Legal Alert

May 2010

Joseph P. Richardson
jrichardson@gblaw.com
602-256-4452

Traditional Fiduciary Duties and LLCs

A recent case decided in the Delaware Court of Chancery clarified that managers and controlling members of an LLC owe fiduciary duties to the LLC and its members, unless the governing LLC agreement explicitly expands, restricts or eliminates these fiduciary duties. The court also held that the fiduciary duties in the LLC context are analogous to the duties of "loyalty" and "care" owed by corporate directors to a corporation and its stockholders, and include the duty of majority stockholders not to cause a corporation to enter into a transaction at the expense of minority stockholders.

Factual Background

The recent Delaware case, Kelly v. Blum (Del. Ch. No. 4516-VCP, Feb 24, 2010), arose out of a dispute between majority and minority members and managers of Marconi Broadcasting Company, LLC (Marconi). The plaintiff, Thomas Kelly, formed Marconi in late 2006 as a vehicle to acquire radio broadcast rights and licenses, including a radio tower and FCC licenses of an AM radio station in the greater Philadelphia area. Marconi's purchase of the radio station was funded by a US$2.5 million loan and US$2.5 million equity investment from the defendant ELB Capital Management, LLC and affiliated entities (ELB) and US$1 million equity investment from Kelly.

By March 2008, Marconi required an additional US$2 million secured loan from an ELB subsidiary, largely due to continued lack of cash flow to maintain operations. ELB informed Kelly that Marconi must "begin to explore a sale as well as other means of making the station financially viable."

In September 2008, a special meeting of Marconi's board of managers was convened, and a few minutes before the meeting, Kelly was informed that he was being terminated as president of Marconi, though he would remain a member and manager.

In the first quarter of 2009, ELB sought to sell Marconi, and engaged a financial advisor who determined that Marconi had a maximum fair market value of US$2.6 million. In March, ELB's chairman and founder proposed a US$7 million merger of Marconi with an ELB subsidiary, the effect of which would be that Kelly would be squeezed out of his ownership interest in Marconi for nominal consideration. The ELB affiliated members of Marconi approved the merger by written consent without seeking or receiving Kelly's consent.

Within hours of a filing of the Certificate of Merger in Delaware, Kelly brought suit against ELB and its affiliates on behalf of himself and Marconi, alleging, among other things, that the ELB appointed managers and affiliated members of Marconi breached their fiduciary duties of loyalty and care.

The Chancery Court's Analysis of the LLC Managers' and Members' Fiduciary Duties

In reviewing the case on a motion for summary judgment, the Delaware Court of Chancery found that Kelly's complaint alleged sufficient facts to support his claim that the ELB affiliated managers and members breached their fiduciary duties to Kelly by entering into a merger transaction designed solely to eliminate Kelly's interest in Marconi.

In rendering its opinion, the court noted that the basic approach of Delaware's Limited Liability Company Act (LLC Act) is to provide members with broad discretion in drafting an LLC agreement and to give "maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." In the case of fiduciary duties, Section 18-1101(c) of the LLC Act allows contracting parties to expand, restrict or eliminate duties, including fiduciary duties, owed by members and managers to each other and the LLC.

Citing recent Delaware precedent, the Chancery Court found that the LLC Act grants LLC members "significant discretion and wide latitude" in the ordering of their relationships, including the flexibility to limit or eliminate fiduciary duties. However, in the absence of a contrary provision in the LLC agreement, LLC managers and members owe traditional fiduciary duties of loyalty and care to each other and the company. Thus, unless the LLC agreement explicitly expands, restricts or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members, and controlling members owe those duties to minority members.

Further, the court noted that having been granted great contractual freedom by the LLC Act, drafters of provisions in an LLC agreement should be clear and unambiguous when they are intended to expand, restrict or eliminate the operation of traditional fiduciary duties.

Following a textual analysis of the Marconi LLC agreement, the Chancery Court concluded that the agreement did not restrict or eliminate the applicability of traditional fiduciary duties. Those duties included the managers' duties of loyalty and care, and the majority members' duties not to cause Marconi to enter into a transaction that would benefit the controlling members at the expense of Kelly, Marconi's minority member.

Lessons From Kelly v. Blum

o Traditional Fiduciary Duties Apply by Default in the LLC Context. Unless otherwise explicitly agreed by the parties to an LLC agreement, managers and members of a Delaware LLC owe traditional fiduciary duties of care and loyalty to the LLC and to each other, which are analogous to the duties of directors and majority stockholders of Delaware corporations.

o Freedom of Contract. Unlike corporate law, the Delaware LLC Act provides "significant discretion and wide latitude" in the ordering of relationships between parties to an LLC agreement, including the flexibility to limit or eliminate fiduciary duties.

o Use Clear and Unambiguous Language. If parties to an LLC desire to expand, restrict or eliminate fiduciary duties, it is critical that it be done explicitly with clear and unambiguous language in the LLC agreement. Absent clear and unambiguous language, a Delaware court will apply traditional fiduciary duties by default.