What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?

Sandra K. Miller*

I. INTRODUCTION ........................................................................................................ 566

II. ACADEMIC AND THEORETICAL APPROACHES TO THE STUDY OF
FIDUCIARY DUTIES ................................................................................................. 573
A. The Corporate Context of the Fiduciary Duty Debate ....................................... 575
B. The Unincorporated Context of the Fiduciary Duty Debate .............................. 577
C. A Closer Look at the Schools of Thought ........................................................... 580
   1. The Contractarian School ........................................................................... 580
   2. Traditionalists ............................................................................................. 581
   3. The Team Production Theory of the Corporation, Fiduciary Duties, and
      Social Norms .............................................................................................. 581
   4. Game Theory Applied to Fiduciary Duties ................................................. 583
   5. The Empirical Study of Fiduciary Duties .................................................... 583
   6. The Structural Model for Fiduciary Duty Terms ........................................ 586

III. THE LLC STATUTES ................................................................................................ 586

IV. THE CASES: NO SHORTAGE OF FIDUCIARY DUTY VIOLATIONS ....................... 588
A. A Mandatory Core of Minimum Standards Emerges in Courts Outside of and
   Within Delaware ................................................................................................. 588
B. Traditional Broad Formulations of Fiduciary Duty Outside of Delaware ..... 589
C. The Entire Fairness Test Within Delaware ..................................................... 590
D. The Importance of a Duty of Candor ................................................................. 592
E. Troubling Decisions Suggest the Importance of Turning to Contractually
   Oriented Limitations ........................................................................................... 592
   1. The Need to Distinguish the Right to Compete from the Duty of Candor ... 592
   2. Contractual Standards That Ensure the Enforcement of the Spirit of the
      Contract ......................................................................................................... 594
   3. Recognition That the Right to Privately Order LLC Relationships is Not
I. INTRODUCTION

The American limited liability company (LLC) is like an incorporated partnership.¹

¹Professor, Widener University; B.S., S.U.N.Y. at Stony Brook 1976; J.D., Hofstra University School of Law, 1978; M.S., American University Graduate School of Business, 1981; L.L.M., Villanova University School of Law, 1990. Professor Miller was an American Bar Advisor to the drafting committee that revised the Uniform Limited Liability Company Act sponsored by the National Conference of Commissioners on Uniform State Laws. This Article has been prepared in connection with Professor Miller’s PhD dissertation for Monash University in Australia. Professor Miller would like to thank Thomas Gue, Kenneth Miller, and Thomas Rutledge for their insightful comments.
Applying Fiduciary Duties to LLC Managers

The LLC allows private business owners to form a company that provides protection from personal liability for business debts, without incurring a second level of corporate federal income tax on the business entity’s earnings. It provides freedom from cumbersome corporate processes by offering unparalleled flexibility in management structure. Although unburdened by an entity level corporate tax, the LLC can have centralized management similar to that of a corporation or create any number of alternative modes of management.

Beginning with Wyoming in 1977, states across the country eagerly embraced the LLC concept. Although in 1994 the National Conference of Commissioners on Uniform State Laws adopted a uniform act, the LLC concept continued to spread, with the majority of states adopting the act by 1998.

1. Howard M. Friedman, The Silent LLC Revolution—The Social Cost of Academic Neglect, 38 CREIGHTON L. REV. 35, 42-43 (2004) (indicating that the LLC presented an entrepreneur’s ultimate dream by offering partnership taxation and default rules more suited to small business than corporate default rules); see Thomas E. Rutledge, To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPs, and LLLPs in Interstate Transactions, 58 BAYLOR L. REV. 205, 208 n.6 (2006) (discussing burgeoning forms of limited liability entities and considering the extent to which limited liability will be respected where the entity engages in interstate activities in a jurisdiction with no express recognition of the limited liability afforded by a structure’s home jurisdiction); see also Robert B. Thompson, Piercing the Corporate Veil: Is the Common Law the Problem?, 37 CONN. L. REV. 619, 627 (2005) (discussing limited liability in the context of the LLC).

2. See Classification of Certain Business Entities, 26 C.F.R. § 301.7701-3 (2001) (containing tax classification rules for LLCs that create a default partnership tax status if no tax election is filed, but making corporate entity-level taxation available upon the filing of an affirmative election requesting that the LLC be taxed as a C corporation).


4. Prior to 1993, Treas. Reg. § 7701-2(a)(3) provided that an unincorporated entity would be taxable as a corporation if the organization possessed more corporate than non-corporate characteristics, such as continuity of life, centralization of management, limited liability, and free transferability of interests. See United States v. Kintner, 216 F.2d 418 (9th Cir. 1954); see also Thomas E. Rutledge, The Lost Distinction Between Agency and Decisional Authority: Unfortunate Consequences of the Member-Managed versus Manager-Managed Distinction in the Limited Liability Company, 93 KY. L.J. 737, 743 (2005) (exploring the frequently overlooked implications of the member-managed as compared to the manager-managed structure of the LLC).

5. See ALA. CODE §§ 10-12-1 to 10-12-61 (LexisNexis 2005); ALASKA STAT. §§ 10.50.010 to 10.50.995 (2003); ARIZ. REV. STAT. §§ 29-601 to 29-857 (LexisNexis 2005); ARK. CODE ANN. §§ 4-32-102 to 4-32-1316 (2006); CAL. CORP. CODE §§ 17000 to 17705 (Deering 2005); COLO. REV. STAT. ANN. §§ 7-80-101 to 7-80-913 (West 2005); CONN. GEN. STAT. ANN. §§ 34-100 to 34-242 (West 2004); DEL. CODE ANN. tit. 6, §§ 18-101 to 18-101-1109 (2005); D.C. CODE ANN. §§ 29-1301 to 29-1375 (LexisNexis 2005); FLA. STAT. ANN. §§ 608.401 to 608.705 (West 2005); GA. CODE ANN. §§ 14-11-100 to 14-11-1109 (1994); HAW. REV. STAT. §§ 428-101 to 428-1302 (2004); IDAHO CODE ANN. §§ 53-501 to 53-672 (2005); 805 ILL. COMP. STAT. 180/1-1 to 205/8.5 (2005); IND. CODE ANN. §§ 23-16-10-1 to 23-18-12 (LexisNexis 2005); IOWA CODE ANN. §§ 490A.100 to 490A.1601 (West 2004); KAN. STAT. ANN. §§ 17-7601 to 17-7656 (2004); KY. REV. STAT. ANN. §§ 275.001 to 275.455 (LexisNexis 2005); LA. REV. STAT. ANN. §§ 12:1301 to 12:1369 (2005); ME. REV. STAT. ANN. tit. 31, §§ 601 to 762 (2005); MD. CODE ANN., CORPS. & ASS’NS §§ 4A-101 to 4A-1103 (West 2005); MASS. ANN. LAWS ch. 156C, §§ 1 to 68 (LexisNexis 2005); MICH. COMP. LAWS ANN. §§ 450.4101 to 450.5200 (2005); MINN. STAT. ANN. §§ 322B.01 to 322B.960 (West 2005); MISS. CODE ANN. §§ 79-29-101 to 79-29-112 (2006); MO. ANN. STAT. §§ 347.010 to 347.740 (West 2006); MONT. CODE ANN. §§ 35-8-101 to 35-8-1307 (2005); NEB. REV. STAT. ANN. §§ 21-2601 to 21-2653 (LexisNexis 2005); NEV. REV. STAT. ANN. §§ 80,010 to 86,590 (LexisNexis 2004); N.H. REV. STAT. ANN. §§ 304-C:1 to 304-C:81 (2005); N.J. STAT. ANN. §§ 42:2B-1 to 42:2B-70 (West 2005); N.M. STAT. ANN. §§ 53-19-1 to 53-19-74 (LexisNexis 2005); N.Y. L. CODE ANN. §§ 1403 (2004); N.C. GEN. STAT. §§ 57C-1-01 to 57C-10-07 (2005); N.D. CENT. CODE §§ 10-32-01 to 10-32-156 (2005); OHIO REV. CODE ANN. §§ 1705.01 to 1705.58 (LexisNexis 2006); OKLA. STAT. tit. 18, §§ 2000 to 2060 (2005); OR. REV. STAT. §§ 63.001 to 63.990 (2003); PA. CONS.
State Laws (NCCUSL) endorsed a uniform LLC statute called the Uniform Limited Liability Company Act (ULLCA), most states had just completed the process of adopting their own self-styled LLC statutes, and few states wanted to quickly return to their legislative chambers to adopt a different LLC statute. Consequently, only a handful of states adopted ULLCA and the great majority of LLC statutes differ considerably from state to state.

The variation among LLC statutes is particularly striking with regard to the standard of care applicable to LLC managers, the duty of loyalty owed to the LLC, and the extent to which remedies are available to address wrongful treatment when one LLC member or manager has mistreated another. Some states contain mandatory statutory standards, while others defer to the contractual provisions adopted by the LLC members. The state of Delaware—long considered the most important jurisdiction in developing business entity laws in the United States—has taken the lead in permitting not merely the modification of default fiduciary duties, but their elimination by contract.

This Article explores two of the most controversial issues that enlivened the
NCCUSL Committee’s discussions in revising the Uniform Limited Liability Company Act including: 1) whether fiduciary duties should be articulated in the LLC statute or left solely to judicial articulation; and 2) whether fiduciary duties should be subject to a partial or complete waiver in the LLC operating agreement. Fiduciary duties are generally regarded as consisting of the duty of loyalty and the standard of care in the conduct of management. This Article focuses exclusively on the duty of loyalty, and a separate, related article addresses the questions concerning the standard of care. The present Article analyzes the LLC litigation that has occurred over the last ten years among LLC investors and managers. Also, it considers the empirical data that has been gathered on the contractual practices of attorneys representing majority and minority LLC investors.

The above questions concerning duties and waivers are ripe for reconsideration now that the Uniform Limited Liability Company Act has been revised and states have had some time and experience working with their LLC statutes. Also, the American Bar Association is currently in the process of revising the ABA’s Prototype Limited Liability Company Statute. Legal scholars have disagreed on the extent to which mandatory statutory protections should be given to minority LLC participants. They have further disagreed on whether the standard of care for managers should be based on the requirement to exercise due care, or a standard based on the duty to refrain from grossly negligent conduct, or on some other formulation.

The contractarian view of investors in unincorporated entities is that parties should be free to strike their own bargain free from external interference. This position has gained significant popularity, particularly in Delaware. The contractarian philosophy embraces the view that statutory business laws should be kept to a minimum, giving maximum freedom to business participants to contractually determine their legal rights and responsibilities. Based on this philosophy, several LLC statutes, including that of Delaware, expressly defer to the parties’ agreement. The Delaware statute contains few

15. See infra Part IV.
16. See infra Part II.C.5.
18. See infra Part II.C.
19. Id. The standard of care is the subject of a separate related paper.
20. See infra Part II.
22. See infra Part II.C.1.
23. See Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999) (discussing Delaware’s LLC statute and indicating that Delaware’s approach is to give the broadest possible discretion in drafting contractual provisions and further observing that the LLC members’ rights typically begin and end with the Operating
default statutory rules for the operating agreement and fails to provide the statutory remedy of a dissolution or buy-out in the event that the controlling LLC owner engages in fraudulent, illegal, or oppressive conduct. This contractarian approach presupposes that majority and minority participants will be represented by legal counsel and will be able to negotiate for suitable exit rights and/or remedies in the event of a dispute.

The more traditional view is that mandatory protections are needed to govern managerial conduct and to stem the tide of opportunistic and/or abusive conduct. The concept of mandatory fiduciary duties has its origins in the laws of trusts and of agency relationships. They dictate that the fiduciary is required to act in the exclusive interest of the beneficiary or principal and must refrain from engaging in transactions from which he might gain for himself or harm the beneficiary. Disgorgement of gains is the remedy for a breach of duty by a fiduciary.

This Article argues for mandatory minimum fiduciary duties grounded in statute—hereinafter referred to as the Mandatory Core Theory of Duties. This approach permits the LLC manager to contractually tailor his or her duties to the LLC but nevertheless includes a statutory articulation of mandatory minimum fiduciary duties and a standard of conduct that managers cannot completely waive. Under the Mandatory Core approach, the duty of loyalty is articulated in the statute, with the expectation that courts will elaborate upon duties as the context requires. The standard of care would be based upon the duty to exercise reasonable care, subject to the application of the business judgment rule, to be discussed in a separate article. The approach has a mandatory dimension because duties cannot be eliminated, but is contractarian in the sense that it welcomes parties to contractually define their duties within a mandatory framework.

The Revised Uniform Limited Liability Company Act (hereinafter referred to as ULLCA II) offers a slightly less contractarian alternative to the Delaware paradigm. The Delaware LLC statute permits not only the modification of duties, but also the complete Agreement).

24. See generally Del. Code Ann. tit. 6, § 18-101 to 18-101-1109 (2005). For special protections under Delaware’s Close Corporation statute, see tit. 8 § 8-341, 8-353 (2006) (providing a remedy where shareholders are divided). No special duties are recognized for minority owners by virtue of their status as owners of a close corporation. See Riblet Prods. Corp. v. Nagy, 683 A.2d 37, 39 (Del. Super. Ct. 1996) (involving a lawsuit by a fifteen percent minority shareholder/employee of the corporation who claimed that the majority breached its duty by dismissing him as an employee and indicating that the company’s status as a closely held company did not alter the duties of shareholder); Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993) (refusing, in the absence of an election, to develop any judicially-created rules for treatment as a statutory close corporation where plaintiffs had alleged that the board of directors breached its fiduciary duties to non-employee minority shareholders by failing to offer the minority the same liquidity offered to employee-shareholders who were covered by an ESOP plan and key man life insurance); Olsen v. Seifert, 1998 Mass. Super. LEXIS 592 (Aug. 28, 1998) (declining relief to minority owner). But see Walker Res. Dev. Co., Ltd., LLC., 791 A.2d 799, 817-18 (Del. Ch. 2000) (imposing a constructive trust on the interest of a participant who was removed without compensation for his eighteen percent interest).


27. See id. at 602-03.

28. See id. at 603.
contractual elimination of fiduciary duties.\textsuperscript{29} The final ULLCA II approach permits, “\textit{if not manifestly unreasonable},” the operating agreement to eliminate the following duties: the duty to account;\textsuperscript{30} to refrain from dealing with the LLC on behalf of a party with an adverse interest; and to refrain from competing with the LLC.\textsuperscript{31} Earlier versions of ULLCA II prohibited the operating agreement from eliminating the duty of loyalty, but permitted the identification of specific categories of activities that do not violate the duty of loyalty.\textsuperscript{32} This more moderate statutory position endorsed by earlier versions of ULLCA II is recommended here and reflects what I shall call the Mandatory Core approach. The Mandatory Core approach provides the best of both worlds by preserving the longstanding duty of loyalty and by permitting the operating agreement to alter and curtail particular aspects of duties.\textsuperscript{33}

From a theoretical standpoint, the Mandatory Core approach advanced by this Article recognizes that one of the central roles of business entity governance is to foster investor confidence. Our LLC statutes further the overall goal of promoting investor confidence by playing a prominent role in defining the social context of the firm. The social context of the firm conveys critical social cues on expectations of trustworthy behavior. This Article argues that to effectively defer opportunistic conduct, the law should promote and reflect reasonable expectations of trustworthiness within the context of defined business relationships.\textsuperscript{34} The retention of the duty of loyalty, with an opportunity for limited contractual carve-outs to permit specific deviations, conveys the appropriate overall social cue that trustworthy behavior is expected.

The Mandatory Core theory is truly a moderate approach that effectively balances the interest in contractual freedom with the need for mandatory constraints to deter and censor opportunistic conduct. Simply put, it permits considerable contractual innovation, does not unduly burden the pursuit of the individual’s interests, and yet provides basic limitations on managerial conduct.

It is recognized that the driving force underlying much of the clamor for freedom of contract is a legal system that imposes astronomical legal fees and sky-rocketing legal judgments. Arguably, these costs have indirectly led to a distortion and perhaps unwarranted relaxation of substantive legal standards as the legal community has struggled to protect parties from excessive burdens of the system.\textsuperscript{35} Therefore, this

\textsuperscript{29} See infra Part V.B.


\textsuperscript{31} See infra Part V.B.

\textsuperscript{32} See National Conference of Commissioners on Uniform State Laws ULLCA Drafting Committee, Alternative to Sections 110, 409 and 410 of the 2004 Annual Meeting Draft § 110(g), available at http://www.law.upenn.edu/bll/ule/ulc/ULLCA_Alternatives_061804-1.htm (last visited Feb. 15, 2007) (stating that “an operating agreement may not . . . (5) eliminate the duty of loyalty under Section 409(b), but: (i) the operating agreement may identify specific types of categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable . . . ”).

\textsuperscript{33} See infra Part V.C.

\textsuperscript{34} See infra Part V.C.

