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**FOREWORD [FNaa1]**

Once again, in his inimitable style, Chief Justice Myron Steele has directed his judicial scrutiny to a critical issue of alternative entity law that others have either assumed or ignored. The issue that Chief Justice Steele focuses on is whether, given a clearly stated public policy of freedom of contract and the maximization of enforceability of alternative entity agreements, fiduciary law should serve as the default standard governing parties' internal agreements or whether the implied contractual covenant of good faith and fair dealing should supply the appropriate default standard. Chief Justice Steele examines the issue through several avenues and concludes, economically and statutorily, that rationality obliges a default contractual standard.

**I. INTRODUCTION**

Since its introduction, the Delaware Limited Liability Company Act (DLLCA) has been a powerful economic vehicle that, unlike its corporate counterpart, allows for ultimate contractual customization among its owners and management. [FN1] As evidence of the Delaware limited liability company's (LLC) prowess, the Delaware Secretary of State reports that nearly 112,000 new LLCs were formed in 2007, compared to just 43,000 new formations in 2001. [FN2] One reason for the success of the LLC is the carte blanche flexibility Delaware's legislature seemingly provided owners in crafting the LLC operating agreement, allowing the parties to contract between themselves. This flexibility made the LLC form ideal for those wanting to craft a highly specialized and customized vehicle, specifying the duties and benefits among owners and managers. [FN3]

Ronald Regan famously said: “If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it.” [FN4] Reagan's truism proved all too true for LLCs. The carte blanche some believed to be contemplated by the Delaware legislature gave way to judicially imposed mandatory and unwaivable fiduciary duties. [FN5]

In 2004, though, Delaware's legislature amended the LLC statute to clarify that, to the extent that default fiduciary duties [FN6] exist, as determined [223] by Delaware courts, those duties can be entirely eliminated. [FN7] Today, Delaware courts are free to determine whether to apply default fiduciary duties at all. [FN8] It is clear from the language of the LLC statute that Delaware's legislature wishes the courts to answer the policy question of whether default fiduciary duties exist in the first instance.

Even with this statutory permission--and perhaps mandate--to make the policy decision of whether to apply default fiduciary duties, Delaware courts have still commonly accepted default fiduciary duties, without engaging in a
thorough policy analysis. [FN9] Since the 2004 statutory amendment, one case, though, does question the long-held assumption that default fiduciary duties apply to LLCs. [FN10]

In this article, rather than embrace the commonly accepted puritanical default fiduciary duty norm, I analyze default fiduciary duties of LLCs from two different policy perspectives to determine whether courts should apply default fiduciary duties at all. First, I argue that default fiduciary duties violate the strong policy favoring freedom of contract enunciated by Delaware's legislature. [FN11] Considering Delaware's strong policy favoring freedom of contract, Delaware courts should analyze mutually bargained-for LLC agreements that define the parties' conduct without any application of default*224 fiduciary duties, even if the parties have not specifically provided for the elimination of fiduciary duties. Where an operating agreement provides for a specific set of conduct, the court should not read any default fiduciary duties into the agreement because the parties' prescribed and proscribed conduct contains the entire agreement that the parties intend and expect. Courts should favor the contracting parties' ex ante calculation of costs and benefits of fiduciary duties, and courts should not, on their own, endeavor to reassess that (albeit perhaps now imprudent) decision ex post.

Second, I analyze the different economic rationales for and against default fiduciary duties, concluding that the costs of default fiduciary duties outweigh the minimal benefits that they provide. I contend we have no reason to assume that parties to an LLC agreement would have provided for fiduciary duties in the contract. As an elaboration on that point, I also argue that default fiduciary duties add significant contracting and litigation costs. When courts assume default fiduciary duties, parties bear the costs of those judicially created fiduciary duties. In the nebulous universe of default fiduciary duties, [FN12] speculating on whether the court will apply default fiduciary duties creates an inconsistency, making it more difficult for parties to effectively eliminate those default duties.

Moreover, the wholly Byzantine approach, whereby parties must define the duties and rights they intend to keep while simultaneously disclaiming other duties that the parties wish to exclude, adds unnecessary chaos into the parties' contract negotiations, thereby increasing their contracting costs. Instead, assuming a clean slate where the organic agreement crafts the rights and duties owed among and between members and managers gives the parties clear expectations about which duties will apply and clear expectations about the other parties' conduct.

Finally, from the prospect of potential litigation cost, without default duties, parties will focus their arguments specifically on the agreements they made, and not on default norms imposed on them by courts. To the extent that an answer to a party's contractual duty is not clear, parties will focus their litigation on contract interpretation rather than fiduciary duties, which will eliminate litigation on claims that the parties never intended to include in their agreements.

*225 Before beginning my analysis of the issues I address in this article, I must first establish some relevant ground rules. This article specifically discusses the relationships among and between member, managers, and the LLC in an LLC and among partners, limited partners, and the limited partnership (LP) in LPs. Those relationships are governed by the relevant Delaware LP and LLC statutes, [FN13] which are in turn interpreted by Delaware courts. Because of the unique judicial system in Delaware, I do not imply that my analysis can or should be extended to other jurisdictions. Further, I assume that each partner, member, and manager had a bargained-for exchange when entering the relationship. By this I assume that the parties' organic agreement is not an agreement imposed on, for instance, a passive LLC member who simply purchased units in the LLC. Likewise, I assume that partners bargained for and received a benefit from the partnership agreement that they reached.

