

# VALUING THE DUTY OF LOYALTY IN A LIMITED LIABILITY COMPANY

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In his video presentation on eliminating the duty of loyalty in limited liability companies,<sup>1</sup> Professor Fershée presents a strong case for allowing members to eliminate the duty of loyalty and proposes guidelines on the minimum procedural requirements for such elimination. I offer some additional thoughts on how members may be able to assess the cost or benefits of such elimination.

Professor Fershée advocates, correctly in my view, that courts, lawyers, and scholars should treat limited liability companies (LLCs) as a separate and unique type of legal entity distinct from corporations and limited partnerships. As a “creature of contract,”<sup>2</sup> LLCs offer a wide range of flexibility in both business operations and governance structures. Therefore, as noted by Professor Fershée, referring to and applying the larger body of corporate or limited liability partnership legal concepts to an LLC is appropriate so long as there is a specific reason to do so.

Professor Fershée then applies these ideas to the questions of whether and how an LLC may eliminate the duty of loyalty and concludes that (1) an LLC should be permitted to eliminate the duty of loyalty, (2) the elimination should be specifically bargained for—that is, there should be a duty of loyalty unless the LLC operating agreement expressly eliminates the duty, and (3) all members of the LLC must agree to any amendment to an existing LLC operating agreement that eliminates the duty of loyalty unless the LLC operating agreement expressly permits such elimination by a vote of less than all of the members.

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<sup>1</sup> See Joshua Fershée, *An Overt Disclosure Requirement for Eliminating the Duty of Loyalty*, 20 TENN. J. BUS. L. 979 (2019).

<sup>2</sup> *Id.* at 974; (quoting *Kuroda v. SPJS Hldgs., LLC*, 971 A.2d 872, 880 (Del. Ch. 2009)).

Professor Fershée then discusses the value that the elimination of the duty of loyalty may have to the members of the LLC in permitting members to pursue other economic opportunities that might otherwise conflict with the duty of loyalty. This discussion raises the question of how a potential investor in an LLC can determine the value of retaining or eliminating the duty of loyalty.

Consistent with Fershée's views on the great flexibility and variety presented by the LLC as a form of legal entity, the value of retaining or eliminating the duty of loyalty will depend on the nature of the business that the LLC will engage in, and the nature of the structure of the LLC. For an LLC that will operate like a public corporation and whose membership interests may be publicly traded, the duty of loyalty may have significant value. For example, in evaluating the creditworthiness of corporations (including some insurance companies, financial institutions and public utilities), the rating agency, Standard and Poor's Financial Services LLC,<sup>3</sup> has included as a factor the extent to which the board of directors in a company with entrepreneurial or family-bound ownership and control of management has "independent members who are capably engaged in risk oversight on behalf of all stakeholders, including minority interests" or, if not, whether "it has a proven track record of discharging its fiduciary responsibilities on behalf of all stakeholders."<sup>4</sup> Standard and Poor's further states: "Ownership structure is a governance deficiency if controlling ownership negatively influences corporate decision-making to promote the interests of the controlling owners above those of other stakeholders."<sup>5</sup> These criteria suggest that an express waiver of the duty of loyalty would adversely affect the credit rating of this type of enterprise, and would therefore adversely affect the value of the LLC interests.

On the other hand, if an LLC is formed for the limited purpose of holding assets and distributing cash flow from the assets, then the presence or absence of a duty of loyalty may have no importance for the

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<sup>3</sup> Standard and Poor's Financial Services LLC is a nationally recognized statistical rating organization registered with the Securities and Exchange Commission. *See* 15 U.S.C.A § 78o-7 (201X); Order Granting Registration Of Standard & Poor's Ratings Services As A Nationally Recognized Statistical Rating Organization, Exchange Act Release No. 34-56513 (September 24, 2007), *available at* <https://www.sec.gov/rules/other/2007/34-56513.pdf>.

<sup>4</sup> *See* STANDARD AND POOR'S RATING SERVICES, GENERAL CRITERIA: METHODOLOGY: MANAGEMENT AND GOVERNANCE CREDIT FACTORS FOR CORPORATE ENTITIES AND INSURERS ¶45 (Nov. 13, 2012, updated as of Sept. 26, 2017).