\textsuperscript{35} See FLA. STAT. ANN. § 608.4228 (LexisNexis 2007) (apparently attempting to circumvent traditional tort law by limiting a manager’s liability to third parties as well as to other members); CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES ¶ 10.06[2][b] at 510-40 (Supp. 2006) (indicating that if read broadly Florida’s provision would work a revolution in the law of tort). The growing use of arbitration clauses further demonstrates the desire of private business owners to protect against the costs of litigation.
Article suggests that such systemic problems be separately studied. Studies should be undertaken to develop strategies that will encourage parties to proactively plan their business affairs, develop statutory supplements for governing small LLCs, and improve out-of-court processes for settling business disputes.

Part II of this Article discusses the competing theoretical approaches that have been taken by academics in the study of fiduciary duties, including empirical approaches. Part III offers a brief overview of the fiduciary duty statutory provisions. Part IV turns to emerging case law. This Article observes that courts outside of Delaware are combating fundamentally unfair conduct through the use of broad traditional partnership and/or corporate fiduciary duty language and observes the important role played by the fiduciary duty of candor or disclosure. It also discusses Delaware’s use of the entire fairness test to combat furtive conduct.

Part IV goes on to critically examine recent decisions in Georgia where fiduciary duties may now be completely waived by contract. It argues that the grant of a right to compete does not automatically mean that the grantor has simultaneously waived the fiduciary duty of candor, the duty to avoid self-dealing, or the implied contractual covenant of good faith and fair dealing. The Article argues that in jurisdictions permitting complete waivers of fiduciary duties, it is important for courts to develop strategies to preserve basic notions of fair play and fair dealing in business relationships while still recognizing the central role of the LLC operating agreement. Sensible judicial approaches discussed include the recognition of oral LLC agreements in certain situations, the narrow construction of waivers of duties where appropriate, and the rigorous interpretation of contractual standards of performance, such as the duty to deal at arm’s length. Also, the implied contractual covenant of good faith and fair dealing is discussed as a judicial tool to curb the abusive conduct.

Turning to legislative proposals, Part V recommends the adoption of the Mandatory Core Theory of fiduciary duties. The Mandatory Core paradigm permits some contractual modification, allows the elimination of particular aspects of duties, but rejects the right to completely eliminate all fiduciary duties. As such, it does not unduly restrict contractual freedom, yet nevertheless sends a strong social signal that the context requires trustworthy conduct.

The Article argues that the retention of a mandatory statutory core of fiduciary duties promotes and reflects positive social norms and that abusive conduct over the last decade underscores the need for strong mandatory minimum standards. The empirical evidence reviewed suggests that controlling and minority investors may not be equally represented by counsel and may not have contractual protections in place. Many LLCs may not even have written LLC agreements, and if there is an agreement, it may be a

36. Alternatives such as capping or otherwise fundamentally limiting punitive damages should be studied, including earmarking proceeds of punitive damage awards for public use. Practices of other legal systems should be studied in detail—including the British approach of requiring the losing plaintiff to pay the defendant’s legal costs. See Richard Abel, Who Feels Their Pain?: The Challenge of Noneconomic Damages in Civil Litigation: General Damages Are Incoherent, Incalculable, Incommensurable, and Inegalitarian (But Otherwise a Great Idea), 55 DEPAUL L. REV. 253, 326 (2006) (suggesting that the bulk of awards be earmarked for regulation rather than for private pockets of victims); see also Clare Krumlauf, Ohio’s New Modified Joint and Several Liability Laws: A Fair Compromise for Competing Parties and Public Policy, 53 CLEV. ST. L. REV. 333 (2005-2006) (criticizing the tort system and examining Ohio’s recent reforms).
Applying Fiduciary Duties to LLC Managers

simple, no-frills contract without extensive investor protections. In some cases, the true significance of a complete contractual waiver of fiduciary duties embedded in an LLC operating agreement may be easily overlooked in the haste to economically form an LLC or lock in what appears to be a superior business deal. In other cases, passive investors may not have the bargaining power or financial wherewithal to change the terms of an LLC agreement prepared by the counsel representing the LLC manager. A balanced statutory framework provides a much-needed safety net in light of the practical realities of the contractual playing field.

II. ACADEMIC AND THEORETICAL APPROACHES TO THE STUDY OF FIDUCIARY DUTIES

The academic study of fiduciary duties, with respect to both corporate and unincorporated business organizations, has been driven primarily by the need to control explosive legal liability, and by the equally compelling need to control misconduct and abuse in the business arena. In the corporate arena, it is widely recognized that directors, executives, and controlling shareholders owe both a duty of loyalty and a duty of care to the corporation.\textsuperscript{37} LLC statutes have embraced various formulations of these duties. As one court explained:

\ldots The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict of interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated.\textsuperscript{38}

In partnerships, Justice Cardozo described the duty of loyalty owed to partners on a level higher than the morals of the marketplace.\textsuperscript{39} However, the U.S. Supreme Court has long recognized that duties of a partner are not without limits.\textsuperscript{40} Although one partner may not profit clandestinely from partnership property or operations, the partner is not accountable to the partnership for transactions outside of the scope of the partnership’s business.\textsuperscript{41}

A heightened duty of loyalty has been extended to close corporations in some jurisdictions.\textsuperscript{42} However, Delaware does not recognize special duties arising in business

\textsuperscript{37} See PRINCIPLES OF CORP. GOVERNANCE: ANALYSIS & RECOMMENDATIONS 137 (Am. Law Inst. Supp. 2005) (discussing the relationship between the duty of care and the duty of loyalty (also called fair dealing)).

\textsuperscript{38} Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (affirming the lower court’s holding that the president of a company had violated his duty of loyalty by appropriating an opportunity to take over Pepsi-Cola Enterprises and rejecting his contention that he had offered the company the opportunity); see also PRINCIPLES OF CORP. GOVERNANCE, supra note 37, at 205.

\textsuperscript{39} Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

\textsuperscript{40} Latta v. Kilbourn, 150 U.S. 524, 542 (1893).

\textsuperscript{41} See id. (involving a partner who was not accountable to the partnership for certain real estate transactions that he and a non-partner engaged in because the transactions in question had not been expressly authorized by the partnership and thus were not part of the partnership’s business).

entities that are closely held.\textsuperscript{43} State LLC statutes have taken a variety of approaches to the duty of loyalty, some of which embrace traditional corporate or partnership concepts of loyalty while others authorize self-dealing transactions in defined circumstances, such as where informed consent is given.\textsuperscript{44} As discussed in Part III, a number of LLC statutes have codified a duty to account, to refrain from competing with the LLC, etc.\textsuperscript{45}

In the partnership context, a duty of candor, also referred to as a duty of disclosure, is sometimes articulated as a free-standing fiduciary duty.\textsuperscript{46} In the corporate context, when directors, senior executives, or controlling shareholders are interested in a transaction affecting the company, appropriate disclosure and consent serve as a means of discharging one’s overall duty of loyalty, or duty of fair dealing. Some LLC decisions have recognized a duty of disclosure as part and parcel of the LLC manager’s “fiduciary duties.”\textsuperscript{47}

The duty of care concerns the diligence with which the managerial function must be discharged and is the subject of a separate, related paper.\textsuperscript{48} In corporate and partnership contexts, the duty of loyalty frequently takes center stage in litigation. Commentators have had difficulty citing many leading cases in which courts imposed liability solely for a breach of the duty of care without a concomitant breach of the duty of loyalty.\textsuperscript{49}

\begin{itemize}
\item \textsuperscript{43} See Riblet Prods. Corp. v. Nagy, 683 A.2d 37, 39 (Del. 1996) (involving the refusal of the court to recognize any alteration in duties of the majority or minority shareholders by virtue of the company’s closely held ownership structure); see also Nixon v. Blackwell, 626 A.2d 1366, 1379-81 (Del. 1993) (declining to recognize judicially created rules to protect minority investors of closely held companies that have not elected to be organized under the special close corporation statute).
\item \textsuperscript{44} See infra Part III; see also BISHOP & KLEINBERGER, supra note 35, at 10-26 (discussing the LLC statutes and their various approaches to the duty of loyalty).
\item \textsuperscript{45} See infra Part III.
\item \textsuperscript{46} See Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989).
\end{itemize}

[W]e only reaffirm here the most basic principle that a court will not countenance the behavior of a fiduciary who, without full disclosure and consent, enters into a financial arrangement placing his spouse’s interests at odds with the interests of those to whom he owes a duty of undivided loyalty.

\begin{itemize}
\item \textsuperscript{47} See infra Part IV.B.
\item \textsuperscript{48} See PRINCIPLES OF CORP. GOVERNANCE, supra note 37, at 137 (citing AMERICAN BAR ASSOCIATION, THE CORPORATE DIRECTOR’S GUIDEBOOK 1599-1600 (2004)): providing:
\begin{enumerate}
\item I. Duty of Loyalty
By assuming his office, the corporate director commits allegiance to the enterprises and acknowledges that the best interests of the corporation and its shareholders must prevail over any individual interest of his own. The basic principle to be observed is that the director should not use his corporate position to make a personal profit or gain other personal advantage.
\item II. Duty of Care
In addition to owing a duty of loyalty to the corporation, the corporate director also assumes a duty to act carefully in fulfilling the important tasks of monitoring and directing the activities of corporate management.
\end{enumerate}
\item \textsuperscript{49} See Joseph W. Bishop Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 YALE L.J. 1078, 1099 (1968) (observing that only four cases involved negligence uncomplicated by duty of loyalty breaches); see also Stuart R. Cohn, Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule, 62 TEX. L. REV. 591, 638 (1983) (analyzing the breadth of the business judgment rule).
\end{itemize}
Similarly, in the LLC context, much of the litigation concerns allegations of disloyalty, sometimes coupled with allegations of a breach of the duty of care, but not usually involving simply a breach of the duty of care, uncontaminated by disloyal conduct.\textsuperscript{50}

The schools of thought with regard to fiduciary duties may be loosely categorized as the traditional/moralistic school, the contractarian school, the social science school (emphasizing social norms), the game theory school, the empirical school, and the structural school.

\textit{A. The Corporate Context of the Fiduciary Duty Debate}

In 1985, the Delaware Supreme Court decision in \textit{Smith v. Van Gorkom}\textsuperscript{51} held that outside directors were liable for gross negligence for approving a merger without informing themselves of the value of the company. The decision caused a riot of controversy and many feared that the decision would discourage participation on boards of directors and would make it impossible to obtain insurance in the event of lawsuits for breaches of conduct. Academics debated the wisdom of developing legislation that would permit directors to “opt-out” of liability for certain breaches of duties. The so-called “contractarians” argued for expansive freedom to opt-out of mandatory fiduciary duties while the “traditionalists” argued that such freedom led to a “race to the bottom.”\textsuperscript{52}

Ultimately, legislators throughout the country enacted legislation to permit articles of incorporation to eliminate liability for monetary damages arising from breaches of fiduciary duties except for specifically defined transgressions such as violations of the duty of loyalty, acts or omissions not in good faith, and/or conduct involving improper personal benefits.\textsuperscript{53} Section 8.51 of the Revised Model Business Corporation Act now

\textsuperscript{50} See infra Part IV; see also Foster-Thompson, LLC v. Thompson, No. 8:04-cv-2128-T-30EAJ, 2005 U.S. Dist. LEXIS 29991, at *3-4 (M.D. Fla. Nov. 18, 2005) (involving an LLC that was awarded a $24 million contract to supply the Coalition Provisional Authority in Iraq an electrical power generating facility and containing allegations of kickbacks, failure to supervise project, and wrongful withdrawals); see also Shell v. King, No. E2003-02124-COA-R3-CV, 2004 Tenn. App. LEXIS 507, at *5-7 (Aug. 5, 2004) (involving the wholesale delegation of bookkeeping responsibilities that led to an embezzlement and also involving improper billing processes with regard to the employees of the defendant’s separate business).

\textsuperscript{51} Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

\textsuperscript{52} See, e.g., Daniel E. Fischel, The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law, 76 NW. U. L. REV. 913, 944 (1982).

\textsuperscript{53} See Van Gorkom, 488 A.2d 858 (directing the Court of Chancery to award damages where the members of a Board of Directors were not entitled to the presumption that their business decision was an informed one); see also DEL. CODE ANN. tit. 8, § 102(b)(7) (2006) (permitting a provision eliminating or limiting the personal liability of a director for monetary damages for breach of a fiduciary duty as director, provided that the provision does not eliminate or limit liability for a breach of the duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law, certain violations in connection with dividends, stock purchases or redemptions, or transactions from which the director derived an improper personal benefit); KY REV. STAT. ANN. § 271B.020 (LexisNexis 2006) (permitting a provision eliminating or limiting personal liability of a director to the corporation or its shareholders for monetary damages for breach of duties as a director, but the provision may not eliminate or limit liability for any transaction in which the director’s personal financial interest is in conflict with the financial interests of the corporation or its shareholders, acts or omissions not in good faith which involve intentional misconduct or are known by the director to be a violation of law, for votes or assents to certain unlawful distributions, or any transactions from which the director derived an improper personal benefit); Douglas M. Branson, Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors, 57 FORDHAM L. REV. 375, 381-82 (1988) (indicating that Delaware passed the first authoritative provision that
provides for indemnification if the director, acting in his official capacity, has conducted himself with good faith and with the reasonable belief that the conduct was in the best interests of the company. 54

In the wake of the Enron and WorldCom debacles and other accounting scandals that rocked American financial markets, the debate between the traditionalist and contractarian scholarly world views of corporate regulation has re-surfaced. 55 Further debate regarding the appropriate scope of board regulation was spawned by the Delaware Chancery Court’s decision in In re Walt Disney Co. Derivative Litigation, 56 wherein the Delaware Chancery Court decision upheld a Board’s award of executive compensation totaling $140 million for roughly twelve months of work. 57

The debate between traditionalists and contractarians continues over the Sarbanes-Oxley Act 58—far-reaching federal legislation designed to increase corporate accountability by regulating the accounting profession, increasing criminal penalties, requiring reports on internal controls, and calling for certifications of the financial statements by the Chief Financial Officer. 59 This enhanced corporate oversight continues to be criticized by a variety of academics, including contractarians who maintain that the market should be left to regulate itself. 60 While some cry for increased corporate accountability, others urge a relaxation of legal constraints, arguing that expensive audits of internal financial controls, increased state prosecutions, and abusive class action lawsuits are driving industries to raise capital in non-U.S. stock markets. 61

allowed the articles of incorporation to limit or exclude corporate directors’ liability for any breach of duty of care provided that the provision did not eliminate or limit the liability for a breach of loyalty, for acts or omissions not in good faith or involving intentional misconduct, or for transactions from which the director derived improper personal benefits and indicating that other states have for the most part followed Delaware’s lead by permitting corporations to opt out of liability for violations by their officials).


55. Susanna Kim Ripkin, The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, 58 BAYLOR L. REV. 139, 146 (2006) (criticizing the emphasis on disclosure as a means of regulating the securities market); see also Lundgren, supra note 12, at 210 (praising the separation of governance norms from legal standards of culpability).


57. See Mark R. High, Disney Directors Survive Attack on Magic Kingdom, 15 BUS. LAW TODAY, Jan./Feb. 2006, at 23 (discussing the Disney decision and suggesting that the Board’s deference to its chairman Eisner should not be emulated); see also Stone v. Ritter, 911 A.2d 362 (Del. 2006) (holding that the Chancery properly dismissed a complaint against directors where bank employees failed to file Suspicious Activity Reports and Anti-Money-Laundering reports and emphasizing that only a sustained or systematic failure to exercise oversight, such as an utter failure to attempt to assure a reasonable information and reporting system, would constitute bad faith, and clarifying that the duty to act in good faith is not an independent duty but a subsidiary element of the duty of loyalty); Shaev Profit Sharing Account v. Armstrong, No. 110, 2006 Del. LEXIS 596 (Del. Nov. 6, 2006) (affirming dismissal of complaint alleging that defendants violated their fiduciary duties to Citigroup shareholders by failing to exercise reasonable and prudent supervision in connection with WorldCom and Enron investment activities).


60. See Larry E. Ribstein, Bubble Laws, 40 HOUS. L. REV. 77, 97-98 (2003) (stressing that the market should be left to regulate itself).

61. See Stephen Labaton, Businesses Seek New Protection on Legal Front, N.Y. TIMES, Oct. 29, 2006, at A1, A26 (discussing the Paulson Committee, the committee of the U.S. Chamber of Commerce, and the
Applying Fiduciary Duties to LLC Managers

B. The Unincorporated Context of the Fiduciary Duty Debate

In the non-corporate arena, business planning practitioners sought limited liability from third party suits as well as increased control over suits generated by internal disputes among investors and/or managers. The enactment of the Revised Uniform Partnership Act (RUPA) by the National Conference of Commissioners on Uniform State Laws (NCCUSL) stirred much debate between traditionalists and contractarians. Ultimately, the final version of RUPA attempted to limit the duty of loyalty to three codified duties, to the exclusion of all else, in order to avoid expansive judicial rulings on fiduciary duties. Under RUPA, the “only” fiduciary duties are the duty to account for property, profits or benefits, the duty to refrain from dealing with the partnership on behalf of a party having an adverse interest, and the duty to refrain from competing with the partnership. This heavily “contractarian” approach was duplicated in the Uniform Limited Liability Company Act in 1993. In a recent reversal of this trend, however, some states have removed the word “only” from the list of the partner’s fiduciary duties. The removal of the word “only” clarifies that the statutory listing of duties is not consideration of such strategies as prosecuting individuals rather than corporations or auditing firms, curtailing the policy of forcing companies under investigation to withhold paying for legal fees where executives are suspected of wrongdoing, relaxing the Sarbanes-Oxley requirement of audits of internal financial controls, and eliminating the award of damages under Rule 10-b5; see also Stephen Labaton, Treasury Chief Urges ‘Balance’ in Regulation of U.S. Companies, N.Y. TIMES, Nov. 21, 2006, at C1, C4 (indicating that Henry M. Paulson, Jr. urges balance in corporate regulation).