II. BACKGROUND

A. Delaware LP and LLC Law

In 2004, Delaware's legislature amended Delaware's LP and LLC statutes to clarify that the relationships among
members, managers, partners, and their organizations may be governed exclusively under contract law, that is, without any fiduciary duties. [FN14] That amendment changed the rule established under *Gotham Partners* that an LP or an LLC agreement could not entirely eliminate fiduciary duties. [FN15] In the four years after that statutory amendment, Delaware courts have decided some cases involving LPs or LLCs that have modified or eliminated fiduciary duties. [FN16] Two cases have addressed what the initial default position is on fiduciary duties, that is, *whether the fiduciary duties must be eliminated or whether they must be built into the parties' internal agreement.* [FN17] A third case decided by the Delaware Supreme Court did not address the issue of default fiduciary duties because the entity's agreement expressly disclaimed fiduciary duties. [FN18]

**B. Delaware's Statutory Provisions**

Any analysis of the duties owed in an LP or an LLC begins with the relevant statutory provisions. Both statutes similarly provide: “It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.” [FN19] The statutes also provide:

To the extent that, at law or in equity, a partner or other person had duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing. [FN20]

Finally, the statutes also provide that the “rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.” [FN21]

*227* Of course, notably absent, and actually implicit in the sections above, the statutes do not provide any fiduciary duties, default or mandatory. The 2004 statutory amendments clarified that common law fiduciary duties could be expanded, restricted, or eliminated in a partnership agreement, whereas, the statute previously provided that the common law fiduciary duties could only be “modified,” a term the Delaware Supreme Court chose to conclude allowed only for expansion or restriction— not elimination.

Before the 2004 amendments, the Delaware Supreme Court held that LPs applied unwaivable, mandatory fiduciary duties, even in the face of an LP agreement's attempt to eliminate those duties. [FN22] In an earlier article published shortly after the 2004 amendment, I argued that parties should be able to eliminate fiduciary duties, contrary to the holding in *Gotham Partners*. [FN23] Today, the statutes make it abundantly clear that any common law fiduciary duties can be waived. However, the statutes themselves do not establish any default fiduciary duties. [FN24] Instead, the statutes provide that “to the extent that” a partner has any duties, those duties may be modified or eliminated. [FN25] Of course, that same statutory language does not explicitly disclaim the application of default fiduciary duties. Thus, the statute leaves that issue wholly for the courts to decide.

*228* **C. Delaware Case Law**

Before the 2004 statutory amendment clarified that all fiduciary duties could be disclaimed, Delaware courts accepted, as a matter of course, default fiduciary duties. The Supreme Court, in *Gotham Partners*, “noted[d] the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly.” [FN26] The Supreme Court, of course, assumed that there were default fiduciary duties to escape. A treatise on Delaware LLCs explains:

The [Delaware] LLC Act does not state whether, to what extent, or under what circumstances a member or manager or other person possessing management authority in regard to a Delaware limited liability company owes fiduciary duties to other members, managers, holders of limited liability company interests, the company itself, or others. The statute leaves such matters to development in the Delaware case law. It seems
clear that, in the absence of appropriate provisions in the limited liability company agreement, there are circumstances in which a member or manager or other person holding management power owes fiduciary duties. [FN27]

In another case decided before the statutory amendments, a vice chancellor explained:

As a practical matter, the defendants' contractual argument ignores the implications that the specific terms of the LLC Agreement have on the managers' fiduciary duties. Obviously, one of an LLC manager's duties is to govern the LLC in accordance with the LLC Agreement. If an LLC manager knowingly permitted the LLC to violate a contractual duty owed to one of the company's members, that would, as I find later, constitute a breach of fiduciary duty. [FN28]

He further explained that:

the [defendants'] proposition that the managers of an LLC have no fiduciary duty at all to ensure that the LLC lives up to its contractual duties is one that is difficult to accept and that is certainly not supported by prior precedent. How can an LLC perform a contract except through its managers and officers? [FN29]

*229 The statutes, as I explained above, do not prescribe any default fiduciary duties. Rather, the legislature deferred to the courts to determine the policy choice of applying default fiduciary duties. It is not entirely clear why these cited cases assumed default fiduciary duties, nor is it clear that the courts chose to apply default fiduciary duties because of a thorough policy analysis. [FN30] But, with new statutory language in tow, making it abundantly clear that any common law fiduciary duties may be eliminated, the Delaware courts can now reassess the application of default fiduciary duties-- and in two different cases, the Court of Chancery has split on this issue.

In Fisk Ventures, LLC v. Segal, [FN31] Chancellor Chandler used some broad language that indicates that LLC duties are implicitly contractual and, therefore, fiduciary duties must be affirmatively included in the LLC agreement. [FN32] He wrote: “Contractual language defines the scope, structure, and personality of limited liability companies.” [FN33] Moreover, he stated:

In the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC Agreement or some other contract. Because the plaintiff's counterclaims and third-party claims fail to allege breaches of duties found in the [LLC] agreement, the Court must dismiss Count I .... [FN34]

The agreement provided that “no member shall have any duty to any member of the Company except as expressly set forth herein or in other written agreements.” [FN35]

On one hand, one could argue that this language provided a clear and unambiguous elimination of fiduciary duties. However, this language is somewhat ambiguous because it speaks only generally of “duty.” It does not specifically reference fiduciary duties. Rather, the language may mean only that no member has any contractual duty other than those enumerated in the LLC agreement, without any regard to what fiduciary duties they owe. In light of Chancellor Chandler's strongly worded general language—that the agreement is the only source of any duties owed—it appears that he believes, in an agreement that fully fleshes out the conduct of the parties, no default duties should be assumed. This, of course, is a stark departure from Gotham Partners' language explaining the “historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty” should be “scrutinized searchingly.” [FN36] To the contrary, Chancellor Chandler decided that the language of the contract created instead of escaped all of the duties owed.

