New York Law Journal

NOT FOR REPRINT

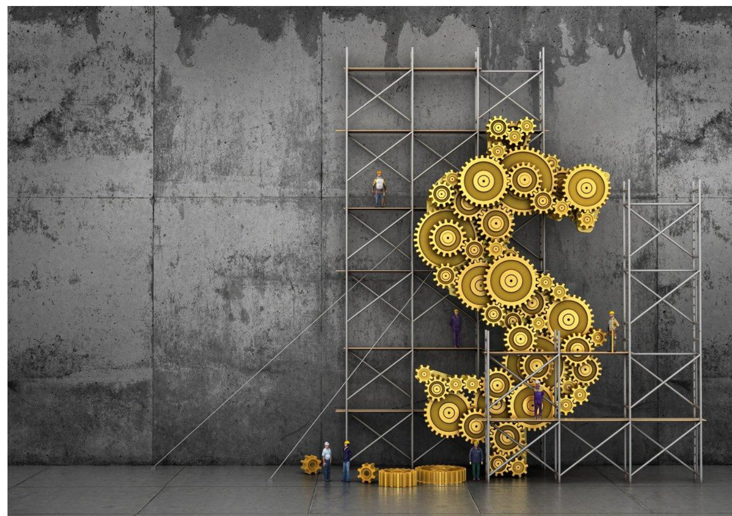
Click to print or Select '**Print**' in your browser menu to print this document.

Page printed from: *https://www.law.com/newyorklawjournal/2018/11/09/you-cant-unring-the-bell-costly-waivers-in-llc-operating-agreements/*

You Can't Unring the Bell: Costly Waivers in LLC Operating Agreements

In a recent decision, the Delaware Court of Chancery reaffirmed the policy of Delaware and many other states, including New York, of enforcing broad contractual waivers of fiduciary duties and demonstrated the importance of carefully negotiating contractual rights and obligations when forming or investing in a limited liability company.

By **Laura A. Colca and Ryan W. McNagny** | November 09, 2018



In its recent decision in *Miller v. HCP & Co.*, C.A. 2018 WL 656378, No. 2017-0291-SG (Del. Ch. Feb. 1, 2018), the Delaware Court of Chancery dismissed a case brought by minority members of a limited liability company claiming that the majority's sale of the company was unfair to the minority members and violated the covenant of good faith and fair dealing implied in the company's operating agreement. In doing so, the

court reaffirmed the policy of Delaware and many other states, including New York, of enforcing broad contractual waivers of fiduciary duties and demonstrated the importance of carefully negotiating contractual rights and obligations when forming or investing in a limited liability company.

Case Background

In *Miller*, the company that was sold, Trumpet Search—a limited liability company offering clinical services to individuals with autism and other developmental disabilities—was controlled by a private equity firm, HCP & Company, and its affiliates. As the majority owner of membership interests, HCP was entitled to appoint four of the seven managers of the Trumpet Search Board, thereby controlling the Board of Managers. As such, HCP could effectively approve a sale of the company unilaterally with the only condition, as set forth in the operating agreement, that the sale be to an unaffiliated third party. Moreover, the operating agreement specifically provided that the members expressly agreed to waive all fiduciary duties to one another and from the managers to the members.

On May 5, 2016, the members of Trumpet Search entered into a Second Amended and Restated Operating Agreement, which created a new class of membership interests, the "Class E" units. HCP, which already owned 87.5 percent of the Class D units, purchased 78.5 percent of the Class E units, bringing HCP's aggregate capital investment in Trumpet Search to nearly $14 million. Significantly, pursuant to the Second Amended and Restated Operating Agreement, holders of the Class D and E units would be entitled to a payout equal to 200 percent of the holders' investment upon a sale of the company *before* the Class A, B, and C unit holders would be entitled to *any* payments. This "waterfall" payout structure meant that HCP was entitled to roughly $28 million of the first $30 million in proceeds received in the event of a sale of Trumpet Search. Thus, the HCP-controlled Board of Managers had a strong incentive to sell the company for up to $30 million but little to no incentive to negotiate for anything further.

Unsurprisingly, HCP quickly found a prospective buyer, MTS Health Partners, which offered $31 million to acquire Trumpet Search. Although the minority of the Board of Managers opposed the transaction, the HCP-controlled majority refused to pursue an open-market sales process to maximize the sales price and gave the minority board members five days to find competing offers. When Trumpet Search was able to obtain a letter of intent from another buyer to purchase the company for approximately $36 million, MTS increased its offer to $41 million. Despite the minority board members' belief that MTS's increased bid demonstrated that Trumpet Search was being substantially undervalued, the HCP-controlled majority continued to reject an open-market sales process and pursued MTS's $41 million offer.