63. See Allan W. Vestal, “Assume a Rather Large Boat . . .”: The Mess We Have Made of Partnership Law, 54 Wash. & Lee L. Rev. 487, 512-13 (1997) (emphasizing that RUPA rests on the flawed assumption that the relations of partners are matters of contract, not status, and that historical fiduciary duties could be assumed away and substituted by a coherent partnership statute); Donald J. Weidner, Three Policy Decisions Animate Revision of the Uniform Partnership Act, 46 BUS. LAW. 427, 462 (expressing the concern that vague broad statements of a powerful duty of loyalty caused too much uncertainty among some committee members); Donald J. Weidner, A Perspective To Reconsider Partnership Law, 16 Fla. St. U.L. Rev. 1, 38 (1988) (suggesting reforms were needed with regard to the duties of loyalty and care); see also Donald J. Weidner, RUPA and Fiduciary Duty: The Texture of Relationship, LAW & CONTEMP. PROBS. Spring 1995, 81, 86 (1995) (observing that RUPA offers more certainty to the fiduciary duty area).


66. See CAL. CORP. CODE § 16404 (Deering 2006) (stating the partner’s fiduciary duties “are the duty of loyalty and the duty of care,” without declaring that they are the “only” duties). Other states that removed the word “only” from the list of partner’s fiduciary duties include Colorado, Idaho, Illinois, and Kentucky. See, e.g., Colo. REV. STAT. § 7-64-404 (2006); Idaho Code Ann. § 53-3-404 (2005); 805 ILL. COMP. STAT. 206/404 (2005); Ky. REV. STAT. ANN. § 362.1-404 (LexisNexis 2006) (stating “[t]he fiduciary duties . . . include the
exhaustive and leaves room for courts to articulate other fiduciary duties or particular aspects of duties not fully stated in the statute.

The issue of whether fiduciary duties should be “cabin’d” and limited to those expressly stated in the statute is only one of two important issues in the fiduciary duty debate. A second issue concerns the extent to which such “default” duties can be modified and/or eliminated by contract. This latter question resurfaced after the Delaware Supreme Court decided *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.* In *Gotham Partners*, the Delaware Supreme Court in dicta states that a partner’s fiduciary duties may be expanded or restricted by provisions in a limited liability company agreement, but may not be completely eliminated.  

Thereafter, the Delaware legislature revised its Revised Uniform Limited Partnership Act and its Limited Liability Company Acts to permit parties to expand, restrict, or eliminate duties, including fiduciary duties at law or in equity, provided that they do not eliminate the implied covenant of good faith and fair dealing. Only a few other states have liberalized their provisions to permit the elimination of fiduciary duties. Further, Delaware’s indemnification provision is very liberally worded, permitting the LLC to indemnify a member or manager from all claims and demands. In contrast, Delaware’s corporate statute permits a provision eliminating personal liability for monetary damages for breach of a fiduciary duty of a director, but not for acts or omissions not in good faith, acts involving intentional misconduct or knowing violations of law, certain improper dividends or redemptions and for transactions involving improper personal benefit.

---

68. Id.
69. DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (2006).
70. See ARK. CODE ANN. § 4-32-404 (2006) (permitting the elimination of fiduciary duties); COLO. REV. STAT. ANN. §7-80-108 (West 2005) (permitting an operating agreement to eliminate or modify, if the elimination or modification is not unreasonable, the duty to refrain from competing and the duty to account for property, profits or opportunities); see also GA. CODE ANN. §14-11-306 (2006) (providing for indemnification but indicating that there can be no indemnification for intentional misconduct or knowing violation of law or for transactions for which a person received a personal benefit in violation for the operating agreement); IDAHO CODE ANN. § 53-624 (2006) (allowing the operating agreement to eliminate or limit the personal liability of a member or manager for monetary damages); KY. REV. STAT. ANN. §275.180 (LexisNexis2006) (providing the operating agreement may eliminate or limit the personal liability for monetary damages for a breach of any duty).
72. Compare DEL. CODE ANN. tit. 8, § 102(b)(7) (2006) (providing that a corporation may eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages but shall not eliminate or limit liability for any breach of the duty of loyalty, acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, certain violations under § 174 and for transactions from which the director derived an improper personal benefit) with DEL. CODE ANN. tit. 6, § 18-108 (2006) (providing that subject to standards and restrictions if any in the operating agreement, a limited liability company may indemnify any member or manager or other person from and against any and all claims and demands whatsoever).
With regard to the first question, the revised Uniform Limited Liability Company Act “uncabins” fiduciary duties. Instead of providing an exhaustive list of duties, the Revised Act provides that the duty of loyalty includes the duties specified, implying that there may be other duties not addressed.\(^\text{73}\)

With regard to the second issue concerning the scope of fiduciary duty waivers, the ULLCA II Committee initially refused to endorse the complete elimination of fiduciary duties.\(^\text{74}\) However, the final version of ULLCA II permits the operating agreement to eliminate the duty to account, to refrain from dealing with the company on behalf of a party having an interest adverse to the LLC, and to refrain from competing, if not manifestly unreasonable.\(^\text{75}\) The American Bar Association’s Committee on Partnerships & Unincorporated Business Organizations is also revising the ABA Prototype Limited Liability Statute, and there appears to be considerable support within the Committee for permitting the elimination of duties.\(^\text{76}\)

Only a handful of states permit the elimination of fiduciary duties and a much greater number of states place restrictions on the ability to completely alter fiduciary duties. Thus, a robust debate has re-surfaced regarding whether private parties should be free to eliminate fiduciary duties.\(^\text{77}\)

---

73. See infra Part V. Section 409(b) provides:
   The duty of loyalty of a member in a member-managed limited liability company includes the duties:
   (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
      (A) in the conduct or winding up of the company’s activities;
      (B) from a use by the member of the company’s property; or
      (C) from the appropriation of a limited liability company opportunity.
   (2) to refrain from dealing with the company in the conduct or winding up of the company’s activities as or on behalf of a person having an interest adverse to the company; and
   (3) to refrain from competing with the company in the conduct of the company’s activities before the dissolution of the company.

74. For example, see the alternative draft of ULLCA II presented at a June 16, 2004 teleconference which provided, in part, that an operating agreement may not “eliminate the duty of loyalty under Section 409(b), but:
   (i) the operating agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.” National Conference of Commissioners on Uniform State Laws ULLCA Drafting Committee, Alternative to Sections 110, 409 and 410 of the 2004 Annual Meeting Draft § 110(g), available at http://www.law.upenn.edu/bll/ullca/ULLCA_Alternatives_061804-1.htm (last visited Feb. 15, 2007).

75. See Revised Uniform Limited Liability Company Act, July 7-14, 2006, http://www.law.upenn.edu/bll/ullca/2006annualmeeting_approvedtext.htm; see also infra Part V.


C. A Closer Look at the Schools of Thought

1. The Contractarian School

The contractarian school of thought regards the business entity as a nexus of contracts. Consequently, private parties should be permitted to strike their own bargains with a minimum of external legal intrusion. Expansive judicial rulings carrying moral overtones are regarded as a destructive and costly burden on the market. Proponents of this view typically focus on the enterprise governed by a negotiated legal agreement, rather than the smaller, less informal business entity that may not be governed by a written agreement.

The “contractarian framework” is derived from the impact of economic theory upon business law. The role of the state, vis-à-vis the business entity, is to enable the parties to develop and enforce their private bargain in the most efficient manner possible. The contractarian scholars argue that fiduciary duties interfere with the market for corporate control and impede profit maximization. Mandatory fiduciary duties are criticized for their interference with the market for corporate control and their potential to impede profit maximization. The contractarian school argues that fiduciary duties are not necessary to the efficient operation of the market and that they can be replaced by market mechanisms.

---

79. See id. But see John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 COLUM. L. REV. 1618, 1619-20 (emphasizing the importance of the judicial role in monitoring and interpreting the corporate contract); see also Scott FitzGibbon, Fiduciary Relationships Are Not Contracts, 82 MARQ. L. REV. 303, 304 (1999) (emphasizing that fiduciary relationships function in ways alien to contractualist thought and facilitate the doing of justice, the promotion of virtue, and the enhancement of freedom).
80. See Donald J. Weidner, Three Policy Decisions Animate Revision of the Uniform Partnership Act, 46 BUS. LAW. 427, 462 (1991) (explaining that vague, broad statements of a powerful duty of loyalty cause too much uncertainty); Donald J. Weidner, A Perspective To Reconsider Partnership Law, 16 FLA. ST. U. L. REV. 1, 38 (1988) (suggesting reforms of the Uniform Partnership Act should focus on the duties of loyalty and care); see also Donald J. Weidner, RUPA and Fiduciary Duty: The Texture of Relationship, 58 LAW & CONTEMP. PROBS. 81, 86 (1995) (observing that RUPA offers an attempt to add more certainty to language that is often indeterminate).
81. But see Barbara Ann Banoff, Company Governance Under Florida’s Limited Liability Company Act, 30 FLA. ST. U. L. REV. 53, 80 (2000) (reflecting upon the unsophisticated LLC owner and observing that do-it-yourselfers may be unpleasantly surprised by the lack of a default buy-out rule provided in the revised Florida LLC statute); Report, The Committee on Corporate Laws, ABA Section of Business Law, Managing Closely Held Corporations: A Legal Guidebook, 58 BUS. LAW. 1073 (2003) (providing some direction and guidance to nonlawyers by offering a practical overview of important legal principles governing directors, officers and close corporation shareholders).
83. See Goddard, supra note 82, at 67-68 (citing in footnote 13, R.H. Coase, The Nature of the Firm, 4 ECONOMICA 386 and indicating that this piece is reproduced in C.J. STIGLER & K.E. BOULDING, READINGS IN PRICE THEORY (1952)).
Applying Fiduciary Duties to LLC Managers 581

increasing costs that are inefficient and undesirable. 85

2. Traditionalists

The traditionalists have criticized the contractarian school of thought generally and in particular, the approach taken by the Revised Uniform Partnership Act that limits fiduciary duties “only to” three statutorily defined duties. 86 As stated by Allan W. Vestal:

The Revised Act is substantively deficient because it provides a narrower range of intra-partner obligations. It establishes an unsatisfactory set of rules that defeats the reasonable expectations of the participants and it sends a socially impoverished message. 87

The traditionalists embrace fiduciary duties as a moral precept and argue that ambiguous fiduciary duty judicial language necessarily conveys its aspirational quality and its high moral ground. 88 In the context of the close corporation, Professor Mitchell argues for the imposition of mutual fiduciary duties on controlling and minority participants. 89 He argues that fiduciary duties require altruistic, selfless conduct, and that it is appropriate for the controlling and minority participants to look after each others’ interests. As summarized by Professor Mitchell:

. . . this mutual altruism . . . restores a vision of human behavior and social good that is at the heart of fiduciary duty, while at the same time acknowledging the economic rights of the other side. In so doing, it again elevates the desirable level of corporate ethics above the morals of the marketplace reflected in the current intent-based tests developed by the courts. 90

Thus, the traditionalists seek the very judicial ambiguity so vigorously criticized by the contractarians. 91

3. The Team Production Theory of the Corporation, Fiduciary Duties, and Social Norms

Professors Lynn Stout and Margaret Blair offer a theory of the corporation that

---


88. See Mitchell, supra note 86, at 1696 (discussing the application of partnership-like fiduciary duties to the close corporation).

89. See id. at 1728-29 (recommending mutual fiduciary obligations on the majority and minority investor).

90. See id. at 1731.

regards the various stakeholders in the corporation as being engaged in a team production activity.92 Under the team production theory of the corporation, the role of corporate directors is to mediate conflicts among the team.93 Stout and Blair argue that economic efficiency is best served when the Board engages in behavior that maximizes the interests of all groups. They argue that directors can be expected to do a good job when the environment fosters trustworthy behavior.94

Blair and Stout argue that the contractarian approach that allows directors to opt out of fiduciary duties undermines the effectiveness of the law in fostering responsible director conduct by sending the wrong signals to the directors, explaining:

[The experimental evidence consequently indicates that most people behave as if they have two personalities or preference functions. In some social contexts they are competitive and behave selfishly. But when the social conditions are right, their cooperative, other-regarding personalities emerge. Social “framing,” tempered by considerations of personal costs, plays a critical role in determining whether or not individuals choose to trust and be trustworthy.]

According to Blair and Stout, the social context conveys critical cues on expectations of trustworthy behavior.96 Under this worldview, the private culture of the firm and the law of business entity governance including the articulation of fiduciary

---

93. See id. at 249.
95. See Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. PA. L. REV. 1735, 1742-43 (2001) (discussing the social context of corporate behavior and the importance of establishing conditions that promote trustworthy behavior).
96. Id.
Applying Fiduciary Duties to LLC Managers

4. Game Theory Applied to Fiduciary Duties

Some scholars have used game theory to explore the way in which the expectations of loyalty in the fiduciary relationship can promote trustworthy behavior. Professor Peter H. Huang has constructed a broker/investor securities investing game. Under this approach, a breach of fiduciary duty can mitigate or deter the misappropriation of investments, not only through financial or monetary penalties, but also because of the actor’s need to avoid feelings of remorse or guilt. A breach of fiduciary duty is thought to carry the “stench of dishonesty.” Under the game model Huang proposes, the pay-off for a broker’s misbehavior is decreased if the broker-dealer understands that the investor expects him or her to owe a fiduciary duty of loyalty. In this circumstance, the pay-off for misbehavior is reduced not only by the possibility of punishment, but also by the guilt derived from breaking the law or by morally disappointing clients.

Professor Huang argues that fiduciary duty law is powerful because it harnesses emotions to comply with desirable social norms. He emphasizes that fiduciary law can have important psychological and rhetorical roles in shaping behavior.

An LLC statute (or any business organization act) that permits unlimited waivers of fiduciary duties could disrupt the game theorist's decision tree. It is posited that in the usual case, the cost of untrustworthy behavior is offset by both the possibility of punishment and the associated guilt. If sufficiently broad waivers of fiduciary duties were permitted, untrustworthy behavior would neither be stigmatized nor punished. Arguably, the “moral stench” typically associated with dishonesty or disloyalty would be cleansed by the presence of a statutory provision permitting unlimited waivers.

5. The Empirical Study of Fiduciary Duties

I have conducted empirical studies of the contractual playing field to gain insight into the effectiveness of the bargaining process between majority and minority LLC investors. The question of whether there is typically a fair and effective contractual bargaining process that accompanies the formation of LLCs goes to the heart of the practicality of the contractarian theory LLC of governance. If the LLC operating agreement is to be the centerpiece for the investors’ legal protections to the exclusion of statutorily imposed fiduciary duties, it follows that: a) a written LLC operating agreement

---

97. See ERIC A. POSNER, LAW AND SOCIAL NORMS 5 (2000) (positing that people engage in a signaling game in which they try to show that they are desirable partners in cooperative endeavors); see also Peter H. Huang, Reasons Within Passions: Emotions and Intentions in Property Rights Bargaining, 79 OR. L. REV. 435, 447-49 (2000) (creating a game theory to discuss a bargaining process).
99. See id. at 1075.
100. See id.
101. See id. at 1081.
102. See id. at 1061-62.
103. See Huang, supra note 98, at 1066.
should exist in the usual case; b) all parties to the LLC operating agreement should be adequately represented by competent counsel who are well-trained in fiduciary duties and standards of conduct generally; c) LLC operating agreements should contain such legal protections as contractual buy-outs for minority members; and d) the parties and their legal counsel should be well-informed of the default provisions in the LLC statute and understand the full implications of discretionary clauses and contractual waivers of duties. Although the debate between traditionalists and contractarians has attracted many participants and spanned decades, both sides have largely failed to marshal facts to support or refute these underlying assumptions.

My first empirical study was conducted in California, Delaware, New York, and Pennsylvania. I surveyed over 3,000 attorneys to which 25% (or 770) replied to questions concerning their contractual practices with regard to their representation of majority and minority LLC investors. The study found a disparity between the percentage of respondents claiming to frequently represent the majority as compared to minority investors. The findings cast doubt on whether many LLC agreements are extensively negotiated by attorneys who are well-versed in LLC statutory law and governance issues. Also, the study documented the prevalence of LLC disputes, showing that over 25% had handled LLC majority/minority disputes, many of which involved the filing of a lawsuit (29%). Interestingly, almost twice as many Delaware attorneys indicated that they had handled a dispute where a lawsuit had been filed, than non-Delaware attorneys.

