

Exculpatory Provisions Under Delaware Law: Say What You Mean And Mean What You Say

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Exculpation provisions in operating agreements must be carefully crafted in order to protect members, managers, directors and officers for breaches of fiduciary duties. In *In re Simplexity, LLC*, the Chapter 7 trustee sued the former officers and directors (who were also members and/or managers) for failing to act to preserve going concern value and exposing the debtors to WARN Act claims. The defendants argued the exculpation language in the operating agreements shielded against breach of fiduciary duty liability. The Delaware bankruptcy court found that the plain language of the applicable operating agreement did not protect the defendants from liability for breach of fiduciary duty; therefore the members, officers and directors could be liable for damages.

Under Delaware law, charter documents, such as a limited liability company operating agreement, can reduce or eliminate fiduciary duty liability for managers and controlling members of limited liability companies. The intent to reduce or eliminate such liability, however, must be “plain and unambiguous.” In the absence of plain and unambiguous intent, managers and controlling members owe fiduciary duties. To ascertain whether such intent was present in the *Simplexity* case, the court began where it must, with the language of the operating agreements.



If you want exculpation, be explicit.

The relevant provisions of the *Simplexity* operating agreement (*Simplexity Agreement*) provided:

Limitation on Liability. No current or former Manager of [Simplexity] shall be personally liable to the Company or the Member for monetary damages for breach of fiduciary duty as a Manager of [Simplexity]...provided, however, that this provision shall not eliminate liability of a Manager (i) for any breach of the Manager's duty of loyalty to the Company and the Member, (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, or (iii) for any transaction from which the Manager derived an improper personal benefit...

Limitation of Duties; Conflict of Interest To the maximum extent permitted by applicable law, the Company and each Member, Manager, officer and employee of the Company hereby waives any claim or cause of action against any [Parent Company] Person for any breach of any fiduciary duty to the Company or its Members or any of the Company's Affiliates by any such [Parent Company] Person, including, without limitation, as may result from a conflict of interest between the Company or its Members or any of the Company's Affiliates and such [Parent Company] Person or otherwise. Each Member acknowledges and agrees that in the event of any such conflict of interest, each such [Parent Company] Person may, in the absence of bad faith, act in the best interests of such [Parent Company] Person, including without limitation its Affiliates, employees, agents and representatives...[S]uch waiver shall not apply to the extent the act or omission was attributable to the Manager's gross negligence or knowing violation of law as determined by a final judgment, order or decree of a court of competent jurisdiction...

The similar provisions of the operating agreement for *Services, LLC*, *Simplexity's* subsidiary, provided (*Services Agreement*):

Exculpation.

(a) No Fiduciary Duties. To fullest extent permitted by law:

(i) notwithstanding any duty otherwise existing at law or in equity, and notwithstanding any other provision of this Agreement, no Indemnified Party shall owe any duty (including fiduciary duties) to the Company, the Member or any other Person that is a party to or is otherwise bound by this Agreement, in connection with any act or failure to act, whether hereunder, thereunder or otherwise; provided, however, that this clause (i) shall not eliminate the implied contractual covenant of good faith and fair dealing, and

(ii) No Indemnified Party shall have any personal liability to the Company, the Member, or any other Person that is a party to or is otherwise bound by this Agreement for monetary damages in connection with any act or failure to act, or breach, whether under this Agreement, the Act or otherwise; provided, however, that this clause (ii) shall not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

(b) No Personal Liability. If any provision of [the above-cited sections] is held to be invalid, illegal or unenforceable, the duties and personal liability of any Indemnified Party to the Company, of the Member or any other Person that is a party to or is otherwise bound by this Agreement shall be eliminated to the greatest extent permitted under the Act.

The defendants argued that they had no liability for breaches as to Simplexity because most of the parties to the Services Agreement were also party to the Simplexity Agreements, and therefore, the broad language of the Services Agreement that any "Member or any other Person that is a party to or is otherwise bound by this Agreement" covered Simplexity's managers in their management of Simplexity. Thus, they argued that the broad exculpation provisions of the Services Agreement were applicable to the managers of Simplexity.

The court disagreed and concluded that the Simplexity Agreement controlled the question of liability for management of Simplexity. The plain language of the Simplexity Agreement did not contain a clear intention to exculpate members and managers from fiduciary duty liability (contrast the language in the Services Agreement). In other words, the Simplexity Agreement did not mitigate fiduciary duties and associated liability to the fullest extent permissible under Delaware law. Rather, it expressly preserved claims for the breach of the duty of loyalty, gross negligence, and knowing violations of law. Thus, the defendants owed fiduciary duties and therefore could be held liable for their breach.

The take away is clear: Delaware law permits a limited liability company's top brass to be insulated from fiduciary duty liability, but any such protection requires "plain and unambiguous" language in the charter documents. In the absence of plain and unambiguous language, managers and controlling members owe fiduciary duties, and can be found liable if they breach those duties. If you want exculpation, be explicit.

Authors