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Corporate Governance Group Client Alert

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DELAWARE COURT REFUSES TO DISMISS BREACH OF FIDUCIARY DUTY CLAIMS AGAINST CONTROLLING UNITHOLDER OF LLC

Applies entire fairness standard in allowing minority unitholders to challenge terms of LLC merger sponsored by controlling unitholder

But dismisses claims against individual directors and officers based on protective LLC agreement provisions

Recently, the Delaware Court of Chancery refused to dismiss claims brought by minority unitholders of a publicly traded limited liability company ("LLC") alleging that the controlling unitholder breached its fiduciary duties to them in connection with a going private transaction. In *In re Atlas Energy Resources, LLC, Unitholder Litigation*,[1] the Court determined that because the LLC's operating agreement neither eliminated such fiduciary duties nor provided a standard for resolving a conflict of interest between the controlling unitholder and minority unitholders, the transaction must be reviewed under the rigorous entire fairness standard applicable to interested corporate transactions. On this basis, the Court refused to grant the controlling unitholder's motion to dismiss. However, the Court dismissed claims brought by the minority unitholders against the LLC's directors and officers based on limitations of their individual liability included in the LLC operating agreement.

Background

Atlas Energy Resources, LLC, a Delaware limited liability company ("Energy"), was formed in 2006 by Atlas America, Inc. ("America") to, among other things, develop natural gas production in the Marcellus Shale, a gas-rich formation of marine sedimentary rock found in parts of the Appalachian Mountains. America retained 47.3% of Energy's Class B Units, which traded on the New York Stock Exchange, and

[1] C.A. No. 4589-VCN (Del. Ch. Oct. 28, 2010).

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all of Energy's Class A Units and day-to-day operations were controlled by another America subsidiary. Many of America's directors and officers also served in similar capacities at Energy. Energy became one of the largest producers of the Marcellus Shale, and its quarterly cash distributions to unitholders either increased, or at least remained constant, for every quarter since the company's formation.

In January 2009, management representatives of Energy and America made a presentation to America's Board of Directors discussing "challenges facing both companies as a result of continued poor economic conditions." This presentation focused on the cash distributions required to be made by Energy to the Class B unitholders. A week later, without obtaining any input from the Energy Board, America developed five strategic alternatives for Energy, which included a merger between America and Energy that would (i) require the public unitholders to exchange their Units for stock in America, (ii) result in Energy becoming a wholly-owned subsidiary of America and thereby (iii) eliminate cash distributions payable to the Class B unitholders. Soon after these alternatives were presented to the Energy Board by America, the Energy Board delegated consideration to a newly-formed Special Committee. The Special Committee in turn engaged its own legal and financial advisors. On April 7th, America's management left Energy with fewer alternatives by informing the Special Committee's advisors that America was not interested in either selling Energy's assets or converting Energy to a publicly-held corporation. Several days later, the Special Committee determined that a merger with America was the "proper alternative for Energy."

Over the next three weeks, the Special Committee and representatives of America negotiated the terms of the merger, which was announced on April 27th. The Special Committee initially proposed a "majority of the minority" condition for Energy unitholder approval of the transaction, but that was rejected by America. With respect to the consideration to be paid to Energy's public unitholders, America initially proposed an exchange ratio representing a greater than 13% *discount* to Energy's then-current trading price. After the Special Committee rejected this price, the parties eventually negotiated an exchange ratio representing a 0.3% *premium*. The merger agreement also suspended Energy's cash distributions pending receipt of approvals for the merger. By September 29th, the necessary approvals from holders of a majority of Energy's common units, holders of a majority of America's shares and 51% of Energy's creditors, were obtained, and the merger was consummated.

The Plaintiffs' Claims

Two of Energy's minority unitholders brought suit, claiming that America, as controlling unitholder, breached its fiduciary duties to the minority unitholders by imposing an unfair process that produced a merger with unfair terms. These unitholders argued that the conflict of interest between America and the minority unitholders inherent in the transaction, together with the absence of any provision in Energy's LLC Agreement eliminating America's fiduciary duties of care and loyalty, required that the merger be reviewed under the entire fairness standard used in the corporate setting. Application of this standard would in turn require America to establish the fairness of both the price and the process. As for the price, the unitholders claimed that the exchange ratio was unfair because it did not include a premium that accounted for the elimination of Energy's cash distributions or the value of the Marcellus Shale assets. As for the process, the unitholders contended that America unfairly dictated the timing of the merger – when the Units were trading at a "historically low price" – and forced the Special Committee to agree to unfair terms, such as elimination of Energy's cash distributions and the lack of "majority of the minority" condition.

