LIMITED LIABILITY COMPANIES AND OPTING-OUT OF LIABILITY: A NEW STANDARD FOR FIDUCIARY DUTIES?

The limited liability company (LLC) is an exciting new entity that may soon replace the need for many traditional business forms. In particular, the close corporation,[1] general partnership,[2] and limited partnership[3] may shortly become relics of the past.[4] The popularity of an LLC is largely due to what this versatile new business form has to offer.[5] Most notably, members may actively participate in the management of the LLC without exposing themselves to personal liability and may still elect to be treated as a "partnership" for federal taxation purposes.[6] With this new progression, however, comes the need to re-examine the traditional duties that participants owe to the entity and to other participants. Should this increased flexibility create correspondingly higher duties? What standard of accountability should the courts and legislatures demand?

To respond to these queries, it is necessary to examine the preeminent framework for defining the obligations and responsibilities of participants in the world of business associations—fiduciary duties. One of the main concerns of any shareholder, partner, or member of an organization is liability.[7] This is, therefore, an abundantly relevant, and often

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[1] *See infra* Part II.C.2 (providing an overview of the close corporation).

[2] *See infra* Part II.C.3 (providing an overview of partnership law).

[3] *See infra* Part II.C.3 (providing an overview of partnership law).

[4] *See* Robert B. Thompson, *The Taming of Limited Liability Companies*, 66 U. COLO. L. REV. 921, 921 (1995).

[5] *See infra* notes 22-30 and accompanying text (discussing the attributes of LLCs).

[6] *See* 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES §§ 1.04, 3.05, at 1-3, 3-6 (1996); Claire Moore Dickerson, *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 417, 426 (1995); Wayne M. Gazur, *The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role*, 58 LAW & CONTEMP. PROBS. 135, 137 (1995); Sandra K. Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U. L. REV. 465, 476 (1994) [hereinafter *What Remedies Should Be Made Available*]; Sandra K. Miller, *What Standards of Conduct Should Apply to Members and Managers of Limited Liability Companies?*, 68 ST. JOHN'S L. REV. 21, 36 (1994) [hereinafter *What Standards of Conduct Should Apply*].

[7] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 1.04, at 1-3. The main attraction of the LLC is the shield of liability it provides to its members. *See* 1 *id.* While all limited liability statutes afford members protection from the obligations and liabilities of the LLC,

dispositive factor to consider when determining what type of entity to select.[8] Because LLCs are so new, there are no clear cut criteria for delineating the duties and obligations of the members and managers of an LLC.[9] In particular, characterization of this fiduciary relationship and, subsequently, the extent to which the parties may contract out of any such obligations,[10] remains largely without definition.[11] This uncertainty leaves many attorneys in a sort of quandary when attempting to discern any potential restrictions that may infringe upon the extent to which the parties may tailor their agreements.[12]

Examination of this problem also presents two unique difficulties. First, while a Uniform Limited Liability Company Act (ULLCA) does exist, state statutes have generally adopted divergent approaches on the issue of fiduciary responsibilities and have not been very receptive to the ULLCA.[13] Accordingly, to assist in formulating a baseline for analysis, this Comment will explore the statutory and decisional law in two states—Delaware and New York. The selection of these states is based upon their unique position in the sphere of corporate law. Delaware, often referred to as the incorporation capital of the world,[14] has a good deal

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limited liability will not safeguard against the members' own negligence, to certain degrees. *See* 1 *id.*

[8] *See* 1 *id.* §§ 2.01, 2.02, at 2-2 to -3. Liability is also a relevant concern for jurisdictional choice, and is consistent with the Professor Cary's coined terminology, the "race to the bottom," where states contend for "business" by enacting pro-management environments. *See* Carl Samuel Bjerre, Note, *Evaluating the New Director Exculpation Statutes*, 73 CORNELL L. REV. 786, 786 (1988). A prime example is Delaware's director exculpation statute. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996). After Delaware adopted this provision, numerous states followed, using Delaware's language almost word for word. *See* Bjerre, *supra*, at 786 & n.3.

[9] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 9.01, at 9-1 to -2. While there has been no real evolution of LLC case law to date, these fiduciary responsibilities will surely take shape from the already developed law surrounding partnerships and corporations. *See* 1 *id.* at 9-2. To what degree remains the question. *See* 1 *id.*

[10] *See* 1 *id.* § 9.04, at 9-9. "The critical question is not whether consent or waiver ever will be enforced in the LLC, but how extensively it will be enforced. There is no developed case law . . . on this issue." 1 *id.*

[11] *See What Standards of Conduct Should Apply*, *supra* note 6, at 28. There has been a lack of focus on the interrelation between the duties of members/managers and the LLC. *See id.* Many articles have instead preferred to focus on comparing the LLC to other business structures. *See id.* at 27.

[12] *See generally* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879 (noting the difficulties of pinpointing the exact nature of the fiduciary obligation and arguing that a cookie cutter approach of applying contract law as a general overlay is oftentimes insufficient by itself).

[13] *See* Dickerson, *supra* note 6, at 418 & n.5 (1995); *infra* notes 224-38 (discussing the ULLCA's statutory method of structuring fiduciary duties). For a broad overview of the ULLCA, see generally Dickerson, *supra* note 6.

[14] *See* Edward M. McNally & John H. Small, *Alternative Entities: The Multiple Choices Available in Delaware*, 14 DEL. LAW. 27, 27 (Fall 1994). As one commentator

of experience in handling corporate law issues and often approaches these matters in an innovative fashion.[15] New York, on the other hand, is a prime hub for activity because of its status as the leading center for finance and commerce, and it is subsequently where many parties turn because of its sophisticated administration of commercial law.[16] A second obstacle in the study of LLCs is the distinct lack of decisional law. Hence, much of the material covered in this Comment will be drawn from the LLC's predecessors—the corporation and partnership.

This Comment provides a cohesive framework for addressing the issue of fiduciary obligations in the context of an LLC and ultimately proposes a workable standard of review for the courts. Part I of this Comment provides a general overview of the characteristics and attributes of LLCs and then examines the statutory framework of LLCs in New York and Delaware.[17] Part II endeavors to unravel the current treatment of fiduciary duties by examining how the New York and Delaware LLC statutes and decisional law address fiduciary relationships. In exploring the case law, this Part primarily focuses on three related entities and their interpretations of fiduciary standards: (1) the corporation; (2) the close corporation; and (3) the partnership.[18] Finally, Part III of this Comment proposes a cohesive and workable standard of review for evaluating the extent to which parties may define their agreement in the LLC arena.[19]

I. OVERVIEW OF THE LLC STATUTES OF NEW YORK AND DELAWARE AND RELATED ISSUES

A. *The Nature of the Beast: A General Look at LLCs*

LLCs are a hybrid of sorts, inheriting some characteristics from corporate as well as partnership models.[20] One commentator defined the

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remarked in an article comparing numerous forms of business entities, Delaware is "known as the home of the corporation." *See id.*

[15] *See* Brad Karp, *The Litigation Angle in Drafting Commercial Contracts* at 39, 57-58 & n.28 (PLI Corp. L. & Practice Course Handbook Series No. B4-7109, 1995).

[16] *See* Joseph D. Becker et. al., *Proposal for Mandatory Enforcement of Governing Law Clauses and Related Clauses in Significant Commercial Agreements* at 199, 201 (PLI Corp. L. & Practice Course Handbook Series No. A4-4485, 1995).

[17] *See infra* notes 20-75 and accompanying text (illustrating the basic framework and structure of LLCs).

[18] *See infra* notes 76-202 and accompanying text (examining relational obligations commensurate with other business forms).

[19] *See infra* notes 203-74 and accompanying text (suggesting a new standard of review for determining the extent to which participants in an LLC may opt out of fiduciary obligations).

[20] *See* Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1198 (1995); *What Remedies Should Be Made Available*, *supra* note 6, at 473-76; *What Standards of*

LLC as a "noncorporate business in which all of the members have limited liability, in the absence of personal guarantees, and in which the members can, and frequently do, actively participate in management."[21] In certain respects, this unique form of entity reflects the "best of both worlds."[22]

From their corporate forefathers, LLC have secured the protection of limited liability for their members.[23] Logistically, however, this relatively new breed of organization often functions very much like a partnership.[24] First, just as limited partnership agreements delineate the governance of a limited partnership's operations, "limited liability company agreements" command and regulate the inner workings of the LLC.[25]

Conduct Should Apply, *supra* note 6, at 32-36. For a general overview of the nature and characteristics of LLCs, see generally Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. L. REV. 44 (1992); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, BUS. LAW., Feb. 1992, at 375; Jimmy G. McLaughlin, Commentary, *The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231 (1993).

[21] 1 RIBSTEIN & KEATINGE, *supra* note 6, § 1.02, at 1-2. Ribstein suggests that three primary distinctions between the LLC and the corporation render the LLC noncorporate:

> First, LLCs usually are not bound by the restrictions as to finance that historically have bound the corporate form . . . . Second, unlike corporations, LLCs are not bound by special requirements for management by a board of directors or equivalent body [and] [t]hird, LLCs are designed to avoid two-tier corporate tax treatment.

1 *id.* (footnotes omitted).

[22] *See* Marybeth Bosko, Note, *The Best of Both Worlds: The Limited Liability Company*, 54 OHIO ST. L.J. 175, 198 (1993); *see also* Goforth, *supra* note 20, at 1217 (explaining that "an LLC is an entity which takes many of the most desirable attributes of the partnership and combines them with the most desirable features of the corporation").

[23] *See* Goforth, *supra* note 20, at 1217; *What Remedies Should Be Made Available*, *supra* note 6, at 466; *What Standards of Conduct Should Apply*, *supra* note 6, at 32. One of the principle advantages that LLCs offer over a partnership structure is limited liability for all members, not just the limited partners. *See* Gazur, *supra* note 6, at 137.

[24] *See* sources cited *supra* note 20. The strong resemblance to the partnership form may stem from the fact that, absent the LLC option, the parties would have selected a partnership or close corporation format. *See* Gazur, *supra* note 6, at 135. The ideology behind the LLC is to furnish limited liability in a noncorporate manner. *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 1.03, at 1-2 to -3.

[25] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 417 (McKinney 1997). Different states handle the "operating agreement" in different manners. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 417 (McKinney 1997). For example, New York's § 417(a) requires that the members:

> *shall* adopt a *written operating agreement* that contains any provisions not inconsistent with the law or its articles of organization relating to (i) the business of the limited liability company, (ii) the conduct of its affairs and (iii) the rights, powers, preferences, limitations or responsibilities of its members, managers, employees or agents, as the case may be.

N.Y. LIMITED LIABILITY COMPANY LAW § 417(a) (McKinney 1997) (emphases added). While New York mandates a written operating agreement, *see id.*, Delaware has no spe-

Second, similar to the partnership model, an LLC's structure allows for members to actively participate in the daily operations of the business.[26] Third, an LLC member's interest typically lacks a public market,[27] and the LLC operating agreement generally restricts transferability.[28] Finally, and perhaps the initial propelling force behind the development and popularity of this entity, is the ability of LLCs to opt for taxation as a "partnership."[29] This advantageous tax status and the veil of limited liability are generally hailed as the preeminent features of the LLC.[30]

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cific provision relating to the governing agreement and does not mandate that the members adopt a "limited liability company agreement." *See* DEL. CODE ANN. tit. 6, § 18-101(7) (Supp. 1997). Instead, title 6, § 18-101(7) of the Delaware Code merely defines "limited liability company agreement" as a "written agreement of the members as to the affairs of a limited liability company and the conduct of its business." *Id.*

[26] *See* DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 401(a) (McKinney 1997) ("Unless the articles of organization provides for management of the limited liability company by a manager or managers or a class or classes of managers, *management of the limited liability company shall be vested in its members* who shall manage the limited liability company in accordance with this chapter. . . ." (emphasis added)). Title 6, § 18-402 of the Delaware Code provides:

> Unless otherwise provided in a limited liability company agreement, *the management of a limited liability company shall be vested in its members* in proportion to the then current percentage or other interest of members in the profits of the limited liability company owned by all the members . . . provided however, that if a limited liability company agreement provides for the management . . . by a manager, the management of the limited liability company, to the extent so provided, shall be vested in the manager who shall be chosen by the members in the manner provided in the limited liability company agreement.

DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996) (emphasis added).

[27] *See What Remedies Should Be Made Available*, *supra* note 6, at 473 & n.21; *What Standards of Conduct Should Apply*, *supra* note 6, at 34 & n.26. LLCs are privately held to avoid taxation as a corporation. *See What Remedies Should Be Made Available*, *supra* note 6, at 473 & n.21; *What Standards of Conduct Should Apply*, *supra* note 6, at 34 & n.26.

[28] *See* Ronold P. Platner, *Limited Liability Companies Are Increasingly Popular*, 47 TAX'N FOR ACCT. 364, 367 (1991) (observing that when drafting an LLC operating agreement most attorneys focus on negating continuity of life and free transferability). Generally, an LLC's operating agreement will greatly restrict transferability to avoid potential classification as a "corporation" for tax purposes. *See id.* A typical non-transferability clause reads as follows:

> Unless the unanimous written consent of the . . . Members is obtained, no Member shall sell, gift, assign, pledge or otherwise transfer or encumber ("Transfer") all or any part of his or her Membership Interest, or assign any of his or her rights or delegate the performance of any of his or her obligations under this Agreement, and any attempt by any Member to make such Transfer, or to make any such assignment of rights or delegation of performance of obligations, shall be invalid and ineffective.