Significantly more respondents said they frequently represented the controlling rather than the minority (56% compared 20%). A great number of respondents replied that they believed many LLC agreements are based on form agreements that are not extensively negotiated (68%), and only a handful of respondents indicated that they included a contractual right to a dissolution upon a showing of illegal, fraudulent, or oppressive conduct (14%). Also, there were indications that many respondents were not familiar with the default exit rights under their state’s statutory laws. In Pennsylvania, 56% incorrectly replied “No” when asked whether the LLC member would be entitled to a buy-out upon dissociation prior to the winding up of the Pennsylvania LLC.

I conducted a second study of contractual LLC practices in Colorado, Delaware, Kentucky, Minnesota, Montana, and New York. Approximately 4200 surveys were distributed and 12% (or 517) attorneys replied. This survey gave attorneys the

105. See id.
106. See id. at 380-81.
107. See id. at 381 (indicating that 50% of Delaware respondents reported that a lawsuit was filed in connection with the disputes that they had handled, as compared with 21%, 9%, and 25% of respondents in California, New York, and Pennsylvania, respectively).
108. See id. at 375-76.
109. See Miller, supra note 104, at 383.
110. See id. at 382.
111. See id. at 393.
113. See id. at 615.
Applying Fiduciary Duties to LLC Managers

opportunity to reply “often,” “sometimes,” or “never” to a variety of questions concerning the nature and scope of their contractual LLC practices. This second study found widespread usage of simple no-frills LLC agreements (85%), frequent formation of LLCs without an operating agreement (40%), and the pervasive presence of contractual language attempting to limit or eliminate fiduciary duties (41%). The results of this second study challenge the stereotype of the unsophisticated, unrepresented minority investor because so many of respondents replied “sometimes” or “often” when asked whether they had represented the active minority investor (67%), many of whom had agreements containing a buy-out clause (82%). However, relatively few replied “often” when asked whether they had represented the active minority where the LLC agreement contained a buy-out clause (18%). A greater percentage of respondents reported representing the controlling member than the active minority investor (84% versus 67%), thus suggesting a disparity in levels of legal representation of the controlling and minority investors in the sample surveyed. This disparity may be even greater than this 17% spread if the actual population of LLC owners contains more minority investors than controlling investors. Finally, the study found that fewer respondents outside of Delaware had participated in continuing legal education seminars on fiduciary duties within the last twelve months than their Delaware counterparts (19% compared to 43%).

Taken together, the empirical research casts doubt on three very basic assumptions that are critical to the practical effectiveness of the contractarian theory of LLC governance. First, written LLC operating agreements are likely to be executed. Second, the operating agreements will be highly negotiated and will contain important express contractual protections for both sides. Third, the attorneys drafting the LLC agreements will be well-educated in LLC statutory default rules and LLC governance issues. The fact that Delaware respondents were twice as likely to report the filing of lawsuits than their...

114. For a discussion of recent rates of LLC filings, see Howard M. Friedman, Annual Survey of Issues Affecting Nebraska Law: The Silent LLC Revolution—The Social Cost of Academic Neglect, 38 CREIGHTON L. REV. 35, 36-40 (2004) (drawing from 2003 data on the number of business filings made annually in each state based on a study by the International Association of Commercial Administrators and showing that Delaware, Kentucky, and Montana were among the 29 states in which LLC filings exceeded corporation filings, Colorado and Minnesota were among the 16 states in which LLCs were popular but not predominant, and New York was among the six states in which incorporation filings were double the LLC filings).

115. Miller, supra note 112, at 618.

116. Id.

117. Id.

118. Id.

119. Id.

120. The scope of the lawyer’s ethical responsibilities, including the duty to be adequately versed in the law of private business entities, has not received much scholarly attention. But see Richard W. Painter, Ethics in the Age of Un-incorporation: A Return to Ambiguity of Pre-incorporation or an Opportunity to Contract for Clarity? 2005 U. ILL. L. REV. 49, 50 (observing that the attorney’s ethical obligations are not always clear in light of the fluidity of the un-incorporation framework and recommending that lawyers contractually address whether the lawyer for the entity is also the lawyer for the individuals, to whom important information should be sent, and the scope of the lawyer’s responsibilities); see also Thomas E. Rutledge & Allan W. Vestal, Making the Obvious Choice Malpractice: LLPs and the Lawyer Liability Time Bomb in Kentucky’s 2005 Tax Modernization, 94 KY. L.J. 17, 18 (2006) (analyzing Kentucky’s tax modernization act and the implications for legal malpractice flowing from choice of entity recommendations).
non-Delaware counterparts challenges the notion that increased statutory tolerance for contractual flexibility will promote private contracting and thereby reduce lawsuits.

The empirical research paints a picture of an imperfect and diverse contractual playing field. The LLC serves a broad constituency of businesses varying widely in sophistication, financial stature, and legal representation. Some, but by no means all, LLCs can be expected to be governed by highly-negotiated, sophisticated LLC agreements drafted on both sides by experts in LLC governance.

6. The Structural Model for Fiduciary Duty Terms

Dean Allan Vestal and J. William Callison have argued that the standard of care should vary depending upon the firm’s owners and their levels of power and participation in the firm. 121 William Callison has gone on to recommend that statutes not attempt to articulate fiduciary duties at all. 122 He argues that if a participant acts as a paid agent for the business, he or she should be held to a simple negligence standard, whereas if co-owners both participate in running the business, they should be held to a gross negligence standard of care. 123 Professor Callison’s model emphasizes the importance of the relationship of the parties and the roles of the players.

The Mandatory Core approach advanced by this thesis is discussed in Part V and builds upon many of the above models. The Mandatory Core approach relies heavily on Blair’s notion of the transmission of cues through the social context and recommends a statutory legal framework of minimum mandatory fiduciary duties that cannot be contracted away. The minimum core duties are regarded as being important because they shape expectations of trustworthy behavior. This in turn promotes and reflects positive social norms.

III. THE LLC STATUTES

Statutory treatments of the duty of loyalty and the duty of care are quite diverse. As discussed below, some state statutes take a traditional, partnership-like approach to the duty of loyalty, others take RUPA’s modern partnership approach, while others use corporate-like language. In some cases, the LLC statutes are silent as to fiduciary duties. 124 A number of states contain express statements that the fiduciary duty of members and/or managers is limited to certain duties specifically designated in the statute—for example, duties to account for certain benefits, to refrain from dealing with the LLC on behalf of an adverse party, or duties to refrain from competing with the LLC. 125 This approach was taken in the Uniform Limited Liability Company Act as

122. Callison, supra note 14, at 472.
123. Id.
124. See ALASKA STAT. § 10.50.130 (2006) (providing that “[u]nless otherwise provided in an operating agreement,” the member “does not have the fiduciary duty of a manager”); ARK. CODE ANN. § 4-32-402 (2006) (containing no statements about the duty of good faith or loyalty but indicating that a member or manager shall not be liable unless the act or omission constitutes gross negligence or willful misconduct).
125. See HAW. REV. STAT. ANN. § 428-409 (LexisNexis 2006) (indicating that the only fiduciary duties a
originally drafted.\textsuperscript{126} The duty to account language is included in the Revised Uniform Partnership Act along with more specific statements regarding self-dealing and competition.\textsuperscript{127} A number of the LLC statutes impose the duty to account to other members for profits made from LLC transactions.\textsuperscript{128} The statutes also vary in the extent to which they permit contractual modifications to the statutory standard for fiduciary duties.\textsuperscript{129} Some LLC statutes contain express restrictions on the right to contractually modify the members’ or managers’ standards of conduct in the articles of organization or operating agreement, whereas others do not.\textsuperscript{130} There is also considerable variation with

member owes are those specified in the statute and that the duty of loyalty is limited to accounting for property, profits, or benefits, refraining from dealing with the LLC as an adverse party, and refraining from competing with the LLC; 805 ILL. COMP. STAT. 180/15-3 (LexisNexis 2006) (indicating that the fiduciary duties include the duty to account for certain benefits, to act fairly when acting on behalf of a party with an adverse interest to the company, and to refrain from competing with the company); see also 805 ILL. COMP. STAT. 180/15-5(b)(6) (LexisNexis 2006) (indicating that the operating agreement may not “eliminate or reduce a member’s fiduciary duties”). But see CAL. CORP. CODE § 17153 (Deering 2006) (stating merely that the fiduciary duties owed are those of a partner to a partnership); CAL. CORP. CODE § 17155 (Deering 2006) (indicating indemnification allowed except for breach of fiduciary duties in § 17153). Colorado, Illinois, and Kentucky have also uncabinied these duties. See supra note 66 and accompanying text.

126. UNIF. LIMITED LIABILITY COMPANY ACT § 409 (1996).
127. REV. UNIF. PARTNERSHIP ACT § 404(b) (1997) provides in part:

A partner’s duty of loyalty to the partnership and the other partners is limited to the following:

(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;

(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and

(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

\textit{Id.} The original version of ULLCA § 409 contains substantially similar language. The duty to account language has its actual roots in the Uniform Partnership Act of 1916. \textit{Id.}

128. See BISHOP & KLEINBERGER, supra note 35, at 10-27 (summarizing the duty of loyalty in the LLC and indicating that many LLC statutes employ language that tracks UPA § 21, providing that every partner must account to the partnership for any benefit and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property). A number of LLC statutes adopt similar language pertaining to the duty to account to other members for profits. See also LARRY R. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES app. 9-6 (Supp. 2005) (containing a chart summarizing LLC states’ provisions dealing with waivers of fiduciary duties).

129. See \textsc{Appendix A}.

130. See ALA. CODE § 10-12-21 (LexisNexis 2006) (providing that, effective Jan. 1, 2001, an operating agreement may modify the member’s or manager’s duties but may not unreasonably restrict rights to information or records or eliminate the duty of loyalty); D.C. CODE ANN. § 29-1020 (LexisNexis 2006) (indicating that liability “may be limited or eliminated in the articles of organization” except for willful misconduct); FLA. STAT. ANN. § 608.4228 (LexisNexis 2006) (providing, in part, that a manager or managing member shall not be personally liable to its members unless there was a breach or failure to perform duties and it was a violation of criminal law, a transaction in which an improper personal benefit was received, it was a distribution that violated the LLC statute, or involved certain conscious disregard for the best interest of the company or willful misconduct). The corporate counterpart to the partnership-like duty to account language is the duty to act in good faith in the manner the director reasonably believes to be in the best interests of the corporation.
regard to the duty of care with some states, including Delaware, failing to adopt any express statutory standard of care, and others employing language similar to that applied to directors under the Model Business Corporation.

IV. THE CASES: NO SHORTAGE OF FIDUCIARY DUTY VIOLATIONS

Abusive conduct in the context of the LLC spans many jurisdictions with a wide variety of different formulations of the duty of loyalty and the duty of care. The fact patterns vary, but the misconduct is familiar. The cases involve several strains of abusive conduct including furtive sales of the LLC, inventive squeeze-outs, and creative diversions of assets.

Some of the litigation arises under state LLC statutes that recognize partnership-like heightened fiduciary duties in the LLC. Others have arisen under corporate-style statutes. Still other cases have arisen under state LLC statutes that use both corporate language (the duty to discharge duties in good faith with the care of an ordinarily prudent person in a like position) and partnership formulations. Cases have also arisen in Delaware, which now permits the contractual elimination of fiduciary duties.

A. A Mandatory Core of Minimum Standards Emerges in Courts Outside of and Within


132. See Model Bus. Corp. Act § 8.30(a) (rev. 1998) (The Act previously provided that a director “shall discharge his duties . . . (1) in good faith; (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.” The Act now provides that the directors shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances); see Appendix B.

133. See Credentials Plus, LLC v. Calderon, 230 F. Supp. 2d 890 (N.D. Ind. 2002) (involving the usurpation of business opportunities by the LLC’s business manager who allegedly solicited the LLC’s clients to her new firm and involved Indiana’s partnership-style LLC statute); Purcell v. S. Hills Invs., LLC, 847 N.E.2d 991, 997 (Ind. Ct. App. 2006) (holding that common law fiduciary duties, similar to ones imposed on partnerships and closely held corporations are applicable to Indiana LLCs and indicating that a co-manager breached his fiduciary duty to the company and the other member of the LLC where he failed to forward payments received by a different company that were meant for the jointly-owned LLC); see also id. (affirming the trial court’s holding that the defendant had breached a fiduciary duty by using payments received by the LLC for the defendant’s repayment of a personal loan, and also concluding that the misconduct constituted willful misconduct or recklessness and was not excused from liability under the terms of the agreement that provided that a member or manager was not liable for damages to the LLC or its members unless the act or omission constituted willful misconduct or recklessness).

134. See Flippo v. CSC Assocs. III, 547 S.E.2d 216 (Va. 2001) (involving the unilateral transfer of non-cash LLC assets to a new LLC to accomplish the majority’s personal estate planning goals in Virginia where an LLC manager must discharge duties in accordance with a good faith business judgment in the best interests of the LLC).


136. See supra Part II.B; VGS, Inc. v. Castiel, No. 17995, 2000 Del. Ch. LEXIS 122 (Aug. 31, 2000) (involving a merger in which two board members failed to notify the plaintiff, which had the effect of diluting the plaintiff’s interest in the LLC and divesting the plaintiff of majority control); see also Solar Cells, Inc. v. True N. Partners, LLC, No. 19477, 2002 Del. Ch. LEXIS 38, at *26-27 (Apr. 5, 2002). These cases arose prior to the revision in the statute that permits the contractual elimination of fiduciary duties.
Applying Fiduciary Duties to LLC Managers  

Delaware

With regard to the duty of loyalty, prior to Delaware’s revision of its statute to permit the elimination of fiduciary duties, it could be said that a number of courts both within and outside of Delaware were laying the foundation for a rigorous mandatory minimum level of acceptable conduct in the LLC. Outside of Delaware, this mandatory minimum was achieved through a rigorous interpretation of fiduciary duties. Within Delaware, the mandatory minimum could be seen in terms of the requirement that LLC directors with conflicts of interest demonstrate the entire fairness of their conduct.  

Now that Delaware has changed its LLC statute to permit the complete elimination of fiduciary duties, the legal arguments challenging questionable director conduct can be expected to change. Will appropriate limitations on opportunistic conduct be crafted even where the parties involved have contractually eliminated all fiduciary duties? To what extent will deceptive conduct be tolerated in the face of a right to compete clause, a clause giving the manager every possible discretion, and/or a clause that broadly relinquishes or disclaims contractual rights?  

It is hoped that the jurisdictions permitting the broad elimination of fiduciary duties will develop meaningful limitations to curb abusive conduct using contractually based concepts. However, as discussed in Part V, the better approach is to statutorily prohibit the complete elimination of fiduciary duties.

B. Traditional Broad Formulations of Fiduciary Duty Outside of Delaware

Outside Delaware, traditional partnership and/or corporate-style fiduciary duty formulations have been quite successful in combating unilateral seizures of property as well as the diversion of business opportunities. While the statutory formulations may vary, the patterns of abuse fall into familiar categories. Also, a duty of full disclosure has been relied upon to prevent one LLC member from unfairly appropriating profit upon the eventual total sale of the LLC to a third party.

137. See infra Part II.C (discussing the requirement that directors with conflicts of interest demonstrate the entire fairness of a challenged transaction).

138. See, e.g., Kira, Inc. v. All Star Maint., No. A-03-CA-950 LY, 2006 WL 2193006 (W.D. Tex. July 31, 2006) (denying summary judgment for the defendant where the plaintiff, a 10% owner of the LLC, alleged that the two defendants who collectively owned 90% improperly diverted management fees to an entity they owned to the exclusion of the plaintiff, notwithstanding a contractual disavowal of the corporate opportunity rule in the LLC agreement).  

139. James McConvill & Mirko Bagaric, Opting Out of Shareholder Governance Rights: A New Perspective on Contractual Freedom in Australian Corporate Law, 3 DePaul Bus. & Com. L.J. 255, 286-87 (2005) (observing that courts exercise substantial discretion to accept or reject contractual innovation, depending on the policy underlying the norm in question and the nature of the conflict with the charter provision).  


142. See Daniel S. Kleinberger, Careful What You Wish For—Freedom of Contract and the Necessity of Careful Scrivening, ABA, PUBOGRAM, Oct. 2006, at 19 (observing the risks associated with improperly drafted LLC agreements in jurisdictions that defer to the contract and apparently sometimes read agreements literally to
Furtive LLC sales have been effectively attacked through the broad interpretation of fiduciary duties and the recognition of a duty of full disclosure. Most of these cases have involved deception by managing LLC members. For example, in *Salm v. Feldstein*, the defendant bought out the plaintiff’s 50% LLC interest for $1.375 million and a $1.3 million consulting contract payable over five years. A few days later, the defendant, who was the managing member of the automobile dealership, sold the entire dealership for $16 million. The defendant allegedly misrepresented the value of the dealership at between $5 and $6 million and failed to disclose that a firm offer already had been made to purchase the entire LLC for $16 million. The Supreme Court of New York, Appellate Division ruled that the defendant had breached his fiduciary duty and in particular, his duty to make full disclosure.

