

# RUPA AND FIDUCIARY DUTY: THE TEXTURE OF RELATIONSHIP

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## I

### INTRODUCTION

The fiduciary duty rules in the Revised Uniform Partnership Act (1994) ("RUPA")<sup>1</sup> have been criticized by some as being too contractarian<sup>2</sup> and by others as being too paternalistic.<sup>3</sup> Professor J. Dennis Hynes, whose agency and partnership casebook I have long admired,<sup>4</sup> joins those who believe that RUPA is overly paternalistic. His thesis is that RUPA's fiduciary duty rules invite too much judicial intervention. He asserts that, unless the bargaining of

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1. The Uniform Partnership Act (last amended 1994), 6 U.L.A. 280 (Supp. 1995), as it is titled by the National Conference of Commissioners on Uniform State Laws, is more commonly referred to as the Revised Uniform Partnership Act ("RUPA"), as it will be in this article. RUPA is intended to replace the Conference's earlier product, the UNIFORM PARTNERSHIP ACT (last amended 1914), 6 U.L.A. 9 (1969) (the "UPA").

2. For the opinion that there is a contractarian shift in RUPA that reverses decades of case law and "sends a socially impoverished message," see Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 573 (1993). See also Claire M. Dickerson, *Is It Appropriate To Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111, 156-57 (1993):

RUPA section 404 proposes changes to the traditional understanding that partners' classic fiduciary duties are mandatory. This change reflects the influence of contractarian corporate law theories on partnership law . . . . Not only may those theories not prove out on their home ground, but they are incompatible with an important aspect of the partnership relation: trust.

Professors Vestal and Dickerson were responding to earlier drafts of RUPA, but their criticism pertains to the final draft.

3. Professor Larry Ribstein, perhaps the leading contractarian in this arena, stated that RUPA's mandatory fiduciary duties "change decades of prior law under the UPA," arguing that never before have there been mandatory fiduciary duties among partners. Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 57 (1991). Professor Ribstein also argued that "[m]andatory fiduciary duties are also bad policy because they preclude worthwhile contracts." Professor Hynes has criticized RUPA's fiduciary duty rules for inappropriately encouraging judicial activism. "Judges are invited to scrutinize terms of the partnership agreement without regard to the bargaining process by which those terms were reached. The power this appears to grant to courts to act as 'roving commissions' searching out injustice is worrisome." J. Dennis Hynes, *The Revised Uniform Partnership Act: Some Comments on the Latest Draft of RUPA*, 19 FLA. ST. U. L. REV. 727, 757 (1991). Although these articles were directed toward earlier drafts of RUPA, their criticism again applies to the final product.

4. J. DENNIS HYNES, AGENCY AND PARTNERSHIP: CASES, MATERIALS, PROBLEMS (4th ed. 1994).

the parties is flawed, courts should refrain from intervening in the resulting contract. Only if the bargaining process is flawed should "unconscionable" provisions be set aside.<sup>5</sup>

The essence of my response is that RUPA represents a major and sufficient move toward a contractarian statement of the law. In particular, I reject the assertion that partners should be free to contract away all fiduciary duties. First, individuals rarely "bargain" as equals for partnership agreements that completely define their relationship. The law should assume that the completely defined partnership relationship is the exception rather than the norm. It should also take into account the probability that the bargaining process involves human foible and important information asymmetries, if not outright fraud. Second, even apart from the imperfections of bargaining, prohibiting certain types of relationships is preferable to permitting them. Mandatory minima are designed to prevent types of relationships that would cost more than they would benefit. Finally, the language of fiduciary law, with its mandatory rules, is preferable to the language of the law of the sale of goods, with its mandatory rules. The language stating the minima among partners ought to reflect the texture of their relationship, which is one of a powerful mutual agency, ill-defined hierarchy, and joint and several liability. If the indeterminacy of the minima is kept in check, the benefit of the minima will far exceed the cost.