Battle Fowler New York Long Form LLC Operating Agreement at 19 (footnote omitted) [hereinafter BF Operating Agreement].

[29] *See* Dickerson, *supra* note 6, at 426; *see also* Goforth, *supra* note 20, at 1199-206 (tracing the development of LLC legislation and discussing the Internal Revenue Service's

As noted above, one of the predominant forces behind the LLC is "partnership" status under the Internal Revenue Code (Code).[31] Prior to the recent Code amendments that allow this election,[32] members often expended a good deal of energy shaping their LLC agreement to comply with the Code's classification requirements.[33] Under the prior Code regulations, the LLC was not permitted to have more corporate than noncorporate characteristics.[34] Although there were six corporate characteristics,[35] only the following four characteristics were relevant in the context of an LLC: (1) continuity of life; (2) centralized management; (3) limited liability; and (4) free transferability.[36] The members' goal was, therefore, to have no more than two of these four attributes.[37] Furthermore, because the quintessential nature of the LLC is to provide limited liability for its members, members were only really left with the ability to pick up one additional element when structuring their operating

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rulings in connection with Wyoming's passage of the first LLC statute in the United States).

[30] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, §§ 1.04, 3.05, at 1-3, 3-6; Gazur, *supra* note 6, at 137; *What Remedies Should Be Made Available*, *supra* note 6, at 476; *What Standards of Conduct Should Apply*, *supra* note 6, at 36.

[31] *See* Dickerson, *supra* note 6, at 426.

[32] *See* 61 Fed. Reg. 66,590 (1996) (to be codified at 26 C.F.R. § 301.7701-3). Effective January 1, 1997, the new Code regulations provide that:

> A business entity that is not classified as a corporation . . . can elect its classification for federal tax purposes as provided in this section. An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation . . .) or a partnership. . . .

Id.

[33] *See* Gazur, *supra* note 6, at 136; Goforth, *supra* note 20, at 1210.

[34] *See* 26 C.F.R. § 301.7701-2(a)(3) (1996) *amended by* 61 Fed. Reg. 66,589 (1996) ("An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics.").

[35] *See id.* § 301.7701-2(a)(1) *amended by* 61 Fed. Reg. 66,589 (1996) (defining "corporate" characteristics as follows: "(i) [a]ssociates, (ii) an objective to carry on business and divided [sic] the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests").

[36] *See id.* § 301.7701-2(a)(3) *amended by* 61 Fed. Reg. 66,589 (1996). Characteristics common to both "associations," organizations requiring classification as a corporation for tax purposes, and partnerships do not count when determining whether there are more corporate characteristics than not. *See id.* "Associates" and "an objective to carry on business for joint profit" are common to almost all organizations. *See id.* § 301.7701-2(a)(2) *amended by* 61 Fed. Reg. 66,589 (1996).

[37] *See id.* § 301.7701-2. In this manner, the LLC would not have more corporate than noncorporate traits. *See id.*

agreement.[38] Typically, the members would expressly eliminate free transferability and continuity of life.[39]

In varying degrees, the current statutory language of LLC laws also tends to reflect the tax sensitive nature of this entity. Many statutes attempt to devise a structure corresponding to the federal taxation guidelines for "partnership" status.[40] In some instances, the state statutes are "bulletproof," requiring the members' unanimous consent to prevent dissolution upon disassociation of one of the members to admit subsequent members.[41] In this manner, the LLC essentially remained boxed into compliance with prior Code guidelines; there was no continuity of life and the members' interests were not freely transferable.[42] Although this guaranteed tax protection provided security, this rigid structure negatively impacted the parties' ability to structure the agreement to best suit their needs.[43] Conversely, while "flexible" statutes permit variations on these restrictions,[44] they demand greater care by the drafters when structuring the agreement.[45]

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[38] *See* Dickerson, *supra* note 6, at 441 (noting that the LLC will almost always have limited liability).

[39] *See* Platner, *supra* note 28, at 367 (observing that when drafting an LLC operating agreement most attorneys focus on negating continuity of life and free transferability).

[40] *See* Thompson, *supra* note 4, at 930.

[41] *See* Martin I. Lubaroff & Paul M. Altman, *Delaware Limited Liability Companies*, INSIGHTS, Nov. 1992, at 32, 33. "Bulletproof" statutes consist of mandatory provisions, unalterable by agreement, that guarantee compliance with the federal tax statutes for partnership classification. *See id.* The other two classifications of statutes are "flexible" and "bulletproof flexible." *See id.*; *supra* notes 44 & 46.

[42] *See supra* notes 34-39 and accompanying text (discussing the requirement that an LLC must eliminate at least two of the four tax classification characteristics for favorable "partnership" classification).

[43] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 3.05, at 3-7. Ribstein also observes that many mandatory provisions "freeze" the evolution of tax rules and therefore become obsolete with any new changes in the tax law. *See* 1 *id.*

[44] *See* Lubaroff & Altman, *supra* note 41, at 33. "Flexible" statutes, in contrast to "bulletproof' statutes, give greater deference to freedom of contract and allow the parties to structure their agreement as they see fit. *See id.* While "flexible" statutes allow the parties to fashion their own agreement, the risk, of course, is that the parties will draft provisions that would take the LLC outside of the partnership classification. *See id.*

[45] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 3.05, at 3-6. An error in drafting the operating agreement concerning tax classification matters could be significant and may very well fall on the shoulders of the attorney who drafted the agreement. *See* 1 *id.*

B. *The Framework of the New York and Delaware Statutes: Admission of New Members and Continuation upon Dissolution*

1. New York

New York's LLC statute is generally referred to as a "default," or "bulletproof flexible," statute.[46] This genre of "flexible" statute represents a happy medium between the rigidity of a bulletproof statute and a statute that provides no safeguards on which to fall back.[47] Here, if the members fail to reference a particular subject or issue within the operating agreement, the default provisions of the Limited Liability Company Law prevail.[48] This fallback, however, did not necessarily guarantee favorable tax classification under the old tax law.[49] A default statute is primarily concerned with alerting parties to a potential issue rather than providing protection.[50] In a non bulletproof statute, two key statutory provisions are those that govern dissolution of the organization and the admittance of new members because of the strong link these provisions have to the tax classification issues: dissolution bears directly on continuity of life, while admittance of new members relates to free transferability.[51]

In New York, § 701 governs the dissolution of an LLC.[52] This provision authorizes the members to elect to continue the LLC when an

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[46] *See* Bruce A. Rich & Cheryl Parsons-Reul, Practice Commentaries, N.Y. LIMITED LIABILITY COMPANY LAW, at 4 (McKinney 1997). A "bulletproof flexible", the statute contains default provisions that protect the parties from stepping outside partnership classification, but which may also be altered by the parties. *See* Lubaroff & Altman, *supra* note 41, at 32, 33. Thus, this genre of statute provides the safety of the bulletproof statutes with the added flexibility of allowing the members to modify the default provisions. *See id.*

[47] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 3.05, at 3-7; Lubaroff & Altman, *supra* note 41, at 33.

[48] *See* Rich & Parsons-Reul, *supra* note 46, at 4.

[49] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 3.05, at 3-7.

[50] *See* 1 *id.*

[51] *See supra* notes 36-39 and accompanying text (discussing the partnership classification process under the prior tax law).

[52] *See* N.Y. LIMITED LIABILITY COMPANY LAW § 701 (McKinney 1997). Section 701 provides:

> A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following:
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> (a) the latest date on which the limited liability company is to dissolve, if any, provided in the articles of organization;
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> (b) at the time or upon the happening of events specified in the operating agreement;
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> (c) . . . the vote or written consent of at least two-thirds in interest of the members;

event of dissolution occurs.[53] Prior to 1992, there was still some doubt regarding whether majority consent to continue would annul the continuity of life trait.[54] Today, however, it is well-settled that a majority continuation provision suffices to eliminate continuity of life.[55] Thus, while flexibility certainly has its benefits, the parties must always keep current on the progression of these classification issues and be careful to craft their agreements accordingly.[56]

> (d) the bankruptcy, death, dissolution, expulsion, incapacity or withdrawal of any member . . . or the occurrence of any such event specified in the operating agreement . . . *unless* within one hundred eighty days after such event *the limited liability company is continued either*:
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> (1) by the vote or written consent of the *percentage in interest* . . . stated in the operating agreement; *or*
>
> (2) if no such percentage is specified in the operating agreement, by the vote or written consent of a *majority* in interest
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> . . . .

Id. § 701(d) (emphases added).

[53] *See id.*

[54] *See* Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 447-50 (1991) (discussing some of the private letter rulings and decisions of the Internal Revenue Service (I.R.S.) regarding the uncertainty surrounding this issue).

[55] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 16.14, at 16-44 to -45 (suggesting that after a 1992 Revenue Ruling concerning limited partnerships, majority consent is probably sufficient to eliminate continuity of life); BRIAN L. SCHORR, SCHORR ON NEW YORK LIMITED LIABILITY COMPANIES & PARTNERSHIPS § 7:01, at 7-2 to -3 (1996) (commenting that a majority consent provision in a limited partnership agreement will still annul the continuity of life trait). Pursuant to the I.R.S. Revenue Rulings, this concept should carry over to LLCs. *See id.* at 7-3 & n.5. Continuity of life for tax purposes is defined as follows:

> An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization, or expulsion of any member will cause a dissolution of the organization . . . . [C]ontinuity of life does not exist notwithstanding the fact that a dissolution of the limited partnership may be avoided, upon such an event of withdrawal of a general partners, by the remaining general partners agreeing to continue the partnership or *by at least a majority in interest of the remaining partners agreeing to continue* the partnership.

26 C.F.R. § 301.7701-2(b)(1) (1996) *amended by* 61 Fed. Reg. 66,589 (1996) (citation omitted) (emphasis added).

[56] To overcome any doubts regarding the continuation by majority vote, a dissolution provision in a New York operating agreement would typically incorporate a unanimity requirement, as in the following example:

> (a) Subject to the provisions of [Section (b)] hereof, the Company shall be dissolved and its affairs wound up and terminated upon the first to occur of the following: (i) [specify finite date], unless extended by the [Members]; (ii) The determination of the [Members] to dissolve the Company; (iii) A sale of all or substantially all the assets of the Company; or (iv) An Event of Withdrawal of a [Member] of the Company.

Similar to the dissolution provision, the section pertaining to the admission of new members possesses a majority default, if the members fail to provide otherwise in their operating agreement, admission of a new member requires a majority in interest vote.[57] While there are still some unresolved issues regarding what constitutes free transferability, majority consent is generally adequate to protect the LLC from this trait.[58] Oftentimes, however, many parties incorporate a unanimous consent requirement instead of the majority default, perhaps to allay any fears regarding the unsettled tax classification issues.[59] This mechanism is also utilized as a control device to ensure that any new member is a satisfactory associate to the current members.

> (b) Notwithstanding the provisions of [Section (a)] hereof, the occurrence of an Event of Withdrawal of a [Member] shall not dissolve the Company if, within 180 days after the occurrence . . . *all of the remaining Members unanimously agree* in writing to continue . . . .

BF Operating Agreement, *supra* note 28, at 22-23 (footnotes omitted) (emphasis added). Note, however, that this issue is probably of less concern now that the new Code regulations allow for the election of partnership status. See *supra* note 32, for a review of the new regulations.

[57] *See* N.Y. LIMITED LIABILITY COMPANY LAW §§ 602, 701 (McKinney 1997). Section 602 provides:

> (a) A person becomes a member of a limited liability company on the later of: (1) the effective date of the initial articles of organization; or (2) the date as of which the person becomes a member pursuant to this section or the operating agreement . . . (b) After the effective date of a limited liability company's initial articles of organization, a person may be admitted as a member: (1) . . . if the operating agreement does not so provide, upon the vote or written consent of a *majority in interest* of the members. . . .

Id. § 602 (emphasis added).

[58] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 16.09, at 16-33 (suggesting that the consent of all members is *not* necessary and that something less, such as majority consent, would suffice in the LLC context). In contrast, Ribstein observes that free transferability exists when the "members owning all or substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization." 1 *id.* at 16-32 (citing 26 C.F.R. § 301.7701-2(e)(1) (1996)). The two unanswered questions on this issue of free transferability are (1) what interests need consent; and (2) what type of consent is required. *See* 1 *id.* at 16-33; *see also* 1 *id.* at 16-32 to -35 (discussing free transferability generally); Susan Pace Hamill, *The Limited Liability Company: A Possible Choice for Doing Business?*, 41 FLA. L. REV. 721, 737-40 (1989) (same).

[59] *See* BF Operating Agreement, *supra* note 28, at 20. A standard New York operating agreement generally contains a provision similar to the following:

> no transferee or assignee . . . shall be a substitute Member . . . entitled to all the rights and benefits under this Agreement of the transferor or assignor of such interest *unless and until:* (i) the *unanimous written consent* of the [Members] has been obtained, which consent each [Member] may withhold in its sole discretion . . . .