A similar duty of full disclosure was recognized in *Blue Chip Emerald LLC v. Allied Partners, Inc.* in which the plaintiffs had sold their 50% interest in the LLC to the defendants for a price based on an $80 million valuation of the LLC’s property. Two weeks later, the defendants sold the property to a third party for a price based on a property valuation of $200 million. Although the plaintiff had contractually disclaimed all interest in any profit realized by the defendants on a future sale of the LLC property and had been given an opportunity to conduct a due diligence investigation, the court indicated that the defendants, as managing coventurers, were held to a stringent standard of conduct and as fiduciaries were strictly obligated to disclose any information that could reasonably bear on the offer.

Finally, in *TIC v. HR Software Acquisition Group, Inc.*, the New York Supreme Court refused to give effect to an attempted transfer of the assets of a troubled software development LLC. While the majority in interest was known to be on vacation over Christmas holidays, the defendant informed the other LLC owners that absent any written objections, he would transfer the LLC’s assets to a newly formed company in exchange for a $1 million promissory note and would buy out the investors’ interests for 15% of their initial investment. The court refused to enforce the note in spite of a contractual release that had been signed, observing that the LLC statute prohibits an operating agreement from limiting liability of any manager for acts or omissions in bad faith or involving intentional misconduct.

### C. The Entire Fairness Test Within Delaware

Prior to the amendment of Delaware’s LLC statute that now permits LLC
agreements to contractually eliminate fiduciary duties, Delaware in effect established mandatory minimum standards of conduct through the use of the entire fairness test as applied to self-interested transactions.\textsuperscript{154} It was thus able to challenge opportunistic director conduct without sacrificing its commitment to enforcing the LLC agreement. Under Delaware law, where a majority of the directors representing the corporation are conferring benefits upon themselves out of the assets of the corporation, “the burden is upon the directors to prove . . . that the transaction was in good faith,” and was intrinsically fair.\textsuperscript{155} The directors must show that the challenged transaction was conducted in a fair process and at a fair price.\textsuperscript{156}

In both \textit{Solar Cells, Inc. v. True North Partners, LLC},\textsuperscript{157} and \textit{VGS, Inc. v. Castiel},\textsuperscript{158} the Delaware courts successfully challenged underrhanded mergers involving LLCs through the application of the entire fairness test. In \textit{VGS, Inc. v. Castiel}, two of three board members had failed to notify the plaintiff of a proposed merger that reduced plaintiff’s majority control of the LLC.\textsuperscript{159} In \textit{Solar Cells}, the defendant also made a secret attempt to gain control over the LLC.\textsuperscript{160} In both cases, the business judgment rule did not protect the defendant because the transactions were tainted by self-interest. Therefore, the burden was upon the defendants to demonstrate the existence of a fair process and a fair price.\textsuperscript{161}

Based on \textit{VGS} and \textit{Solar Cells}, Delaware’s entire fairness test seems to achieve at least the same level of protection against opportunistic business decisions as would broad statements embracing fiduciary duties.\textsuperscript{162} Also, in other jurisdictions, minority LLC squeeze-outs have been successfully attacked where the LLC statute codified the fundamental fairness test. Thus, in \textit{Gottsacker v. Monnier},\textsuperscript{163} the defendants transferred the LLC’s property to a newly formed entity to the exclusion of the plaintiff. The Supreme Court of Wisconsin remanded the case to the circuit court to determine whether the defendants had violated Wisconsin’s statutory provision that prohibits the willful failure “to deal fairly with [the] LLC or its other member” in a self-interested

\textsuperscript{154} See Sandra K. Miller, \textit{The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC}, 152 U. Pa. L. Rev. 1609, 1635 (2004).
\textsuperscript{155} Gottlieb v. Heyden Chem. Corp., 90 A.2d 660, 663 (Del. 1952); see Gottlieb v. Heyden Chem. Corp., 91 A.2d 57, 57 (Del. 1952) (indicating that directors who have a conflict of interest must demonstrate “utmost good faith” and “scrupulous inherent fairness”).
\textsuperscript{156} See Weinberger v. UOP, 457 A.2d 701, 711 (Del. 1983) (challenging the elimination of the minority interest in a cash-out merger).
\textsuperscript{157} No. 19477, 2002 Del. Ch. LEXIS 38 (Apr. 25, 2002).
\textsuperscript{158} No. 17995, 2000 Del. Ch. LEXIS 122 (Aug. 31, 2000), aff’d 781 A.2d 696 (Del. 2001).
\textsuperscript{159} Id. at *5.
\textsuperscript{160} Solar Cells, 2002 Del. Ch. LEXIS 38, at *26-27.
\textsuperscript{161} Id. at *22 (holding that the plaintiff demonstrated a reasonable likelihood of success with regard to fairness claim); VGS, 2000 Del. Ch. LEXIS 122, at *14-17 (holding that clandestine attempt to gain control violated the duty of loyalty).
\textsuperscript{163} Gottsacker v. Monnier, 697 N.W.2d 436 (Wis. 2005).
\textsuperscript{164} Id. at 438-40.
The entire fairness test has been effective in challenging self-interested mergers in cases prior to the change in Delaware’s LLC statute that permits the complete contractual elimination of fiduciary duties. However, the entire fairness test arises because of an allegation that the actor has violated a duty of loyalty. If fiduciary duties can be contractually eliminated, the entire fairness test becomes irrelevant. Contractually-oriented theories then assume increased importance in the effort to address opportunistic conduct.

E. Troubling Decisions Suggest the Importance of Turning to Contractually Oriented Limitations

In a small minority of jurisdictions, including Arkansas, Delaware, Idaho, and Kentucky, fiduciary duties in the LLC may be modified and even eliminated. What protections remain in such jurisdictions that exalt the private agreement? Some judicial relief may be derived through: 1) the recognition that a contractual grant of a right to compete does not necessarily eliminate disclosure obligations that are relevant to decision making; 2) a judicial willingness to recognize oral LLC operating agreements in appropriate circumstances; 3) the careful interpretation of contractual waivers and of other contractual standards that appear in the operating agreement to establish and monitor standards of performance; 4) a fair and reasonable interpretation of the covenant of good faith and fair dealing; and 5) the application of equitable theories such as unjust enrichment.

1. The Need to Distinguish the Right to Compete from the Duty of Candor

In jurisdictions with statutes that go so far as to permit the waiver of fiduciary duties, it is critically important that courts carefully identify what specific contractual rights are contained in the operating agreement and what particular duties are being waived. In Ledford v. Smith the court confuses the right to compete with the duty of candor. The grant of a right to compete identifies the business activities in which the parties may engage. The grant of a right to compete does not inherently eliminate the duty of candor. The duty of candor refers to the duty to disclose relevant facts.

For example, in Ledford v. Smith, the Georgia Court of Appeals held that active

---

165. Id. at 446.
166. See supra Part II.B.
167. Id.
169. Id. at 636-38.
171. Ledford, 618 S.E.2d 627.
LLC members did not violate their fiduciary duties to the passive members when they failed to disclose that their exercise of a buy-out right was merely a step in a broader plan by a third party to purchase the entire LLC.\textsuperscript{172} The active members of the LLC exercised their contractual right to purchase the LLC interests of the passive members pursuant to a mandatory put and call provision. However, the active members failed to disclose to the passive members that the purchase price of the buy-out was being financed by a third party to whom all of the LLC assets were to be eventually sold.\textsuperscript{173} The third party had previously conducted negotiations to purchase the entire LLC directly from both the active and passive members, but one of the passive members refused the offer. The case arose under Georgia’s LLC statute which permits the member’s or manager’s duties and liabilities to be expanded, restricted, or eliminated provided that such provisions do not eliminate or limit liability for intentional misconduct or a knowing violation of law.\textsuperscript{174}

Under the particular facts of \textit{Ledford}, the result in favor of the defendants is supportable because the defendants did not obtain a disproportionate profit on the ultimate sale of the LLC assets to the third party. The plaintiffs were not financially harmed. They had signed a mandatory put and call agreement that required each side to agree \textit{unconditionally} to a forced sale or purchase of the others’ interests. Given these facts, the court’s result was correct. The mandatory nature of the buy-out made the financing of the buy-out irrelevant and thus, the duty of disclosing the financing nonexistent.

The court should have decided the case on the narrow ground that the disclosure of the financing was irrelevant because the buy-out was mandatory. Instead, the court broadly remarked upon the wide latitude given to modify the LLC agreement and to permit competition. The court perhaps incorrectly observed that the contractual right to compete clause eliminated any duty of disclosure.\textsuperscript{175} The situation in \textit{Ledford} was unusual, and the case should be distinguished from other fact patterns that do not involve mandatory, unconditional put and call provisions. Most importantly, the duty of candor and the right to compete should be recognized as presenting two separate issues.

In other cases that have upheld an investor’s right to compete, the defendant’s conduct has been candid. In \textit{McConnell v. Hunt Sports Enterprises},\textsuperscript{176} after three of six LLC members rejected the terms of a proposed lease for an arena, three of the six formed a new entity that ultimately accepted the lease terms and were awarded a hockey franchise.\textsuperscript{177} The defendants had conducted themselves in an honest and forthright manner and had been candid in their dealings with the LLC. The existence of a non-compete clause by no means dispenses with the implied covenant of good faith and fair dealing. Nor does it negate the duty of candor nor eliminate the duty to avoid express

\textsuperscript{172} Id. at 636-38.
\textsuperscript{173} See id. at 635-36. Under the LLC agreement, at any time either the active or the passive members could set a price and force a mandatory sale of their interests to the other group or could force a mandatory purchase of the interests of the other group (a so-called push-pull clause). Although there was some dispute as to the facts, a third party who had initially tried but failed to buy the entire LLC directly from all of the LLC members, eventually purchased the entire assets by first financing the active members’ mandatory purchase of the passive members’ interests and then purchasing the entire assets of the LLC.
\textsuperscript{174} GA. CODE ANN. § 14-11-305 (1994)
\textsuperscript{175} \textit{Ledford}, 618 S.E.2d at 635.
\textsuperscript{177} Id. at 1206-07.
material misrepresentations or material omissions.

2. Contractual Standards That Ensure the Enforcement of the Spirit of the Contract

As indicated in Part V, the recommended statutory approach is to prohibit the broad waiver of fiduciary duties as a means for establishing legally and ethically acceptable investor conduct. However, in a statutory environment that permits the elimination of duties, courts may use a variety of contractually-oriented strategies to ensure that the agreement between the parties is enforced, and that the performance of the contract is consistent with the spirit of the contractual relationship. Given the important policy interests served by the imposition of fiduciary duties, it may be argued that waivers of fiduciary duties should be specific, narrowly construed, and conspicuous. To be effective, the waiver of a duty of disclosure, for example, should specifically state that the duty of disclosure is eliminated in specifically designated types of transactions.

Also, in certain circumstances, evidence of oral LLC operating agreements may be appropriate. For example, in *Stoker v. Bellemeade, LLC*,\(^{178}\) the Georgia Court of Appeals held that the defendants had not breached their fiduciary duty when they failed to develop real property with the plaintiffs.\(^{179}\) The defendants successfully argued that the written operating agreement had granted them a right to compete and the plaintiffs had no right to participate in the development of additional parcels of land.\(^{180}\) However, in some circumstances it may be appropriate to allow the plaintiff to offer proof of an oral operating agreement. In *In re Tri-River Trading, LLC*,\(^{181}\) the court might have ruled for the plaintiff had it been appropriate to allow evidence of an oral LLC agreement between the parties requiring that the defendant corporation use the services of the LLC in question exclusively.\(^{182}\)

Courts may further protect reasonable expectations of honest and trustworthy investor conduct through a careful interpretation of standards of performance set in the contract, and also through the implied covenant of good faith and fair dealing. Recently, a Delaware Court rigorously interpreted the duty to conduct transactions on an arms-length basis and thereby allowed the plaintiff to obtain a temporary injunction. In *Flight Options International v. Flight Options, LLC*,\(^{183}\) the plaintiffs sought to enjoin the issuance of $5 billion units that would have had the effect of diluting the plaintiff’s interest in the company to a 1% interest.\(^{184}\) The court granted an interim 30 day injunction because the defendant’s process of valuing the LLC in question was too informal and did not comport with conduct that would be expected from an arm’s length standard.

3. Recognition That the Right to Privately Order LLC Relationships is Not a License to

---

179. *Id.* at 826-27.
180. *Id.*
182. See *id.* at 257 (involving an LLC that eventually went bankrupt after Jersey County Grain Company stopped using the LLC for its barge needs because the plaintiff had declined the sexual advances made by Jersey County Grain’s chief owner).
184. *Id.* at *2.
Applying Fiduciary Duties to LLC Managers

Exploit, Steal, Self-Deal, or Deceive

In all jurisdictions, even those permitting complete waivers of fiduciary duties, the law recognizes fundamental constraints on investor conduct. The right to privately order LLC relationships is not a license to exploit, steal, or lie. As noted in *Wartski v. Bedford*,185 in connection with exculpatory clauses, "exculpatory provisions of corporate articles create no license to steal."186 In navigating through the rapidly developing landscape of private ordering, it should be recognized that the grant of a right to compete does not relieve a manager of the duty to avoid self-dealing.187 Thus, where a defendant had purchased mobile homes and sold them to the LLC at a profit without disclosing details, the right to compete did not necessarily negate plaintiff’s fiduciary duty to account for profits.188 The duty to account or to disclose important material information is not eliminated by the grant of a right to compete. Along the same lines, the waiver of one fiduciary duty (or specific aspects of a fiduciary duty) does not waive all fiduciary duties in their entirety.

The fiduciary duty of loyalty and the implied covenant of good faith and fair dealing, for that matter, serve as the integrated centerpiece for contemporary alternative business entity relationships. The implied covenant of good faith and fair dealing is rooted in contractual law and presupposes honesty and fairness in the arm’s length business relationship. The duty of loyalty springs from the law of trusts and presupposes that one’s dealings will proceed in the best interests of the business entity. Both concepts are central to the preservation of trust and the protection of reasonable expectations of fairness in the marketplace. Accordingly, contractual waivers of the implied covenant of good faith and fair dealing are typically not allowed at all, and contractual waivers of the duty of loyalty, if permitted, should be narrowly construed.

A Texas district court has recently recognized that the contractual waiver of one aspect of the duty of loyalty should not be construed as the disavowal of all fiduciary duties. In *Kira v. All Star Maintenance*,189 the operating agreement disavowed the business opportunity rule.190 Plaintiff had alleged that the defendants had usurped management fees owed to the LLC and improperly used its assets. The court was careful to point out that the agreement merely disavowed the business opportunity rule and did not disavow all fiduciary duties under the law.191

4. Good Faith as an Implied Covenant to Ensure the Enforcement of Reasonable Expectations

The implied covenant of good faith is not a fiduciary duty and is arguably narrower in scope than a fiduciary duty. Nevertheless, the implied duty of good faith stands as a non-waivable pillar of contract law that ensures that reasonable expectations will be

186. Id. at 20.
190. See id. at *14-15.
191. See id.
enforced. It is designed to prevent trickery, deceit, or fraud. Ultimately, the implied covenant of good faith prevents one party from depriving the other of the fruits of the contract. It is a constraint that underlies every contractual relationship and is a fundamental tool that prevents parties from violating the spirit of the bargain.

As Vice Chancellor Strine stated in Abry Partners V, L.P. v. F & W Acquisition LLC in connection with the issue of whether an exculpation clause would be enforced:

[A] concern for commercial efficiency does not lead ineluctably to the conclusion that there ought to be no public policy limitations on the contractual exculpation of misrepresented facts. Even commentators who recognize that there are aspects of bargaining in which it is often expected that parties will lie—such as when agents refuse to disclose or misrepresent their principals’ reservation price—there is little support for the notion that it is efficient to exculpate parties when they lie about the material facts on which a contract is premised.

While the implied covenant of good faith should be interpreted as an elastic concept that cannot be given a precise definition, the covenant should be construed as clearly applying to instances of intentional fraud, deceit, trickery, or misrepresentation. For example, where the defendants had knowingly presented waterfall calculations that did not reflect the partnership books, the Delaware Chancery court held that the conduct would have breached the implied covenant of good faith if the conduct had not also breached a specific contractual obligation.

Also, it has been held that good faith duties of a member of an LLC include a duty of candor which encompasses a full and fair disclosure of all material facts relating to matters involving the LLC. Ultimately, while

192. See Mkt. St. Assocs. v. Frey, 941 F.2d 588, 597 (7th Cir. 1991) (indicating that if one party tried to trick the other party into turning down a financing request to trigger a bargain sales price, this would amount to a breach of the implied covenant of good faith and fair dealing).


194. 891 A.2d 1032 (Del. Ch. 2006).

195. See id. at 1062 (holding that if the buyer showed knowledge or intentional misrepresentations, then the exclusive remedy clause would be invalid as against public policy in a case involving plaintiffs who contended that various misrepresentations and non-disclosures resulted in it purchasing the company for a grossly inflated price).