In another recent LLC case decided by Chancellor Chandler, the court's opening remarks are telling: “For Shakespeare, it may have been the play, but for a Delaware limited liability company, the contract's the thing. Ultimately, it is the contract that compels the Court's decision in this case because it is the contract that ‘defines the scope, structure, and personality of limited liability companies.’” [FN37]
The case, R&R Capital, LLC v. Buck & Doe Run Valley Farms LLC, presented the court with two New York LLCs that sought dissolution and winding up of nine Delaware LLCs. In the alternative, petitioners sought the appointment of a receiver for the Delaware entities. The Delaware LLCs responded that the petitioners were neither members nor managers under sections 18-802 and 18-803 and therefore lacked standing to seek dissolution. Finding the petitioners were neither members nor managers in some of the Delaware LLCs, the court granted the motion to dismiss these claims. The remaining claims centered upon the judicial appointment of a receiver under section 18-805.

At the core of this case, an issue of first impression in Delaware, were provisions in Delaware LLC operating agreements that waived judicial dissolution and the appointment of a liquidator. Petitioners claimed the waivers were invalid even if bargained for by sophisticated parties on the grounds that: (1) judicial dissolution should not be a waivable provision and (2) as a matter of public policy, waivers of judicial intervention at dissolution should not be modifiable.

The Chancellor, citing Delaware's strong public policy favoring freedom of contract and noting the sophistication of the parties to the bargain, held that the waivers were enforceable. In the Chancellor's words:

[i]t is the unwaivable protection of the implied covenant of good faith and fair dealing that allows the vast majority of the remainder of the LLC Act to be so flexible. There is no threat to equity in allowing members to waive their right to seek dissolution because there is no chance that some members will be trapped in a limited liability company at the mercy of others acting unfairly and in bad faith. Not only is this case insightful for its ruling on judicial dissolution, it is important for its absence of analysis of fiduciary duties. Throughout the opinion, the Chancellor makes clear that the entity is contractual, the parties' relationship is contractual, and that any “bad acting” will be ferreted out by the parties' bargain and the implied covenant of good faith and fair dealing. This is the contractual construct anticipated by the Delaware legislature when the statutory policy of freedom of contract was adopted in the LLC statute.

On the other hand, in Twin Bridges Limited Partnership v. Draper, Vice Chancellor Parsons employed the more traditional notion of default provisions. He wrote:

Consistent with the underlying policy of freedom of contract espoused by the Delaware Legislature, limited partnership agreements are to be construed in accordance with their literal terms. “The operative document is the limited partnership agreement and the statute merely provides the ‘fall-back’ or default provisions where the partnership agreement is silent.” Only “if the partners have not expressly made provisions in their partnership agreement or if the agreement is inconsistent with mandatory statutory provisions .... will [a court] look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence.” In other words, unless the partnership agreement is silent or ambiguous, a court will not look for extrinsic guidance elsewhere .... Specifically on the issue of fiduciary duties, Vice Chancellor Parsons concluded:

Under Delaware law, a general partner in a limited partnership has a duty to “exercise the utmost good faith, fairness and loyalty” and such duty is often compared to that of corporate directors. Unless the partnership agreement preempts fundamental fiduciary duties, “a general partner is obligated to act fairly and prove fairness when making self-interested decisions.” Vice Chancellor Parsons' language in Twin Bridges differs drastically from Chancellor Chandler's language in Fisk and R&R Capital. Under the Twin Bridges approach, fiduciary duties are fundamental and must be unambiguously eliminated in the partnership agreement. Fisk and R&R Capital, rather than speak in terms of fundamental duties, talk of contractual duties and, presumably under Chancellor Chandler's approach, the court would look only to common law fiduciary duties in the absence of a bargained-for agreement regulating the conduct in operating agreements.
Given this existing inconsistency in the Court of Chancery, the remainder of this article sets out several different reasons why Delaware courts should eschew their addiction to default fiduciary duties and instead adopt a policy of no default fiduciary duty.

III. POLICY ANALYSIS

Delaware's prominent position in corporate chartering, and more recently LLC chartering, is due in part to wise policy choices adopted by the legislature and the expertise of Delaware courts. Part of the Delaware courts' expertise involves the judges' experience with and willingness to apply logical and economically rational rules. To determine whether to apply default fiduciary duties, a Delaware court should engage in a thorough economic analysis of this issue. As Cooter and Ulen explain, “replacing inefficient default terms with efficient default terms creates a surplus.” Thus, in this article, I set out some important economic rationales for a court to consider in finding an efficient default duty for Delaware LLCs and LPs.

