Disclaimed Traditional Fiduciary Duties in LLC Agreement Re-imposed on Manager by Contradictory Language in LLC Agreement

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The Delaware Court of Chancery's decision in *Cadira Grp. Holdings, LLC Litig.* reflects the importance of precision in addressing a manager's fiduciary duties within the operating agreement of a Delaware limited liability company. In its latest decision concerning contractual fiduciary duties, the court denied the defendants' bid to dismiss a fiduciary duty claim based on language in the operating agreement. Although the operating agreement evidenced an intent to restrict traditional fiduciary duties, the drafters failed to achieve this objective in a plain and unambiguous manner, thereby causing the manager to owe a duty of care and loyalty to the limited liability company.

Background

Knights Genesis Healthcare, LLC (KGH) and Perseverance Med, LLC formed Cadira Group Holdings, LLC, a Delaware limited liability company, to invest in the healthcare industry. KGH was purportedly induced into joining the venture based on the representations of Cadira's future manager that it had experience in the healthcare field and that his companies have always operated with the utmost integrity and in compliance with the law. An opportunity to acquire a distressed hospital arose, and the parties entered into a series of agreements in furtherance of this purpose.

First, Cadira executed a promissory note, under which KGH loaned Cadira $1 million to acquire the hospital. Second, Cadira and KGH entered into a subscription agreement, which granted KGH a 49 percent membership interest in Cadira in exchange for a $2 million payment, a separate payment of $1 million for working capital, and payment of $1.5 million "on an as needed basis for working capital … subject to the unanimous consent of the [m]embers … ." Third, Cadira's operating agreement was executed. The operating agreement provided that KGH shall hold a 49 percent member interest in Cadira upon making the payments specified in the subscription agreement. Following the execution of the documents, Cadira's manager incurred debts on behalf of the company without seeking KGH's approval, and KGH refused to make the $1.5 million payment for working capital. KGH also learned that various insurers sued Cadira's manager and his companies for insurance fraud.

Both KGH and Cadira filed suit in the Delaware Court of Chancery. KGH asserted claims for fraud, equitable fraud, breach of contract, breach of fiduciary duties, and unjust enrichment, while Cadira sought a declaration that KGH breached its obligations under the subscription agreement and an injunction compelling KGH to satisfy its funding requirements. Both parties moved for dismissal of the competing complaint.

Analysis

With respect to KGH's breach of fiduciary duty claim, the operating agreement stated that a manager shall not be liable to the company for acts that do not constitute fraud, gross negligence, willful misconduct, or a material breach of the agreement. Elsewhere, the operating agreement stated that it intended "to restrict the liability and fiduciary duties of [members and managers] to the maximum extent permitted by applicable law." However, that very section indicated that neither the company, the manager, nor a member shall have a claim against any manager or member, provided that the relevant act does not constitute bad faith, gross negligence, willful misconduct, or actual fraud. KGH argued that these provisions obligated Cadira's manager to honor certain standards of conduct. The defendants countered that the operating agreement replaced traditional fiduciary duties with contractual duties, for which KGH failed to plead a claim upon which the court could grant relief.

The Delaware Court of Chancery denied the motion to dismiss KGH's complaint based, in part, on the failure of the drafters of the operating agreement to eliminate fiduciary duties in a plain and unambiguous fashion. "Where an LLC agreement purports to replace traditional fiduciary duties with duties not to engage in bad faith, willful misconduct, or gross negligence, that agreement 'essentially' replaces traditional fiduciary duties with identical contractual duties." Although a separate section of the operating agreement sought to limit the liability and fiduciary responsibilities of the manager to the fullest extent, that same section authorized claims against the manager based on bad faith, gross negligence, willful misconduct, and fraud. While this finding may be confusing, the court was essentially saying that "a contractual duty to refrain from 'willful misconduct' or 'bad faith' corresponds with the traditional duty of loyalty, and a contractual duty to refrain from 'gross negligence' corresponds with the traditional duty of care." As such, according to the court, the manager had in fact agreed contractually that it "owe[d] the default traditional fiduciary duties of care and loyalty to [the Members]" because, by "green-light[ing] claims against the Manager arising from the 'Manager's bad faith, gross negligence, [or] willful misconduct'" after purporting to eliminate fiduciary duties, the operating agreement had effectively reimposed them. This language precluded a finding that the drafters of the operating agreement intended to eliminate fiduciary duties, and thus, the manager may be held liable for a breach of its fiduciary duties under the agreement.

Conclusion

This decision shines a bright light on the operating agreements of Delaware limited liability companies, in which managers and members often attempt to limit or eliminate fiduciary duties within the agreement. Delaware law is clear—the drafters of an operating agreement must use plain and unambiguous language to curtail or abolish fiduciary duties. The failure to address the existence of these duties or, in the alternative, the use of contradictory or ambiguous language in the operating agreement to restrict them will cause the court to hold a manager responsible for a breach of its traditional fiduciary duties. The biggest takeaway here is that if you intend to eliminate fiduciary duties completely, do not eliminate traditional fiduciary duties and replace them with duties not to engage in bad faith, willful misconduct, or gross negligence. Drafters of operating agreements must plan accordingly.