



Corporate Governance Group

Client Alert

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DELAWARE COURT SUPPORTS FREEDOM OF LLC MEMBERS TO CONTRACT AWAY OBLIGATION TO ACT “REASONABLY”

Dismisses breach of contract and fiduciary duty claims rather than contradict plain meaning of LLC operating agreement

The Delaware Court of Chancery has consistently ruled, in a variety of circumstances, that where a party’s rights are governed by the unambiguous terms of a contract, it will not imply fiduciary duties or look to implied covenants to change the benefits bargained for by the parties.¹ The Court recently affirmed this position in *Related Westpac LLC v. JER Snowmass LLC*² by dismissing various contractual and extra-contractual claims brought by a member of a limited liability company who was frustrated with the unwillingness of another member to grant needed consents and provide additional financing. In so ruling, the Court confirmed that “Delaware law respects contractual freedom and requires parties ... to adhere to the contracts they freely enter.”

Background

In December 2006, Related Westpac LLC (“Related”), JER Snowmass LLC (“JER Snowmass”) and a third, passive investor formed two limited liability companies (“LLCs”) to pursue a redevelopment project in Snowmass, Colorado. This project involved “condominiums, luxury hotels, retail and community recreation facilities, skier services, and office and commercial facilities” that “would transform Snowmass Village into a ‘world-class tourist destination.’”

¹ For example, see our previous Client Alerts entitled (i) “Delaware Chancery Court Grants Dismissal of Fiduciary Duty Claims Raised Against Members of a Limited Liability Company,” June 2, 2008 (discussing *Fisk Ventures, LLC v. Segal et al.*, 2008 WL 1961156 (Del. Ch. May 7, 2008)), (ii) “Delaware Court of Chancery Adheres to Preferred Stock Valuation in Certificate of Designation for Purposes of Appraisal Proceeding,” May 11, 2009 (discussing *In Re Appraisal of Metromedia International Group, Inc.*, No. 3351-CC (Del. Ch. April 16, 2009)), and (iii) “Delaware Court of Chancery Relies on Terms of Employee Stock Plan to Determine Rights of Shareholders,” May 21, 2009 (discussing *Nemec v. Shrader*, C.A. No. 3878-CC (Del. Ch. April 30, 2009)).

² C.A. No. 5001-VCS (Del. Ch. July 23, 2010).

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Under the operating agreements governing the LLCs, Related acted as the Operations Manager for the project and JER Snowmass was to provide funding. As Operations Manager, Related had the “authority and duty to supervise the day to day activities” of the project in a manner consistent with the business plan and approved budget. To this end, Related was required to submit an annual budget and an annual business plan for the approval of JER Snowmass.

The operating agreements also required JER Snowmass’s consent for any of 23 “Major Decisions” that Related might make in its capacity as Operations Manager. This consent right was qualified by a “duty to act reasonably,” *except* in regards to “Major Decisions” that constituted a “Material Action.”³ Consequently, JER Snowmass would appear to have been free to give or withhold its consent to Material Actions in its sole discretion and according to its commercial interest, but was required to act reasonably when asked to consent to other matters.

The operating agreements also granted Related, in its capacity as Operations Manager, the right to issue capital calls to the members at its discretion. However, the sole liability and remedy if a member defaulted on a capital call was either the withdrawal of the capital call or funding by the non-defaulting members, such that “[n]o Member... shall have any personal liability to provide such Additional Funds.”

On three separate occasions, when the demands of the project exceeded the agreed upon budget, Related sought consent and/or additional capital from JER Snowmass. In each such instance, JER Snowmass either refused to consent or conditioned consent on Related giving it certain commercial benefits or using its own funds.

Despite the language of the operating agreements, Related brought suit seeking an order requiring JER Snowmass to pay damages and to meet future capital calls. Related based its suit on the theory that JER Snowmass’s refusals to give unconditional consents and to meet capital calls were “unreasonable,” thereby causing the LLCs harm by, among other things, compromising “the ability of the LLCs to proceed with their development plans.” Specifically, Related alleged that JER Snowmass’s refusals (i) breached the express terms of the operating agreements, (ii) breached the implied covenant of good faith and fair dealing, (iii) unjustly enriched JER Snowmass by virtue of Related’s having to make the capital infusions that JER Snowmass refused to make and (iv) breached its fiduciary duty to the LLCs and their other members.