A. Freedom of Contract

As discussed above, Delaware's legislature tipped its hat to the courts, allowing the courts to apply principles of fiduciary duties so long as parties could, by contract, eliminate any of those duties. Although the legislature has not provided an answer to the question of default fiduciary duties, one way or the other, the legislature has guided the courts by instructing them to give full effect to the freedom of contract between the parties. I contend that this general principle of freedom of contract announced by the legislature indicates that courts should not assume that default fiduciary duties apply.

First, the legislature provided the strongest possible indication of its public policy to effectuate the parties' contracts, here the LP or the LLC agreement. Going back to Fisk, R&R Capital, and cases that pose similar situations, suppose that the members agreed to an LLC agreement that proscribed a specific list of conduct. However, the agreement never provided an explicit elimination of fiduciary duties. Further assume that one member engaged in conduct, not proscribed, but clearly self-interested. Another LLC member sued based upon a theory of breach of fiduciary duty. The question becomes: how will the court resolve this issue?

Had the agreement been a typical bargained-for commercial contract, a Delaware court would have examined the conduct under the lens of the contractual language, with magnification from the many useful tools for contract interpretation. As noted in Cooter and Ulen's textbook, “economic efficiency requires enforcing a promise if the promisor and promisee both wanted enforceability when it was made.” Not surprisingly, if the parties agreed to the duty of loyalty, it would certainly be enforced.

If, however, a fulsome contract interpretation analysis revealed no provision of a fiduciary duty of loyalty, the court would not apply a default term. As Cooter and Ulen note, a court should only “impute the terms to the contract that the parties would have agreed to if they had bargained over all the relevant risks.” In Cooter and Ulen's terms, contracting parties may leave “rational gaps,” or perhaps even conscious ambiguity, so that courts can apply default rules. Under Delaware contract jurisprudence, Delaware courts have limited their application of default duties to the implied contractual duty of good faith and fair dealing. Thus, Delaware courts have apparently concluded that the parties would have agreed only to the implied contractual duty of good faith and fair dealing. Notably, the Delaware courts, in the contracts context, have determined that parties would not provide the fiduciary duty of loyalty. Absent specific language in the contract creating a fiduciary relationship, a court would be loath to revert to a fiduciary duty of loyalty and hold the defendant liable for acting in his own best interest--so long as the implied contractual duty of good faith and fair dealing was met.

But, under Delaware's approach to LLC agreements, the answer to whether the court will apply default fiduciary
duties is not so clear. Applying Fisk or R&R Capital, a Delaware court would look to the LLC agreement and find that the conduct in this hypothetical was not explicitly covered by the agreement and, thus, not explicitly prohibited. [FN53] But, in other cases, because the agreement did not eliminate fiduciary duties, the court, under Twin Bridges, [FN54] would decide to apply the common law fiduciary duty of loyalty.

To resolve this split, my answer is simple: treat it like a contract. The legislature has announced the clear public policy to enforce the parties' freedom of contract. Delaware courts have already determined what default duties, in fact also codified in the statute, [FN55] apply in the context of contracts, thus courts should simply apply those same default duties, but no more, to LLCs and LPs.

Further, default fiduciary duties run the risk of creating a shortcut whereby a court might look to default fiduciary duties rather than conduct a complete and potentially difficult contract interpretation. This, of course, further violates the statutory principle “to give maximum effect to the principle of freedom of contract.” [FN56] The danger in applying default fiduciary duties is that, rather than determining the ex ante intent of the parties as contemplated by their agreement, a court might be wooed by plaintiffs' fiduciary duty claims and accept their proposal to apply an ex post fiduciary duty analysis.

B. Economic Analysis

Although, as I argued above, the freedom of contract principle articulated by the statutes suggests that the court eliminate default fiduciary duties, it is also unquestionable that the legislature authorized the courts to apply default fiduciary duties, if they so choose. Cooter and Ulen describe a simple, economically rational rule for determining default terms: “Impute the terms to the contract that the parties would have agreed to if they had bargained over all the relevant risk.” [FN57]

Of course, as explained above, Delaware courts have already provided a default duty for contracts the implied contractual duty of good faith and fair dealing. [FN58] Courts, presumably, have eschewed applying the corporate fiduciary duty of loyalty to all contracts for good reason. [FN59] In the next section, I argue that Delaware courts should conform default duties for LLCs to those default duties applied in contract and depart from the default duties announced under our corporate jurisprudence. To make my point, I explain why, from an economic policy perspective, default fiduciary duties should not be the norm, and instead Delaware courts should assume no default fiduciary duties apply.

*237 I. The Hypothetical Bargain

In determining which default duties should apply, courts seeking to adopt economically sensible default duties might begin by considering whether the parties to an LLC would provide for fiduciary duties if they had bargained over all of the risks— that is, the hypothetical bargain. [FN60] To help answer this question, it is important to note that sophisticated parties bargain for the obligations and duties provided in an LLC agreement. [FN61] The choice of the LLC form was an intentional form, chosen by sophisticated parties because that form provides the contracting parties with the maximum ability to customize their relationship. Understanding this key difference between LLCs and corporations points us away from adopting default corporate-like fiduciary duties and, instead, applying only Delaware’s default contractual duties. To understand this point, in the context of LLC contracting by sophisticated parties, we can assume that the parties' choice to not provide fiduciary duties is a conscious and deliberate choice— rather than a “rational gap.”