## II

### RELATIONSHIPS, BARGAINS, AND RULES

#### A. The Dazzling Array of Partnership Relationships

An association of co-owners of a business constitutes a partnership unless the owners adopt some other form of business organization.<sup>6</sup> In this context, association has always meant simply a voluntary relationship. Under this broad definition, partnership remains both a designated and a residual classification. If the economic essence of the relationship exists, a partnership is created unless the participants choose a different form of organization.<sup>7</sup>

The partnership statute, therefore, is the constitutional law of the relationship among people who have chosen to own a business together. The rights and obligations of third parties are largely determined by other doctrines, such as those contained in the Uniform Commercial Code (the "UCC"), federal and

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5. J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 *LAW & CONTEMP. PROBS.* 29 (Spring 1995).

6. RUPA § 202(a)-(b), 6 U.L.A. at 295 (Supp. 1995).

7. Thus, for example, a person cannot claim to be merely a lender and not a co-owner if there is a contribution to capital, a vote in management, and a share in profits, net cash flow, proceeds of refinancing or sale, and taxable income or loss. Co-owners may form a business organization other than a partnership, such as a corporation, a limited partnership, or a limited liability company. If they do not, a partnership results.

state legislation affecting transactions, and other regulatory law. The partnership act simply applies these rights and obligations in the context of a partnership relationship.

Consider, now, the dazzling array of relationships for which the partnership act serves as a constitution. There are relationships with only a few members and others with many members. Some are nominally capitalized relationships and others involve great wealth. Some relationships are created for isolated and brief transactions and others are expansive in scope and duration. There are relationships that are expected to remain constant over time and those that are expected to evolve. Some relationships are entered into with great solemnity and others are entered into inadvertently or with frivolity. There are relationships that concern relatively passive investment and those that concern great business activity. There are relationships in which all owners contribute the same admixture of goods and services and those in which each contributes something different. There are relationships that are democratically run and those headed by an absolute monarch. There are relationships that involve family members with close personal ties and those among virtual strangers. Some relationships are defined by elaborate written agreements, and others are not. There are relationships formed with the assistance of counsel and those that are not. There are relationships based on trust and those that are not. And there are partners who are honest and those who are not.

#### B. The Core Mission of RUPA: Serve the Small Partnership

The Drafting Committee attempted to craft statutory language that would accommodate the great array of relationships currently classified as partnerships<sup>8</sup>; however, we realized that we could not draft a statute that equally serves each of the highly divergent types. At many points, we had to choose the type of relationship we most wanted to serve. Many policy decisions were clearly interrelated. In short, it was important to keep in mind the types of relationships that were our first priority. Only with the texture of the relationship in mind could we draft an appropriate constitution.

The basic mission of RUPA is to serve small partnerships. Although we have attempted to craft a statute that also serves large partnerships, in the event of a conflict, the small partnership is given priority. Large partnerships can fend for themselves more easily by drafting partnership agreements that suit their special needs. Because almost all of RUPA's rules governing the relations among partners are default rules rather than mandatory rules, partners are free to agree to virtually any relationship they wish. If they do not like RUPA's minimalist mandatory rules,<sup>9</sup> they may adopt a different form of organization.

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8. Indeed, the only significant substantive change in the definition of partnerships is RUPA § 202(c)(3)(v), 6 U.L.A. at 295 (Supp. 1995), which makes it easier for shared-appreciation mortgagees to avoid being classified as partners.

9. The mandatory rules in RUPA are listed in RUPA § 103(b), 6 U.L.A. at 288 (Supp. 1995).

### C. The Texture of the Relationship

Consider, then, the nature of the small partnerships that are the principal focus of RUPA. They often are created quite informally. There may be no written partnership agreement or the agreement might only address selected aspects of the partnership relationship. Individuals who become partners enter a relationship in which they are highly interdependent in terms of risk, function, and reward. They tend to invest a great deal of their own capital and labor in a single partnership. These characteristics of small partnerships often lead to ill-defined management lines. Finally, people who become partners in small partnerships typically place a great deal of trust in one another.

Part of the reason partnership agreements are so often cursory or nonexistent is that people who become partners are often risk takers who press ahead in business without a highly defined sense of process or outcome. They may be romantics or even visionaries. The relationship of partnership has frequently been compared to the relationship of marriage, and appropriately so. Like many individuals who become husband and wife, those who become partners may have very little sense of the road they will travel together. Like individuals getting married, persons forming partnerships often fail to think through, or discuss, the possibility of breaking up. Partnership agreements, like agreements to become husband and wife, are particularly weak in addressing what can go wrong with the relationship and how it can be ended. Like marriages, partnerships are much more difficult to end than to begin.

