Entity Choice Matters When Waiving/Modifying Fiduciary Duties

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A key advantage of a LLC over a corporation is the ability to modify or eliminate traditional fiduciary duties: the duty of loyalty and the duty of care. These fiduciary duties may be imposed by statute or by common law, depending on the state, and the specific terms of the fiduciary duties can vary from state to state. The duty of care generally requires that a LLC's managers (or its members, if the LLC is managed directly by its members) or a corporation's directors act in good faith and in a reasonably prudent manner. The duty of loyalty typically requires that an LLC's managers or a corporation's directors act in the best interest of the LLC or corporation, and a duty of confidentiality is typically viewed as a subset of the duty of loyalty. Similarly, the corporate opportunity doctrine is a key component of the duty of loyalty and provides that LLC managers or corporate directors may not appropriate for themselves a business opportunity that belongs to the entity for which they are serving as managers or directors.

It is common for entity joint ventures to be structured in a way that allows each party to the JV to appoint one or more managers or directors to the JV entity's governing board. Similarly, it is common for a PE firm to have the ability to appoint one or more managers or directors to the governing board of a portfolio company. The underlying assumption in each instance is that the manager or director of the JV entity or portfolio company, as applicable, will take into account what is in the best interest of the entity that appointed such person. However, this can lead to inherent conflicts of interest that are more easily addressed and managed in a LLC because, unlike the fiduciary duties applicable to corporations, many states expressly permit the owners/members of the LLC to modify or eliminate the duty of care and the duty of loyalty in a LLC (though LLCs may not eliminate the implied covenant of good faith and fair dealing).

Subject to any applicable state law limitations, LLCs may include provisions in their governing documents that permit the modification or even elimination of the duty of loyalty and the duty of care with respect to the LLC's members or managers, as applicable. Examples of such provisions include the following:

- Each manager shall be entitled to consider the interests of the member who appointed such manager and shall have no duty or obligation to prefer or favor any interest of the LLC or any other member, even if there is a conflict between the interests of the member who appointed such manager and the LLC or any other member.
- A manager may engage or invest in a business opportunity outside of the LLC whether or not it is an opportunity that would also be beneficial to the LLC and whether or not the manager learned of the opportunity in the manager’s capacity as a manager of the LLC, and the manager need not disclose an opportunity to the LLC that the manager learned of in the manager’s capacity as a manager of the LLC.
- If a member takes any action or fails to take any action that is in such member's discretion and not otherwise required pursuant to the terms of the LLC’s operating agreement, even if such action or inaction is motivated solely by what such member perceives to be in its own best interest and not necessarily in the best interests of the other members or the LLC, such member's taking or failing to take such action shall not be deemed a breach of any of its duties or obligations, including fiduciary duties, owed to the other members or to the LLC.
- The members recognize and agree that from time to time any member may refuse to consent to or approve any action requiring such member's consent (i) even if such refusal prevents the LLC from pursuing its stated purpose, and (ii) regardless of whether such refusal to consent or approve is motivated by what such member perceives to be in its own best interest and not necessarily in the best interests of the other members or the LLC.
- The managers’ duty of care in the discharge of their duties to the LLC shall be limited to discharging their duties pursuant to the LLC’s operating agreement in good faith.

Historically, corporations generally have not had the freedom to eliminate or significantly modify fiduciary duties imposed on corporate directors. This may be changing. In May of 2023, the Delaware Court of Chancery held that sophisticated shareholders could significantly tailor the fiduciary duties owed to the corporation and the shareholders by entering into a written shareholders agreement.[1] However, in that case the waiver of the duty of loyalty was permitted only between sophisticated shareholders and only so long as the waiver was sufficiently specific; a waiver that contains broad language is not likely to be enforceable. Further, this approach does not yet appear to have been adopted in other states. However, because many states look to Delaware’s corporate laws, this could be an evolving area.

Takeaways

In the absence of express legal authority permitting the modification or elimination of fiduciary duties, the duty of loyalty and duty of care will apply to directors and managers. However, to the extent that owners of an entity wish to modify or eliminate such fiduciary duties, they should, subject to applicable state laws, strongly consider forming such entity as a LLC and using the LLC’s governing documents to specify the fiduciary duties that will govern the LLC’s managers and members. If you have any questions, please contact your Vorys attorney.

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[1] *New Enter. Assocs. 14 LP v. Rich*, C.A. No. 2022-0406-JTL (Del. Ch. May 2, 2023).