Whether parties imprudently chose the LLC form, or whether it appears that ex post the parties ineffectively bargain for their rights and obligations, [FN62] should be of no moment for the court. The only time the court *238 can intervene to add terms to the LLC contract is if the parties’ intent can be implied from the agreement or other law fills in those terms. [FN63] In the alternative, a court may strike terms to an agreement if it finds some indicia of

fraud, undue influence, or adhesion. Simply because, on occasion, parties may ineffectively bargain, ex ante, does not require the courts to swoop in as a protector for ill-advised contract makers.

2. Economic Costs and Benefits to Fiduciary Duties

A more nuanced approach to the hypothetical bargain requires the court to determine what the economic costs and benefits are of applying fiduciary duties to LLCs. Professor Larry Ribstein has written extensively on the economic costs and benefits of fiduciary duties. [FN64] Professor Ribstein explains that “the existence of default fiduciary duties depends solely on the structure of the parties' relationship that is, on the terms of their express or implied contract -- and not on any vulnerability arising other than from this structure.” [FN65] Specifically, for LLCs, Ribstein sets forth three economic rationales to narrowly define fiduciary duties.

First, according to Ribstein, even where fiduciary duties have some benefits, those benefits are outweighed by costs such as “effect on the purported fiduciary's incentives and the reduction of trust or reciprocity from substituting legal duties for extralegal constraints.” [FN66] In particular, Ribstein notes, “courts often ignore the costs of fiduciary duties perhaps because these costs matter most in the cases that do not get to court, and therefore seem insignificant compared to the unfairness in the case being litigated.” [FN67] Second, Ribstein argues that “there are benefits to clearly delineating the situations in which fiduciary duties apply, including minimizing litigation and contracting costs and effecting extralegal conduct norms.” [FN68] Third, and finally, Ribstein concludes that “a narrow approach to fiduciary duties inheres in the contractual nature of such duties.” [FN69] Ribstein warns that “[a]pplying fiduciary duties broadly threatens to undermine parties' contracts by imposing obligations the parties do not want or expect.” [FN70]

Professor Ribstein's thoughtful analysis also applies to default fiduciary duties. In particular, the benefit of applying any default fiduciary duty is outweighed by its cost. First, default fiduciary duties add unnecessary costs to contracting. Second, default fiduciary duties also add unexpected litigation costs. Finally, any benefit to default fiduciary duties is limited because the LLC, by its nature, is designed to be a highly customized vehicle, determined primarily by contract. A critic to my cost-benefit analysis will invariably argue: (1) there is no cost to default fiduciary duties because the LLC statute provides that parties may eliminate any default duties and (2) parties benefit from fiduciary duties because they expect them and need not contract for them. However, I will demonstrate why those criticisms are misplaced.

First, default fiduciary duties add unnecessary contracting costs. The nebulous nature of default fiduciary duties makes it difficult for parties to eliminate some, but not all, potential fiduciary duties. Although I agree that a wholesale elimination of duties in an LLC agreement comes at little cost, the costs rise dramatically when the parties intended to keep some, but not all, duties. Imagine that the parties intend to include a provision proscribing self-dealing but intend to eliminate any other aspect of the duty of loyalty. It is difficult for parties to contract for this if there are default fiduciary duties. Part of the default fiduciary duties would certainly include a ban on self-dealing, but the default duties will also contain other aspects of the duty of loyalty. In order for the parties to achieve their objective, provisions in the contract will necessarily appear contradictory - that is, part of the contract will disclaim the duty while another provision will provide for that duty--and thus require the parties to spend additional resources to assure that the LLC agreement appropriately provides for a self-dealing ban while eliminating all other potential fiduciary duties.

If we assume no default fiduciary duties, the parties need only explicitly provide for a self-dealing proscription. The contract is much easier to draft, and the parties have more confidence that they adequately provided for that ban without also introducing other unwanted fiduciary duties.

A question remains: how often will parties want to remove the default fiduciary duties? If, for the most part, parties simply intend to keep the default fiduciary duties, then it would be less costly for parties to contract. How-
ever, if we proceed from the baseline of no default fiduciary duty, adding in a wholesale provision adopting Delaware's fiduciary duty principles could also be easily achieved -- without much cost. As I described in the last paragraph, this will benefit the parties who intend to adopt a discrete number of those duties because it will be less costly to contract for those limited duties. Moreover, by adopting an LLC, the parties have consciously chosen to use a highly customizable vehicle--in so choosing, we naturally infer that the parties intend customization. [FN71]

Second, default fiduciary duties introduce unexpected litigation expenses. Without default fiduciary duties, the parties' litigation will focus solely on the agreement between them--and not on fiduciary duty principles outside of the contract. Simply put, default fiduciary duties create the opportunity to enter into litigation based upon rights not provided by the LLC agreement--even in cases where the agreement attempts to eliminate or minimize those default duties. Moreover, if the parties intended, but failed because of contractual complexity, to limit default fiduciary duties or if the LLC agreement were ambiguous, the parties might be forced to litigate a claim they never intended to facilitate in the original agreement. In light of the heightened contracting cost with default fiduciary duties, this result might frequently occur.