<sup>5</sup> *Id.*

members that have an economic interest in the LLC.<sup>6</sup> For example, LLCs are commonly used in securitization and structured finance transactions as special purpose bankruptcy remote entities whose purpose is to purchase and hold a large pool of receivables that produce cash flow, such as automobile loans or leases, other equipment loans or leases, and other types of consumer and business loans.<sup>7</sup> The LLC acquires these receivables from operating companies that originate or acquire the receivables. To obtain funds for such acquisition, the LLC will issue debt securities (a securitization) or borrower funds under a credit agreement (a structured finance transaction) and in each case will grant a security interest in the receivables to secure the debt securities or the loan.<sup>8</sup>

By limiting the activities of the LLC to acquiring the receivables from the originator or subsequent owner (which will be an operating company), and issuing debt secured only by the receivables, the debt holders or lender take only the risk that the receivables will fail to perform as predicted. They will not assume any of the risks of the operating

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<sup>6</sup> Another example of a limited purpose entity that appears not to implicate the presence or absence of the duty of loyalty are companies whose only significant assets are one or two noncontrolling equity interests (NCEIs) in other financial and nonfinancial corporate entities. Standard and Poor's established ratings criteria for these companies, and the rating for these entities, depends on the degree to which the companies have sufficient control over the NCEIs to prevent the diminution of the expected dividends on the NCEIs. See STANDARD AND POOR'S RATING SERVICES, GENERAL CRITERIA: METHODOLOGY FOR COMPANIES WITH NONCONTROLLING EQUITY INTERESTS (Jan. 5, 2016) (This criteria does not mention any fiduciary duties as elements of the criteria).

<sup>7</sup> Thomas E. Plank, *The Key to Securitization: Isolating the Assets to Be Securitized from the Risk of An Insolvency Proceeding*, in OFFERINGS OF ASSET BACKED SECURITIES § 2.01 at 2-5 to -11 [hereinafter, *Key to Securitization*].

<sup>8</sup> See generally Reed D. Auerbach & Charles C. Sweet, *The Structure of Asset-Backed Securities and the Federal Regulatory Regime*, in OFFERINGS OF ASSET BACKED SECURITIES 1-1 (Reed D. Auerbach & Charles C. Sweet, eds., 4th ed. 2019) [hereinafter, OFFERINGS OF ASSET BACKED SECURITIES]; Plank, *The Key to Securitization*, supra note 7 at 2-5 to -11 [hereinafter, *Key to Securitization*]; Jonathan C. Lipson, *Defining Securitization*, 85 S. CAL. L. REV. 1229, 1238-46 (2012); Thomas E. Plank, *The Securitization of Aberrant Contract Receivables*, 89 CHI. KENT L. REV. 171, 171-73 (2013) [hereinafter, *Securitization of Aberrant Contracts*]; Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1660-66 (2004) [hereinafter, *Security of Securitization*]. A securitization and a structured finance transaction are essentially identical except that a securitization involves the issuance of securities. The largest category of asset backed securities and loans are backed by mortgage loans, which are held predominantly in common law trusts or Delaware statutory trusts. OFFERINGS OF ASSET BACKED SECURITIES at 1-8. For many years, non-mortgage loan receivables were held primarily by Delaware LLCs but more recently they have been held either by Delaware LLCs or Delaware statutory trusts.

company that originated or sold the receivables. In contract, if (i) the operating company owned the receivables and granted a security interest in the pool of receivables, and (ii) the receivables were to generate sufficient cash flow to repay the secured debt, but (iii) the operating company got into financial difficulty for reasons unrelated to the performance of the receivables, then the operating company could file a petition under the United States Bankruptcy Code to liquidate or reorganize.<sup>9</sup> The commencement of a case under the Bankruptcy Code would automatically stay any payments on the secured debt of the operating company and any actions of secured creditors to collect the debt.<sup>10</sup> Accordingly, regardless of the credit quality of the receivables securing the debt, secured creditors of an operating company bear the risks and costs of a bankruptcy proceeding by the operating company, and the creditors recoup these risks and costs by charging a higher interest rate.<sup>11</sup>

A bankruptcy remote LLC, however, is limited to owning receivables and incurring debt secured by the receivables. Accordingly, the creditors of the LLC with a security interest in the receivables should become a debtor in bankruptcy only if the receivables themselves were performing poorly.<sup>12</sup> Limiting the risk of bankruptcy allows the LLC to obtain financing from the debt holders or lender at a lower rate of interest

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<sup>9</sup> 11 U.S.C. § 301.

<sup>10</sup> 11 U.S.C. § 362(a)(6).

<sup>11</sup> See Plank, *Key to Securitization*, *supra* note 8, § 2.02[B]; Plank, *Securitization of Aberrant Contracts*, *supra* note 8, at 174; Plank, *Security of Securitization*, *supra* note 8, at 1669-1671.