Id. (footnote omitted) (emphases added).

2. Delaware

Delaware, like New York, has a "bulletproof flexible" statute.[60] As of August 1, 1996,[61] Delaware has switched to a default of majority consent for continuation upon dissolution.[62] As noted previously, this provision should adequately annul the trait of continuity of life.[63] Additionally, title 6, § 18-801(1) mandates a maximum duration of thirty years unless the parties select another finite term or perpetual life.[64] If the members fail to provide otherwise, the LLC automatically dissolves at the end of this thirty-year period.[65] It is important to note, however, that a fixed duration does not negate the characteristic of continuity of life; rather, it remains a possible avenue for dissolution.[66] Members must continue to comply with the tax classification rules regarding continuity of life.

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[60] *See* Lubaroff & Altman, *supra* note 41, at 33.

[61] *See* 1996 Del. Laws C. 360 (H.B. 528) (changing the requirement from unanimous consent to majority consent).

[62] *See* DEL. CODE ANN. tit. 6, § 18-801 (1991 & Supp. 1996). Title 6, § 18-801 provides, in part:

> A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following:
>
> (1) At the time specified in a limited liability company agreement, which limited liability company agreement may include a provision for the perpetual existence of the limited liability company, *or 30 years from the date of the formation* of the limited liability company *if no such time is set forth in the limited liability company agreement*; or the limited liability company does not provide for the perpetual existence of the limited liability company;
>
> (2) Upon the happening of events specified in a limited liability company agreement;
>
> (3) Unless otherwise provided in a limited liability company agreement, upon the *written consent of all members;*
>
> (4) The death, retirement, resignation, . . . of any member . . . unless the business of the limited liability company is continued (i) within 90 days . . . either (A) by the vote or written consent of the percentage in interest . . . stated in the limited liability company agreement, or (B) if no such percentage is specified in the limited liability company agreement, by the vote of not less than a majority in interest of the remaining members . . . .

Id. (emphases added).

[63] *See supra* note 55 and accompanying text (noting the sufficiency of majority continuation provisions).

[64] *See* DEL. CODE ANN. tit. 6, § 18-801(1) (Supp. 1996).

[65] *See id.*

[66] *See* Gazur & Goff, *supra* note 54, at 450 & n.334 ("a fixed period of existence, however abbreviated, does not vitiate continuity"). In addition, because this merely states a maximum term, dissolution prior to this term would not be considered in contravention of the agreement. *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 11.05, at 11-12.

Similarly, the Delaware provisions governing admission of new members protect LLCs against unfriendly tax treatment.[67] Title 6, §§ 18-301 and 18-704 prohibit both new members and assignees from gaining admission to an LLC without unanimous consent, unless the agreement provides otherwise.[68] Thus, in the event the parties fail to specify anything regarding this issue, the Delaware statute automatically shields the LLC from having the characteristic of free transferability.[69]

The basic framework of the New York and Delaware statutes illustrates the general structure of the two primary provisions relating to past tax concerns: continuity of life and free-transferability.[70] While, prior to the new Code regulations, it was imperative that the parties addressed these matters, the issues were more or less perfunctory, which the parties could handle with minimal inconvenience.[71] As illustrated above, even if the parties neglect to mention certain issues, both statutes' default language generally provides a safeguard against disfavored classification under the old tax law.[72] Consequently, tax classification matters under the old tax regulations were procedural details of formation and did not present many challenges if diligently handled.[73] Today, tax considerations remain even less of a concern because of the new Code regulations, which allow for a "check the box" election of partnership status.[74] Liability issues, on the other hand, are substantially more difficult to systematize.[75]

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[67] *See supra* note 58 (reviewing the concept of free transferability).

[68] *See* DEL. CODE ANN. tit. 6, § 18-301(b) (Supp. 1997) (providing that a when "a person who is not an assignee" acquires an interest in the limited liability company, the person is admitted as a member "*upon the consent of all members*" (emphasis added)); *id.* § 18-704(a)(1) (1993) (requiring the "approval of *all* of the members of the limited liability company other than the member *assigning* his limited liability company interest" (emphasis added)).

[69] *See id.* §§ 18-301(b), -704(a) (1993 & Supp. 1997); *supra* note 58 (discussing the avoidance of free transferability).

[70] *See supra* notes 46-69 and accompanying text (completing a survey of the New York and Delaware LLC laws).

[71] While there is always some uncertainty concerning classification issues, many of the potential pitfalls of these uncertainties are negated by statutory LLC provisions that comply with current classification regulations. *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 3.05, at 3-7.

[72] *See supra* notes 46-69 and accompanying text.

[73] *See supra* note 71.

[74] *See* 61 Fed. Reg. 66, 590 (1996) (to be codified at 26 C.F.R. § 301.7701-3); *supra* note 32.

[75] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 9.01, at 9-1 to -2. The duties and obligations of the members are generally more fact sensitive and thus more open to potential dispute and varying interpretations. *See* 1 *id.* Another impediment is the lack of case law available to aid in defining the appropriate standards of conduct in the LLC arena. Policy issues also play a strong role in the manner in which the courts will inter-

II. LIABILITY ISSUES: HOW LIMITED IS "LIMITED" UNDER THE NEW YORK AND DELAWARE LLC STATUTES AND RELATED DECISIONAL LAW?

A. A Backdrop for Analysis: The Fiduciary Relationship

In contrast to the procedural character of an LLC's tax structure, liability is largely substantive in nature.[76] Accordingly, it is often the court's interpretation of the statutory language that defines the parameters of liability.[77] The LLC by its very name pronounces the accolades of "limited liability." This is not, however, a *carte blanche* designed to permit the random conduct of members wholly lacking in standards, fiduciary or otherwise; accordingly, limited liability is not entirely limited in all cases.[78] The key question then becomes to what extent members are exposed to personal liability.

In addressing this inquiry, one must first define the fiduciary standards that give rise to the duties of LLC participants. It is here, however, that the true enigma lies. The difficulty rests in attempting to pinpoint exactly how courts will interpret the fiduciary obligations in an LLC environment.[79] Generally, to unravel a query of this nature, the typical method of analysis would include a review of the respective state statutes and decisional law.[80]

LLCs, however, present an interesting problem. Because many of the LLC enabling statutes have only been enacted in the past few years, courts have not yet had an opportunity to decide any cases pertaining to

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pret fiduciary obligations. *See What Standards of Conduct Should Apply*, *supra* note 6, at 66. Some of these policy concerns are: (1) flexibility and freedom to contract; (2) some degree of exactness when defining member/manager duty; (3) promotion of risk taking; (4) responsible member conduct to other members and to third parties; and (5) responsibility to the general public. *See id.*

[76] *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 9.01, at 9-1.

[77] *See* 1 *id.* (recognizing that case law, not statutes, lends a fuller definition to fiduciary obligation).

[78] *See infra* notes 217-27 (summarizing some statutory limitations on member/manager conduct).

[79] *See* Howard N. Lefkowitz, *Standards of Conduct for Members and Managers: Fiduciary Duties*, in *Forming and Using Limited Liability Companies & Limited Partnerships 1994* at 659, 668 (PLI Corp. L. & Practice Course Handbook Series No. B4-7055, 1994). Lefkowitz suggests that while to some extent, a well-drafted agreement may reduce some of this incertitude, there is always a question as to enforceability. *See id.* at 668-69.

[80] *See What Standards of Conduct Should Apply*, *supra* note 6, at 80-81 (proposing that the judiciary will play a key role in lending definition to the standards of conduct imposed on members/managers of an LLC).

the fiduciary obligations of the participants.[81] Consequently, two sources for exploration remain: (1) the LLC statutes; and (2) the decisional law from the LLCs corporate and partnership primogenitors. These sources, however, are not perfect because they cannot adequately capture the hybrid nature of an LLC.[82] Depending on the sophistication of the parties and nature of the agreement, endless possibilities exist for potential LLCs.[83] Nonetheless, one can formulate a workable methodology by piecing together some theories from both corporate and partnership law, as well as reviewing the nature and structure of LLCs.

B. Limited Liability: An Examination of the New York and Delaware Statutory Provisions

Both the New York Limited Liability Company Law and the Delaware Limited Liability Act restrict the members' ability to shield themselves entirely from personal liability by imposing certain statutory checks on this privilege.[84] In New York, the members may include a provision in the operating agreement that eliminates or limits the members' personal liability.[85] The members may not, however, eliminate liability for bad faith, intentional misconduct, or ill-gotten financial gains.[86] The New York law also charges managers with certain mini-

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[81] *See* Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, BUS. L. TODAY, Mar./Apr. 1995, at 51, 51 (observing that "where the ink on many of the enabling statutes is barely dry, courts have yet to decide questions concerning the existence and scope of fiduciary duties among participants").

[82] *See supra* notes 20-30 (discussing the LLC's corporate and partnership characteristics).

[83] *See infra* notes 210-13 and accompanying text (illustrating the variety of structural formats that participants may select when forming an LLC).

[84] *See* DEL. CODE ANN. tit. 6, § 18-1101 (1993 & Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW §§ 409, 417, 420 (McKinney 1997).

[85] *See* N.Y. LIMITED LIABILITY COMPANY LAW § 417(a) (McKinney 1997). "The operating agreement may set forth a provision eliminating or limiting the personal liability of managers to the limited liability company or its members for damages for any breach of duty in such capacity. . . ." *See id.* In addition, § 609(a) of the New York Law provides that:

> *[n]either* a *member* of a limited liability company, a *manager* of a limited liability company managed by a manager or managers nor an *agent* of a limited liability company (including a person having more than one such capacity) *is liable for any debts, obligations or liabilities of the limited liability company or each other, whether arising in tort, contract or otherwise, solely by reason of being such member, manager or agent* or acting (or omitting to act) in such capacities or participating (as an employee, consultant, contractor or otherwise) in the conduct of the business of the limited liability company.

Id. § 609(a) (emphases added).

[86] *See id.* § 417(a)(1).

mum standards of conduct.[87] Section 409(a) of the New York law mandates an objective good faith standard.[88] As a reward for compliance with this standard, a manager cannot be held liable for any acts or omissions while acting in this capacity.[89] Finally, under § 420, a New York LLC has the authority to indemnify its members and managers as long as there is no bad faith or unlawful personal gain involved.[90]

The Delaware Act contains even less restrictive language.[91] To avoid liability for any fiduciary duties imposed in "law or equity," the statute merely requires "good faith reliance" on the terms of the limited liability agreement.[92] This lack of any strict fiduciary standard follows from Delaware's strong attachment to freedom of contract, an underlying theme that pervades the Delaware Act.[93] The Act strives to put the terms and structure of the agreement in the hands of the members, filling in gaps only when the members fail to specify otherwise.[94] Title 6, § 18-1101(b) emphasizes this underpinning by expressly stating that the policy of the Delaware Act is to defer to freedom of contract to the maximum extent possible.[95]

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[87] *See id.* § 409(a).

[88] *See id.* (requiring managers to "perform [their] duties . . . in good faith and with that degree of care that an ordinarily prudent person in a like position would use under similar circumstances").

[89] *See id.* § 409(c).

[90] *See id.* § 420. Specifically, § 420 reads as follows:

> [s]ubject to the standards and restrictions, if any, set forth in its operating agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless, and advance expenses to, any member, manager or other person, . . . provided, however, that no indemnification may be made to or on behalf of any member, manager or other person if . . . his or her acts were committed in bad faith or were the result of active and deliberate dishonesty and were material to the cause of action so adjudicated or . . . he or she personally gained in fact a financial profit or other advantage to which he or she was not legally entitled.

Id.

[91] *See* Lefkowitz, *supra* note 79, at 664.

[92] *See* DEL. CODE ANN. tit. 6, § 18-1101(c)(1) (Supp. 1996).

[93] *See* Lubaroff & Altman, *supra* note 41, at 32-33 (providing a general examination of fiduciary duties under the Delaware Limited Liability Company Act). Lubaroff and Altman point out that the "Act's basic approach is to permit members to have the broadest possible discretion in drafting their limited liability company agreements and to furnish answers only in situations in which the members have not expressly made provision in their . . . agreement." *See id.* at 32; *see also* DEL. CODE ANN. tit. 6, § 18-1101(b) (1993).

[94] *See* Lubaroff & Altman, *supra* note 41, at 32.

[95] *See* DEL. CODE ANN. tit. 6, § 18-1101(b) (1993). Title 6, § 18-1101(b) provides that the "policy of this chapter [is] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." *Id.; see*

Accordingly, many Delaware LLC agreements contain strong indemnification and exculpation provisions exonerating the participants from liability to the LLC and to other participants.[96] Within Delaware, there exists no express statutory impositions or opt-out provisions that require managers and members to act within a particular realm of acceptable conduct.[97] As a result, the LLC agreement defines the scope and nature of member and manager responsibilities.[98] The Delaware Act also allows for unlimited indemnification of the members and managers to the extent provided in the LLC agreement.[99]

While seemingly unfettered, the contractual freedom of the Delaware Act is not as absolute as it appears; the mere absence of statutory standards will not remove an LLC participant from any common-law restraints.[100] Additionally, whereas title 6, § 18-1101 appears to give great deference to freedom of contract principles, title 6, § 18-1104 preserves the rules of "law and equity."[101] Accordingly, member conduct remains subject to the impositions and restraints of the decisional law—the question is, to what degree.