The unitholders also sued the individual directors and officers of Energy, alleging that Article 12 of Energy's LLC Agreement imposed traditional duties of care and loyalty which the directors and officers breached by agreeing to a merger which was unfair to the minority unitholders. In addition, the unitholders claimed that the Special Committee members breached their fiduciary duties by ceding to America's demands and failing to negotiate in good faith.

America responded with a motion to dismiss, arguing that regardless of any fiduciary duties it might have in its capacity as controlling unitholder, Energy's LLC Agreement provided a contractual method to resolve the conflict of interest, and that this methodology had been followed. Separately, Energy's directors and officers argued that the claims against them should be dismissed because Energy's LLC Agreement eliminated their fiduciary duties in favor of a contractually-defined duty of good faith that the directors and officers had satisfied. Finally, all the defendants argued that "the Court should not import the corporate law concept of entire fairness into the limited liability company merger context where the LLC Agreement imposes contractual protections that make the protections of entire fairness unnecessary."

The Court ruled in favor of Energy's directors and officers, granting their motion to dismiss, but refused to grant American's motion to dismiss.

The Court's Analysis

The Court began its analysis by acknowledging that LLCs are "creatures of contract 'designed to afford the maximum amount of freedom of contract … and flexibility to the parties involved.'" This includes the ability of the parties to "contractually expand, restrict, modify, or fully eliminate the fiduciary duties owed by the company or its members, subject to certain limitations." At the same time, the Court cautioned that "in the absence of explicit provisions in a limited liability company agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the limited liability company context." The Court concluded, therefore, that it must analyze each provision of the Energy LLC Agreement at issue to determine (i) its applicability to a particular defendant, (ii) if so, whether the provision imposes a duty that differs from that defendant's "traditional fiduciary duties," and (iii) whether plaintiffs stated a claim for breach of any such applicable duty.

Claims Against America – Motion to Dismiss Denied

The Court reviewed Section 7.9(a) of the LLC Agreement, which set forth a methodology for addressing conflicts of interest in transactions between a member of Energy, on the one hand, and Energy itself, on the other. The plaintiffs claimed that this methodology was not applicable to the merger transaction by which America acquired the Class B Units of the public unitholders in exchange for America stock. In plaintiffs' view, the conflict raised by the transaction was between America, who as controlling unitholder sought to acquire the remainder of the Units at the lowest possible price, and the public minority unitholders, who sought the highest value possible. The Court agreed with plaintiffs that there was indeed a conflict of interest between America and the public unitholders, as opposed to Energy, and therefore, that this conflict of interest was not addressed by Section 7.9(a).

The Court also noted that no other provision of the LLC Agreement purported to eliminate America's fiduciary duties as Energy's controlling unitholder. Accordingly, "in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, controlling members in a manager-managed LLC owe minority members the traditional fiduciary duties that controlling shareholders owe minority shareholders" in the corporate context. The Court was "especially wary of eliminating such duties in the context of a publicly traded limited liability company without sufficient evidence within the contractual language of the parties' intent to do so."

On this basis, the Court turned to *Kahn v. Lynch Comm. Sys., Inc.*[2] and its progeny for the proposition that "a negotiated merger between a corporation and its controlling shareholder must be evaluated under entire fairness regardless of any safeguards the deal includes to protect the minority's interest." The Court did not hesitate to extend *Kahn v. Lynch* to the LLC world, noting that "a merger between a parent and its publicly held limited liability company subsidiary inherently threatens the rights of minority unitholders." Only if the parties to an LLC agreement "specify by contract the protections, or lack thereof, that they want the minority to have against such threats" will the Court "not apply the default standard of review."

