

The Investment Lawyer

Covering Legal and Regulatory Issues of Asset Management

VOL. 22, NO. 7 • JULY 2015

REGULATORY MONITOR

State Law Developments

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A Call to Duty: Waivers of Fiduciary Duty under Delaware Law

Fiduciary duty should be preserved as an essential element of a private fund manager's relationship with its investors,¹ despite the permitted waivers of fiduciary duty under Delaware law as applicable to private funds formed as limited partnerships (LPs) or limited liability companies (LLCs).² After the near collapse of the financial markets in 2009 coupled with financial scandals such as Bernie Madoff's³ Ponzi scheme, institutional investors should carefully review a fund manager's fiduciary duties and whether any waiver of such duties is incorporated into a fund's governing documents. This article provides an overview of Delaware's current approach to waivers of fiduciary duty, discusses possible implications of such waivers, and provides certain tactics when negotiating fiduciary duty in connection with a subscription to a private fund.

Delaware's Approach to Fiduciary Duty

Prior to 2004, general partners of LPs and managing members of LLCs were bound by unwavering fiduciary duties – duty of care, duty of loyalty, and duty of good faith – owed to their respective limited partners and members.⁴ In 2004, the Delaware

legislature enacted laws that shifted the focus from protecting the traditional fiduciary relationship to an emphasis on a party's right to freedom of contract. Both the Delaware Limited Liability Company Act (DLLCA) and Delaware Revised Uniform Limited Partnership Act (DRULPA) were amended to provide that fiduciary duties may be expanded, restricted or eliminated through the provisions of operating agreements and partnership agreements.⁵ As Delaware courts struggled to synthesize and, at times, disagree over enforcement of this new legislation, the Delaware legislature clarified in 2013 that in the absence of provisions to the contrary, traditional fiduciary duties still apply as a matter of default.⁶

Consistent with the underlying rationale that LPs and LLCs are creatures of contract, which should afford parties the right to negotiate the terms of their respective governing documents, Delaware courts generally uphold and enforce negotiated contract language modifying, restricting or even eliminating fiduciary duties.⁷ Similarly, Delaware courts enforce language in an agreement that specifically sets forth certain acts that will be deemed to be in satisfaction of a partner's or a member's fiduciary duties.⁸ However, despite this contractual freedom, Delaware courts require that language

intended to restrict or waive fiduciary duties be clearly provided for in the agreement, otherwise courts may still apply traditional fiduciary duties as default rules in the absence of explicit language to the contrary.⁹

In *In re Atlas Energy Resources*, the Delaware Court of Chancery expressed its concern of being “especially wary of eliminating such duties . . . without sufficient evidence within the contractual language of the parties’ intent to do so.”¹⁰ In particular, the Delaware Chancery Court has wrestled with finding an explicit waiver of fiduciary duty within contractual language intended to delineate the rights of a general partner or managing member to act in its “sole discretion.” In *Paige Capital Management, LLC v. Lerner Master Fund, LLC*,¹¹ a hedge fund investor challenged a general partner’s utilization of the fund’s gate provision to limit redemptions. The gate provision provided that the general partner could invoke the gate in its “sole discretion.”¹² Despite the partnership agreement’s contractual language permitting the general partner to act in its sole discretion, the court stressed that such a clause was insufficient to constitute an explicit waiver of the general partner’s fiduciary duties.¹³ The court explained that to effectively waive fiduciary duties, the partnership agreement should clearly and unambiguously define sole discretion in a manner that is not only inconsistent with, but also precludes the application of fiduciary duties.¹⁴ Without such an explicit waiver, the court held that the general partner is still bound to act in the good faith belief that it is advancing the best interests of the fund and its partners.¹⁵ The court held that the general partner breached its fiduciary duties as it had imposed the gate provision for only self-interested reasons and not in consideration of the fund’s or the investors’ interests.¹⁶ Thus, at a minimum, Delaware courts require language in a limited partnership or limited liability company agreement to clearly set forth the fiduciary duties owed to partners or members or they will apply traditional fiduciary duties in the absence of language to the contrary.¹⁷

Implications of Waiving Fiduciary Duty

By contractually waiving fiduciary duty obligations, a fund manager “has almost no extracontractual constraints on it.”¹⁸ If all fiduciary duties are eliminated, then the limited partners are left to rely upon the “the implied covenant of good faith and fair dealing,”¹⁹ which is explicitly protected within the Delaware statutes,²⁰ but seldom found by the Delaware courts as a source of protection.²¹ Distinct from fiduciary duties, the implied covenant of good faith and fair dealing is a uniform, objective standard that applies to all contracts and intended to supply implied terms as gap fillers to any express provisions of a contract. However, as the Delaware Chancery court specifically expressed how “[p]laintiffs cannot reintroduce fiduciary review through the backdoor of the implied covenant,”²² a waiver of fiduciary duty eliminates any bargained for “code of conduct” being imposed on the fund manager.²³ This leaves an institutional investor with a thin veneer of protection at the Delaware state law level against acts by a manager or general partner it deems not acting in the best interests of the investors.