C. The Decisional Law

To attempt to define the scope of liability, one must first define the applicable standard of conduct. Once molded, this standard dictates acceptable and non-acceptable behavior, liability imposed only on the latter. An interesting corollary to this concept is, then, to what extent the parties may alter this common-law standard by contract. In other words, will the law permit the parties to "opt-out" of a pre-defined standard of duty.

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also Lubaroff & Altman, *supra* note 41, at 32-33 (illustrating the contractual flexibility that the Delaware Act permits in the fiduciary arena).

[96] *See* Lubaroff & Altman, *supra* note 41, at 32.

[97] *See* DEL. CODE ANN. tit. 6, §§ 18-101 to -1109 (1993 & Supp. 1996). In contrast, title 8, § 102(b)(7) of Delaware's General Corporation Law entitles the corporation to eliminate the personal liability of directors. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996). Even this clause, however, contains some limits on the extent to which the corporation can contract out of liability. *See id.* The section prohibits the waiver of the duty of loyalty and good faith, among other things. *See id.*

[98] *See* DEL. CODE ANN. tit. 6, §§ 18-402, -405 (1993 & Supp. 1996) (providing that the limited liability company agreement may impose certain penalties on managers who breach the terms of the agreement).

[99] *See id.* § 18-108 (1993).

[100] *See* Thompson, *supra* note 4, at 935-36. The Delaware statutory language, title 6, §§ 18-1101 and 18-1104 in particular, is ambiguous enough to leave open the question of whether there is adequate justification for the courts to interfere with the parties' agreement when crafted according to the statutory scheme. *See id.* In other words, when should the courts override what is statutorily permissible is left open by the Delaware statute. *See id.*

[101] *See* DEL. CODE ANN. tit. 6, §§ 18-1101, -1104 (1993 & Supp. 1996).

This issue, in more generalized terms, reflects the tensions between freedom of contract and the court's equitable powers to intervene and modify the parties' agreement.[102] Accordingly, the quintessential dilemma becomes how far the parties may go in structuring their agreement without any judicial interference.[103]

1. General Corporation Law

Because our first task is to construct the basic standard of LLC conduct, it would be helpful to examine the current impositions of the corporation and partnership law in our two sample states.[104] In corporate law, the two generalized notions of responsibility are the duty of care[105] and the duty of loyalty.[106] Courts have traditionally evaluated the duty of

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[102] In the corporate schematic, there has already been a move towards allowing contract to take a more prevalent role in governing the relationship between the parties. *See* Thompson, *supra* note 4, at 935. Thompson illustrates this concept by referencing the Delaware Supreme Court case of *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993), where the court refused to "soften" the corporate statutory scheme by holding that "'[i]t would do violence to normal corporate practice and our corporation law' to fashion a judicial remedy." *Id.* at 935 & n.60. The theory behind this reasoning is that the participants in the corporate form have selected this type of governance by becoming shareholders and thus this is not something the judiciary should alter. *See id.* On the flip side, however, is the argument that the parties have selected the limited liability, and along with this, the governance rules are imposed upon participants. *See id.* This has graver implications for minority shareholders who, of course, will effectively be governed by the majority. *See id.*

[103] *See* Thompson, *supra* note 4, at 922 (predicting that a key issue in future LLC cases will be the relationship between the parties' freedom to contract and mandatory laws).

[104] *See id.* at 922-23. As the courts begin to hear cases involving LLCs, they will be confronted with many of the same issues that have arisen in context of other business associations, for example the partnership and corporation. *See id.* at 922. It is thus likely that much of the new LLC case law will turn out very similar to the partnership and corporation law of the past. *See id.* at 922-23.

[105] *See* Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 FORDHAM L. REV. 375, 375-76 (1988). Many state statutes now allow corporations to opt-out of the duty of care. *See id. See generally* Harvey Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMP. L. REV. 13 (1988) (assessing the soundness of duty of care opt-out provisions and the extent to which they actually relieve directors of liability).

[106] *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d Cir. 1984) (applying New York law); *In re* Albion Disposal, Inc., 152 B.R. 794, 821-22 (Bankr. W.D.N.Y. 1993); *see also* Branson, *supra* note 105, at 375.

The duty of care incorporates the standard that a fiduciary owes the shareholders when acting on behalf of the corporation. *See Norlin*, 744 F.2d at 264. The duty of loyalty prohibits self-dealing unless the fiduciary can show that the transaction is equitable and is in the corporation's best interests. *See id.* When there is self-dealing or a lack of good faith, the duty of loyalty takes precedence over the duty of care; the director is thus no longer afforded the protection of the business judgment rule and must prove the fairness of the transaction. *See id.* at 265.

care under the business judgment rule,[107] whereas both New York and Delaware have codified the duty of loyalty.[108]

As noted above, the duty of care is largely defined by a concept known as the business judgment rule.[109] The general theory behind the business judgment rule is to maintain managerial freedom and protect shareholders' interests.[110] This doctrine has developed primarily because of the courts' recognition that it is nearly impossible to objectively adjudicate what are in essence business judgments.[111] Courts also acknowledge that the judiciary is not the ideal candidate for corporate decision-making and, hence, business determinations are best left in the boardroom instead of the courtroom.[112] Provided director conduct meets certain minimum standards of care, the doctrine prohibits judicial inquiry into the soundness of a corporate decision.[113]

New York and Delaware courts have handled the business judgment rule in a similar manner.[114] This doctrine essentially protects directors from any second-guessing by creating a presumption that they acted appropriately, "appropriate" behavior consisting of informed[115] and disin-

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[107] *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805 (Del. 1984). While the business judgment rule is a creature of the decisional law, New York has codified a general standard of care embodied by an objective reasonableness standard. *See* N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1997). Directors are also entitled to rely on the reports of officers, employees, counsel, and other professionals as long as the director believes that party to be "reliable and competent in the matters presented." *Id.* § 717(a)(1)-(3).

[108] *See* DEL. CODE ANN. tit. 8, § 144 (1991); N.Y. BUS. CORP. LAW § 713 (McKinney 1986).

[109] *See, e.g., Van Gorkom*, 488 A.2d at 872; *Aronson*, 473 A.2d at 811.

[110] *See Aronson*, 473 A.2d at 811 & n.4. The business judgment rule stems from the basic axiom that directors manage the affairs of the corporation. *See Van Gorkom*, 488 A.2d at 872. Title 8, § 141(a) of the Delaware Code and New York's § 701 codify this essential premise. *See* DEL. CODE ANN. tit. 8, § 141(a) (1991); N.Y. BUS. CORP. LAW § 701 (McKinney 1986). Directors, as managers of the corporation, are charged with unique fiduciary obligations to the corporation and shareholders. *See Van Gorkom*, 488 A.2d at 872.

[111] *See* Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

[112] *See id.*

[113] *See id.* In *Auerbach*, the New York Court of Appeals described this doctrine as one that "bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes." *Id.*

[114] *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264-65 (2d Cir. 1984).

[115] The seminal case in Delaware on what constitutes "informed conduct" is *Smith v. Van Gorkom*. *See* 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the issue was whether the board of directors had arrived at an informed decision regarding the approval of a merger proposal. *See id.* at 874. The court, applying a standard of gross negligence, held that the board failed to reach an "informed business judgment" when they voted to sell the corporation for $55 per share. *See id.* The court explained that the directors neglected to

terested conduct.[116] Consequently, to rebut this presumption, the opposing party must show that the directors were either self-interested or not adequately informed.[117] If successfully rebutted, the burden of proof then shifts to the directors to show that the transaction was "fair" to the corporation—a concept sometimes referred to as the "entire fairness doctrine."[118]

The duty of loyalty, on the other hand, is codified in both states—under § 713 of the New York Business Corporation Law and title 8, § 144 of the Delaware Code.[119] In general, this duty prohibits self-dealing

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take adequate steps to assess the true value of the company. *See id.* Specifically, the directors approved the transaction without any prior notice of the proposal and after a meeting that lasted only two hours. *See id.* at 869, 874. Their decision was based solely on what one of the directors and officer, Van Gorkom, presented orally at the meeting. *See id.* at 874. There was neither written documentation nor any support to substantiate the valuation as a fair price. *See id.* The court emphasized that while directors are entitled to rely on reports of officers under title 8, § 141(e) of the Delaware Code, they are not entitled to blind reliance. *See id.* at 874-75. Thus, even though the current market price was only $38 and the collective experience of the board illustrated a highly sophisticated group of directors, the directors were hailed as neglecting to meet their duty. *See id.* This case illustrated, among other things, the willingness of the Delaware courts to enforce the duty of care as something more than a superfluous standard, and it is thus not surprising that this duty to be informed was no longer taken lightly. *See id.*

[116] *See Norlin*, 744 F.2d at 264-65 (explaining the presumption of appropriate behavior); Stoner v. Walsh, 772 F. Supp. 790, 800-01 (S.D.N.Y. 1991); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (explaining the presumption that conduct is informed and in the corporation's best interest); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (same); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (same). In *Aronson*, the Delaware Supreme Court characterized this baseline for review as a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* (citations omitted).

Note that under some circumstances, such as a hostile takeover, the Delaware courts have required an enhanced duty of care. *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995). The Delaware Supreme Court has justified the imposition of this "enhanced judicial scrutiny test" because of the "'inherent conflict of interest' during contests for corporate control." *Id.* (quoting Stroud v. Grace, 606 A.2d 75, 82 (Del. 1992) (quoting *Unocal*, 493 A.2d at 954)). In these instances, the burden is on the directors to establish that (1) they reasonably believed that a threat to the corporation existed; and (2) the defensive action taken was a reasonable course of action relative to the threat posed. *See id.*

[117] *See* Crouse-Hinds Co. v. Internorth, Inc., 634 F.2d 690, 702 (2d Cir. 1980) (applying New York law). Directors must "'account for their actions only when they are shown to have engaged in self-dealing or fraud, or to have acted in bad faith.'" *Id.*; Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[118] *See, e.g., Crouse-Hinds*, 634 F.2d at 702; *Norlin*, 744 F.2d at 264; *Cede*, 634 A.2d at 361 (explaining the entire fairness doctrine).

[119] *See* DEL. CODE ANN. tit. 8, § 144 (1991); N.Y. BUS. CORP. LAW § 713 (McKinney 1986).

unless the self-interested relationship was disclosed and approved.[120] A self-interested relationship ordinarily involves a situation where a director is involved on both sides of the transaction.[121] The intent of the statutory exemptions is to allow a "limited safe harbor" that prevents the automatic voiding of corporate action merely because of potential board conflicts.[122] If, however, the director fails to comply with the statutory mandates of disclosures and approval, the decision of "fairness" reverts to the courts under the "entire fairness doctrine."[123]

Aside from the protection of the business judgment rule, the corporate statutes in both states permit the corporation to "opt-out" of certain liabilities imposed upon directors.[124] In New York, § 402(b) of the Business Corporation Law authorizes inclusion of a provision in the charter that eliminates or limits the directors' exposure to personal liability, subject to certain non-waiveable restrictions.[125] Delaware contains a similar opt-out provision under title 8, § 102(b)(7) of its General Corporation Law.[126]

In summary, the corporate landscape embodies fiduciary standards for corporate governance controlled by statutory guidelines and further defined by the courts.[127] In both jurisdictions, directors are cloaked in a shield of protection known as the business judgment rule.[128] If the directors meet the prerequisites of this doctrine, courts will not substitute their judgment for that of the directors.[129] If not, however, the courts will adjudge director conduct by a much more stringent fairness standard.[130] Moreover, the corporate statutes provide additional protection to directors by permitting the elimination of liability for breach of fiduciary duty, subject to certain non-waiveable obligations.[131]

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[120] *See* DEL. CODE ANN. tit. 8, § 144 (1991); N.Y. BUS. CORP. LAW § 713 (McKinney 1986).

[121] *See Aronson*, 473 A.2d at 812.

[122] *See Cede*, 634 A.2d at 365.

[123] *See* DEL. CODE ANN. tit. 8, § 144(a)(3) (1991); N.Y. BUS. CORP. LAW § 713(b) (McKinney 1986).

[124] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1996).

[125] *See* N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1996).

[126] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996).

[127] *See supra* Part II.C.1 (discussing general corporation law).

[128] *See* DEL. CODE ANN. tit. 8, § 141(a) (1991); N.Y. BUS. CORP. LAW § 701 (McKinney 1986); *supra* notes 110-18 and accompanying text (examining the business judgment rule).

[129] *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

[130] *See supra* note 118 and accompanying text.

[131] *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1996); N.Y. BUS. CORP. LAW § 402(b) (McKinney Supp. 1996).

2. Close Corporation Law

As indicated above, the corporate structure affords directors a great deal of protection, whether through the business judgment rule, the elimination of fiduciary duties within the charter, or indemnification.[132] Nonetheless, the "close corporation" represents a species of corporate entity where the common law may displace or limit the liability shields that states typically grant directors in a publicly traded corporation.[133] Defining the exact specifications of what constitutes a close corporation, however, is not an easy task.