JER Snowmass moved to dismiss, asserting that (i) its right to withhold consent to Major Decisions involving Material Actions was unqualified, (ii) its freedom to withhold consent bargained for in the operating agreements “precludes both the operation of any implied contractual duty or the imposition of an equitable fiduciary duty” and (iii) the unjust enrichment claim must fail because the operating agreements specify the sole remedy available when a party fails to meet a capital call. The Court, siding with JER Snowmass, dismissed Related’s claims in their entirety.

³ “Material Action” is defined as “anything that would ‘require additional Capital Contributions’ or ‘involve any material change in the budget... or in any line item therein.’”

The Court's Analysis

Breach of Contract

The Court found Related's breach of contract claim to be "plainly inconsistent with the Operating Agreements." Noting that JER Snowmass's "obligation to give consent in other situations was qualified by the commonplace 'which shall not be unreasonably withheld,'" the Court found that the absence of such qualifying language in regards to approval of Material Actions demonstrated "that JER Snowmass had retained the freedom not to give approval to a request involving Material Actions if it did not view such a request as being in JER Snowmass's own commercial interests."

The Court rejected Related's attempt "to escape this obvious reality" by arguing "that JER Snowmass was somehow akin to a contractual partner exercising control over joint venture assets by refusing to accede to certain action." In the Court's view, there was no doubt that Related was aware that, "[a]t the bargaining table, Related clearly relinquished any reasonableness condition to JER Snowmass's consent right as to future business plans and budgets." The Court refused, therefore, "to imply a condition into the consent right... that was expressly excluded by the terms of the contract," thereby reaffirming that "Delaware law respects the freedom of parties in commerce to strike bargains and honors and enforces those bargains as plainly written."

Similarly, the Court determined that "JER Snowmass had no contractual responsibility to pay damages for failing to fund Related's capital calls." Because the operating agreements explicitly set forth the "sole remedy" for the failure of a member to fund a capital call, the Court refused to allow Related to "avoid its own express contractual promise about the remedy that would exclusively govern these situations."

Implied Covenant of Good Faith and Fair Dealing

The Court also refused to "imply a reasonableness condition as part of the Operating Agreements' implied covenant of good faith and fair dealing." Having determined that "[t]he express bargain of the parties covers this subject," the Court reasoned that it "cannot imply an obligation inconsistent with the parties' express agreement."

Unjust Enrichment

According to the Court, "[u]nder Delaware law, '[w]hen the complaint alleges an express, enforceable contract that controls the parties' relationship... a claim for unjust enrichment will be dismissed.'" As a result, the Court found that "an unjust enrichment claim cannot stand against... JER Snowmass... because the Operating Agreements govern the Parties' rights."

Breach of Fiduciary Duty

Finally, the Court observed that Related's breach of fiduciary duty claim "is essentially identical to the language in Related's breach of contract claim" which asked the Court to hold JER Snowmass liable for failing to act "reasonably." And, consistent with its dismissal of the breach of contract claim, the Court concluded that where parties to a contract "cover a particular subject in an express manner, their contractual choice governs and cannot be supplanted by the application of inconsistent fiduciary duty principles that might otherwise apply as a default." Accordingly, the Court refused to imply a fiduciary duty that would be "plainly inconsistent with the contractual bargain struck by parties to an LLC" because to do so "would nullify the parties' express bargain."

Conclusion

The Court of Chancery's decision re-affirms that where a claim involves a dispute over the rights and duties governed by an express agreement between contracting parties, whether in an LLC operating agreement or otherwise, Delaware courts will be quite hesitant to alter the negotiated terms by invoking fiduciary duties or looking to implied covenants of good faith and fair dealing. The Court succinctly explained the deference required to be paid to the plain meaning of unambiguous contract terms by noting that "while I am left with little doubt that Related believes that JER Snowmass has acted in a manner that Related did not anticipate, I also have no doubt that JER Snowmass has acted in a manner that Related knew was permitted under the express terms of the Operating Agreements. Although Related may regret the freedom of action it granted to JER Snowmass in the Operating Agreements... and the limitations on remedial actions..., Related cannot alleviate its regret by seeking relief clearly contrary to the LLCs' Operating Agreements."

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