In light of those potential costs, the courts must also weigh them against any benefits to applying default fiduciary duties. Professor Ribstein explains that “[i]n general, this is a matter of articulating standard form terms to minimize contracting costs. It is difficult and expensive for parties to enter into customized contracts covering all of the details of a long-term agency-type relationship.” [FN72] However, it is important to remember that in the context of an LLC that the parties have specifically chosen to use an LLC agreement, which provides contractual flexibility, and have bargained for the relevant provisions in this agreement. Thus, it does not necessarily follow that default fiduciary duty principles will more accurately reflect the parties' intent rather than principles of contract interpretation. Instead, because the parties chose a Delaware LLC and because the Delaware judiciary is skilled in resolving difficult issues of contract interpretation, the opposite conclusion is likely true, that is, parties would prefer Delaware courts to determine their rights and duties in accordance with the terms of the contract and not an un bargained-for default fiduciary principle. Moreover, if the parties intended to apply traditional fiduciary duties to their relationship, they could easily add a provision stating precisely that in the agreement.

A final point is necessary in evaluating costs of fiduciary duties in LLCs and LPs in Delaware. As I noted in prior sections, the Delaware LP and LLC acts are silent on fiduciary duties. Although Vice Chancellor Parsons in Twin Bridges assumed fiduciary duties applied by default in an LP agreement, no discussion or analysis was undertaken as to what those fiduciary duties encompass. Stated differently, if Delaware courts continue to infuse fiduciary duties in LPs and LLCs, what will be the compass for those duties where LPs and LLCs live and thrive in a purely contractual regime? Surely corporate fiduciary principles do not fit a bargained-for contractual venture where parties have structured their rights and duties, including management, voting, distribution, exit, and other rights. Even in LLCs with management vested in a board of managers, the LLC, unlike its corporate counterpart, has planned this contractual managerial style without any recourse to gap filling by the LLC statute. The operating agreement controls every action of the board of managers. In other words, the LLC may look like a corporate duck but it quacks like a contract.

IV. CONCLUSION

Delaware's legislature has provided Delaware courts with the opportunity--if not mandate--to engage in a thorough policy analysis of default fiduciary duties. To date, Delaware courts have addressed this issue in only limited circumstances. But at some point, the courts will have to address, head on, whether default fiduciary duties should apply. In order to answer this policy question, Delaware courts will invariably look to an economic analysis to determine whether to apply default fiduciary duties. I conclude that an economic analysis mandates that the courts reject default fiduciary duties. Instead, the courts should analyze LLC agreements by the parties' agreement alone. Default fiduciary duties introduce unnecessary confusion to contracting and add undesired litigation costs without providing any substantial benefit. Who can conscionably say no to reducing confusion and litigation costs?

[FN1]. Chief Justice of the Supreme Court of Delaware Before serving as the chief justice, he served as a justice on the Supreme Court of Delaware, a vice chancellor for the Court of Chancery of Delaware, and a judge on the Superior Court of Delaware. Chief justice Steele is the author of many significant opinions in alternative entity law. Thanks to John Allen Eakins for his invaluable assistance and Professor Ann E. Conaway for her review.

[FNaa1]. Ann E. Conaway, Professor of Law, Widener University School of Law, Wilmington, Delaware authored the Foreword.

[FN1]. The Delaware General Corporation Law (DGCL), DEL. CODE ANN. tit. 8, §§ 101(h)(7) & 122(17) (2009), provides substantially less freedom in contracting for fiduciary duties than the DLLCA, DEL. CODE ANN. tit. 6 § 18-1101 (2009), and the Delaware Revised Uniform Limited Partnership Act (DRULPA), DEL. CODE ANN. tit. 6. § 17-1101.

[FN2]. Over the same time period, the per annum number of new corporations has decreased.

[FN3]. Both DRULPA, DEL. CODE ANN. tit. 6, § 17-1101, and DLLGA, DEL. CODE ANN. tit. 6, § 18-1101, originally gave full effect to freedom of contract principles between the parties and, further, allowed for the modification of any judicially created fiduciary duties.


[FN5]. See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002). See also Myron T. Steele, Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 DEL. J. CORP. L. 1 (2007) (holding “that, while a limited partnership agreement could provide for contractually created fiduciary duties substantially mirroring corporate common law fiduciary duties, a limited partnership agreement could not ‘eliminate’ the fiduciary duties or liabilities of a general partner.”).

[FN6]. Throughout this article, when I refer to fiduciary duties, I refer to the corporate-like fiduciary duties of loyalty and care that have been applied to LPs and LLCs by Delaware courts. Fiduciary duty, in this article, does not refer to the implied contractual duty of good faith and fair dealing. Instead, I specifically identify when I do discuss that implied contractual duty. Compare Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 795 A.2d 1 (Del. 2001), aff’d, 840 A.2d 641 (Del. 2003) and Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., C.A. No. 15754-NC, 2000 Del. Ch. LEXIS 141 (Sept. 27, 2000) with Gotham Partners, 817 A.2d 160.

[FN7]. DEL. CODE ANN. tit. 6, §§ 17-1101(d) & 18-1101(c).

[FN8]. The statute provides that, “[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement ....” Id. § 18-1101(c). The legislature, here, did not provide for any default fiduciary duties. Instead, the legislature provided the court with the task of determining whether to apply any default fiduciary duties.


[FN10]. Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 Del. Ch. LEXIS 158, at *28 (Del. Ch. May 7, 2008) (“In the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC agreement or some other contract.”).
See, e.g., \textit{Del. Code Ann. tit. 6, § 18-1101}(b) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”).


See supra note 7 and accompanying text discussing fiduciary duties.