For instance, there are no mandatory criteria that corporations must satisfy to be treated as a close corporation, and the states differ in the formation of a close corporation.[134] Delaware mandates that the charter denominate the corporation as a "close corporation"[135] and has a subchapter devoted entirely to close corporations.[136] In contrast, New York merely includes language in its general corporation law authorizing an election by the corporation to be managed by shareholders instead of directors.[137] In both states, the shareholders then assume any liabilities that the directors would have had.[138] Both statutes exclude corporations that are publicly traded from electing this classification.[139] Thus, these entities, sometimes referred to as "incorporated partnerships,"[140] typically possess three distinguishing features: (1) few shareholders; (2) stock that is not traded; and (3) significant management/shareholder overlap.[141] Additionally, restrictions on transferability are likely to be

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[132] *See supra* Part II.C.1 (reviewing the corporate decisional law).

[133] *See* Dickerson, *supra* note 6, at 429.

[134] *See* DEL. CODE ANN. tit. 8, §§ 341-356 (1991 & Supp. 1996); N.Y. BUS. CORP. LAW § 620 (McKinney 1986).

[135] *See* DEL. CODE ANN. tit. 8, § 343 (1991).

[136] *See id.* §§ 341-356 (1991 & Supp. 1996).

[137] *See* N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986).

[138] *See* DEL. CODE ANN. tit. 8, § 350 (1991); N.Y. BUS. CORP. LAW § 620(f) (McKinney 1986).

[139] *See* DEL. CODE ANN. tit. 8, § 342(a)(3); N.Y. BUS. CORP. LAW § 620(c).

[140] *See* Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 514 (Mass. 1975); *see also* James W. Lovely, *Agency Costs, Liquidity, and the Limited Liability Company as an Alternative to the Close Corporation*, 21 STETSON L. REV. 377, 379 (1992); Brent Nicholson, *The Fiduciary Duty of Close Corporation Shareholders: A Call for Legislation*, 30 AM. BUS. L.J. 513, 513 (1992).

[141] *See Donahue*, 328 N.E.2d at 511; *see also* Nicholson, *supra* note 140, at 513, 515; Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 465 (1985). Management overlap exists when shareholders act in a dual capacity as managers thus skewing their independence. *See* Peeples, *supra*, at 465.

applied more liberally in the close corporation than in the regular corporation context.[142]

In general, courts have imposed a higher set of fiduciary obligations on the shareholder/directors in this type of environment.[143] Some courts apply a "heightened fiduciary duty," whereas others apply an "intrinsic fairness" test, to situations that benefit the majority shareholders at the cost of the minority shareholders.[144] The preeminent close corporation cases defining fiduciary duties come from the Massachusetts courts.[145] For example, in *Donahue v. Rodd Electrotype Co.*,[146] the Supreme Judicial Court of Massachusetts held that shareholders' duties in a close corporation are akin to those in a partnership setting.[147] What the court deemed a "strict good faith standard" encompassed the Massachusetts partnership standard of "'utmost good faith and loyalty.'"[148]

The *Donahue* court's decision rested upon the unique circumstances surrounding a minority shareholder's position in a close corporation.[149] Notably, minority shareholder challenges to board decisions are technically possible, but practically unfeasible.[150] This is primarily due to the deference that courts grant board decisions under the business judgment rule.[151] Consequently, decisions involving the declaration of dividends,

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[142] *See* J.R. Kemper, Annotation, *Validity of "Consent Restraint" on Transfer of Shares of Close Corporation*, 69 A.L.R.3d 1327, 1328-29 (observing that while state statutes generally permit restrictions on transferability, the likelihood of enforcement is greater in the close corporation context); *see also* DEL. CODE ANN. tit. 8, § 202 (1991) (permitting restrictions on transferability in general); N.Y. BUS. CORP. LAW § 508(c) (McKinney 1991) (same).

[143] *See* Nicholson, *supra* note 140, at 513-15.

[144] *See id.* Nicholson proposes a legislative solution that utilizes "partnership-type dut[ies]" to define the relationship between the shareholders. *See id.* at 515. For a discussion of the treatment that various courts have imposed upon majority shareholders in the close corporation context, see generally Nicholson, *supra* note 140.

[145] *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 661-63 (Mass. 1976); Donahue v. Rodd Electrotype Co., Inc., 328 N.E.2d 505, 513 (Mass. 1975). New York appears to follow the trend in *Wilkes* and *Donahue* and has recognized that shareholders in close corporations warrant unique protection from the courts. *See, e.g.*, Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1331, 1318-19 (N.Y. 1989). Delaware, on the other hand, has explicitly declined to follow *Wilkes*, at least in the context of employment contracts. *See* Riblet Prods. Corp. v. Nagy, 683 A.2d 37, 39 (Del. 1996). Delaware does, however, appear to acknowledge the potential for majority-owed fiduciary obligations to minority shareholders in general. *See id.* at 40.

[146] 328 N.E.2d 505 (Mass. 1975).

[147] *See id.* at 515.

[148] *See id.* (citation omitted).

[149] *See id.*

[150] *See id.* at 513.

[151] *See Donahue*, 328 N.E.2d at 513. The court opined that "in practice, the plaintiff will find difficulty in challenging dividend or employment policies [because] [s]uch policies are considered to be within the judgment of the directors." *Id.* (footnote omitted).

payment of exorbitant salaries to the majority, and deprivation of minority participation in the management/employment of the company are not readily contestable in the judicial arena.[152] Secondly, many minority shareholders have significant amounts of capital invested in the enterprise.[153] Unlike a publicly traded corporation, however, no open market exists for these shares where a minority investor can readily cash out his or her interest.[154] While this shareholder may, absent any transfer restrictions, attempt to sell his or her shares to another party, it is unlikely that any buyer would knowingly step into an oppressive situation.[155] Thus, without the heightened scrutiny applied in a close corporation

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Some commentators and courts have criticized the application of the business judgment rule in the close corporation context. *See* Peeples, *supra* note 141, at 465. Peeples suggests that some of the problems stem from inappropriate justifications and assumptions surrounding the application of the business judgment rule. *See id.* at 483-87. In particular, some of the typical justifications for employing this rule, reassuring capable managers, encouraging risk taking and inappropriateness of judicial review, are not applicable in a close corporation context. *See id.* at 483. Reassuring owners who are also managers is unnecessary. *See id.* Encouraging the owner/managers to take risks by allaying any fears of liability is also unwarranted; the owners presumably are already cognizant of any business risk. *See id.* at 483-84. Finally, concerns that the courts are not qualified to determine "business decisions" is lessened due to the often less complex issues that arise in close corporations. *See id.* at 484.

In addition, Peeples suggests that widespread litigation flooding the courts is also unlikely due to (1) the smaller number of potential plaintiffs/shareholders; and (2) the lack of incentive that the shareholders have to bring derivative suits, which would only serve to benefit the majority shareholders because the proceeds flow back to the corporation. *See id.* at 484-85. Peeples further questions the dubious nature of the traditional assumptions inherent in the business judgment rule. *See id.* at 485-87. One of the standard assumptions involved in the rule's application is the independence of the directors. *See id.* at 485. In an environment where the directors are also the shareholders and oftentimes the employees, however, there will always be the potential for conflict, involving compensation and dividends for example. *See id.* Another assumption is that of external controls on management, such as the federal securities laws, which are not present in the close corporation. *See id.* at 486. Finally, in the corporation context it is presumed that there are always alternative remedies available to the dissatisfied shareholder—the shareholder may simply sell his or her shares. *See id.* at 487. Again, however, this assumption does not hold true in the close corporation where there is no open market for the shareholders' interest in the corporation. *See id.*

To remedy these disparities, Peeples completes a comprehensive review of the potential solutions, including statutory and judicial standards, shareholder agreements and other potential remedies, and concludes by endorsing the "reasonable expectation analysis" as the alternative that is most beneficial to minority shareholders in a close corporation. *See id.* at 487-509. This approach provides for a statutory remedy of "involuntary dissolution" where there has been "oppressive conduct." *See id.* at 501. Oppressive conduct is gauged by the "reasonable expectations of the parties: frustration of a party's reasonable expectations results in 'oppression.'" *Id.* (footnote omitted).

[152] *See Donahue*, 328 N.E.2d at 513.

[153] *See id.* at 514.

[154] *See id.*

[155] *See id.* at 515.

context, minority shareholders would essentially be left without a remedy.[156]

The *Donahue* standard was further refined in the subsequent Massachusetts case of *Wilkes v. Springside Nursing Home, Inc.*[157] In *Wilkes*, the court held that the correct measurement for determining compliance with the "strict good faith" standard was to weigh any legitimate business purpose with the feasibility of employing a less harmful course of action.[158] Here, the court examined the alleged "freeze-out" of a minority shareholder, Wilkes, where the majority refused to allow him to continue his employment as a salaried employee.[159] The court found no legitimate business reason for this refusal because Wilkes was not involved in any misconduct and had always accomplished his share of the responsibilities in a satisfactory manner.[160] Therefore, the court concluded that this action was motivated by an attempt to force Wilkes to sell his shares back to the corporation at an unreasonably low price.[161]

In summary, close corporations present unique issues and are therefore generally granted special deference by courts deciding shareholder disputes with management.[162] In particular, courts tend to apply an overlay of partnership fiduciary principles rather than the traditional corporate standards.[163]

3. Partnership Law

Another body of law likely to impact future LLC cases is partnership law. The two primary forms of partnerships are the general partnership and the limited partnership.[164] A general partnership can be formed

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[156] *See generally* Terry A. O'Neill, *Self-Interest and Concern for Others in the Owner-Managed Firm: A Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations*, 22 SETON HALL L. REV. 646 (1992) (exploring the option of dissolution in the close corporation as opposed to the partnership setting).

[157] 353 N.E.2d 657 (Mass. 1976).

[158] *See id.* at 663.

[159] *See id.* at 661. The court noted that the denial of salaried employment may be one of the most "pernicious" measures that a controlling group may engage in to force a shareholder out of the corporation, which is known as "freeze-out." *See id.* at 662. Many shareholders in a close corporation rely on this type of active participation and expect to earn most of the benefits through a salaried position. *See id.*

[160] *See id.* at 663-64.

[161] *See id.* at 664.

[162] *See supra* notes 143-61 and accompanying text.

[163] *See supra* notes 143-61 and accompanying text.

[164] *See* 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 1.01(b), at 1:7 (1996). A general partnership has one class of members, general partners, whereas a limited partnership has two classes, general and limited partners. *See* 1 *id.* General partners participate in the day-to-day control of the business and are exposed to personal liability. *See* 1 *id.* Limited partners, on the other hand, are im-

without agreement and even inadvertently,[165] whereas a limited partnership requires filing a certificate with the secretary of state in the appropriate jurisdiction.[166]

General partners in general partnerships are liable for the obligations of the partnership and are jointly and severally responsible for the actions of the other partners.[167] Similarly, the general partner or general partners in a limited partnership are responsible for all partnership obligations.[168] In contrast, limited partners are only at risk to the extent of their investment in the limited partnership.[169] Additionally, the conduct of general partners, in both general and limited partnerships, is subject to fiduciary duties.[170]

In general, the limited partnership statutes give little guidance as to what these duties entail.[171] Both the New York Revised Limited Partnership Act and the Delaware Revised Uniform Limited Partnership Act merely provide that general partners have the same rights and are subject to the same restrictions as general partners in a general partnership.[172] Additionally, Delaware, but not New York, expressly allows indemnification clauses in the limited partnership agreement.[173] Partnership law, as the mechanism for characterizing the attributes of non-statutory business associations, such as the general partnership, is thus pertinent to delineating the role of general partners in a limited partnership setting.

Partnership duties, including the fiduciary relationship, have historically originated from the common law.[174] Other sources of authority emerge from the Uniform Partnership Act (UPA), adopted by most

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mune from personal liability, but are also generally precluded from any active management in the business. *See* 1 *id.*

[165] *See* Dickerson, *supra* note 6, at 424. While inadvertent general partnerships can be created by the actions of the parties, for example, by agreement to share in the profits and losses of a particular deal, the majority of general partnerships are formed by written agreement. *See* McNally & Small, *supra* note 14, at 27.

[166] *See* DEL. CODE ANN. tit. 6, § 17-201 (1993) (requiring the filing of a certificate of limited partnership); N.Y. PARTNERSHIP LAW § 121-201 (McKinney Supp. 1997) (same).

[167] *See* McNally & Small, *supra* note 14, at 27.

[168] *See id.* at 28.

[169] *See id.*

[170] *See id.* at 27, 28; *infra* notes 174-202 and accompanying text (discussing partner fiduciary duties).

[171] *See* DEL. CODE ANN. tit. 6, § 17-403 (1993 & Supp. 1996); N.Y. PARTNERSHIP LAW § 121-403 (McKinney Supp. 1997).

[172] *See* DEL. CODE ANN. tit. 6, § 17-403 (1993 & Supp. 1996); N.Y. PARTNERSHIP LAW § 121-403 (McKinney Supp. 1997).