Within the context of regulated investment advisors, there is also a fundamental conflict between a waiver of fiduciary duty under Delaware law and the fiduciary duty “imposed on an [investment] adviser by operation of [securities] law because of the nature of the relationship” between an investment adviser and the fund it advises as its client.²⁴ Specifically, the Investment Advisers Act of 1940, as amended (the Act), does not set forth an obligation of fiduciary duty, but rather provides a broad framework of fiduciary duty that is inherent in court rulings and enforcement actions by the US Securities and Exchange Commission (SEC).²⁵ Fiduciary duty is also “enforceable [under] section 206 of the Act, which contains the Act’s anti-fraud provisions, and incorporated indirectly into the Act in various provisions and disclosure requirements.”²⁶ Fiduciary duty under the Act also might not be able to be “negotiated away.”²⁷

With legislation permitting contractual waivers of fiduciary duties at the Delaware state law level, government agencies such as the SEC, have expressed heightened concerns regarding the need for investment managers to be subject to a statutorily imposed fiduciary duty. SEC Chairperson Mary Jo White recently called on the SEC Staff to develop rulemaking recommendations on a uniform fiduciary standard for investment advisors and opined that the Commission should “proceed with rulemaking.”²⁸ The focus on this issue by federal regulatory agencies may result in the imposition at a federal level of fiduciary duties that could conflict with the ability to waive these duties by contract at a state level. This could also subject registered investment advisors to a different standard of care than their counterparts who are not registered, leaving institutional investors with additional due diligence tasks when evaluating potential private fund investments.

A waiver of fiduciary duty under Delaware law also raises additional concerns within the context of pension plans. Pension plans typically are managed by a manager or trustee, which owes fiduciary duties to the pension plan and its investors.²⁹ However, issues arise when such pension plan managers or trustees invest in private funds requiring them to delegate investment decisions to general partners or managing members, who may not be bound by similar fiduciary duties.³⁰ As Jeffrey Horvitz explains:

If the fiduciary institutional investor delegates, but then waives, fiduciary duty for the general partner or investment manager and/or provides substantial other exculpation and indemnification protection as to create a de facto elimination of fiduciary duty, there is no one left with any fiduciary duty at all. This waiver could be seen by a court as a backdoor method for eliminating the entire fiduciary duty of the plan sponsor or trustees, which might be in violation of state or federal law and public policy.³¹

The Employee Retirement Income Security Act of 1974, as amended from time to time (ERISA), imposes strict requirements on pension plan managers and trustees that delegate investment discretion to fund managers in an attempt to avoid imputation of such fund manager’s errors or wrongful acts.³² Particularly, ERISA requires pension plan managers or trustees managing “plan assets” to accept and represent to the pension plan that it is a fiduciary to such plan. Thus, a waiver of fiduciary duty might violate ERISA and create unintentional liabilities for pension plan managers or trustees.³³ Institutional investors subject to ERISA should keep this in mind when making their investment decisions regarding investment funds organized under Delaware law.

Negotiating Fiduciary Duty

As federal regulatory agencies begin to address the issue of fiduciary duties of private fund managers and general partners, institutional investors should carefully review and negotiate fiduciary duty obligations under a fund’s partnership or operating agreement. The Delaware Chancery Court has stressed that a waiver of fiduciary duty must be explicit.³⁴ Thus, negotiations of Delaware partnership and operating agreements should focus on any language ambiguities and obtaining clarifications of such terms through an amendment to the governing documents of the fund, a side letter agreement or even an email confirmation from the fund manager. In particular, institutional investors should carefully review contract language permitting a fund manager to act in its “sole discretion.” Although the Delaware Chancery Court held that simply stating that a fund manager may act in its “sole discretion” is insufficient to eliminate fiduciary duties, institutional investors should insist on written confirmation that the term “sole discretion” is interpreted to impose an obligation on the fund manager to consider and take into account the fund and its investors when exercising such “sole discretion.” The intent of such confirmation is to make it clear that the investor does not

permit the fund manager or general partner to waive its fiduciary duty under Delaware law, and could be important in maintaining an institutional investor's legal remedies under Delaware law if the manager or general partner no longer acts in the best interests of the fund or its investors.

