

Gatz Highlights Standards for Affiliated-Party Transactions

If you have any questions regarding the matters discussed in this memorandum, please contact Allison Land in the Wilmington office at 302.651.3180, the Investment Management attorneys listed on page 3 or your regular Skadden contact.

* * *

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

One Rodney Square, Wilmington, DE 19899
Telephone: 302.651.3000

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

In *Gatz Properties, LLC v. Auriga Capital Corp.*,¹ the Delaware Supreme Court required a manager and controlling member of a Delaware limited liability company to satisfy the entire fairness standard of conduct and judicial review for a conflict transaction because the LLC agreement required affiliated-party transactions to be no less favorable than those entered into with arms-length third parties. The Supreme Court declined to decide whether Delaware law imposes the fiduciary duties of care and loyalty by default on managers or controlling members of an LLC where the operating agreement is silent since the agreement at issue expressly imposed fiduciary duties by way of the “arms-length” provision, notwithstanding a long line of cases in the Delaware Court of Chancery concluding that such duties are implied.

Background

In *Gatz*, the manager and controlling member of an LLC engaged in a self-dealing transaction aimed at buying out minority investors in the LLC. The manager and controlling member, incentivized to squeeze out the minority investors, refused to entertain offers from third parties to purchase the company’s assets, then commissioned an auctioneer to sell the assets in a “sham” auction, at which the manager and controlling member was the sole bidder, without adequately disclosing the existence of the third-party offers to the auctioneer or to the minority investors. As a result, the manager and controlling member purchased the assets for a fraction of the amount that the third party had previously indicated it was willing to offer.

Contractual Entire Fairness

The Supreme Court affirmed the Court of Chancery’s finding that the manager and controlling member breached his fiduciary duties.

The operating agreement at issue prohibited any affiliated-party transactions that are “on terms less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of the non-affiliated Members.”² On its face this provision only requires that a fair price be obtained, yet the Supreme Court held that the provision was the “contractual equivalent of the entire fairness equitable standard of conduct and judicial review.”³ As such, the manager and controlling member had the burden of demonstrating both the “fair price” and “fair dealing” prongs of the entire fairness standard, since he did not obtain consent from a majority of the non-affiliated members.

Applying this standard to the facts, the Supreme Court held that the course of dealing during the sale process, including the inadequate disclosures, did not satisfy the entire

1 No. 148, 2012, 2012 WL 5425227 (Del. Supr. Nov. 7, 2012).

2 *Id.* at *5.

3 *Id.*

fairness standard. Moreover, because of the manager and controlling member’s bad faith and misrepresentations to the minority investors, he was not eligible for exculpation or indemnification under the provisions of the LLC agreement.

Default Fiduciary Duties Under Delaware Law

Although the Court of Chancery had based its holding, in part, on its conclusion that fiduciary duties apply by default to managers and controlling members of Delaware LLCs in the absence of an express disclaimer thereof, the Supreme Court refused to address this issue, since the LLC agreement expressly imposed fiduciary duties by way of the “arms-length” provision. Accordingly, the Supreme Court, noting that the Delaware LLC Act is “consciously ambiguous” on this point, declined to express any view regarding whether Delaware law imposes such “default” fiduciary duties and suggested that the “organs” of the Delaware bar consider proposing amendments to the LLC Act to clarify this point. The Supreme Court further explained that the Court of Chancery’s *sua sponte* analysis of default fiduciary duties under Delaware law “must be regarded as dictum without any precedential value.”⁴

Implications

The Supreme Court’s application of the entire fairness standard of review in *Gatz* reminds contracting parties to express clearly in their operating agreement the scope of, and any limitations on, managers’ and members’ fiduciary duties, any presumptions of good faith or applicable standards of review, and the ability to rely on any experts or processes to ease the burden of review. More significantly, this case highlights the need to ensure that managers subject affiliated-party transactions to a robust process that ensures both procedural and substantive fairness or validation that will withstand a heightened level of scrutiny, especially in cases where a party’s operating agreement contains provisions requiring the equivalent of arms-length bargaining.

4 *Id.* at *10.

Contacts in the Investment Management Group

Heather Cruz	New York	212.735.2772	heather.cruz@skadden.com
Philip H. Harris	New York	212.735.3805	philip.harris@skadden.com
Michael K. Hoffman	New York	212.735.3406	michael.hoffman@skadden.com