[173] *See* DEL. CODE ANN. tit. 6, § 17-108 (1993).

[174] *See* Caryl B. Welborn, *Avoiding Personal Liability to Co-Members, Partners and Third Parties: How Far Can the Partnership or Operating Agreement Go?*, in Partnerships Revisited: New Rules, New Entities, Old Issues, New Sections 323, 325 (ALI-ABA Course of Study, June 18, 1996).

states, and the relatively new Revised Uniform Limited Partnership Act (RUPA), which by contrast has not been well-received.[175] The UPA defers primarily to the common law for fixing the limits of relational obligations among partners.[176] RUPA, on the other hand, furnishes substantially more statutory guidance.[177]

Section 404 of RUPA, entitled "General Standards of Partner's Conduct," specifically delineates the scope of the partner's fiduciary duties.[178] Like the corporation statutes, the two duties that section 404 incorporates are the duty of care and the duty of loyalty.[179] RUPA also

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[175] *See id.* As of August 1995, only three states had enacted a version of RUPA. *See* Dickerson, *supra* note 6, at 435 & n.70. For a review of the Delaware and New York laws, see *infra* notes 184-90 and accompanying text.

[176] *See* UNIF. PARTNERSHIP ACT (1914) (UPA) § 21, 6 U.L.A. 608 (1995). This section provides only that

> [e]very 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.

Id. Despite the absence of express definition in the UPA, courts and commentators have implied a "fiduciary relationship" between partners. *See* Welborn, *supra* note 174, at 326. Included among these implicit relationship-based obligations are that of loyalty and care, such as forbidding the use of partnership assets for individual benefits, prohibiting competition with the partnership, taking advantage of opportunities that belong to the partnership, improper usage of confidential information, and grossly negligent or bad faith conduct. *See id.*

[177] *See* UNIF. PARTNERSHIP ACT (1994) (RUPA) § 404, 6 U.L.A. 58-59 (1995). For a discussion of the revision of partnership law and the development and contributions of RUPA, including fiduciary obligations, see generally Donald J. Weidner, *A Perspective to Reconsider Partnership Law*, 16 FLA. ST. U. L. REV. 1 (1988); Donald J. Weidner, *The Revised Uniform Partnership Act Midstream: Major Policy Decisions*, 21 U. TOL. L. REV. 825 (1990) and Donald J. Weidner & John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1 (1993).

[178] *See* RUPA § 404, 6 U.L.A. 58-59.

[179] *See id.* Subsection (b) defines the duty of loyalty to the partnership and other partners as 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.

Id. § 404(b), 6 U.L.A. 58.

Subsection (c) defines the duty of care as follows:

> A partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law.

restricts the extent to which these relational duties may be limited or waived.[180] For example, while the partners may not eliminate the duty of loyalty, they may redefine their obligations as long as the limitations are not "manifestly unreasonable."[181] RUPA also forbids any "unreasonable reduction" of the duty of care[182] and any "manifestly unreasonable" alteration of the standards by which the good faith and fair dealing standard are adjudged.[183]

In addition to the UPA and RUPA, both New York and Delaware have codified partnership laws.[184] Neither, however, gives much additional guidance relative to the fiduciary duties of the parties.[185] Similar to the UPA, these statutes leave the work of molding these duties to the courts.[186] Specifically, § 43 of the New York law echoes section 21 of the UPA by merely laying out a general foundation; the title, "Partner accountable as a fiduciary," is perhaps more telling than the content.[187] Delaware offers even less by not expressly stating any fiduciary obliga-

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Id. § 404(c), 6 U.L.A. 58. Section 404 also demands that the partners perform their duties "consistently with the obligation of good faith and fair dealing." *Id.* § 404(d), 6 U.L.A. 58. Finally, section 404(e) provides that there is no violation of the RUPA "merely because the partner's conduct furthers the partner's own interest." *Id.* § 404(e), 6 U.L.A. 58.

[180] *See id.* § 103, 6 U.L.A. 16-17.

[181] *See id.* § 103(b)(3), 6 U.L.A. 16.

[182] *See id.* § 103(b)(4), 6 U.L.A. 17.

[183] *See id.* § 103(b)(5), 6 U.L.A. 17. *See generally* Robert M. Phillips, Comment, *Good Faith and Fair Dealing Under the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 1179 (1993) (examining the concept of good faith and fair dealing in the context of RUPA).

[184] *See* DEL. CODE ANN. tit. 6, §§ 1501-1544 (1974 & Supp. 1996); N.Y. PARTNERSHIP LAW §§ 1-126 (McKinney 1988 & Supp. 1997).

[185] *See* DEL. CODE ANN. tit. 6, §§ 1501-1544 (1974 & Supp. 1996); N.Y. PARTNERSHIP LAW §§ 1-126 (McKinney 1988 & Supp. 1997).

[186] *See* UPA § 21, 6 U.L.A. 608 (1995) (indicating that common law is generally responsible for fixing the limits of fiduciary duties); DEL. CODE ANN. tit. 6, § 1505 (1993); N.Y. PARTNERSHIP LAW § 43 (McKinney 1988); *supra* note 176 (discussing UPA section 21).

[187] *See* N.Y. PARTNERSHIP LAW §§ 5, 43 (McKinney 1988). A portion of § 43 reads as follows:

> 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.

Id. § 43(1).

tions.[188] As in the LLC statute,[189] Delaware's title 6, § 1505 defers to the "rules of law and equity" for any definitional purpose.[190]

In light of the absence of statutory detail, partnership case law is the primary source for defining the relational obligations of partners.[191] Whatever the UPA and the state statutes may lack in detailing these responsibilities, *Meinhard v. Salmon*,[192] a New York Court of Appeals case, defines with grandeur. In this seminal case, Judge Cardozo eloquently delineates the partner's role as fiduciary as including a strict duty of loyalty.[193] More recent New York cases continue to reinforce the venerability of these fiduciary obligations.[194] The New York Court of Appeals, in *Birnbaum v. Birnbaum*,[195] continued to fortify the unyielding concept of the fiduciary's duty of undivided loyalty.[196] Generally, in defining the scope of these responsibilities, the courts have emphasized that fiduciaries may not involve themselves in situations where their personal interests may impair their obligations to the partnership.[197]

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[188] *See* DEL. CODE ANN. tit. 6, §§ 1501-1547 (1993 & Supp. 1996) (making no mention whatsoever of any express fiduciary obligations).

[189] *See id.* § 18-1101(c) (Supp. 1996).

[190] *See id.* § 1505 (1993). New York contains an identical provision. *See* N.Y. PARTNERSHIP LAW § 5 (McKinney 1988).

[191] *See* Welborn, *supra* note 174, at 325. The same general partnership principles apply equally to general partners in a limited partnership setting. *See* Riviera Congress Assocs. v. Yassky, 223 N.E.2d 876, 879 (N.Y. 1966).

[192] 164 N.E. 545 (N.Y. 1928).

[193] *See id.* at 546. This oft-cited passage reads as follows:

> Joint adventures, like co-partners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honestly alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.

Id. (citation omitted).

[194] *See, e.g.*, Birnbaum v. Birnbaum, 539 N.E.2d 574, 576 (N.Y. 1989); Lichtyger v. Franchard Corp., 223 N.E.2d 869, 874 (N.Y. 1966); Drucker v. Mige Assocs. II, 639 N.Y.S.2d 365, 366 (App. Div. 1996).

[195] 539 N.E.2d 574 (N.Y. 1989).

[196] *See id.* at 576. In particular, the court stated that "it is elemental that a fiduciary owes a duty of undivided and undiluted loyalty to those whose interests the fiduciary is to protect. This is a sensitive and 'inflexible' rule of fidelity . . . . [The fiduciary] is bound to single-mindedly pursue the interests of those to whom a duty of loyalty is owed . . . ." *Id.* (citations omitted).

[197] *See, e.g., id.* (finding that a partner's payments to his wife of partnership funds as compensation conflicted with his duty as a fiduciary); *Drucker*, 639 N.Y.S.2d at 366

The Delaware courts have given similar deference to the partners' status as "fiduciaries."[198] As the Delaware chancery court stressed, "[a] fiduciary duty is not a simple moralism; it supplies an important component of the utility of any form of organization that promotes capital aggregation from many sources."[199] The court went on to state that the formidable purpose of imposing fiduciary duties was to balance the interests of the investors with those of the managers, who need to be able to manage with a good deal of discretion.[200] The fiduciary duty of loyalty superimposes upon the partners a general standard of conduct.[201] The primary goal of this common-law duty is to prevent the need for unwarranted and unnecessarily detailed contracting, including circumstances that are foreseeable and those that are not.[202]

III. FIDUCIARY OBLIGATIONS IN AN LLC SETTING: A NEW STANDARD

A. Setting a Framework for Review: A Structural Recap of the LLC

As noted above, LLCs are a cross-breed of the partnership and corporate forms, falling somewhere in the middle of the two.[203] The fiduciary obligations will also lie along the lines of this spectrum—the question is where should their placement be, and perhaps more importantly,

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(finding that the use of voting provision under the partnership agreement for personal gain constituted a breach of fiduciary duty).

[198] *See, e.g., In re* USACafes, 600 A.2d 43, 48-49 (Del. Ch. 1991) (holding that fiduciary obligations are imposed upon the directors of a corporate general partner); US W., Inc. v. Time Warner Inc., No. CIV.A.14555, 1996 WL 307445, at *20-21 (Del. Ch. June 6, 1996) (holding that a fiduciary duty imposes an obligation to act in good faith to advance the beneficiary's interests); Davenport Group MG, L.P. v. Strategic Inv. Partners, Inc., 685 A.2d 715, 720 (Del. Ch. 1996) (holding that general partners are subject to requirements of common-law fiduciary duties); James River-Pennington Inc. v. CRSS Capital, Inc., No. CIV.A.13870, 1995 WL 106554, at *11 (Del. Ch. Mar. 6, 1995) (holding a general partner accountable as a fiduciary to the partners and the partnership). *See generally* Bradford P. Weirick, *Fiduciary of Delaware Directors in a Limited Partnership Context*, 5 INSIGHTS 11, Nov. 1991, at 29 (discussing *USACafes* and the potential expansion of fiduciary duties in a partnership to its corporate directors).

[199] *See US W., Inc.*, 1996 WL 307445 at *21.

[200] *See id.* (emphasizing the need to "safeguard[ ] investors in placing funds in the hands of others for indefinite periods, without contracted for returns, and in delegating to managers very broad and flexible discretion").

[201] *See id.*

[202] *See id.*

[203] *See supra* notes 20-30 and accompanying text (examining the general characteristics of LLCs).

whether it should be fixed or flexible.[204] To respond to this inquiry, it would be helpful to review the nature of this new entity and the manner in which New York, Delaware, and the ULLCA have addressed some of the issues surrounding fiduciary obligations and waiver.

How do parties form an LLC, why do parties chose this form, what type of bargaining process is available to the parties, how much of their investment is at risk, and how easy is it for a dissatisfied participant to exit from the LLC? To form an LLC, the parties must file a certificate of formation with the appropriate state office,[205] thus precluding any inadvertent formation, as there sometimes is in a general partnership setting.[206] Accordingly, members knowingly become part of the LLC. This point is not to be overstated, however, as most parties are generally aware of becoming part of an entity—general partnership or otherwise.

The choice of the LLC format is primarily generated by two guiding forces: limited liability for all members and partnership taxation treatment.[207] By having limited liability, the amount of investment at risk is only the members' investment in the LLC, not the members' personal assets.[208] The key benefit of the LLC, however, is combining limited liability and partnership taxation with the flexibility to structure and operate the LLC as the members desire.[209] Accordingly, the ability of parties to bargain and participate in the active management of the LLC will depend largely on the structure of each individual LLC.

An LLC can function in many different ways.[210] The parties may chose to have the members run the LLC, much as a general partnership

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[204] *See* Thompson, *supra* note 4, at 922-23 (suggesting that the LLC case law will evolve to mimic the corporation and partnership case law, resulting in a "judicial taming of this new beast").

[205] *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-201(a) (1993 & Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 203(d) (McKinney 1997).

[206] *See* Dickerson, *supra* note 6, at 419.

[207] *See* Thompson, *supra* note 4, at 929. LLCs are driven by limited liability and favorable tax treatment, but not by form of governance. *See id.* As articulated by the Prefatory Note to the Uniform Limited Liability Company Act, "[t]he allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms—properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership." UNIF. LTD. LIAB. CO. ACT (1995) (ULLCA), 6A U.L.A. 426 prefatory note (1995 & Supp. 1996).

[208] *See* Dickerson, *supra* note 6, at 419 ("[the LLC] provides limited liability for its owners without concern for the extent of their involvement in management").

[209] *See supra* note 30 and accompanying text.

[210] *See* McGeever, *supra* note 81, at 54 (observing that LLCs can be member or manager managed).

works.[211] Alternatively, the LLC could be managed by a board of managers elected by the members, similar to the corporate structure.[212] Finally, the LLC could opt for a structure where there is a managing member or members who control(s) the day-to-day operations of the LLC with the remainder of the members having only limited decision-making authority, much like a limited partnership.[213] The potential permutations of this chameleon-like beast are therefore highly relevant factors when attempting to formulate a workable standard for defining fiduciary duties and the freedom to opt-out of these obligations.