NOTES

¹ Heather Traeger, Kris Easter, and Matthew Cohen, "Compliance Issues for Establishing New Client Relationships: Part 2 of 2," *The Investment Lawyer*, Vol. 20, No. 5 (May 2013); see also SEC Staff, *Study on Investment Advisers and Broker-Dealers: As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (Jan. 2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

² See generally *In re Atlas Energy Res., LLC*, 2010 Del. Ch. LEXIS 216, 2010 WL 4273122 (Del. Ch. Oct 28, 2010).

³ Stephanie Yang, "5 Years Ago Bernie Madoff was Sentenced to 150 Years in Prison – Here's How His Scheme Worked," *Bus. Insider* (Jul. 1, 2014, 6:54 PM), available at <http://www.businessinsider.com/how-bernie-madoffs-ponzi-scheme-worked-2014-7>.

⁴ Winnifred A. Lewis, "Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies," 82 *Fordham L. Rev.* 1017 (2013), available at <http://ir.lawnet.fordham.edu/flr/vol82/iss2/20>.

⁵ DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c).

⁶ DEL. CODE ANN. tit. 6, §18-1104.

⁷ See generally Jay W. Eisenhofer and Caitlin M. Moyna, "What Is the State of Delaware Law as It Relates to the Scope of Fiduciary Duties Owed to Investors in So-Called Alternative Entities? (Part II)," *Corporate Law & Accountability Report* (Jan. 2, 2015), available at <http://www.bna.com/state-delaware-law-n17179921814/>.

⁸ See generally Eisenhofer and Moyna, *supra* n.7.

⁹ See *Auriga Capital Corp. v. Gatz Prop., LLC*, 40 A.3d 839 (Del. Ch. 2012).

¹⁰ See *In re Atlas*, 2010 Del. Ch. LEXIS 216, at *23-24.

¹¹ *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, 2011 Del. Ch. LEXIS 116, 2011 WL 3505355 (Del. Ch. Aug. 8, 2011).

¹² *Id.* at *102.

¹³ *Id.* at *114-117.

¹⁴ *Id.* at *110-111.

¹⁵ *Id.* at *109-110.

¹⁶ *Id.* at *125-127.

¹⁷ *Id.*

¹⁸ Lewis, *supra* n.4, at 1036.

¹⁹ *Id.* at 1030.

²⁰ *Id.*; see also DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c).

²¹ Eisenhofer and Moyna, *supra* n.7.

²² *In re Encore Energy Partners LP Unitholder Litig.*, 2012 Del. Ch. LEXIS 214, 2012 WL 3792997 at *54 (Del. Ch. Aug. 31, 2012).

²³ Lewis, *supra* n.4, at 1037. We note that the Delaware Supreme Court recently overturned the Delaware Chancery Court's dismissal of a claim for breach of the implied covenant of good faith and fair dealing; however, this issue is beyond the scope of this article. See *Gerber v. Enterprise Products Holdings, LLC*, 67 A.3d 400 (Del. 2013).

²⁴ Staff of the Investment Adviser Regulation Office, Division of Investment Management, US Securities and Exchange Commission, "Regulation of Investment Advisers by the U.S. Securities and Exchange Commission www.SEC.Gov," 23 (March, 2013), available at http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ "Chair White Asks SEC Staff to Ready Recommendations on Uniform Fiduciary Standard," *IA Watch* (March 26, 2015), available at <http://www.iawatch.com/Content/Print/269117>.

²⁹ The Department of Labor recently proposed rules to redefine the scope of fiduciary duties. See Evan Weinberger, "Labor Dept. Seeks to Expand Fiduciary Duties," *Law360* (April 14, 2015, 3:09pm), available at <http://www.law360.com/articles/642937/labor-dept-seeks-to-expand-fiduciary-duties>. A discussion on the proposed rules is not the intent of this column, which focuses solely on current law.

³⁰ Jeffrey E. Horvitz, “Fiduciary Duty Waivers of LPs May Expose Sponsors,” *Pensions & Investments* (Oct. 14, 2013), available at <http://www.pionline.com/article/20131014/PRINT/310149994/fiduciary-duty-waivers-of-lps-may-expose-sponsors>.

³¹ *Id.*

³² *Id.*

³³ *Id.*

³⁴ See *In re Atlas Energy Res., LLC*, 2010 Del. Ch. LEXIS 216, 2010 WL 4273122, at *19 (De. Ch. Oct 28, 2010).

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