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LIMITED LIABILITY COMPANIES

Lessons for Minority Investors in Failed Challenge to LLC Sale

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The objectives and incentives of different classes of investors may not always align. For example, the interests of different investors may be at odds in the context of a sale of the company. This can give rise to a conflict of interest or result in the provision of disparate consideration or unique benefits to some but not all investors. If the company were a corporation, common-law fiduciary duties would apply, and the stringent entire fairness standard of review could apply to the transaction in such an instance. Where the parties have eschewed the corporate form, however, and instead opted not only to create a limited liability company but also to waive all fiduciary duties, aggrieved investors generally have few avenues to seek relief in court.

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Miller v. HCP & Company, a recent decision by the Delaware Court of Chancery, illustrates the impact the choice of organizational form can have on litigation outcomes. The latitude afforded by the Delaware Limited Liability Company Act to privately order the affairs of the entity by, among other things, eliminating default fiduciary duties, can significantly reduce the defense costs and risks of litigation. In *Miller*, the court dismissed an action brought by a co-founder/minority investor in a Delaware LLC against the LLC's controlling member and its board designees for breach of the implied covenant of good faith and fair dealing. The claim arose in connection with the sale of the LLC, which yielded the controller a 200% return on its investment but provided the other LLC members with little or no consideration. The court rejected the plaintiff's argument that, although the LLC's operating agreement waived all fiduciary duties and gave the controlled board sole discretion to approve a sale to an unaffiliated third party, divergent incentives arising from the distribution waterfall in the LLC's operating agreement demanded that the court infer a requirement that any sale

be conducted pursuant to an open-market auction to ensure that maximum value would be generated for all LLC members and not just the controller, who had priority to sale proceeds up to a certain amount but stood to receive little above that amount under the waterfall.

The decision thus contrasts with the court's typical treatment of corporate cases involving similar facts. It also shows the limited protection afforded by the implied covenant, which often is a weak claim of last resort for plaintiffs in the LLC context. *Miller* further highlights the importance of careful drafting of contractual rights and protections when fiduciary duties have been modified or eliminated, especially for members holding a minority position in the LLC.

The Facts of the Case

According to the complaint, Christopher Miller cofounded Trumpet Search, LLC in 2008 and was a member and manager until its sale. HCP & Company, a private equity firm, first invested in Trumpet in 2014 when it acquired a majority of Trumpet's Class D units, becoming Trumpet's largest member. In 2016, HCP purchased nearly all of Trumpet's newly created Class E units and, in connection with that purchase, Trumpet's operating agreement was amended.

Under the amended agreement, HCP, as holder of most of the Class E units, was entitled to a first-priority return of 200% of its Class E capital contribution. The agreement also set out a distribution waterfall for determining members' returns on capital investment in the event of a sale that effectively would give HCP, which also held 90% of the next-in-line Class D units, the first $30 million before any sale proceeds would go to other members. The operating agreement waived all fiduciary duties of Trumpet's members and managers and provided HCP the right to appoint a majority of Trumpet's seven-person board. The agreement also gave the HCP-controlled board the right to approve a sale of Trumpet to an independent third party and provided that the board could determine in its sole discretion the manner in which a third-party sale would occur (whether as a sale of assets, merger, transfer of membership interests or otherwise). If the board approved a sale, the operating agreement obligated every member to consent to it.

Seven months after the operating agreement was amended in connection with its purchase of Class E units, HCP allegedly pushed for a sale of Trumpet to MTS Health Partners, L.P., an unaffiliated third party, which initially offered $31 million. The non-HCP managers objected to the lack of an open-market process and low price. In response, the HCP managers allowed Trumpet to undertake an abbreviated sale process and contact two entities who had previously expressed interest. This outreach led to competing indications of interest (including one valued between $50 million and $60 million). HCP nevertheless continued to pursue a sale to MTS, which threatened to revoke its offer or file suit for breach of an alleged exclusivity agreement as a result of Trumpet's outreach to other prospective buyers. The competitive pressure, however, moved MTS to increase its bid to $41 million and then to $43 million. According to plaintiff, the HCP managers exploited the lack of other firm offers on the table at the time (as well as MTS's threat of litigation) to ''wear down'' two of the non-HCP managers into accepting MTS's offer, pursuant to which non-HCP holders received little or no consideration for their interests.

