



LPs and LLCs Continue to Reign Supreme for Private Equity Funds and Sponsors in Delaware

Jul 26, 2023

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This was originally [published](#) in Reuters Legal News (July 26, 2023).

Private equity and investment fund sponsors have historically chosen Delaware limited partnership (LP) and limited liability company (LLC) models when structuring and organizing their domestic funds. Most funds rely on Delaware law due to the wide discretion available to contracting parties and the ability of its courts to properly adjudicate sophisticated and complex business matters.

More importantly, the principal advantages to forming an LP or LLC in Delaware are the partnership pass-through entity tax treatments and the flexibility to define the entire relationship of the parties by contracting for provisions in governance documents (an LP Agreement or LLC Operating Agreement, as applicable) with minimal statutory constraints. The Delaware Court of Chancery's recent decision in *New Enterprise Associates 14, L.P. v. Rich*, underscores and reinforces the superior benefits of Delaware LPs and LLCs for private equity funds (No. 2022-0406-JTL, 2023 WL 3195927 (Del. Ch. May 2, 2023)).

In its opinion, the court states:

"[T]he constitutive document of an LLC (the LLC agreement) can (i) fully eliminate any duties existing at law or in equity, including fiduciary duties, (ii) provide indemnification and advancement unconstrained by any statutory standards, and (iii) fully eliminate any and all liabilities, except for bad faith breaches of the implied covenant of good faith and fair dealing. By contrast, the constitutive document of a corporation (the charter and bylaws) (i) can shape fiduciary duties but cannot eliminate them, (ii) cannot eliminate monetary liability for breach of fiduciary duty except for breaches of the duty of care, (iii) cannot provide indemnification or advancement that goes beyond statutory standards, and (iv) cannot constrain liability for breach of the implied covenant of good

faith and fair dealing.”

In the private equity context, members and managers of an LLC and the certain partners of an LP, through their governance documents, may expand or eliminate (i) the fiduciary duty of care whereby a controlling member, manager or general partner of a fund must be fully and adequately informed and act with care when making decisions for the fund, and (ii) the fiduciary duty of loyalty whereby a controlling member, manager or general partner of a fund must act and make decisions in the best interest of the fund and not in such person’s own personal interest (6 Del. C. 18–1101(e) and 6 Del. C. 17–1101(f)).

Governance documents should be drafted in a manner that eliminates statutorily created duties, especially in those instances that the sponsor acting as a controlling member, manager, or partner has multiple ongoing funds whose businesses may conflict with the interests of the other funds it sponsors.

Under Delaware law, most liabilities may be modified or eliminated except for the implied covenant of good faith and fair dealing and breaches for bad faith. Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement (Second Restatement of Contracts §201). Not every issue is foreseeable during the contracting parties’ business relationship, and violations of good faith and fair dealing occur when a counterparty’s discretionary rights frustrate the other party’s benefits from the contract.

In Delaware, parties are granted great freedom to contract. As a result, if traditional fiduciary duties are eliminated in an LP’s or LLC’s governing document, a claim of the breach of the duty of good faith and fair dealing is very difficult to pursue as the court is unlikely to imply terms into a contract.

However, Delaware courts will enforce claims of good faith and fair dealing against controlling members, managers, and partners for targeted breaches of contract; for example, when (i) contracts lack scope of certain discretionary rights and contractual conditions, and (ii) controlling members, managers, or partners engage in misleading or deceptive conduct. As such, it is imperative such

governance documents clearly and explicitly eliminate or modify fiduciary duties. If the contracting language is too ambiguous, Delaware courts may imply that certain controlling managers, members, and partners may owe fiduciary duties as established by the Delaware statutes and case law.

As a middle ground for the contracting parties, governance documents may include a modified standard of care provision that holds the controlling member, manager, or partners harmless if their conduct satisfies the modified standard of care provision. These modified standards often impose a sponsor-favorable threshold of fraud or a willful misconduct standard (or in less common situations, a good-faith standard) rather than the standards imposed by traditional fiduciary duties.

This shifting framework introduces an intent component rather than a subjective standard when imposing liability. Furthermore, many sponsors include provisions that explicitly grant the controlling member, manager, or partner the presumption of good faith if it relied on the advice and documents provided by the fund's professional advisors.

Another added benefit of structuring a fund as an LP or LLC in Delaware is the ability to provide additional indemnification coverage and expense advancement to controlling members, managers, or partners of the fund beyond the statutory requirements through the inclusion of targeted provisions. Fund sponsors want to ensure that their exposure is limited when experiencing an indemnity or expense advancement obligation.

Section 18-108 of the Delaware Limited Liability Company Act provides the power to indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever. Similarly, section 17-108 of the Delaware Revised Uniform Limited Partnership Act has parallel statutory language. These Acts do not contain any specific limitations on the availability of indemnification provided that such rights are contained in the governance documents.

Additionally, neither Act has provided any restrictions on the advancement of expenses. As provided by Delaware case law,

advancement of expenses may be undertaken as specified in the governance documents. Rights to advancement will not otherwise be assumed or implied in the governing documents.

Overall, sponsors benefit from using the LP and LLC models when forming a fund. Eliminating and modifying traditional fiduciary duties and other obligations permit a sponsor to fulfill multiple roles across various funds and portfolio companies without the fear of potential liability and create standards that provide more certainty to common business risks.

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