

Limited fiduciary duties of LLC managers

By Kathryn Barrett

Limited liability companies are business entities governed primarily by contract — the LLC operating agreement. They are more flexible than other business structures. But this flexibility comes with some perils. Unlike corporations and partnerships, where there is a large body of law that imposes fiduciary duties on partners and company management, those duties can be modified or eliminated in LLCs. The LLC operating agreement can limit the manager's fiduciary duties, permit the manager to compete, and limit the members' ability to oust a derelict manager.

Over the years, I have litigated many cases involving LLCs, on behalf of both investors and management. Invariably these disputes involved the scope of fiduciary duties owed by the manager. Recently we represented the investors of an LLC who learned that the manager used the company's assets to run his own side business. The manager, who owned a very small percentage of the LLC, had been the member who arranged for the creation of the operating agreement, including terms that limited his fiduciary duties and allowed him to compete with the LLC. Further, under the terms of the operating agreement, the manager could not be removed for negligent mismanagement. The investor-members signed the agreement. We ultimately removed the manager by meeting the high standard, as required by the terms of the operating agreement, demonstrating his gross negligence and willful misconduct.

Many LLCs are formed in Delaware, even though they may operate exclusively in California. Delaware's strong policies favoring freedom of contract have resulted in a controversy concerning whether or not it is necessary to explicitly include a provision eliminating fiduciary duties in an LLC operating agreement or if imposition of fiduciary duties is the "default." The issue remains somewhat unsettled in Delaware, although most recent decisions have taken the position that, unless explicitly eliminated, fiduciary duties remain. What is clear, however, is that, even if the operating agreement eliminates fiduciary duties, the "implied contractual covenant of good faith and fair dealing" provides a minimum, albeit vague and unpredictable, standard of conduct. This implied covenant is probably one of the most over-pled and under-proved concept in the law.

In the January case of *Auriga Capital v. Gatz Properties*, the operating agreement was silent on fiduciary duties. The Delaware court recited a litany of bad acts by the manager, finding that he traduced even the squishy bounds of the implied covenant of good faith and fair dealing, and further opined that fiduciary duties of the manager were imposed under general equitable principles. The manager had allowed the LLC's championship-caliber golf course to fall into disrepair. He then arranged for low bids and a sham auction so that he could buy the property at an artificially low price. Investors were left with only a few cents for each dollar originally invested.

In *Bay Center Apartments Owner, LLC v Emery Bay PKI, LLC*, the operating agreement of a Delaware LLC that operated in California contained conflicting provisions regarding fiduciary duties, simultaneously imposing and eliminating such duties. The Delaware court in this case denied a motion to dismiss on the ground that the LLC agreement was as likely as not to retain

fiduciary duties in the face of the conflicting contractual provisions.

In California, unlike Delaware, Corporations Code Section 17153 explicitly imposes fiduciary duties on managers of LLCs. But Section 17005(d) allows this "default" position to be modified by the operating agreement, with the "informed consent" of the members. This can be a problem where the intended manager of the LLC is the one who shepherds the drafting and signing (by members) of the operating agreement. Clauses that permit the manager to compete with the entity and limit fiduciary duties are agreed to when everyone is excited about the company prospects and before any controversy arises as to breaches of duties, self-dealing, and litigation. Similarly, the ability to remove a manager can become a litigation nightmare where the operating agreement imposes limitations (willful misconduct, gross negligence) on the ability of members to remove the manager.

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Buyers beware. An LLC member is entering a contractual relationship. Do not assume that the statutorily-imposed fiduciary duties that govern corporations and partnerships will protect your interests. As with any contract, make sure that your interests are covered in the LLC operating agreement before a controversy arises. Management duties and responsibilities should be spelled out in the operating agreement.



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