Shortly after the majority members of the Board of Managers resolved to pursue MTS's offer, however, Trumpet Search received an unsolicited indication of interest from another potential buyer, FFL Partners, LLC, which valued Trumpet Search somewhere between $50 million and $60 million. Even so, the majority continued to oppose an open-market process and demanded that the board inform MTS of FFL's indication of interest. After MTS threatened to sue Trumpet Search for violation of an alleged exclusivity provision of the letter of intent, MTS increased its purchase offer to roughly $43 million and the Board of Managers accepted. Despite the seemingly significant price increase, the deal provided almost no payout for Class A and B members.

Analysis

Claiming that the company could have been sold for closer to $53 million, which would have resulted in all members receiving a full payout, minority members, including Christopher Miller, a cofounder of Trumpet Search, brought suit against HCP, claiming that HCP had breached the covenant of good faith and fair dealing by failing to pursue an open-market sales process and maximize value for the minority. In dismissing the claim against HCP, the court focused on provisions in the company's operating agreement expressly waiving the members' and managers' fiduciary duties and giving the board *sole* authority to direct a sale of the company (subject only to the restriction

that the sale be to an unaffiliated third party). In light of these provisions, the court found that the operating agreement expressly allowed the board (and therefore HCP) to act in its own self-interest in selling the company and that the implied covenant could not be invoked to "give the Plaintiffs what they failed to get at the bargaining table" when they negotiated the operating agreement. *Miller*, C.A. No. 2017-0291-SG at *14. Notably, the court stressed that the implied covenant of good faith and fair dealing is "rarely invoked successfully" and that when an operating agreement contains a fiduciary-duty waiver, "courts should be all the more hesitant to resort to the implied covenant." Id. at *9–10.

While it may seem harsh, this decision illustrates the policy of many states to enforce contracts to the greatest extent possible, regardless of the whether the result is "fair." Particularly where a contract includes an express waiver of fiduciary duties like the one in *Miller*, courts are generally reluctant to invoke the implied covenant of good faith and fair dealing to rewrite the parties' contract to prevent an unfair result. New York has a similar policy of enforcing contracts between sophisticated business people to the greatest extent possible.

New York

In *Pappas v. Tzolis*, 20 N.Y.3d 228 (2012), the parties formed a limited liability company for the purpose of entering into a lease of commercial property in lower Manhattan, with the defendant contributing $50,000 and the two plaintiffs contributing $50,000 and $25,000, respectively. The defendant later purchased the plaintiffs' collective 60 percent membership interest in the company for just under $2 million, shortly after which the defendant assigned the commercial lease held by the company to a third party for $17.5 million. After learning of the transaction, the plaintiffs brought suit against the defendant for breach of fiduciary duty, fraud, conversion, and unjust enrichment.

In dismissing the plaintiffs' claims, the Court of Appeals found that, because the company's operating agreement expressly disclaimed any obligation the members had not to compete with the company or its other members, and because the plaintiffs signed a certificate releasing the defendant from his fiduciary duties and acknowledging that they performed their own due diligence in selling their membership interests, the defendant was under no obligation to disclose his intent to assign the lease for substantially more than he paid the plaintiffs for their membership interests.

The court emphasized that the plaintiffs were sophisticated businessmen represented by counsel and that, at the time they sold their membership interests to the defendant, their relationship was not one of trust, making any reliance on the defendant's representations unreasonable. While *Pappas v. Tzolis* did not involve the implied covenant of good faith and fair dealing, it imparts the same warning articulated by the Court of Chancery in *Miller v. HCP & Co.*: LLC owners and investors in New York, as in Delaware, should be wary of fiduciary duty waivers and carefully consider the risks associated with such waivers before agreeing to them.

The bottom line: Courts will enforce the provisions of contracts between sophisticated parties whenever possible and generally will not intervene, even to alter a seemingly unfair result. While the *corporate* form carries with it certain fiduciary duties that cannot be waived, members of *limited liability companies* are permitted to waive their fiduciary duties and act in their own self interest. For this reason, when negotiating an operating agreement, whether in the context of forming or investing in an LLC, it is important to carefully weigh the risks associated with waivers of fiduciary duties. In order to avoid the potential pitfalls exemplified by the cases discussed in this article, it is critical to retain counsel to carefully negotiate and draft such agreements to provide for adequate protections.

Laura A. Colca *is a partner and* **Ryan W. McNagny** *is an associate in Goldberg Segalla's corporate services and commercial litigation group.*

Copyright 2018. ALM Media Properties, LLC. All rights reserved.