See \textit{Steele, supra} note 5, at 10 (“In August 2004, the General Assembly amended the Delaware Revised Uniform Limited Partnership Act to express its intent to establish legislative policy in derogation of the common law’s fiduciary duty principles and to give maximum effect to the principle of freedom of contract.”).


\textit{Fisk Ventures, 2008 Del. Ch. LEXIS 158; Tiem Bridges, 2007 WL 2744609}.

\textit{Wood, 953 A.2d 136}.

\textit{Del. Code Ann. tit. 6, § 17-1101}. The identical language is found in the DLLCA. \textit{Id. § 18-1101}(b) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”).

\textit{Id. § 17-1101}(d). The identical language is found \textit{id. § 18-1101}(c) (“To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”).

\textit{Id. § 18-1101}(a). The same language is found in DRULPA. \textit{Id. § 17-1101}(b) (“The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.”).


See \textit{Steele supra} note 5 and accompanying text.

The only Delaware alternative entity statute to provide for standards of conduct is the Delaware Revised Uniform Partnership Act (DRUPA), which is modeled after the Revised Uniform Partnership Act of 1994. Although Delaware adopted standards of conduct at \textit{Del. Code Ann. tit. 6, § 15-404}, Delaware deviated from the Uniform Partnership Act with its enactment of section 15-103(f) specifying that the partnership agreement may:

provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including breach of fiduciary duties) of a partner or other person to a partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partner-
ship agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

Subsection (d) of title 6 also states that: “It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.” DEL. CODE ANN. tit. 6, § 15-103(d).

[FN25]. DEL. CODE. ANN. tit. 6, § 18-1101(c).

[FN26]. Gotham Partners, 817 A.2d at 167.


[FN29]. Id. at 142.

[FN30]. As one commentator has explained:

Courts typically do not attempt to explain why fiduciary duties are imposed in formal fiduciary relationships. Many of these relationships have been considered fiduciary in nature for centuries, and any attempt to explain that status seems unnecessary. By contrast, courts are incessantly attempting to rationalize the law governing informal fiduciary relationships.


This commentator has also challenged the “creation” of a fiduciary “duty of loyalty” by Justice Cardozo in Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928). Meinhard is the seminal partnership case in which Justice Cardozo, without citing to any relevant partnership statute - although New York had adopted the UPA in 1914, at the time the lease was being renegotiated articulated a “duty of finest loyalty.” Id. at 546. As this commentator surmised, “the outcome must be explained by the court's reference to the actions of "agents."” See ROBERT R. KEATINGE & ANN E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY: SELECTING FORM AND STRUCTURE FOR A CLOSELY-HELD BUSINESS (2008).


[FN32]. Id. at *41-43.

[FN33]. Id. at *1.

[FN34]. Id. at *28.

[FN35]. Id. at *34.

[FN36]. Gotham Partners, 817 A.2d at 167.

[FN37]. Fisk Ventures, 2008 Del. Ch. LEXIS 158.

[FN39]. DEL. CODE ANN. tit. 6, § 18-805.

[FN40]. Petitioners also argued that the waiver should be unenforceable under Delaware law. DEL. CODE ANN. tit. 6, § 18-109(d) (2009) provides:

In a written limited liability company agreement or other writing, a manager or member may consent to be subject to the nonexclusive jurisdiction of the courts of, or arbitration in, a specified jurisdiction, or the exclusive jurisdiction of the courts of the State of Delaware, or the exclusivity of arbitration in a specified jurisdiction or the State of Delaware, and to be served with legal process in the manner prescribed in such limited liability company agreement or other writing. Except by agreeing to arbitrate any arbitrable matter in a specified jurisdiction or in the State of Delaware, a member who is not a manager may not waive its right to maintain a legal action or proceeding in the courts of the State of Delaware with respect to matters relating to the organization or internal affairs of a limited liability company. Id.


[FN43]. Id. at *12.

[FN44]. Id. at *20.

[FN45]. I argue that Delaware courts did not previously engage in this analysis because, in Gotham Partners, the Supreme Court of Delaware concluded that statutes prescribed the default fiduciary duties. The 2004 amendment changed that entire calculus and it is now incumbent upon the courts to engage in this policy analysis. The courts, thus far, have had only limited opportunity to readdress this new language. Under the appropriate circumstance, which has not arisen yet, I postulate that a Delaware court would apply an economic analysis to determine whether any default fiduciary duties apply.


[FN47]. DEL. CODE ANN. tit. 6, § 18-1101(b). See Ann E. Conaway, Why No Respect: The Contractual Duties of Good Faith and Fair Dealing in Delaware, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=994624# (“If freedom of contract in unincorporated entity law means anything, then business courts must be willing to jettison entrenched corporate principles and embrace the aged tenets of contract law ... including the contractual duty of good faith and fair dealing ... and other policing techniques permitted under a contractual regime.”).

[FN48]. See supra notes 31-38 and accompanying text.

[FN49]. GOLER & ULEN, supra note 46, at 484.

[FN50]. Id. at 202.

[FN51]. Id. at 199.

[FN52]. Compare Amerisource Bergen Corp. v. LaPoint, 956 A.2d 642 (Del. 2008) (interpreting a merger agreement, even where arguably self-interested conduct, under contract principles and not fiduciary duties), with Jack B.
Jacobs, *Entity Rationalization: A Judge's Perspective, 58 BUS. LAW. 1043 (2003)* (“[I]n cases where the governing instrument displaces fiduciary duty principles in their entirety, the court will employ contract law principles, but will apply them in a manner that protects the interests of investors.”).