Finally, not unlike many other business forms, with the exception of a publicly traded entity, the operating agreement may restrict or prohibit a member from withdrawing from the LLC until dissolution.[214] Moreover, there may be a lesser degree of self-help available to members who are "locked-in" to the association.[215]

B. Statutory Construction: Flexible v. Mandatory Standards

As illustrated in Part II of this Comment, there are diverse approaches to the statutory definition of fiduciary duties.[216] The New York Limited Liability Company Law demands "good faith" performance in accordance with a reasonable person standard[217] and requires the members to adopt a written operating agreement.[218] Although the agreement may limit participants' personal liability for breach of their fiduciary duties, it may not eliminate breaches for bad faith conduct.[219]

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[211] *See* DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 401(a) (McKinney 1997).

[212] *See* DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 408(a) (McKinney 1997).

[213] *See* DEL. CODE ANN. tit. 6, § 18-402 (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 408(a) (McKinney 1997).

[214] *See* DEL. CODE ANN. tit. 6, § 18-603 (Supp. 1996); N.Y. LIMITED LIABILITY COMPANY LAW § 606 (McKinney 1997).

[215] *See* Thompson, *supra* note 4, at 936. One important consideration in the LLC context is the lack of self-help available to the members. *See id.* As opposed to the partnership forum, where all general partners are restrained by liability to the other partners and the partnership, LLC members are not. *See id.* Thus, there is arguably more justification for judicial interference in the limited liability context, than in the partnership setting where the partners can more or less police themselves. *See id.*

[216] *See supra* Part II.

[217] *See* N.Y. LIMITED LIABILITY COMPANY LAW § 409(a) (McKinney 1997) (mandating that a participant act in "good faith and with that degree of care that an ordinary prudent person in a like position would use under similar circumstances").

[218] *See id.* § 417(a).

[219] *See id.* § 417(a)(1).

The Delaware Limited Liability Company Act, on the other hand, sets forth a very narrow mandatory standard of conduct.[220] For a member to be free from liability, the member is obligated only to rely in good faith on the terms of the LLC agreement.[221] The Delaware Act emphasizes freedom of contract, giving maximum effect to the enforceability of the parties' agreement.[222] Accordingly, the Delaware Act affords parties the authority to expand or restrict any duties that may be imposed upon the members, presumably under the common law.[223]

Apart from the New York Law and Delaware Act, there is another approach to structuring fiduciary duties, which has been adopted by the ULLCA.[224] In a unique twist, the ULLCA stands in stark contrast to both the New York Law and Delaware Act by borrowing the methodology of RUPA in structuring its layout of fiduciary responsibilities.[225] Almost verbatim from RUPA, the ULLCA section 409 enumerates explicit standards by which participants must abide.[226] Nonetheless, this

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[220] *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (Supp. 1996); *see also* J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, LAW & CONTEMP. PROBS., Spring 1995, at 29, 49-50 (commenting on an identical provision in the Delaware Limited Partnership Law). Hynes suggests that:

> This narrows the reach of the good faith standard, which is confined to interpreting the parties' contract. Also, Delaware courts have required 'a tortious state of mind' to show a breach of good faith under the statute. This could be read to incorporate a standard of 'honesty in fact,' on the reasoning that a tortious state of mind means a fraudulent state of mind. This reading is reinforced by the philosophy of the statutory language, which is to narrow, not expand, liability.

Id. at 50 (footnotes omitted). He goes on to state that this language is "particularly striking" in a limited partnership act, as opposed to a general partnership act, because of the relative remedial options available. *See id.* Limited partners "do not exercise control and do not enjoy dissociation or dissolution powers," increasing the potential for abuse and exploitation by the general partner(s). *Id.*

[221] *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (Supp. 1996).

[222] *See id.* § 18-1101(b) (1993).

[223] *See id.* § 18-1101(c) (Supp. 1996).

[224] *See* ULLCA § 409, 6A U.L.A. 464-65 (1995 & Supp. 1996).

[225] *Compare id.* (enumerating explicit standards of conduct from members) *with* DEL. CODE ANN. tit. 6, § 18-1101(c) (1993 & Supp. 1996) *and* N.Y. LIMITED LIABILITY COMPANY LAW §§ 409, 417 (McKinney 1997) (expressing vague standards of conduct for members).

[226] *Compare* ULLCA § 409, 6A U.L.A. 464-65 *with* RUPA § 404, 6 U.L.A. 58-59 (1995). Section 409 of the ULLCA reads as follows:

> (a) The only fiduciary duties a partner owes to a member-managed company and its other members are the *duty of loyalty and the duty of care* imposed by subsections (b) and (c).
>
> (b) A member's *duty of loyalty* to a member-managed company and its other members is *limited to the following*:
>
> (1) to account to the company and hold as trustee for it any property, profit, or benefit derived by the member in the conduct or

predefined regimen may be tailored by agreement; the ULLCA section 103 includes an "opt-out" provision that essentially permits the members to reduce their obligations to a minimal threshold of good faith.[227]

The imposition of mandatory fiduciary duties, such as those in ULLCA sections 409 and 103, has generated a fair amount of criticism from commentators—at least in the context of RUPA sections 404 and

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> winding up of the company's business or derived from a use by the member of the company's property, including the appropriation of a company's opportunity;
> (2) 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
> (3) to refrain from competing with the company in the conduct of the company's business before the dissolution of the company.
>
> (c) A member's *duty of care* to the a member-managed company and its other members in the conduct and winding up of the company's business is *limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of the law.*
> (d) A member shall discharge the duties to a member-managed company and its other members under this [Act] or under the operating agreement and exercise any rights consistently with the obligation of *good faith and fair dealing*.
>
> . . .
>
> (h) In a manager-managed company:
> (1) a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member;
> (2) a manager is held to the same standards of conduct prescribed for in subsection (b) through (f).

Id. § 409, 6A U.L.A. 464-65 (emphases added) (alteration in original). The difference in standards for member-managed LLCs and manager-managed LLCs in subsection (h) has been questioned. *See* Dickerson, *supra* note 6, at 437-38. For the relevant text of RUPA § 404, see *supra* note 179.

[227] *See* ULLCA § 103(b), 6A U.L.A. 434-35. Section 103(b) reads as follows:

> The operating agreement may not: . . .
> (2) eliminate the duty of loyalty . . . but the agreement may
> (i) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; . . .
> (3) unreasonably reduce the duty of care . . .;
> (4) eliminate the obligation of good faith and fair dealing . . . but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable . . . .

Id. See generally Dickerson, *supra* note 6 (criticizing and commenting on the manner in which the ULLCA addresses fiduciary responsibilities); Hynes, *supra* note 220 (reviewing RUPA opt-out counter-part to the ULLCA provision). *Cf.* Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, LAW & CONTEMP. PROBS., Spring 1995, at 81 (endorsing mandatory minimum fiduciary standards).

103.[228] One argument is that, by employing mandatory fiduciary standards, RUPA precludes certain types of otherwise reasonable contractual arrangements.[229] One commentator, Professor Larry Ribstein, illustrates this point by suggesting that a partner may have such a substantial investment in the partnership or LLC that the parties may eliminate any duty of care obligation.[230] From a cost-benefit standpoint, this opt-out is perfectly reasonable in light of the low risk of breach, i.e., grossly negligent conduct, and the potentially high cost of litigation.[231]

Professor Ribstein and other commentators also suggest that these mandatory restrictions on opting-out fail to recognize that many parties to these agreements are highly sophisticated; they bargain in detail and often have competent legal counsel by their side.[232] Proponents of the RUPA language, however, claim that mandatory duties are necessary to protect the unsophisticated participants and inadvertent partners.[233]

A second issue of debate arises from the lack of forseeability of a copartner's future conduct.[234] Proponents assert that mandatory fiduciary duties protect partners from this type of unforeseeable and perhaps oppressive behavior.[235] As another commentator aptly notes, however, this uncertainty can "cut[ ] both ways."[236] A prime reason for avoiding fiduciary duties may be to escape the perhaps more risky uncertainties of

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[228] *See, e.g.*, Hynes, *supra* note 220, at 39-45; Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, BUS. LAW., Nov. 1993, at 45, 58-60 (1993).

[229] *See* Ribstein, *supra* note 228, at 58.

[230] *See id.*

[231] *See id.* Other examples include: (1) contracting out of liability for the vague terminology of "intentional misconduct" or a "knowing violation of the law;" (2) certain self-interested transactions (partnership entering into agreement with a partner's management company); and (3) incorporating a with or without cause expulsion provision. *See id.*

[232] *See id.* at 58-59; *see also* Hynes, *supra* note 220, at 39-40. Hynes is a proponent of eliminating the restriction on waiveability. *See id.* He submits that "[p]ersons entering into a partnership relationship ordinarily bargain from an approximately equal position, an equality created by the fact that each party typically has something of near-equal value to offer the other. That is the reason partnership status is being offered by one party and sought by the other." *Id.* at 40. Hynes also offers an interesting study of cases decided prior to the enactment of the RUPA where the courts gave great deference to the parties' agreement, including waivers of fiduciary responsibility. *See id.* at 40-43. He then questions whether these cases would stand under the RUPA provisions. *See id.* at 42.

[233] *See* Hynes, *supra* note 220, at 45. The Comments to RUPA also purport to include the waiver restrictions for the benefit of those who lack either "unequal bargaining power, information, or sophistication." *See* Ribstein, *supra* note 228, at 58 (citing RUPA § 103 cmt. 2).

[234] *See* Hynes, *supra* note 220, at 44-45; Ribstein, *supra* note 228, at 59-60.

[235] *See* Hynes, *supra* note 220, at 44; Ribstein, *supra* note 228, at 59.

[236] *See* Hynes, *supra* note 220, at 44.

litigation and of the court's interpretation of the agreement.[237] Some additional disputes pertaining to waiver restrictions concern the agency relationship between partners/members and the simplification of the contracting process.[238]

C. *A New Framework for Analysis: The Unconscionability Doctrine*

After examining this panoply of statutory methodology, spanning from Delaware's complete endorsement of freedom of contract to the ULLCA's somewhat restrictive and more rigid structure,[239] the most difficult task is at hand. What, if any, fiduciary responsibilities should the statutes and/or the courts impose upon the participants in an LLC?[240] This query entails the quintessential battle between the touchstone of private ordering and the fundamental principles of equity.[241] When should judicial interference be permitted and to what degree should a statute dictate the norms by which the parties wish to conduct their enterprise?

Freedom of contract is a venerable axiom of contract law.[242] Absent fraud, duress, or another reason to doubt the parties' consent, the courts will enforce a party's bargain; this is a fundamental notion, which, if unduly tampered with, could cause great instability.[243] Courts and commentators have nonetheless recognized certain instances where judicial interference is warranted.[244] First, there are the notions of good faith

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[237] *See id.* at 44-45; *see also* Ribstein, *supra* note 228, at 59-60 (proffering that the alternative, disallowing certain waivers, essentially forces the parties into costly legal situations that could have otherwise been avoided).

[238] *See* Hynes, *supra* note 220, at 43-45. Proponents of restricting waivers argue that agency generates the implicit recognition of fiduciary responsibility. *See id.* at 43-44. Because of agency's deference to freedom of contract principles, however, there is also a good argument that these duties may be contracted away. *See id.* Additionally, the proponents maintain that mandatory duties foreclose the need to complete a comprehensive investigation of all potential partners. *See id* at 44. This too may be an unnecessary concern as a default would allow the parties to investigate as needed. *See id.*

[239] See discussion *supra* notes 216-27 and accompanying text.

[240] *See* Thompson, *supra* note 4, at 922 ("From a governance standpoint, a key question is the relationship between mandatory law and private ordering, a question that has long been at the center of corporate law." (footnote omitted)).

[241] *See generally* Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209 (1995) (examining the contractarian and non-contractarian views regarding whether fiduciary duties should be mandatory or default rules and how the parties should proceed if waiveable).

[242] *See* Hynes, *supra* note 220, at 38.

[243] *See id.* (suggesting that "[m]andatory provisions are inconsistent with the bargain principle" and only serve to hamper the reliability of agreements (footnote omitted)).

[244] *See infra* notes 256-66 and accompanying text. *See generally* Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741 (1982) (maintaining

and fair dealing, threshold requirements delineating the parties' relations.[245] These may be implied in the contracted-for exchange or imposed as a societal prerequisite for dealing.[246] Next, and perhaps more intrusive, are doctrines permitting judicial tampering with an agreement that would otherwise be enforceable—predominately accomplished by a mechanism known as unconscionability.[247]

Good faith and fair dealing are difficult standards to capture and are best looked upon as expressing implicit expectations of the parties.[248] In other words, what would the parties expect from one another under the circumstances. Most likely, one would expect that each party is looking out for his or her own interests but would deal "fairly" with one another. The Uniform Commercial Code (U.C.C.) is probably the best guide to this somewhat elusive concept.[249] U.C.C. section 1-203 demands that the parties act in good faith in the performance of their duties.[250] The official comments explain that good faith is not a separate duty, but rather functions as an overlay to the parties' performance;[251] it is a context in which the courts will judge whether the parties have breached an independent duty.[252] For merchants and non-merchants, the U.C.C. imposes divergent standards: for non-merchants all that is required is "honesty in fact," a subjective standard, whereas merchants must comply with the additional requirement of "reasonable commercial standards of fair dealing in the trade," a more objective standard.[253]

The Restatement (Second) of Contracts also imposes a mandatory good faith standard.[254] The Restatement's comments add further detail to this concept, interpreting good faith as the type of behavior the other party would expect in light of the prevailing standards in the community.[255]

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that unconscionability may warrant certain limitations on the fundamental notion that contracts—"bargain promises"—should be enforced).