196. See also Altman & Raju, supra note 13, at 1475 (listing types of bad faith recognized in court decisions).

197. See Pami-Lemb I Inc. v. EMBH-NHC, LLC, 857 A.2d 998 (Del. Ch. 2004) (involving a defendant who insisted that the plaintiff accept a dollar amount that was contrary to the buy-sell provisions in a contract and was contrary to the official books of the partnership and where the court observed that the defendants had acted in bad faith).

there may be a strong public policy interest in enforcing private contracts, there is an even stronger policy interest in promoting honesty and preventing deceit in commercial transactions. Thus, although a buy-sell agreement, exculpatory clauses, or other contractual provisions may be designed to achieve finality, they should not be enforced where conduct has been misleading such as where improper accounting methods have been used or where relevant financial information has been withheld.\textsuperscript{199}

Admittedly, the implied covenant of good faith and fair dealing connotes reasonable commercial standards rather than moral mandates. Unlike fiduciary duties, the implied covenant of good faith permits self-interested behavior. But it does not permit self-dealing.\textsuperscript{200} Some fundamental and mandatory constraints are essential to the effective functioning of a system that embraces the policy interest in contractual freedom.\textsuperscript{201} The implied covenant of good faith and fair dealing is such a constraint. It prevents the principle of freedom of contract from morphing into freedom to trick, confuse, deceive, or steal, and lays the foundation for a contractual playing field on which promises can be believed.

A culpable mental state may be implicated in the strongest of cases involving a breach of the implied covenant of good faith.\textsuperscript{202} However, there is authority for the view that objectively deceptive and misleading conduct also should be treated as a breach of the implied covenant of good faith in egregious cases. As the Delaware Chancery Court observed in \textit{Credit Lyonnais Bank}:

One need not psychoanalyze Mr. Parretti, however, to conclude that his actions sought to deprive Mr. Ladd of the power for which he and CLBN had contracted and did so to a material extent. To conclude that the covenant of

\begin{flushleft}

Oct. 11, 2006 (involving an assertion that the plaintiff creditor induced the LLC to execute a note for $467,500 of which only $125,000 was advanced and breached its good faith duties which include a duty of candor to the LLC members and the obligation of full and fair disclosure of material facts relating to matters affecting the LLC).

\textsuperscript{199} Compare \textit{Am. Anglian Envtl. Techs. L.P. v. Envtl. Mgmt. Corp.}, 412 F.3d 956, 962 (8th Cir. 2005) (enforcing a buy/sell agreement despite seller’s use of improper accounting and failure to disclose certain information) with \textit{Abry Partners V, L.P. v. F& W Acquisition LLC}, 891 A. 2d 1032, 1063-64 (Del. Ch. 2006) (indicating that if seller knew information was false or seller lied, the exculpation clause that limited seller’s liability to misrepresentations within the four corners of the document would be unenforceable in light of the strong public policy against fraud).

\textsuperscript{200} \textit{See} ROBERT A. HILLMAN, THE RICHNESS OF CONTRACT LAW 145 (1997) (discussing Braucher’s view that good faith performance excludes a variety of conduct that violates community standards of decency, fairness, or reasonableness).


Generally speaking, contracting parties are, to a large extent, entitled to act selfishly . . . But while contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract. Where one party’s actions are such as to deprive the other of a material aspect of the bargain for which he contracted, the first party will be found to have violated that elemental obligation of all contracting parties to deal with each other in good faith and to deal fairly with each other with respect to the subject matter of the contract.

\textit{Id.}

\textsuperscript{202} \textit{See} Altman & Raju, \textit{supra} note 13, at 1477 (noting that recent Delaware cases look to a culpable mental state for a violation of the implied covenant).
good faith and fair dealing has been breached, we need not conclude that the
breaching party actually intended to violate a contract right. “Subterfuges and
evasions violate the obligation of good faith in performance even though the
actor believes his conduct to be justified.” Restatement (Second) of Contracts §
205 (Comment d) (1981). The question is not whether Mr. Parretti believed that
his pushing, his threats and his lack of candor constituted evasions of his
contractual obligations under the CGA, the question is whether they objectively
were. 203

While the implied covenant of good faith if properly interpreted should curb
intentional misconduct of the gravest sort, its outer reaches are still evolving. Part V
suggests a statutory alternative to limit the degree to which fiduciary duties may be
waived.

V. THE LEGISLATIVE PROPOSALS: A BALANCED APPROACH TO FIDUCIARY DUTIES

In 2003 a Drafting Committee of the National Conference of Commissioners on
Uniform State Laws was formed to revise the Uniform Limited Liability Company
Act. 204 The initial Uniform Limited Liability Company Act had been enacted in 1994
and was drafted before the IRS adopted its “check-the-box” tax classification rules. 205
Changes in the tax environment and emerging case law prompted the Commissioners to
take a fresh look at LLC governance questions. The Chair and the Reporters felt strongly
that the Committee should not be tied to prior statutory approaches but rather should be
free to consider all available options in light of case law and empirical data that had
emerged over the last decade.

A traditional partnership approach to fiduciary duties arguably requires a greater
degree of judicial scrutiny than the corporate formulation of duties. Traditionally,
partners have owed “[n]ot honesty alone, but the punctilio of an honor the most sensitive
. . . .” 206 ULLCA I departed substantially from this traditional approach. 207 Under
ULLCA I, the “only” duties owed include the duty to account for certain items, the duty
to refrain from dealing adversely, and the duty to refrain from competing. 208 Faced with
numerous cases involving dishonest, furtive, and/or abusive LLC member and/or
manager conduct, the ULLCA II Committee had to decide whether it should revert in part
or in whole to a more traditional formulation of fiduciary duties.

While the drafting project was underway, the Delaware judiciary had taken a
proactive posture that emphasized that fiduciary duties may not be eliminated. In
response to these cases, the Delaware legislature amended its LLC statute to permit not
only the modification of fiduciary duties, but also the elimination of fiduciary duties. The revised law leaves only the implied covenant of good faith and fair dealing as a mandatory feature that may not be contractually eliminated.209

Thus, the ULLCA II Committee was faced with the question of whether to follow Delaware’s lead in sharply restricting the judicial arsenal of weapons historically used to curb abusive conduct in matters of entity governance. Some members of the Committee felt strongly that the Delaware lead should be followed. Others suggested that a stronger mandatory approach should be applied to governance standards in light of epic-scale corporate scandals.210

A. The Policy Debate Unfolds as the Uniform Limited Liability Company Act is Revised

The policy debate that initially stirred the NCCUSL Committee in 1990 and the RUPA debate before that has been re-ignited by the NCCUSL Committee that drafted the revisions to the Uniform Limited Liability Company Act. At several meetings and in informal discussions, debates focused upon the degree to which investors should be allowed to waive all fiduciary duties. Initially, ULLCA II declined to follow the Delaware approach. However, the final version of ULLCA II permits the operating agreement to eliminate the duty to account, to refrain from dealing with the company as or on behalf of party having an adverse interest, and to refrain from competing with the company.

It also permits the operating agreement to alter any other fiduciary duty.


(d) If not manifestly unreasonable, the operating agreement may:
including eliminating particular aspects of other duties.212

Meanwhile in May 2006, the American Bar Association Committee on Partnerships and Unincorporated Business Organizations resumed its independent work on revising the fiduciary duty provisions of the American Bar Association’s Prototype LLC statute. While the Task Force’s work is still in progress, it appears likely that the ABA Prototype will follow Delaware’s approach of permitting the complete elimination of fiduciary duties.

Thus, although a significant number of states now prevent the elimination of fiduciary duties, the legal community is likely to be presented with three heavily contractarian options for fiduciary waivers from Delaware, NCCUSL, and the ABA. This Article argues that a more moderate paradigm, which I loosely describe as the Mandatory Core approach, is appropriate.

B. The Mandatory Core Approach Recommended

ULLCA II codifies default statutory fiduciary duties as consisting of the duty to account, the duty to refrain from dealing with the LLC as or on behalf of a party having an adverse interest, and the duty to refrain from competing with the LLC. These duties are not exhaustive or exclusive. Thus, the default duties have been “un-cabined.” In earlier versions of ULLCA II, section 110 provided that the operating agreement may not eliminate the duty of loyalty but could identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.213 This approach is

(1) eliminate the duty:

(A) to account, as required in Section 409(b)(1) and (g), to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company’s business, from a use by the member of the company’s property, or from the appropriation of a limited liability company opportunity;

(B) to refrain, as required in Section 409(b)(2) and (g), from dealing with the company in the conduct or winding up of the company’s business as or on behalf of a party having an interest adverse to the company; and

(C) to refrain, as required by Section 409(b)(3) and (g), from competing with the company in the conduct of the company’s business before the dissolution of the company.

(2) identify specific types or categories of activities that do not violate the duty of loyalty;

(3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;

(4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and

(5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under 409(d);

(e) The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.

Id.


213. Id. § 10: Operating Agreement.
similar to the moderate path taken by many states which permits the modification of fiduciary duties but not the complete elimination of duties.  

Nevertheless, in the final version of ULLCA II, the business planners on the Committee sought increased contractual freedom. The final version of section 110 of ULLCA II now provides that if not manifestly unreasonable, the operating agreement

(d) Notwithstanding subsection (c)(4):

(1) If not manifestly unreasonable, the operating agreement may:

(A) eliminate particular aspects of the duty of loyalty, including the duty to:
   (i) refrain from competing with the limited liability company in the conduct of the limited liability company’s business before the dissolution of the limited liability company; and
   (ii) account to the limited liability company and to hold as trustee for it a limited liability company opportunity; and

(B) identify specific types or categories of activities that do not violate the duty of loyalty;

(C) change the duty of care;

(D) change any other fiduciary duty, including by eliminating particular aspects of the duty;

(4) the operating agreement may provide indemnification for a member or manager and may eliminate a member or manager’s liability to the limited liability company and members for money damages, except for:

(A) breach of the duty of loyalty;

(B) a financial benefit received by the member or manager to which the member or manager is not entitled;

(C) a breach of a duty under Section 406;

(D) intentional infliction of harm on the limited liability company or a member; or

(E) an intentional violation of criminal law.

(e) The court shall decide any claim under subsection (d)(1) that a provision of an operating agreement is manifestly unreasonable. The court:

(1) shall make its determination as of the time the provision as challenged became part of the operating agreement and by considering only circumstances existing at that time; and

(2) may invalidate the provision only if, in light of the purposes and activities of the limited liability company, it is readily apparent that:

(A) the objective of the provision is unreasonable; or

(B) the provision is an unreasonable means to achieve the provision’s objective.

Id.

214. See infra APPENDIX A for selected states with statutes containing limitations upon waivers of liability. For more detailed treatment, see BISHOP & KLEINBERGER, supra note 35, at 10-44 to 10-47 (Supp. 2005) (citing several LLC statutes that do not permit the limitation of damages for certain types of duty violations, including IOWA CODE ANN. § 490A.707(1) (West 2005) (prohibiting the elimination of liability for financial benefits received and not entitled to, intentional harm to LLC or members, violations involving distributions, and violations of criminal law); IND. CODE ANN. § 23-18-4-2 (West 2006) (allowing the elimination or limitation of liability for actions or failures to act but not if willful misconduct or recklessness); MINN. STAT. ANN. § 322B.663, subd. 4 (West 2005) (providing that the articles may not eliminate liability for breach of the duty of loyalty, acts or omissions not in good faith, or for transactions from which improper personal benefits were derived); see also N.D. CENT. CODE § 10-32-86(5) (2005).
may restrict or eliminate the duty to account, to refrain from competing with the company as or on behalf of a party having an adverse interest to the company, and to refrain from competing with the company. This provision is similar, although not identical to Delaware’s contractarian approach. Delaware’s LLC statute does not define fiduciary duties, thus leaving them to the common law, and indicates that duties may be expanded, restricted, or eliminated by the limited liability operating agreement, provided that the agreement does not eliminate the contractual covenant of good faith and fair dealing.

ULLCA II’s final indemnification provisions are more moderate than Delaware’s LLC indemnification provisions, however. Unlike Delaware’s corporate indemnification provision, Delaware’s LLC indemnification provision provides no statutory limits on the types of conduct for which the LLC may indemnify the member or manager.


(d) if not manifestly unreasonable, the operating agreement may:

(1) restrict or eliminate the duty:

(A) as required in Section 409(b)(1) and (g), to account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company’s business, from a use by the member of the company’s property, or from the appropriation of a limited liability company opportunity;

(B) as required in Section 409(b)(2) and (g), to refrain from dealing with the company in the conduct or winding up of the company’s business as or on behalf of a party having an interest adverse to the company; and

(C) as required by Section 409(b)(3) and (g), to refrain from competing with the company in the conduct of the company’s business before the dissolution of the company.

Id.


(a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(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.

(c) To 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, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

Id.

217. See id. at § 18-1101(c).


219. Compare Del. Code Ann. tit. 8, § 102(b)(7) (2006) (providing that a corporation may eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages but shall not eliminate or limit liability for any breach of the duty of loyalty, for acts or omissions not in good faith or which
eliminating or limiting a member’s or manager’s liability for money damages for five categories of conduct including: 1) breach of a duty of loyalty; 2) receipt of an improper financial benefit; 3) receipt of improper distributions; 4) intentional infliction of harm on the company or on a member; and 5) intentional violation of criminal law. \[220\] ULLCA II’s limitation on indemnification is very much in line with similar provisions across the country.

The NCCUSL Drafting Committee debated fiduciary duty provisions up through its final meeting. Some members from the ABA argued that many clients enter into highly negotiated business arrangements and require complete contractual freedom to define the contours of their duties and responsibilities. Others sought statutory protection for less sophisticated investors without the benefit of highly-paid legal counsel. The provisions finally agreed to were a compromise.

The Mandatory Core approach to fiduciary duties recommended supports the approach taken in earlier versions of ULLCA II that prohibited the complete contractual elimination of duties. The paradigm suggested would permit considerable contractual modification of duties, but would do so against the backdrop of well-developed common law standards that presuppose a general duty of loyalty. Such an approach, which I have termed the Mandatory Core paradigm, makes sense theoretically and serves both policy interests in support of contractual freedom and policy interests that justify mandatory constraints.

Ultimately, this thesis would support the widespread enactment of ULLCA II, but recommend that states modify the wording of section 110 to comply with one of its earlier versions. One such version prohibits the elimination of the duty of loyalty, but permits the operating agreement to identify specific types or categories of activities that do not violate the duty of loyalty. \[221\] Another earlier version that is slightly more permissive, allows the operating agreement to eliminate particular aspects of specific duties, but does not permit the complete elimination of the duty of loyalty. \[222\] Either of involve intentional misconduct or a knowing violation of law, for certain violations under section 174, and for transactions from which the director derived an improper personal benefit) with DEL. CODE ANN. tit. 6, § 18-108 (2006) (providing that, subject to standards and restrictions, if any, in the operating agreement, a limited liability company may indemnify any member or manager or other person from and against any and all claims and demands whatsoever).

220. See REVISED UNIFORM LIMITED LIABILITY COMPANY ACT, FINAL TEXT WITH PROVISIONAL PREFATORY NOTE AND COMMENTS § 110(g), http://www.law.upenn.edu/bll/ullca/2006october_finaltextandcomments.htm (last visited Nov. 22, 2006).

221. See National Conference of Commissioners on Uniform State Laws ULLCA Drafting Committee, Alternative to Sections 110, 409 and 410 of the 2004 Annual Meeting Draft § 110(g), available at http://www.law.upenn.edu/bll/ullca/ULLCA_Alternatives_061804-1.htm (last visited Feb. 15, 2007) (stating that “an operating agreement may not . . . (5) eliminate the duty of loyalty under Section 409(b), but: (i) the operating agreement may identify specific types of categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable . . .”).


(d) Notwithstanding subsection (c)(4):

(1) if not manifestly unreasonable, the operating agreement may:

(A) eliminate particular aspects of the duty of loyalty, including the duty to:
these provisions would be more desirable than the final version of section 110, which permits the agreement to eliminate the specified duties.

As discussed below, a statute that permits the complete contractual elimination of fiduciary duties is out of step with mainstream business norms, fails to effectively convey the mandatory nature of one’s obligations to the LLC, and is contrary to every investor’s reasonable expectations of acceptable business conduct. Litigation revealing a wide range of abusive conduct illustrates the need for the mandatory muscle provided by an intermediate, moderate approach to private contracting. A mandatory minimum level of fiduciary duty sends a statutory message signaling that trustworthy behavior is required. The contractual covenant of good faith and fair dealing may fail to provide a sufficiently strong behavioral signal and may not produce the appropriate remedy.\textsuperscript{223} Empirical research reveals a need to serve a broad spectrum of LLC investors, including those without highly negotiated LLC agreements. Well-developed statutory default rules are arguably needed to guide investors without LLC agreements and to assist courts in providing some degree of certainty and predictability in judicial outcomes.

