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Delaware Chancery Court Finds Private Equity Majority Owner Not Liable to Minority Investors Where LLC Agreement Waived Fiduciary Duties

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In a recent decision, the Delaware Court of Chancery dismissed breach of fiduciary duty claims asserted by minority unitholders in connection with the acquisition of CityMD by VillageMD. In *Kahn, et al. v. Warburg Pincus, et al.*, the minority unitholders of CityMD brought claims against Warburg Pincus, the private equity majority owner of CityMD, and other defendants, alleging, among other claims, breach of good faith and fair dealing in connection with the negotiation and consummation of VillageMD's merger with CityMD. In dismissing the claims, the Court reinforced the importance of contractual drafting and compliance with the four corners of a mutually agreed contract.

Prior to its merger with VillageMD, Warburg Pincus was the majority owner of CityMD and holder of Class A units of the company. CityMD's founders and other minority investors held CityMD's Class B units. In connection with Warburg Pincus' investment and CityMD's earlier merger with Summit Medical Group, Warburg Pincus and the minority investors adopted a limited liability company agreement that contained several provisions relevant to the litigation, including terms related to fiduciary duties, minority protection rights and a provision stating that the LLC Agreement could be amended only with the consent of a majority of the class of unitholders adversely affected by such amendment. The Court noted that the LLC Agreement included "broad waivers of [Warburg Pincus'] fiduciary duties in four provisions" including a statement that Warburg Pincus owed no fiduciary duties other than the duty to comply with the LLC Agreement and an express right permitting Warburg Pincus to "act exclusively in . . . its own interest and without regard to the interest of any other person." The LLC Agreement also included two provisions that granted minority unitholders rights in the event of a change of control transaction, including (i) a requirement that in an "extraordinary transaction," each class of unitholders would receive "the same form and amount of consideration based on their '[p]ro [r]ata [p]ortion'" and (ii) tag-along rights allowing minority unitholders "to participate on equal terms in certain sales of [CityMD] units by" Warburg Pincus.

Merger talks with VillageMD commenced when Warburg Pincus began exploring a sale of CityMD in 2021. After negotiations, CityMD and VillageMD entered into a merger agreement that provided different consideration to the CityMD unitholders: (a) all cash consideration to the Class A unitholders (Warburg Pincus); and (b) a combination of cash and equity to the Class B unitholders, depending on the amount each unitholder elected to roll into the newco. The merger agreement also conditioned the closing on (i) an amendment to the LLC Agreement (to eliminate the minority protection rights requiring all unitholders to receive the same form of consideration and/or tag-along rights) and (ii) the agreement of the minority unitholders to roll over at least 40% of their Class B units and to release claims relating to the merger agreement and LLC Agreement amendment.

Although the proposal for disparate consideration for each class of CityMD units was first proposed in the initial letter of intent, the minority unitholders were only made aware of the merger and different consideration through an information statement delivered a week after execution of the merger agreement, which required an election within 20 days – a point the minority unitholders contend pressured them into supporting the transaction. However, the Court highlighted the facts that the minority unitholders: (a) had their own counsel whom they were told to reach out to with any questions; (b) attended several information sessions to discuss the transaction prior to the closing; (c) elected to roll a portion of their equity into the newco; and (d) voted in favor of the transaction. The Court also noted that only after a year and a loss in value of the rollover equity (in part because the acquiror took a goodwill impairment charge) did the minority unitholders bring a lawsuit "when remorse has set in."

Recognizing that the LLC Agreement waived fiduciary duties, the minority unitholders argued that Warburg Pincus nevertheless breached the covenant of good faith and fair dealing implicit in all contracts. The Court looked to prior case law stating that the implied covenant of good faith and fair dealing "is a limited and extraordinary legal remedy" used to "analyze unanticipated developments or to fill gaps in the contract's provisions." Pointing again to the express amendment requirements and waiver of fiduciary duty provisions in the LLC Agreement, including Warburg Pincus' contractual right to act in its own self-interest, the Court held that there was no contractual gap to be filled by a duty of good faith, stating that the implicit covenant of good faith and fair dealing "does not apply when the contract addresses the conduct at issue, but only when the contract is truly silent concerning the matter at hand."

The Court was equally unconvinced with the minority unitholders' assertion that Warburg Pincus negotiated away the tag-along rights and coerced the minority unitholders to agree to the merger. Reiterating the position that "the implied covenant cannot be wielded to rewrite the LLC Agreement or grant the plaintiffs rights they never bargained for," the Court stated that the LLC Agreement included a mechanism to eliminate rights that disproportionately affect certain holders and, in compliance with the LLC Agreement, the parties obtained the consent of such affected holders to eliminate those rights.

The Court also distinguished the claims brought against CityMD, a limited liability company, from previous caselaw relating to corporations. Whereas the contours of fiduciary duties in the context of corporations are addressed by statute and expansive Delaware precedent, the Court stressed that limited liability companies are assessed by the terms and purposes of a limited liability company agreement. Noting that Delaware law allows limited liability company agreements to eliminate fiduciary duties, the Court found that Delaware courts will respect the terms of the LLC Agreement and are rightfully more hesitant with limited liability companies to resort to the implied covenant of good faith.

The minority unitholders also argued, as a secondary claim, that Warburg Pincus breached an implied duty of disclosure that, according to the minority unitholders, required full disclosure of all material information so as to ensure an informed unitholder vote. Again distinguishing from corporate law, the Court looked only to the terms of the LLC Agreement and found no such duty of disclosure, both because of the express waiver of fiduciary duties and the terms of the LLC Agreement governing required notices for unitholder meetings, which were not breached. "The Company was not a corporation; the plaintiffs are not stockholders. The matters at hand are contractual ones. Delaware law does not provide for quasi-fiduciary damages for a breach of the implied covenant where the contract belies the plaintiff's position."

The Court's decision underscores the limited application of the implied covenant of good faith and fair dealing and the difference in protections available to equityholders of a corporation as opposed to non-corporate entities. Going forward, parties should be mindful of the ability for a limited liability company in Delaware to waive fiduciary duties. The decision in *Khan* is a reminder of Delaware law's broad freedom of contract rights, especially for limited liability companies and the deference Delaware courts will give to the terms of a LLC Agreement. When a LLC Agreement is appropriately drafted, Delaware courts will likely be reluctant to imply additional protections or terms into such agreements.