[FN55]. DEL. CODE ANN. tit. 6, § 18-1101(c) (“the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”); DEL. CODE ANN. tit. 6, § 18-1101(e) (“a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”); DEL. CODE ANN. tit. 6, § 17-1101(d) (“the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”); DEL. CODE ANN. tit. 6, § 17-1101(f) (“a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”).

[FN56]. DEL. CODE. ANN. tit. 6, § 18-1101(b).


[FN59]. Professor Smith establishes a framework for understanding what relationships give rise to fiduciary duties. Although fiduciary duties would not apply to a traditional contract, he argues that “strategic alliances,” potentially in the form of an LLC, is a hard case under his model. Smith, *supra* note 30, at 1476. The central theme of my article, though, focuses on the fact that, by choosing the LLC form and not contracting for fiduciary duties, the parties determined, for themselves, that no fiduciary duty is necessary. I argue that it is improper for the court, in a paternalistic fashion, to apply default fiduciary duties despite the parties' deliberate and bargained-for choice.


[FN61]. Notably, LLCs do not always fall into the definition proposed by Smith that “fiduciary relationships form when one party (the ‘fiduciary’) acts on behalf of another party (the ‘beneficiary’) while exercising discretion with respect to a critical resource belonging to the beneficiary.” Smith, *supra* note 30, at 1402. In some situations, the members may only rarely exercise discretion, leaving the entire task of management up to a third party.

[FN62]. In many situations, parties imprudently form contracts and Delaware courts do not meddle in the process to provide fiduciary duties to correct for ill-advised contract terms. For instance, imagine if Delaware courts, to the horror of negotiated acquisition lawyers, began applying fiduciary duty concepts to merger agreements between sellers and acquirers. Instead, Delaware courts, loathe interpreting contracts using extrinsic evidence beyond the specific terms included in an agreement itself. See *United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 835 (Del. Ch. 2007)* (“The Court must emphasize here that the introduction of extrinsic, parol evidence does not alter or deviate from Delaware's adherence to the objective theory of contracts. As I recently explained to counsel in this case, the private, subjective feelings of the negotiators are irrelevant and unhelpful to the Court's consideration of a contract's meaning, because the meaning of a properly formed contract must be shared or common. That is not to say, however, that a party's subjective understanding is never instructive. On the contrary, in cases where an examination of the extrinsic evidence does not lead to an obvious, objectively reasonable conclusion, the Court may apply the forthright negotiator principle. Under this principle, the Court considers the evidence of what one party subjec-
tively ‘believed the obligation to be coupled with evidence that the other party knew or should have known of such belief.”’ (citations omitted).

[FN63]. The ability of a court to “add” terms to a contract is known as an “implied in fact” contract and is solely determined by the parties’ intent. See RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981). This section is titled, “Supplying an Omitted Essential Term.” It provides: “When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court.” The Commentary to section 204 further provides:

The process of supplying an omitted term has sometimes been disguised as a literal or a purposive reading of contract language directed to a situation other than the situation that arises. Sometimes it is said that the search is for the term the parties would have agreed to if the question had been brought to their attention. Both the meaning of the words used and the probability that a particular term would have been used if the question had been raised may be factors in determining what term is reasonable in the circumstances. But where there is in fact no agreement, the court should supply a term which comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process.

Id. Terms may also be added by the default provisions of the applicable organic law governing the entity, for example, DLLCA or DRLUPA. Once terms are set in a contract, the contractual covenant of good faith and fair dealing attaches to the performance and enforcement of those terms. See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” (emphasis added)). The contractual duty of good faith and fair dealing does not provide a method for courts to add terms to contracts. For an explanation that the implied covenant of good faith and fair dealing cannot provide the basis for “adding or implying” terms to a contract, see Ann F. Conaway, The Multifacets of Good Faith in Delaware: A Mistake in the Duty of Good Faith and Fair Dealing; A Different Partnership Duty of Care: Agency Good Faith and Damages; Good Faith and Trust Law, 10 DEL. L. REV. 89, 96 109 (2008).


[FN65]. Ribstein I, supra note 64, at 212.

[FN66]. Id. at 212-13.

[FN67]. Id. at 213.

[FN68]. Id.

[FN69]. Id. Professor Conaway makes an interesting argument that the fiduciary duties being applied by business courts in the alternative entity context are not “partnership” or “LLC” fiduciary duties but are instead corporate duties that are being misapplied. See Conaway, supra note 63, at 110-14. Certainly at this juncture, no business court has undertaken a principled examination of what a “fiduciary duty” encompasses in the LLC context.

[FN70]. Ribstein I, supra note 64, at 213.

[FN71]. One empirical analysis, based upon a questionnaire mailed to practitioners in different states, demonstrates that many LLCs, across the country, are formed without adequate legal representation. Sandra K. Miller et al., An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors, 43 AM. BUS. L.J. 609 (2006). In this article, I focus only on sophisticated parties entering into a Delaware LLC. I do not
imply that this analysis would apply to all members, specifically passive investors, who are not involved in the formation of the LLC nor does this analysis apply to other states.

[FN72]. Ribstein, I, supra note 64, at 214.

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