\section*{C. Theoretical Justification for the Mandatory Core Theory: Promoting and Reflecting Positive Social Norms}

The theoretical approaches taken to the study of fiduciary duties by the traditionalists, the contractarians, the social norm advocates, the game theorists, and the empirical researchers, each have some merit.\textsuperscript{224} The traditionalists find support from \textit{Salmon v. Meinhard},\textsuperscript{225} in which Justice Cardozo wrote that “[j]oint adventurers, like copartners, owe to one another... the duty of the finest loyalty ... Not honesty alone, but the punctilio of an honor the most sensitive.”\textsuperscript{226} The trail of opportunistic behavior created by the past decade of LLC litigation illustrates a need for increased business ethics training and the development of social norms within the business community that foster responsible business behavior.\textsuperscript{227} At the same time, the need for certainty in the

\begin{itemize}
\item[(i)] refrain from competing with the limited liability company in the conduct of the limited liability company’s business before the dissolution of the limited liability company; and
\item[(ii)] to account to the limited liability company and to hold as trustee for it a limited liability company opportunity; and
\item[(B)] identify specific types or categories of activities that do not violate the duty of loyalty;
\item[(C)] change the duty of care;
\item[(D)] change any other fiduciary duty, including by eliminating particular aspects of the duty;
\end{itemize}

\textit{Id.}

\textsuperscript{223} See infra Part IV.D.

\textsuperscript{224} See supra Part II.C.

\textsuperscript{225} Salmon v. Meinhard, 164 N.E. 545 (N.Y. 1928); see also APPENDIX C.

\textsuperscript{226} Meinhard v. Salmon, 164 N.E. 545, at 546 (N.Y. 1928).

\textsuperscript{227} See Huang, supra note 98, at 1060 (citing Robert E. Scott, \textit{The Limits of Behavioral Theories of Law and Social Norms}, 86 Va. L. Rev. 1603, 1604 (2000)) (discussing guilt and law); see also Amitai Etzioni, \textit{When It Comes to Ethics, B-Schools Get an F}, WASH. POST, Aug. 4, 2002, at B4 (arguing for increased business ethics training in business schools); Robert Prentice, \textit{An Ethics Lesson for Business Schools}, N.Y. TIMES, Aug. 20, 2002, at A2 (arguing that business schools should refocus on teaching compliance with legal, rather than ethical, norms to create a more responsible business environment).
Applying Fiduciary Duties to LLC Managers

law and the desirability for control of one’s legal liability, flexibility in management structure, and freedom to compete are important policy interests that are embraced by the contractarian approach. Additionally, empirical studies about the contractual playing field are helpful in portraying what we can expect from the private contracting process, and what we can expect to be missing in the process.

The Mandatory Core approach recommended imposes mandatory minimum fiduciary duties but allows some private contracting to permit some exceptions to the normal rules prohibiting self-interested behavior. Under this model, the social context dictates the reasonable expectations of the parties. Reasonable expectations of trustworthiness are conveyed. The social context of the LLC will signal the degree of trustworthiness that the situation demands. The model recognizes the powerful and interdependent role played by the law and by social norms.228 Also, it takes into account situational factors that can affect business behavior.

The Mandatory Core model builds upon the previously discussed theories advanced by Blair and Stout, and to some extent, by Dean Allan Vestal and J. William Callison, who have advanced a structural model for crafting fiduciary duties.229 Under Vestal’s and Callison’s model, the duty of care depends upon the allocation of power among participants and the legitimate expectations of participants.230 However, the Vestal and Callison model does not incorporate mandatory minimum statutory default duties. Professors Young-dahl Song and Tinsley E. Yarbrough have also advanced a model in connection with their study of Tax Ethics and Taxpayer Attitudes.231 One advantage of using the Mandatory Core model is that it offers a theoretical framework for developing future empirical research concerning LLC member/manager conduct. Also, the model strikes a balance between advocates of both the traditional and contractarian schools of thought.

The Mandatory Core approach will not satisfy the extreme traditionalists or the extreme contractarians. However, it is consistent with the furtherance of social good that traditionalists seek from fiduciary duties, and offers a considerable measure of flexibility sought by contractarians.232 Most importantly, the Mandatory Core approach emphasizes the importance of a social context that reinforces investor expectations of trust. From Blair’s perspective, the Mandatory Core approach conveys a critical social cue that trustworthy behavior is expected. From the standpoint of game theorists, the moral stench of a breach of fiduciary duty is retained to some extent by the presupposition of a mandatory dimension of minimum duties. The pay-off for misbehavior is reduced by the possibility of punishment and guilt derived from violating the law.233 From the point of view of the empiricist, the retention of minimum mandatory duties recognizes that

228. Social norms are the behavioral standards embraced by the community in question. See Posner, supra note 97, at 34 (“Social norms describe the behavioral regularities that occur in equilibrium when people use signals to show that they belong to the good type. Social norms are thus endogenous: they do not cause behavior, but are the labels that we attach to behavior that results from other factors.”).

229. See supra Part II.C; Callison & Vestal, supra note 121; Callison, supra note 14.


233. See Huang, supra note 98, at 1059.
mandatory constraints are necessary in light of the skewed contractual playing field in which controlling and minority LLC members may not be equally well-represented by legal counsel.

The Mandatory Core approach recognizes that the context may vary and lays the foundation for future empirical studies to be done that focus on situational factors and their impact on LLC manager behavior. The approach suggested recognizes the important role that the law plays in both promoting and reflecting positive business ethics. Also, it creates a framework for fostering the role of the attorney/business planner as a major link between social norms and legal requirements. Finally, it sheds the paternalistic overtones that some practitioners and scholars find objectionable.234 Also, it halts to some extent, what some have criticized as “galloping Meinhardism” —the continuing extension of heightened, expansive, judicially-imposed fiduciary duties.235

D. Litigation Over the Last Decade Illustrates the Necessity of Mandatory Minimum Standards

The multitude of litigation discussed in Part IV underscores the need for judicial oversight to enforce mandatory minimum standards of conduct while recognizing the contractual context in which these standards co-exist. A legal environment that prohibits the complete elimination of fiduciary duties arguably strikes the best balance between the need to police opportunistic behavior and the desire for contractual freedom.

E. The Implied Covenant of Good Faith May Not Effectively Substitute the Fiduciary Duty of Loyalty

There are at least four major reasons why the duty of good faith and fair dealing may not provide a sufficient legislative check on opportunistic and abusive conduct in the context of the LLC. First, the duty of good faith is arguably a contractual constraint limited only to the manner in which the contract is performed.236 Second, under some interpretations, some may take the view that the duty of good faith and fair dealing does not encompass a duty of disclosure or candor.237 Third, the breach of the duty of good faith might not produce appropriate remedies in the context of the LLC.238 Finally, fiduciary duties more vigorously convey the social cue that loyal and trustworthy

234. See Dennis J. Callahan, supra note 91, at 284-85 (tracing fiduciary duties to the Church’s communal values and arguing that the shift from Cardozo’s traditional fiduciary duty formulation to the contractual-oriented approach taken in the Revised Uniform Partnership Act reflects a positive shift from costly and confusing jurisprudence).


237. See Vestal, supra note 87, at 548-50 (arguing that the duty of good faith may be narrow in scope and may not apply to collateral transactions included within the scope of the common law disclosure requirement); see also Mkt. St. Assocs. v. Frey, 941 F.2d 588, 594 (7th Cir. 1991) (“The . . . duty of good faith even expansively conceived, is not a duty of candor.”).

238. See Kleinberger, supra note 236, at 6-8.
behavior is appropriate than the implied covenant of good faith and fair dealing.\textsuperscript{239}

The duty of good faith and fair dealing may be implied from the contract. Also, the duty of good faith and fair dealing has been codified in the Uniform Commercial Code, the Revised Uniform Partnership Act, the Uniform Limited Partnership Act (2001), and in the initial Uniform Limited Liability Company Act. As the comment to RUPA section 404 provides:

The obligation of good faith and fair dealing is a contract concept, imposed on the partners because of the consensual nature of a partnership. It is not characterized, in RUPA, as a fiduciary duty arising out of the partners’ special relationship. Nor is it a separate and independent obligation. It is an ancillary obligation that applies whenever a partner discharges a duty or exercises a right under the partnership agreement or Act.\textsuperscript{240}

As Professor Daniel S. Kleinberger has observed, the obligation of good faith is “subservient to the contractual arrangements. Its function is to allow the contract to mean what it says; it is therefore of no use to police misconduct that is outside the contract.”\textsuperscript{241}

A relationship between an LLC member and/or manager and the LLC is infinitely more complex than a single contract for a specific transaction. Empirical research and case law suggest that some LLCs may not have written operating agreements and in some cases the operating agreement may be gleaned only from the course of dealing as reflected by the parties’ conduct. The contractual duty of good faith and fair dealing is not well-suited to addressing the relational contract that unfolds when LLC members conduct a business enterprise over time.

In contrast to the requirement of good faith, the fiduciary duty applies to the parties’ relationship rather than just to a discrete transaction. As explained by Professor Tamar Frankel, the fiduciary duty arises when one party, the entrustor, is dependent upon the other party.\textsuperscript{242} In the context of the LLC, fiduciary duties present a legal response to the potential abuse of power inherent in the relationship between the LLC and its members if member-managed, or between the LLC and the manager if manager-managed.\textsuperscript{243} Professor Ribstein has argued that the fiduciary duty should apply only in LLCs in which there is a manager who is managing the entity for the benefit of passive LLC investors.\textsuperscript{244} However, considerable case law involves not only abuses in firms with passive investors but also squeeze-outs in firms with one or more active minority shareholders or LLC minority members.\textsuperscript{245}

\begin{thebibliography}{99}
\bibitem{239} See Vestal, supra note 87, at 548-50.
\bibitem{240} See RUPA § 404 cmt. (1997) (citation omitted).
\bibitem{241} See Kleinberger, supra note 236, at 4.
\bibitem{242} Tamar Frankel, Fiduciary Law, 71 CAL. L. REV. 795, 808 (1983) (analyzing the components of the fiduciary duty).
\bibitem{243} See id., at 809 (indicating that the central problem in fiduciary relations is that the possession of power by the fiduciary leaves the entrustor vulnerable to the abuse of power by the fiduciary).
\bibitem{244} Larry E. Ribstein, Are Partners Fiduciaries?, 2005 U. ILL. L. REV. 209, 210-12 (arguing that partners do not delegate open-ended control to their co-partners and that this is done only in the limited partnership context).
\end{thebibliography}
A further problem with replacing the duty of loyalty with the implied covenant of
good faith and fair dealing concerns remedies. Professor Kleinberger has also pointed
out that a breach of a fiduciary duty allows the plaintiff to seek a disgorgement. In
contrast, a suit for a breach of contract requires the proof of damages and remedies tied to
the expectation interest, reliance, or restitution.

The breach of the duty of good faith alone, without a duty of loyalty and a duty of
candor, might not extend to instances that traditionally have been associated with a duty
of candor. In 1993, Dean Allan Vestal predicted that the outcome of a case like
Johnson v. Peckman would be reversed with only a duty of good faith for protection. There, one partner bought out the other one-half partner’s interest in an oil and gas partnership for $1,500 and resold the partnership’s assets for $10,500 without telling his partner about the planned resale. Fortunately, the plaintiff was able to recover based on the common law duty to disclose when one partner buys a partnership interest from another. Professor Vestal’s view has been expressed by Justice Posner who explained that the “. . . duty of honesty, of good faith even expansively conceived, is not a duty of candor.”

A disturbing recent case under Missouri’s LLC law underscores the need for a duty of
candor that cannot be completely waived in an operating agreement. In American Anglian Environmental Technologies v. Environmental Management Corporation, the plaintiffs were buyers who had exercised a so-call push-pull clause. Under this arrangement between the plaintiff and the defendant, each 50% member of the LLC had a right to make an unconditional offer/acceptance at a price it chose, forcing the other party to either buy the offeror’s entire interest, or sell the offeree’s entire interest. The plaintiffs made an unconditional offer to sell its half of the LLC for $4,231,630.00 based on a total estimated value of $8.5 million.

Plaintiffs ultimately realized that the defendants had improperly distributed $500,000 cash, with half going to the plaintiff and half going to the defendant. It learned that the defendants had not used generally accepted accounting principles, thus causing accounting discrepancies and reducing the LLC’s total value by $713,000.

246. See Kleinberger, supra note 236, at 7-8.
247. See RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981) (indicating that the injured party has a right to damages based on his expectation interest plus any other loss including incidental or consequential loss caused by the breach less the cost or loss avoided by not having to perform). But see Cable & Computer Tech., Inc. v. Lockheed Sanders, Inc. 214 F.3d 1030, 1039 (9th Cir. 2000) (involving plaintiff’s entitlement to disgorgement of a subsidiary’s profits where the defendant used plaintiff’s confidential information to secure a winning bid).
248. See Vestal, supra note 87, at 564-65.
249. Johnson v. Peckham, 120 S.W.2d 786 (Tex. 1939).
250. See Vestal, supra note 87, at 564-65.
251. Id.
252. Mkt. St. Assocs. v. Frey, 941 F.2d 588 (Wis. App. 1991) (reversing a summary judgment for the defendants where one party failed to inform the other of a contractual provision that would have entitled the repurchase of property for less than its fair market value upon the denial of a request for financing).
254. Id. at 957-58.
255. Id.
256. Id.
257. Id.
Applying Fiduciary Duties to LLC Managers

Unfortunately, the Eighth Circuit Court of Appeals affirmed the District court’s grant of summary judgment in favor of the defendants as to the accounting discrepancies claimed by the plaintiffs.\(^{258}\) The Court of Appeals based its decision on the principle of giving maximum effect to the principle of freedom of contract.\(^{259}\) The court saw itself as properly enforcing the buy-sell agreement, which was intended to achieve finality, expeditiousness, fairness and continuity.\(^{260}\) The opinion underscores the need for a duty of candor that cannot be completely eliminated and a sufficiently broad interpretation of the covenant of good faith and fair dealing to prevent the type of furtive and dishonest conduct involved in the *American Anglian* case.

Even if the ability to eliminate all fiduciary duties by itself does not invite misconduct and encourage aggressive business practices, it might do so when coupled with a contractual clause permitting competition with the LLC or with other members and a contractual grant of discretionary rights to the manager. One practitioner recently proposed the following discretionary clause to insulate clients from suits for breach of fiduciary duty and breach of the implied covenant of good faith and fair dealing:

> Notwithstanding any other provision of this Agreement or otherwise applicable provision of law or equity, whenever in this Agreement, the General Partner is permitted or required to make a decision in its “sole discretion” or “discretion” or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires, including its own interests, and shall, to the fullest extent permitted by applicable law, have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership or the Limited Partner’s.\(^{261}\)

The practitioner argued that since the purpose of the implied covenant is to enforce the reasonable expectations of the parties, such language would be inconsistent with a requirement that the parties exercise their discretion “reasonably.”\(^{262}\)

At some point, the cumulative effect of permitting the lowering of investor expectations through the combined use of the anti-compete clause, the fiduciary duty waiver, and the sole discretion provision may create a jungle—a business environment characterized by sharp business practices and aggressive conduct. If narrowly interpreted, the implied covenant of good faith and fair dealing will not be nearly as effective in defeating aggressive contractual interpretations as traditional notions of fiduciary duty. For instance, in *Cincinnati SMSA v. Cincinnati Bell Cellular Systems*,\(^{263}\) a Delaware limited partnership was organized to provide cellular service to Cincinnati, Columbus, and Dayton. At the time, the FCC issued two types of licenses in each district, one to wireline telephone companies and the other to non-telephone companies. The partnership agreement prohibited limited partners from directly or indirectly providing cellular service, defining cellular service in accordance with the cellular service that was then

---

259. Id.
260. Id.
262. See id.
The Supreme Court of Delaware refused to use the implied covenant of good faith and fair dealing to enjoin one of the limited partners from competing with the partnership when the limited partner engaged in a newly-developed cellular service that used slightly different radio bandwidths than the cellular service in existence at the time of contracting and specified in the anti-compete clause. The court stressed the narrow scope of the covenant of good faith, and indicated that Delaware Supreme Court jurisprudence is developing along the general approach that implying obligations based on the covenant of good faith and fair dealing is a “cautious enterprise.” It may be argued that the plaintiff should have exercised greater foresight and care in defining the cellular service subject to the anti-compete clause. Nevertheless, the court’s narrow interpretation of the implied covenant of good faith and fair dealing may have had the effect of largely denying plaintiff the benefit of the bargain.

A broader view of the implied covenant of good faith and fair dealing might have prohibited the type of aggressive contractual interpretation permitted in the Cincinnati case. For example, in Kira, Inc. v. All Star Maintenance, All Star Maintenance, the LLC, provided maintenance services to privatized military housing. The plaintiff, a minority owner in All Star, sued two majority owners for a breach of fiduciary duty when the two majority owners formed another entity that competed with All Star and allegedly usurped $1.2 million in All Star’s management fees. The Texas District Court refused to render a summary judgment on behalf of the defendants even though the members had expressly waived claims arising as the result of a competitive activity. The court observed that the implied covenant of good faith and fair dealing would be breached by a party who performs a contract “in a manner that is unfaithful to the purpose of the contract and justified expectations of the other party are thus denied.”