<sup>12</sup> An LLC issuing debt in a securitization or structured finance transaction can be isolated from the risk of the bankruptcy of the operating company that originated or owned the receivables by (i) acquiring the receivables in a true sale, (ii) not being authorized to incur debt owed to other creditors, which could file an involuntary bankruptcy petition against the LLC or institute foreclosure proceedings that would then give the LLC a legitimate reason to file a voluntary bankruptcy petition, (iii) covenanting to comply with specific requirements to ensure that the LLC would operate as a legal entity separate from its members or their affiliates to prevent the LLC from being consolidated with the members under the bankruptcy law doctrine of substantive consolidation, and (iv) authorizing the LLC to file a voluntary bankruptcy petition only with the consent of a manager that is independent of the members to prevent the members from causing the LLC to file a voluntary bankruptcy petition for reasons that would only benefit the members. See *Key to Securitization*, *supra* note 8, at 2-24 to -80; *Securitization of Aberrant Contracts*, *supra* note 8, at 181-85; *Security of Securitization*, *supra* note 8, at 1671-83; see also STANDARD & POOR'S RATING SERVICES, LEGAL CRITERIA FOR U.S. STRUCTURED FINANCE TRANSACTIONS 13-21, 39-41, 39-50 (2006) [hereinafter, STANDARD & POOR'S LEGAL CRITERIA] (discussing criteria when bankruptcy remote special purpose entity is an LLC).

than an operating company could obtain. For this reason, securitization and structure finance provide, indirectly, a source of financing for the operating companies that originate or purchase receivables at a lower cost than the operating companies could acquire by issuing securities or obtaining direct secured credit.<sup>13</sup>

With one exception, the question of eliminating the duty of loyalty does not arise for most LLCs used in securitization or structured finance for several reasons. First, the LLC will typically have only one member, the operating company that originated or acquired the receivables sold to the LLC or an affiliate. Second, in some structured finance and securitization transactions, some or all of the membership interests are sold to multiple investors. In either case, there is little active management of a bankruptcy remote LLC, because the primary value of the LLC membership interests depends on the cash flow of a pool of receivables. The most important management function of the LLC will be the servicing of receivables, including collection of receivables that become delinquent. This servicing function is performed not by the LLC but by a separate servicer with substantial operational capacity, often the originator or seller of the receivables. Furthermore, the activities of the servicer (as well as the LLC) regarding the servicing of the receivables will be subject to important controls by the debt holders or the lender.

There is one critical feature of a bankruptcy remote LLC, however, that will implicate the duty of loyalty as it relates to the creditors of the LLC in a securitization or structured finance transaction. To be a bankruptcy remote LLC, the LLC must have an independent manager (or an independent director of a board of managers or directors). The independent manager must be independent of the member or members that own the LLC, and the independent manager will not have an economic interest in the LLC. The role of the independent manager is limited but crucial: The LLC cannot initiate a voluntary petition in bankruptcy unless the independent manager, taking into consideration the interests of the holders of the secured debt of the LLC, consents.<sup>14</sup> The purpose of the independent manager is to prevent opportunistic behavior by the member or members that could cause the LLC to become a debtor

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<sup>13</sup> See *Key to Securitization*, *supra* note 8, at 2-15 to -24; *Securitization of Aberrant Contracts*, *supra* note 88, at 175-80; *Security of Securitization*, *supra* note 8, at 1669-71.

<sup>14</sup> STANDARD AND POOR'S LEGAL CRITERIA, *supra* note 12 at 43-44, 48-49 (2006).

in bankruptcy for reasons unrelated to the performance of the receivables.<sup>15</sup>

The preceding examples are merely two of the innumerable types of businesses transactions or governance structures of an LLC. For any person thinking of investing in an LLC and trying to determine the value of an LLC interest, a “facts and circumstances” analysis would be necessary—an analysis that is perhaps time consuming and indeterminate. There has been a great deal of discussion about valuing LLC interests and other forms of less liquid equity interests by various appraisal methods, in a variety of contexts, and for a variety of purposes, such as gift and estate taxation,<sup>16</sup> litigation by minority interest holders for majority shareholder oppression,<sup>17</sup> or divorce proceedings.<sup>18</sup> These methods generally require the valuation of the LLC or other legal entity, and they may then apply a discount for a variety of reasons, including primarily for limited marketability and, in the case of minority interests, for lack of control.<sup>19</sup>

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<sup>15</sup> See *Key to Securitization*, *supra* note 7; *Securitization of Aberrant Contracts*, *supra* note 8, at 184; *Security of Securitization*, *supra* note 8, at 1665–66.