[245] See *infra* notes 248-55 and accompanying text for a discussion of these concepts.

[246] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981) (explaining that good faith embodies "faithfulness to a common purpose and consistency with the justified expectations of the other party . . . exclud[ing] . . . bad faith because [it] violate[s] community standards of decency, fairness or reasonableness").

[247] See *infra* notes 265-74 and accompanying text for a discussion of unconscionability.

[248] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981).

[249] *See* UNIF. COMMERCIAL CODE (U.C.C.) § 1-203, 1A U.L.A. 109 (1989) (defining "good faith").

[250] *See id.*

[251] *See id.* official cmts.

[252] *See id.*

[253] *See id.* official cmts.; *id.* §§ 2-103(1)(b), 1-201(19), 1 U.L.A. 65, 185 (1989).

[254] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

[255] *See id.* § 205 cmt. a.

There are, nonetheless, some valid criticisms of limiting statutory constraints to a good faith standard.[256] Good faith, without more, does not embody any fiduciary responsibilities, such as the duties of care and loyalty.[257] One of the key differences between the fiduciary duty principle and good faith is the ability of the participant to act in a self-interested fashion.[258] Good faith is a flexible overlay to the parties' agreement, whereas the concept of a fiduciary responsibility embodies a moralistic tradition of loyalty.[259] A fiduciary can never act contrary to the entity's interests; to do so would inherently conflict with the very nature of this relationship.[260] Thus, mandatory fiduciary duties necessarily preclude any self-interested activity while good faith obligations do not.[261]

The trouble with the non-existence of fiduciary restraints is the potential for oppression of minority members or passive investors.[262] Some commentators caution that without some type of due care standard, permissible self-interest and competition with the LLC would lead to abuse by some participants.[263] By itself, a "good faith and fair dealing" standard is probably not sufficient to properly balance the equation. Highly structured fiduciary statutory restraints, however, are not the answer.[264] Default fiduciary provisions or common-law fiduciary duties coupled with a tempered judicial restraint, such as unconscionability, is a far superior mechanism for balancing private ordering and concerns of abuse.

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256 *See infra* notes 257-63 and accompanying text.

257 *See What Standards of Conduct Should Apply*, *supra* note 6, at 73-74.

258 *See* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1658 (1989). For a comparison of fiduciary duties and good faith, see generally Coffee, *supra*. Professor Coffee notes that one of the central differences is that "a contracting party may seek to advance his own interests in good faith while a fiduciary may not." *Id.*

259 *See* 1 RIBSTEIN & KEATINGE, *supra* note 6, § 9.07, at 9-19 (distinguishing good faith from the duty of loyalty).

260 *See* Coffee, *supra* note 258, at 1658 (explaining that the "traditional fiduciary ethic insists that the fiduciary act selflessly" (footnote omitted)).

261 *See id.*; *What Standards of Conduct Should Apply*, *supra* note 6, at 73-74.

262 *See What Standards of Conduct Should Apply*, *supra* note 6, at 74.

263 *See id.* Miller comments that even with closely defined fiduciary duties and a good faith standard, it is questionable whether these "carefully circumscribed standards," as in the ULLCA, will be adequate to protect against minority abuse. *See id.* at 73.

264 *See, e.g.*, Coffee, *supra* note 258, at 1659. Professor Coffee, under the auspices of corporate duties, sets forth a viable placement of the fiduciary notion by raising the query of whether the "mandatory minimum in corporate law [should] be set at or near the level of the duty of good faith with the fuller, more selfless requirements of traditional fiduciary duty being treated as default rules." *Id.* In this manner, a certain degree of opting-out would be legitimate. *See id.* In other words, "the zone between the duty of good faith and the higher fiduciary standard of selflessness would become negotiable." *Id.*

While concepts such as "good faith and fair dealing" are currently embodied in a fiduciary analysis of LLC members, the unconscionability doctrine is not.[265] Nevertheless, this precept may be a plausible mechanism to police member/manager misconduct in an LLC.[266] By setting unconscionability as a standard for review, intrusive judicial conduct will be minimized, giving maximum deference to the parties' agreement, while preserving some degree of permissive temperance by the courts if the actions of the parties stretch too far.

The best analysis of unconscionability is again derived from the U.C.C.[267] The U.C.C. sets forth the standard for unconscionability in section 2-302, which permits the court to strike all or part of any unconscionable agreement.[268] In general terms, unconscionability encompasses either oppressive terms in the contract itself or disparity in the bargaining environment.[269] Nevertheless, unlike many merchant/consumer situations that arise under the U.C.C., it is unlikely that there will be any procedural or substantive unsoundness in the LLC arena because of its commercial context, primarily because the parties will be on or near equal

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[265] *See supra* notes 217, 226, 227 (illustrating the use of "good faith" in the statutes).

[266] *See* Hynes, *supra* note 220 at 50-54. One commentator has suggested replacing the "manifestly unreasonable" language of section 103 of the ULLCA, which limits the extent to which the parties may modify the duty of loyalty and obligations of good faith and fair dealing, with an "unconscionability" standard. *See id.* The author suggests that there is more evolved case law surrounding the "unconscionability" concept and that there is more "bite," or as he terms it "shock value," to this precept. *See id.* at 51-53. A higher threshold thus aids in preserving the "bargain principle," giving more effect to the parties' agreement. *See id.* at 53.

[267] *See* U.C.C. § 2-302, 1A U.L.A. 15-16 (1989).

[268] *See id.* Section 2-302 reads as follows:

> (1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.
>
> (2) . . . [T]he parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect to aid the court in making the determination.

Id.

[269] *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 4-3, at 137 (4th ed. 1995). The two measures of unconscionability are typically termed "procedural" and "substantive." *See id.* A contract is procedurally unconscionable when there is a defect in the formation, for example disparity of bargaining power or lack of meaningful choice of one party. *See id.* Substantive unconscionability deals with the actual substantive terms of the agreement itself, whether the terms are extremely one-sided or oppressive. *See id.* Although there is no definitive answer from the decisional law, most courts generally mandate a showing under both prongs to support a finding of unconscionability under section 2-302 of the U.C.C. *See id.* § 4-7, at 150.

footing in the negotiations.[270] Most future members of an LLC will have relatively equal bargaining power and will bargain in detail over the terms of the agreement.[271]

Unconscionability would, however, provide courts with a mechanism for policing those instances where the parties were not sophisticated or where one party had substantially more bargaining power than the other.[272] This judicial tool should allay the fears of those who endorse mandatory fiduciary duties, as in RUPA and the ULLCA language cited above, for just this reason. Nevertheless, unconscionability should not be interpreted as a *carte blanche* for judicial interference into any contractual imbalance.[273] A bad bargain is not enough to rise to the level of unconscionability; nor is mere unreasonableness.[274] There is nothing

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[270] *See* Johnson v. John Deere Co., 306 N.W.2d 231, 238 (S.D. 1981) (proffering that the courts are substantially more likely to uphold a U.C.C. § 2-302 challenge "in the case of the downtrodden consumer than they are in the case of the commercial consumer who presumably has a far more meaningful choice"); WHITE & SUMMERS, *supra* note 269, § 4-9, at 155 ("courts have not generally been solicitous of business persons in the name of unconscionability"); *id.* n.2 (citing cases where courts refused to find unconscionability in commercial settings). For a general discussion of unconscionability in commercial settings, see WHITE & SUMMERS, *supra* § 4-9, at 155-59.

[271] *See generally* Robert W. Hillman, *Private Ordering Within Partnership*, 41 U. MIAMI L. REV. 425 (1987) (exploring the bargaining concept in the partnership context).

[272] Unconscionability is a question of law, and hence this would not be an issue delegated to the fact-finder. *See* Jones Distrib. Co. v. White Consol. Indus., Inc., 943 F. Supp. 1445, 1460 (N.D. Iowa 1996); Potomac Plaza Terraces, Inc. v. QSC Prods., Inc., 868 F. Supp. 346, 353 (D.D.C. 1994); Sosa v. Paulos, 924 P.2d 357, 360 (Utah 1996).

[273] *See, e.g.*, Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965). The *Williams* court noted that courts generally view unconscionability as including an absence of meaningful choice by one party and terms unreasonably favorable to the other. *See id.* at 449. The court further explained that meaningful choice is determined by considering all the circumstances. *See id.* The court noted that a meaningful choice can be overcome by a gross inequality of the parties' bargaining power. *See id.* The *Williams* court further described the unconscionability as follows:

> Did each party to the contract, considering his obvious education or lack of it, have a reasonable opportunity to understand the terms of the contract, or were the important terms hidden in a maze of fine print and minimized by deceptive sale practices? Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no objective knowledge of its terms, it is hardly likely that his consent or even an objective manifestation of his consent, was ever given to all the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld.

Id. at 449-50 (footnotes omitted).

[274] A bad bargain in itself would not necessarily imply substantively unconscionable terms. To qualify as such, the contract would have to be one that "no sensible man

wrong with a party attempting to maximize his or her benefits and protections in the agreement, maybe to the detriment of the other. Freedom of contract should be given great deference. The more intelligent and crafty party should not be penalized for his or her business savvy, nor should the less wise be protected and guaranteed a "fair" agreement with equal benefit to both parties. It is not the courts' prerogative to reform all agreements where one party benefits more than the other or even where one party struck a bad deal.

Thus, with the added protection of unconscionability, there is no reason why future LLC statutes should not grant parties complete freedom to structure their agreement as they see fit. A dissatisfied participant in an LLC is exposed to less potential harm than in other business associations. Unlike in a general partnership, a party's risk is limited to the amount of his or her investment.[275] Additionally, the parties knowingly enter into an LLC relationship and should carefully consider the restrictions prior to doing so. The court's function should not be to protect a member from making a bad investment or from his or her inability to easily exit the LLC, especially where the operating agreement expressly sets forth any restrictions on transferability and other issues in great detail.

IV. CONCLUSION

The most plausible alternative for developing LLC relational duties would combine traditional fiduciary concepts with contractual freedoms. Legislatures should keep any statutory restraints to a minimum. Statutory interference should be limited to a good faith and fair dealing standard and, if desired, default fiduciary duties of care and loyalty or minimal statutory obligations.

Moreover, the courts will surely develop some form of common-law fiduciary duties once they begin to hear cases involving LLCs. These fiduciary obligations will most likely embody the concepts of the partnership and close corporation, probably somewhere between the heightened standard of care found in the close corporation context but with more flexibility to opt-out. Nonetheless, depending on the potential diversity of management structures that an LLC may subsume, the courts may end up taking a case-by-case approach.

Any case-by-case approach would, however, run the risk of injecting a good deal of uncertainty into the LLC arena. Thus, it would be preferable that any minimum statutory standards, such as gross negli-

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would make and . . . no honest and fair man would accept." Martin Rispens & Son v. Hall Farms, Inc., 621 N.E.2d 1078, 1087 (Ind. 1993) (citations omitted).

[275] *See* Dickerson, *supra* note 6, at 419.

gence, fraud, or unlawful activity, be expressly defined in the statute. In this manner, there would be greater predictability and the participants would know beforehand to what obligations they were committing themselves. This course is often preferable in a business context when it is desirable to know the risks and obligations up front to make an informed decision on participation and on potential exposure to liability.

In no event should any relational provisions regarding duties of care and loyalty be non-waiveable, with perhaps the exception of certain minimal standards. While a mandatory good faith standard does not create any undue interference with beneficial private ordering, any mandatory fiduciary obligations would unduly infringe upon the traditional notions of freedom of contract. Good faith merely provides an innocuous backdrop for judging performance, but fiduciary standards actually provide a separate duty of performance. As in Delaware, the enabling law and the courts should give maximum effect to the parties' agreement, thus precluding the undesirability of non-waiveable performance obligations.[276]

Any egregious behavior relating to the participants' contract and any corresponding opt-out provisions should be tempered only by the doctrine of unconscionability. As one commentator astutely remarked, "[j]udicial activism is [a] necessary complement to contractual freedom."[277] Here, the courts would be given certain latitude to invalidate any fiduciary waivers in the event the agreement of the parties was unconscionable at the time of formation. Unconscionability would provide a mechanism whereby any great disparities in bargaining power, leading to potentially oppressive conduct, could be tempered by the courts. This doctrine, along with a subset of minimal performance obligations, would create an ideal balance between private ordering and judicial oversight.

Kathleen D. Fuentes

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[276] *See supra* notes 92 and 95 and accompanying text.

[277] *See* Coffee, *supra* note 258, at 1621.