Under this approach, the Court concluded that plaintiffs' allegations of unfair price and process were sufficient to survive America's motion to dismiss. With respect to price, the Court noted that plaintiffs had alleged, among other things, that the 0.3% premium did not adequately account for Energy's prospects or match the valuations used by the Special Committee's financial advisor. The Court also credited plaintiffs' allegations that America did not conduct a fair process because it imposed "take it or leave it conditions" and did not allow the Special Committee either a "majority of the minority condition" or adequate opportunity to consider strategic alternatives.

Claims Against Energy's Directors and Officers – Motion to Dismiss Granted

With respect to the duties owed by Energy's directors and officers to the public unitholders, the Court noted that Section 7.9(d) of the Energy LLC Agreement provided that "[e]xcept as expressly set forth in this Agreement or required by law, none of the Directors, nor any other Indemnitee shall have any duties or liabilities, including fiduciary duties, to the Company or any Member." Therefore, the Court noted, "the only duties owed by the Individual Defendants are those set forth elsewhere in the LLC Agreement or imposed by the implied covenant of good faith and fair dealing."

Next, the Court pointed out that Section 7.9(b) of the LLC Agreement imposed a duty on the directors and officers to act in "good faith" when making any determination or taking or declining to take any action. This section further provided that "[i]n order for a determination or other action to be 'in good faith' for the purposes of the Agreement, the Person or Persons making such determination or taking or declining to take such other action must believe that the determination is in the best interest of the Company."

[2] 638 A.2d 1110, 1116 (Del. 1994).

Plaintiffs offered two arguments to rebut the applicability of this "good faith" standard to the Energy Board's decision to approve the merger:

- First, Plaintiffs argued that Section 7.9(b) was unenforceable because the contractual definition of good faith, which focused on subjective rather than objective good faith, in effect "eliminates the implied covenant of good faith and fair dealing from the LLC Agreement, which is impermissible under the Delaware LLC Act." The Court rejected this position, explaining that the implied covenant of good faith and fair dealing is "'a limited and extraordinary legal remedy' that addresses only events that could not reasonably have been anticipated at the time the parties contracted." To the contrary, the Court observed, "where the parties have contractually agreed to eliminate fiduciary duties, they may not invoke the implied covenant as a back door through which such duties may be reimposed after the fact."

- Next, Plaintiffs argued that because Section 12.2 of the Energy LLC Agreement provided that "the Board of Directors still have no duty or obligation to consent to any merger … and may decline to do so free of any fiduciary duty or obligation whatsoever to the Company or any Member …," the directors subjected themselves "to full traditional fiduciary duties" when they acted voluntarily to approve the merger with America. The Court also rejected this argument, concluding that because Section 12.2 must be read in conjunction with Section 7.9(b), the duty to act in good faith governed the directors' actions in this regard.

Accordingly, the Court instructed that "to state a claim for breach of the contractually defined fiduciary duty against the Individual Defendants, Plaintiffs must present allegations that Individual Defendants negotiated and ultimately approved the merger with America in a manner they subjectively believed was not in the best interests of Energy and its unitholders."

This approach required the Court to turn next to a review of the actions of each of the Energy directors and officers. The Court concluded that although it was possible that the allegations against the Special Committee members "might suffice to state a colorable claim for breach of the traditional fiduciary duties of care and loyalty," plaintiffs had not suggested that any of the individual defendants believed they were acting against Energy's interest (*i.e.*, exhibited subjective bad faith) as required to establish liability under Section 7.9(b). Similarly, the Court found that plaintiffs "do not allege that the [other] Individual Defendants engaged in conduct with the subjective belief that it was contrary to Energy's best interests." Thus, the Court dismissed plaintiffs' claims against the individual Energy directors and officers.

Conclusion

In *In re Atlas*, the Court of Chancery again made it clear that, in the LLC context, it will not interfere with the contractual elimination of traditional fiduciary duties applicable in the corporate setting. However, to be effective, the language of the LLC agreement must set forth explicitly the intention of the parties to limit the fiduciary duties of controlling members and/or directors and officers. If that is not the case, then the Court will not hesitate to impose traditional fiduciary duties from the corporate world, including an intrusive entire fairness review of a transaction between an LLC and its controlling member.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

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