A good example of this opportunistic behavior is the case of *In re WE Financial Co.*, No. 92-01861-TUC-LO (Bankr. D. Ariz. filed June 11, 1992), *discussed in* Plank, *Security of Securitization*, *supra* note 8, at 1665–66. In this case, a bankruptcy remote special purpose entity, a general partnership, had issued \$125 million of high interest rate debt, secured by Government National Mortgage Association mortgage pass-through certificates were worth more than the face amount, or par, because of a decline in interest rates since the date of issuance. The owners of the special purpose entity, who were in financial difficulty, caused the special purpose entity to file for bankruptcy for the sole purpose of accelerating the payment of its debt at par by liquidating the underlying collateral for an amount greater than the par value of the collateral and realizing a profit of about \$11 million to be distributed to its owners. Because of the strenuous objection of the trustee for the debt holders on the grounds that, among other things, the petition was filed in bad faith, the special purpose entity and its owners settled this case with a reinstatement of all but a small portion of the issued debt.

<sup>16</sup> See generally, e.g., Jay T. Brandi, *Estate Tax Valuation And Comparative Discounting For The Limited Liability Company Investment Fund*, 12 J. LEGAL ECON. 27 (2002); Edwin T. Hood et al., *Valuation of Closely Held Business Interests*, 65 UMKC L. REV. 399 (1997).

<sup>17</sup> See generally, e.g., Sandra K. Miller, *Discounts and Buy Outs in Minority Investor LLC Valuation Disputes Involving Oppression or Divorce*, 13 U. PA. J. BUS. L. 607 (2011); Douglas K. Moll, *Shareholder Oppression and “Fair Value”: Of Discounts, Dates, and Dastardly Deeds in the Close Corporation*, 54 DUKE L.J. 293 (2004).

<sup>18</sup> See, e.g., Miller, *supra* note 17.

<sup>19</sup> See, e.g., Hood et al., *supra* note 16, at 401–02, 407–37 (entire entity); *Id.* at 437–48 (stock in a corporation); *Id.* at 448–52 (equity interests in non-stock entities); Miller, *supra* note 17, at 611–18 (discussing a variety of discounts and arguing that discounts should not be applied); Moll, *supra* note 177, at 315–18 (discussing the application of discounts arising

The valuation methods used for estate planning or litigation purposes may provide a basis for valuing LLC interests, but the sources that I have reviewed do not address the extent to which a duty of loyalty or disclaimer of a duty of loyalty may affect valuation. The variability in the types of business transactions and structures of LLC perhaps contributes to what I expect is a dearth of empirical evidence on this valuation issue.

Nevertheless, an LLC membership interest is property that has value and that can be transferred, subject to the limitations in the LLC's operating agreement and applicable law. An investor in an LLC membership interest may seek to finance the acquisition of the membership interest by granting a lender a security interest in the membership interest. Notwithstanding the costs that the Bankruptcy Code imposes on secured creditors, a secured creditor in bankruptcy still fares substantially better than an unsecured creditor of a person that becomes a debtor in bankruptcy.

Accordingly, a lender willing to lend to an investor in an LLC and take a security interest in the LLC membership interest would need to value the LLC interest. Starting with the current valuation methods for LLC interests, the potential investor and the lender would need to make a further valuation of the duty of loyalty or the elimination of the duty of loyalty in the context of the particular business transactions and structure of the LLC in question. Lenders may have difficulty making a meaningful valuation of the membership interest, and therefore lenders may not be willing to do so. Nevertheless, lenders are in the business of lending funds and often seek ways to expand their lending business. Over time, the extension of secured credit by lenders to investors in LLC interests, even if initially at very conservative valuations and loan to value ratios, may produce enough market information to provide some guidance on when a duty of loyalty is more valuable or less valuable than no duty, in the context of a variety of business transactions or LLC structures.

For example, to what extent would the elimination of the duty of loyalty allow a controlling LLC interest holder to affect adversely the expected returns on a minority LLC interest? Conversely, to what extent would such elimination reduce the probability of a minority holder using

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from a fair market value analysis and arguing that discounts should not be applied as a remedy for shareholder oppression).

opportunistic litigation to extract value by asserting a breach of the duty of loyalty? Would the elimination of the duty of loyalty provide greater benefits for certain investors than costs to other investors? Can those differences in benefits and costs be mediated through the price of the investment? Because of the great flexibility of LLCs in terms of both operations and structures, it may take considerable time to gain enough experience and information to provide better answer to these questions. However, the very flexibility of LLCs permits adjustments to the structures of an LLC, including the deliberate elimination of the duty of loyalty in circumstances that are likely to produce a net benefit for all LLC members. The flexibility inherent in the LLC as a legal entity will likely produce greater net social welfare than the a more rigid structure of corporate law.