a mechanism for obtaining approval of the underlying act or transaction, because a procedural safeguard does not necessarily constitute a valid disclaimer. The court's denial of the motion to dismiss suggests that in order to insulate a manager's conduct, the operating agreement must clearly and unambiguously disclaim the fiduciary duties.

Background

The lawsuit arises out of a manager's handling of a real estate transaction on behalf of Largo Hotel, LLC (the Company). The manager used the Company's funds to finance predevelopment of the land, in which hundreds of thousands of dollars were paid to the manager's construction company. The manager then valued the real estate at zero based on excessive predevelopment expenses. Thereafter, the manager conveyed the real estate to a special-purpose vehicle owned by the manager and 85 percent of the members of the Company for no consideration. The manager did not reimburse the Company for the predevelopment expenses. To the contrary, following the transaction, it made a capital call on members of the Company to cover the predevelopment expenses.

The plaintiff holds a 15 percent ownership interest in the Company. Although the manager provided the plaintiff with an opportunity to obtain a proportionate interest in the special-purpose vehicle, the plaintiff declined the offer. After the plaintiff unsuccessfully sought information from the manager regarding the transaction, the plaintiff filed suit, alleging that the manager breached its fiduciary duties of loyalty and care. The manager sought to dismiss the lawsuit by arguing that provisions in the Company's operating agreement shielded it from liability. The court disagreed.

Legal Analysis

Delaware law presumes that a manager of a limited liability company owes a fiduciary duty of care and loyalty unless the duties are expressly disclaimed within the company's operating agreement. While freedom of contract provides an opportunity to preempt common-law principles, the drafters of an operating agreement must disclaim fiduciary duties in clear and unambiguous terms. The Delaware courts will resolve any ambiguity "in favor of the full panoply of duties," thereby shielding investors from surprise.

In *Largo Legacy Grp., LLC*, the operating agreement stated that the Company's manager owed certain fiduciary obligations. The operating agreement also permitted the Company to enter into transactions with the manager, provided that 70 percent of the Company's members approved the transaction. The manager relied on this provision to defeat the plaintiff's claims, but the Court of Chancery rejected the argument. The court found that the plaintiff alleged claims for breach of fiduciary duty based on "an overarching theory of misconduct aimed at depriving [the plaintiff] of information and fair value." Although 85 percent of the members authorized the transaction, "***inequitable action does not become permissible simply because it is legally possible***." In this instance, the court found that the manager's use of the Company's funds to pay his construction company for predevelopment costs, along with its assignment of zero value to the land, supported a claim for breach of fiduciary duties. Despite the existence of the consent provisions in the operating agreement, the breadth of the manager's duties and scope of the plaintiff's claims did not preclude recovery at the motion to dismiss stage. If the drafters of the operating agreement sought to shield the manager from liability, they should have linked the approval procedures to a disclaimer of fiduciary duties in a more overt fashion. Absent an express and unambiguous disclaimer, a member may hold managers liable for a breach of the standard of care.

Conclusion

Largo Legacy Grp., LLC highlights the importance of precision in drafting an operating agreement. The Company's operating agreement required the manager to adhere to a standard of care. This language created an enforceable right for all members. Although the drafters of the agreement may have sought to shield the manager from liability if the relevant act garnered the support of 70 percent of the Company's members, they failed to state that consent satisfied the manager's duty or otherwise absolved the manager of any breach of fiduciary duty claims. Delaware law dictates that any limitation on or disclaimer of a manager's fiduciary duty must be clear and unambiguous.