Thereafter, plaintiff filed suit against HCP and its board designees for (among other things) breach of the implied covenant of good faith and fair dealing, alleging that, when the operating agreement was amended, he reasonably expected that any sale of Trumpet would be by auction in order to maximize the sale price. Plaintiff also asserted that, once HCP gained control of Trumpet, it set out to engineer a sale that would give it a quick exit that ignored the interests of members positioned further down in the distribution waterfall. Defendants moved to dismiss the case.

The Court's Decision

The court granted the motion. The court found that Trumpet's operating agreement did not contain any gap for the implied covenant to fill, rejecting the plaintiff's contention that the agreement was silent as to how Trumpet could be marketed and sold and thus an auction-sale requirement must be implied. The court observed that the operating agreement did not, by its terms, require the Trumpet board to conduct an auction but rather ''explicitly vest[ed] the [b]oard with sole discretion as to the manner in which a sale is conducted, subject to the limitation that the company is ultimately sold to an unaffiliated third-party buyer.'' According to the court, the Trumpet board had ''unfettered discretion to determine both how the company will be marketed and how the sale will be structured, *so long as* the transaction does not involve insiders.'' The court next found inapplicable the principle that, when a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith; the court reasoned that the operating agreement expressly defined the scope of the board's discretion by requiring that any sale be to a third party and, thus, there was no gap in the contract or reason for the court to look to the implied covenant to determine how the discretion should be exercised. In the court's view, the operating agreement indicated that the parties considered the implications of vesting discretion in a conflicted board, expressly addressed that situation with the third-party sale requirement, and thereby left no room for the implied covenant to operate.

The court further held that, even if the operating agreement contained a gap regarding how Trumpet could be sold, the plaintiff's implied covenant claim would fail because nothing suggested his reasonable expectations were frustrated. On the contrary, the express terms of the operating agreement indicated that the parties actually contemplated that Trumpet might be sold through private negotiation rather than an open-market process. Moreover, while the complaint alleged a process that was tilted in favor of the defendants' interests, the court found that the defendants' putative conduct during the sale process was not arbitrary, unreasonable, or unanticipated based on the plain terms of the operating agreement. The court noted that the parties easily could have anticipated this situation given that the defendants' interest in a quick exit, regardless of the effect on Trumpet's other members, was clear from the distribution waterfall itself. Further, the court observed that HCP did not use its control to consummate MTS's initial $31 million offer, but rather allowed for some process to play out over several months and successfully obtained a substantial increase in MTS's offer, which was the only one on the table when

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the deal was approved by the Trumpet board. The court further recognized that, had the plaintiff wanted to circumscribe this conduct, he could have sought explicit contractual protections, such as a minimum sale price, a majority-of-the-minority condition, or a period in which a sale was prohibited. Plaintiff bargained for none of these terms and the court stated that it would not give plaintiff what he failed to get at the bargaining table, explaining that the implied covenant ''is not an equitable remedy for rebalancing economic interests.'' Accordingly, the court dismissed plaintiff's complaint for failure to state a claim for breach of the implied covenant.

Conclusion

The *Miller* decision highlights the latitude business planners enjoy under Delaware law to structure an LLC and define the relationships among its constituents precisely as they desire. *Miller* also shows the deference paid to the express terms of an LLC agreement by Delaware's courts, which will give maximum effect to the principle of freedom of contract and enforce the agreement as written. Key takeaways from the court's opinion include:

Difference between Corporate and LLC Forms. The sale transaction would have been subject to entire fairness review had the parties chosen to use the corporate form, which would have required that the defendants prove the fairness of the sale process and the price. *Miller*, in fact, is reminiscent of *In re Trados Inc. Shareholder Litigation*; in that case, a former common stockholder brought suit challenging a sale of the company wherein preferred stockholders received nearly all of the sale proceeds due to a liquidation preference and common stockholders received no consideration at all. Following trial, the Court of Chancery found that a disinterested and independent majority of the board did not approve the transaction because, among other conflicts, directors affiliated with the preferred stockholders were focused on their firms' desire to exit their investments in the company. The court further found that the company's board did not deal fairly with the common stockholders, reasoning in part that the preferred stockholder-affiliated directors ''did not make this decision after evaluating [the company] from the perspective of the common stockholders, but rather as holders of preferred stock with contractual cash flow rights that diverged materially from those of the common stock.'' While the court held in *Trados* that the defendants did not breach their fiduciary duties because it was entirely fair for the common stockholders to receive nothing for their shares, which the court found to have no economic value, the *Miller* decision shows that costly and burdensome litigation potentially can be avoided or limited (despite similar facts) if the LLC form is employed and fiduciary duties are eliminated.