Thus, whether both parties are sophisticated, as in Cincinnati SMSA, or stand on unequal footing, as in Kira, a narrow interpretation of the implied covenant of good faith and fair dealing may have the effect of frustrating reasonable expectations that are central to the purpose of the contract. While business planners do not want courts to renegotiate their contracts, they do look to the judiciary to protect and enforce the benefits of the negotiated bargain. The benefit of the bargain can indeed be lost as the result of aggressive contractual interpretations, overly broad interpretations of waivers, and inappropriately narrow and literal interpretations of the contract.

F. A Balanced Statutory Framework in Light of Imperfections and Inequalities in the Contracting Process, and Courts that May Lack Business Expertise

As discussed in Part II, empirical research suggests that LLC legislation needs to serve investors who may not have operating agreements or whose operating agreements

---

264. Id. at 991.
265. Id. at 991-94.
266. See id. at 992.
268. Id. at *1-2.
269. See id. at *14.
270. See id. (quoting Hilton Hotels Corp. v. Butch Lewis Prods., 808 P.2d 919, 923 (Nev. 1991)).
271. See Kleinberger, supra note 142.
may not adequately address fiduciary duties. The contractarian approach looks to the contract to restrain abusive conduct and relies upon courts to enforce the contract with little or no statutory guidance. However, a well-developed statutory framework outlining minimum levels of default duties is needed in an environment in which not all LLCs have LLC agreements, and not all investors have well-negotiated contractual protection. The purely contractarian approach may work well in Delaware cases involving highly-skilled attorneys representing affluent clients with highly negotiated LLC agreements in expert Delaware courts. However, empirical evidence and practical litigation experience suggests that many LLCs may not have operating agreements. The contractual playing field for controlling and minority investors may not be equal. Contractual protections may be imperfect or non-existent. Attorneys outside of Delaware may not be experts on fiduciary duties and courts may not be highly specialized in business litigation.

As previously discussed, widespread usage of simple no-frills LLC agreements (85%), frequent formation of LLCs without an operating agreement (40%), and low rates of continuing legal education outside of Delaware regarding fiduciary duties (19%) have been documented in empirical studies. A low rate of familiarity with default statutory buy-out rules has been reported in at least one state. Under these circumstances, LLC legislation should not presume that the typical LLC investor will retain a highly-compensated attorney who is an expert in fiduciary duties to analyze the impact of a contractual waiver embedded in an LLC agreement drafted by the LLC managers or controlling members. Given the imperfect nature of the contractual playing field and the inexpert training of many attorneys and courts throughout the country, a well-developed statutory framework is needed to establish mandatory minimum fiduciary duties.

G. An Express Statutory Duty of Loyalty and Standard of Care is Needed to Guide Courts

Because LLC legislation is commonly understood to uphold and defer to the contract between the parties, the absence of a statutory duty of loyalty and a statutory standard of care may give the erroneous message that common law fiduciary duties growing out of long years of experience were meant to be completely eliminated. Common law fiduciary duties provide fundamental protections that most investors reasonably expect courts to enforce in order to ensure fair play. If the LLC statute leaves

272. See supra Part II.
273. For a discussion of recent rates of LLC filings, see Howard M. Friedman, The Silent LLC Revolution—The Social Cost of Academic Neglect, 38 CREIGHTON L. REV. 35, 36-40 (2004) (drawing from 2003 data on the number of business filings made annually in each state based on a study by the International Association of Commercial Administrators and showing that Delaware, Kentucky, and Montana were among the 29 states in which LLC filings exceeded corporation filings, Colorado and Minnesota were among the 16 states in which LLCs were popular but not predominant, and New York was among the six states in which incorporation filings were double the LLC filings).
274. See supra Part IV.
275. See Miller, supra note 104, at 393 (finding that “56% of Pennsylvania practitioners incorrectly replied ‘No’ when asked whether the LLC member would be entitled to a buy-out upon dissociation prior to the winding up of the company”).
out fiduciary duties and expressly exalts contractual freedom, some courts may mistakenly believe that all fiduciary duties have been eliminated. In *Gottsacker v. Monnier*, for example, concurring Justice Patience Drake Roggensack recently stated in a Wisconsin Supreme Court case:

The rights and obligations of a limited liability company to its members, of the members to the limited liability company and to each other are set by ch. 183. Common law concepts such as the fiduciary duty of a majority shareholder of a corporation to a minority shareholder are replaced by statutory obligations. Those rights and obligations may be adjusted through contract generically known as an operating agreement. . . . The court of appeals improperly engrafted a common law fiduciary duty on Julie and Paul’s status as members. Members’ obligations are set by statute.

This is not the only time a judge has misunderstood the continuing relevance of fiduciary duties in the context of the LLC. Even though the Alabama LLC statute states that the operating agreement may not eliminate the duty of loyalty, an Alabama trial court reached the erroneous conclusion that the defendant owed no fiduciary duties because the operating agreement did not contain an express articulation of fiduciary duties.

The Mandatory Core approach provides the best of both worlds. It can offer much-needed guidance to courts that may lack expertise pertaining to fiduciary duties in the context of unincorporated entities. It offers practitioners a considerable degree of freedom to privately alter some duties. At the same time, it does not simultaneously strip courts of the judicial tools that reflect the wisdom gathered through years of resolving disputes among business owners.

**H. Leaving Room for Contractual Modification Demanded by the Marketplace**

The popularity of the LLC has been explosive. Empirical research shows that in some states the number of corporations formed is declining while the number of LLCs formed is rising. The LLC is attractive not only because it provides limited liability and flow-through taxation, but also because the majority of LLC statutes permit flexibility in management structure and allow the parties to contractually define their business deal. The marketplace is demanding tolerance for contractual innovations and seeks: 1) flexibility in the structuring of corporate governance; 2) a viable means of effectively achieving some measure of control over legal liability; 3) room to compete in the marketplace.

---

276. *Gottsacker v. Monnier*, 697 N.W.2d 436, 438 (Wis. 2005) (involving an LLC owned 25% by the plaintiff, 25% by the plaintiff’s brother, and 50% by an unrelated party in which the plaintiff’s brother, together with the 50% owner, transferred the LLC’s warehouse to another newly-formed LLC for $510,000, the same amount as the original purchase price of the warehouse, where the new LLC was owned 40% by the plaintiff’s brother and 60% by the unrelated third party and then sent plaintiff a check for $22,000 which was meant to represent the plaintiff’s 25% interest in the previously owned LLC’s warehouse).

277. *Id.* at 447 (citations omitted).

278. *See id.* n.3.

279. *See Harbison v. Strickland*, 900 So. 2d 385 (Ala. 2004) (involving plaintiff, an 83% owner of an LLC established by her parents, who initiated a suit against her mother for transferring three pieces of LLC property to plaintiff’s brother allegedly for less than fair market value, where the Alabama Supreme Court held that the court erred in failing to look beyond the four corners of the LLC operating agreement to determine if defendant had violated fiduciary duties).
Applying Fiduciary Duties to LLC Managers

2007

marketplace; and 4) leeway to be innovative and to take risks. There is clearly a call for legislation that permits a considerable degree of contractual modification.

The empirical evidence discussed above on contractual practices in Colorado, Delaware, Kentucky, Minnesota, and New York shows that well over one-third of respondents surveyed had often or sometimes represented investors in firms with and without active minorities where the LLC agreement had limited the duty of loyalty, the duty of care, or other fiduciary duties. Even in states such as New York and Minnesota, practitioners are apparently using statutes in other states that permit contractual modifications in duties. Thus, there is a demand for legislation that tolerates the modification of fiduciary duties. A review of case law also suggests that there is a need for a statutory framework that permits parties to carve out a right to compete in certain settings. The Mandatory Minimum paradigm recommended is an intermediate approach that leaves room for the much-needed contractual tailoring of fiduciary duties.

I. Permitting a Right to Compete Without Eliminating the Duty of Candor or Eliminating Other Fiduciary Duties

ULLCA II’s approach establishes the duty not to compete with the LLC as a default statutory fiduciary duty. Absent a contract to the contrary, the LLC member and/or manager is not permitted to compete with the LLC. Although an investor may contractually grant a specific right to compete, the grant of a right to compete does not eliminate other fiduciary duties including the duty of candor. It is critical for courts to recognize that the grant of a right to compete is not a license to exploit. A contractual right to compete does not automatically waive the duty of candor or other fiduciary duties. Nor does it negate the duty of good faith and fair dealing, or the duty to bargain without making material misstatements or omissions.

As long as the above limitations are recognized, LLC statutes should permit the parties to contractually define the competition that will be permitted. The law has built in safeguards to protect parties from potentially harmful competition when they are positioned in relationships that make them vulnerable to exploitation by competition. Section 8.04 of the Restatement of Agency (Draft No. 6) indicates that, as a general rule, an agent may not compete with the principal. However, the comments to the Restatement indicate that a principal may give express consent to competition by specifying the types of competition permissible in contemporary partnership legislation. A partnership agreement may provide otherwise by identifying “specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable.” Even before the adoption of the Revised Uniform Partnership Act, courts had recognized the important role that a contractual agreement may legitimately play in permitting partners to compete. Two examples of decisions upholding the right

280. Restatement (Third) of Agency § 8.04 (Tentative Draft No. 6, April 4, 2005).
281. See id. cmt. (b) (providing that a partnership agreement may provide otherwise by identifying specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable although the agreement may not eliminate a partner’s duty of loyalty under Rev. Unif. Partnership Act §§ 404(b)(3), 103(b)(3) (1997)).
283. See J. Dennis Hynes, Fiduciary Duties and RUPA: An Inquiry into the Freedom of Contract, 58 Law & Contemp. Probs., Spring 1995, at 41-43 (analyzing the case law under the Uniform Partnership Act that
The Journal of Corporation Law

The requirement that competition be expressly provided for in the LLC operating agreement, working in tandem with the duty to exercise good faith and fair dealing and the duty to utilize only reasonable limitations and/or waivers, provides the correct balance between contractual flexibility and a mandatory minimum of acceptable business conduct.

The contemporary LLC marketplace encompasses LLCs that are engaged in a diverse array of industries. LLC members range from the publicly-traded corporation to the simple “Mom and Pop” venture. Particularly in the real estate industry, the same developer may develop multiple properties. Contemporary business laws must be capable of addressing the needs of the large-scale developer as well as the single venture developer.

The Mandatory Core approach recommended provides the flexibility to grant a right to compete but still retain mandatory duties to curb opportunistic conduct. A contractual curtailment of the duty to refrain from competition or a contractual modification of other duties should not be permitted to morph into carte blanche to divert or otherwise appropriate LLC profits or assets. Trustworthy behavior should be expected and enforced, notwithstanding the grant of a contractual waiver or a statutory commitment to defer to the operating agreement. The grant of a contemporary privilege to privately order one’s responsibilities should not dispense with the notion that a business relationship is based on a mutual commitment to the duty of candor and the duty to engage in fair dealing.

VI. CONCLUSION

A blended theoretical model for LLC governance is advanced that recognizes the important role that the law plays in shaping expectations of trustworthy behavior. The Mandatory Core Model permits contractual innovation within the framework of a mandatory core of minimum statutory fiduciary duties. The Mandatory Core Model creates the framework within which courts can enforce LLC operating agreements while also addressing abusive investor conduct. A purely contractarian paradigm presupposes the existence of a fair and level contractual playing field, a well-negotiated LLC agreement, and a legal community of practitioners and courts that are well-trained in fiduciary duties. Empirical research suggests that written LLC agreements may not always exist, may not frequently contain effective protective provisions, and may not be the product of negotiations between equally well-represented controlling and minority LLC investors. In such an environment, the significance of a contractual waiver

284. See Singer v. Singer, 634 P.2d 766, 768, 772 (Okla. Ct. App. 1981) (upholding the freedom to contractually permit competition where one partner, prior to meeting the other, had asked him to look into the purchase of some land but after the meeting, looked into it himself and bought the land himself with a different partner).

285. See Riviera Cong. Assocs. v. Yassy, 223 N.E.2d 876 (N.Y. 1966) (allowing the general partners to lease a motel to themselves and entities they controlled where the limited partners were fully apprised in the prospectus that the general partners/defendants could lease the property to their own company).
embedded in a form LLC agreement can be easily overlooked. The implied covenant of good faith and fair dealing may not be an effective tool to combat abusive conduct if it is interpreted to apply narrowly to the manner in which a discrete contract is performed and if it is not regarded as encompassing a duty of candor. A statute permitting the complete waiver of fiduciary duties is arguably out of step with the mainstream of business norms nationally, and sends a radically inappropriate and socially undesirable signal as to acceptable business conduct. The Mandatory Core approach recommended correctly balances the interest in contractual freedom with the need to create laws that promote and reflect social norms of trustworthy business conduct.

APPENDIX A

Selected LLC Statutes Containing Limitations on the Contractual Elimination of Duties

<table>
<thead>
<tr>
<th>State</th>
<th>Statutory Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>ALA. CODE § 10-12-21(L)(1)-(4) (LexisNexis 2005).</td>
</tr>
<tr>
<td>California</td>
<td>CAL. CORP. CODE § 17155 (Deering 2006).</td>
</tr>
<tr>
<td>Florida</td>
<td>FLA. STAT. ANN. § 608.4229 (LexisNexis 2005).</td>
</tr>
<tr>
<td>Iowa</td>
<td>IOWA CODE ANN. § 490A.707 (West 2005).</td>
</tr>
<tr>
<td>Minnesota</td>
<td>MINN. STAT. ANN. § 322B.663(4) (West 2005).</td>
</tr>
</tbody>
</table>
The actual language employed varies from statute to statute and this list contains only selected examples. For more comprehensive treatment of waiver provisions, see BISHOP & KLEINBERGER, supra note 35, ¶ 10-16; and RIBSTEIN & KEATINGE, supra note 128, app. 9-1.

APPENDIX B

LLC Statutes Using Good Faith Prudent Person Language

<table>
<thead>
<tr>
<th>State</th>
<th>Statutory Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska</td>
<td>ALASKA STAT. § 10.50.135(a) (2004).</td>
</tr>
<tr>
<td>Connecticut</td>
<td>CONN. GEN. STAT. ANN. § 34-141(a) (West 2005).</td>
</tr>
<tr>
<td>Iowa</td>
<td>IOWA CODE ANN. § 490A.706(1) (West 2005).</td>
</tr>
<tr>
<td>Minnesota</td>
<td>MINN. STAT. ANN. § 322B.69 (West 2005).</td>
</tr>
<tr>
<td>Missouri</td>
<td>MO. ANN. STAT. § 347.088(1) (West 2005).</td>
</tr>
<tr>
<td>New York</td>
<td>N.Y. LTD. LIAB. CO. LAW § 409(a) (McKinney 2005).</td>
</tr>
<tr>
<td>North Carolina</td>
<td>N.C. GEN. STAT. § 57C-3-22(b) (2005).</td>
</tr>
<tr>
<td>Ohio</td>
<td>OHIO REV. CODE ANN. § 1705.29(B) (LexisNexis 2006).</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>OKLA. STAT. ANN. tit. 18, § 2016(1) (West 2005).</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>R.I. GEN. LAWS § 7-16-17(a) (2004).</td>
</tr>
<tr>
<td>Vermont</td>
<td>VT. STAT. ANN. tit. 11, § 3059(c) (2005).</td>
</tr>
</tbody>
</table>

The actual language employed varies from statute to statute. For comprehensive tables, discussion, and analysis of duty of care and duty of loyalty provisions, see BISHOP & KLEINBERGER, supra note 35, at ¶ 10-16; RIBSTEIN & KEATINGE, supra note 128, at app. 9-1.
APPENDIX C

LLC Statutes Using Gross Negligence or Willful Misconduct Language

<table>
<thead>
<tr>
<th>State</th>
<th>Statutory Provisions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>ALA. CODE §§ 10-12-21(g), (k)(2) (2005).</td>
</tr>
<tr>
<td>Arkansas</td>
<td>ARK. CODE ANN. § 4-32-402 (2005).</td>
</tr>
<tr>
<td>California</td>
<td>CAL. CORP. CODE § 17153 (Deering 2005).</td>
</tr>
<tr>
<td>Florida</td>
<td>FLA. STAT. ANN. § 608.4225(1)(b) (West 2005).</td>
</tr>
<tr>
<td>Hawaii</td>
<td>HAW. REV. STAT. § 428-409(c) (2004).</td>
</tr>
<tr>
<td>New Mexico</td>
<td>N.M. STAT. ANN. § 53-19-16(B) (LexisNexis 2006).</td>
</tr>
<tr>
<td>Oregon</td>
<td>OR. REV. STAT. § 63.155(3) (2003).</td>
</tr>
<tr>
<td>West Virginia</td>
<td>W. VA. CODE ANN. § 31B-4-409(c) (West 2005).</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>WIS. STAT. ANN. § 183.0402(1) (West 2005).</td>
</tr>
</tbody>
</table>