Implied Covenant: Ever-present, but Weak. The *Miller* decision exemplifies the Delaware courts' unwillingness to use the implied covenant of good faith and fair dealing to replicate fiduciary review where the parties to an LLC agreement have waived those equitable duties and instead have chosen for the entity to be governed by a detailed contractual scheme. In that context, a court will be ''all the more hesitant to resort to the implied covenant'' because a waiver of fiduciary duties ''implies an agreement that losses should remain where they fall.'' While the implied covenant inheres in every contract and cannot be eliminated by provisions of an LLC agreement, Delaware courts apply it ''cautious[ly]'' and it is ''rarely invoked successfully.'' Importantly, the implied covenant will not ''override the express terms of the contract,'' nor is it a ''free-floating requirement that a party act in some morally commendable sense.'' Rather, it is a narrow ''gap-filler'' that applies only when one party ''proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected'' at the time of contracting. The implied covenant therefore will not save a disappointed party from a bad deal.

Contractual Discretion: Define Scope or be Subject to Implied Covenant. As the court explained in *Miller*, if a contract confers discretion on a party, the implied covenant requires that the discretion be exercised ''reasonably and in good faith.'' However, ''if the scope of discretion is specified, there is no gap in the contract'' for the implied covenant to fill. That is, if an LLC agreement provides a party with discretion to make a determination, but cabins the scope of that discretion with an express limitation, then there generally is no room for the implied covenant to operate so long as the discretion is used in accordance with the contractual limitation. This follows from the principle that the implied covenant addresses unanticipated developments or fills contractual gaps, and ''is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract.'' Thus, in *Miller*, because the LLC agreement provided the board sole discretion to determine the manner of the company's sale and addressed any risk of abuse of that discretion by restricting it solely to transactions with an unaffiliated third party, the court concluded that the parties ''did consider the conditions under which a contractually permissible sale could take place'' and left to the controlled board ''the ability to structure a deal favorable to their interests.'' There thus was no gap in the contract and no room for the implied covenant to work.

No ''Arbitrary, Unreasonable or Unanticipated'' Conduct. In addition to finding that there was no gap in the LLC agreement to fill, the court observed that there were no allegations in the plaintiff's complaint of fraud or other wrongdoing on the part of the defendants that would warrant invocation of the implied covenant. On the contrary, the court noted that the defendants did not force through consummation of the initial offer from the third-party buyer, but instead made an effort to (and did) increase the sale price at the behest of plaintiff and other minority investors. Consequently, the court viewed plaintiff's implied covenant claim as a request to rewrite the express terms of the defendant-friendly agreement struck by the parties, and not as a plea to redress unanticipated misconduct by defendants that violated the spirit of the contract or deprived plaintiff of its benefits. Indeed, according to the court, the ''perverse incentive'' about which plaintiff complained was ''clear from the distribution waterfall'' in the LLC agreement itself.

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The stated statutory policy of the Delaware LLC Act is to give maximum effect to the principle of freedom of contract and the enforceability of LLC agreements. This affords contracting parties great flexibility to privately order the affairs of the LLC and their respective rights and responsibilities. It also means that careful negotiation and drafting are essential to ensure that foreseeable scenarios are addressed and that the parties' bargain is expressed in clear and unambiguous terms in the agreement. Given the latitude provided by Delaware law to organize LLCs with bespoke features, generally speaking no two LLCs are exactly alike. Accordingly, prospective LLC investors should review closely the operating agreement and offering materials so that they are fully aware of the risks, rights, and remedies associated with an investment in the particular LLC. To be

sure, *Miller* serves as a cautionary reminder that ''[p]arties have a right to enter into good and bad contracts[;] the law enforces both.''

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