### D. RUPA's Core of Interrelated Rules

Because RUPA's core mission is to serve small partnerships, including partnerships inadvertently created when no other form of business organization is selected, RUPA does not require filings or even writings to create, modify, or terminate partnerships. Partners are heavily committed co-owners of a business with an equal right and duty to manage.<sup>10</sup> In the event of a disagreement, the majority rules. Every partner has an equal vote, regardless of the size of the partner's ownership interest.<sup>11</sup> As co-owners, partners are jointly and severally liable for the activity they have the authority to coordinate, monitor, and control.<sup>12</sup> Because of the informal and ill-defined roles of partners, each partner has the authority to bind the partnership as a general agent, thus placing the burden on the partners, not third parties, to clarify their authority.<sup>13</sup>

Because of the enormous exposure to liability that inheres in the relationship, any partner may begin to dissociate at any time.<sup>14</sup> Because of the

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10. *Id.* § 401(f), 6 U.L.A. at 309.

11. *Id.* § 401(j), 6 U.L.A. at 309.

12. *Id.* § 306(a), 6 U.L.A. at 306.

13. *Id.* § 301(1), 6 U.L.A. at 299.

14. *Id.* § 601, 6 U.L.A. at 322.

complex nature of the relationship, the process of dissociating has a number of aspects and typically will take some time to accomplish. As a co-proprietor, the departing partner will remain liable for unfinished business, will have lingering authority to bind the partnership to third parties, and will in turn remain jointly and severally liable for certain exercises of authority by those who remain. Because of the intensive investment that might otherwise be locked in, the dissociating partner has a right to be bought out.<sup>15</sup>

From formation<sup>16</sup> through breakup, the partners must honor whatever agreement they have. Like more adversarial commercial actors, they must perform their duties in accordance with the obligation of good faith and fair dealing.<sup>17</sup> More so than adversarial commercial actors, they also must honor the high level of trust implicit in their cooperative, intimate and highly interdependent relationship.<sup>18</sup> They must behave as fiduciaries.<sup>19</sup>

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15. *Id.* § 603(a), 6 U.L.A. at 327. If the partnership is at will, each partner has the right to have the business liquidated. *Id.* § 801(1), 6 U.L.A. at 335.

16. Unlike UPA § 21(1), 6 U.L.A. at 159, which embraces the "formation, conduct, or liquidation of the partnership," RUPA § 404(b)(1), 6 U.L.A. at 313 refers only to the "conduct and winding up" of the partnership business and not to partnership "formation." See also *Waite v. Sylvester*, 560 A.2d 619, 625 (N.H. 1989), which indicates that the point of imposition of fiduciary duties is one on which reasonable people can disagree:

The rule generally accepted . . . imposes a fiduciary duty not only with respect to transactions occurring during the partnership but also with respect to "those taking place during the negotiations leading to the formation of the partnership." This rule reflects the assumption that during negotiations to form a partnership, the parties are not dealing with one another at arm's length, but rather are attempting to structure a common enterprise, one which must be based on trust and loyalty. An equally valid assumption, that parties negotiating to form a partnership deal at arm's length in a struggle for competitive advantage, gives rise to the alternative rule imposing no fiduciary duty until the actual formation of a partnership.

17. Compare RUPA § 404(d), 6 U.L.A. at 313 (Supp. 1995), with UCC § 2-103(1)(b), 1 U.L.A. at 185 (1989).

18. Even under the UCC, the standard of performance rises when an adversary becomes dependent, as in the case of an exclusive dealing contract. See UCC § 2-306(2), 1A U.L.A. at 56, which requires "best efforts" in exclusive dealing relationships. See generally Claire M. Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty and Permitted Harm*, 22 FLA. ST. U. L. REV. 955, 983-85 (1995).

19. RUPA § 404(b), 6 U.L.A. at 313 (Supp. 1995); *id.* § 103(b)(3), 6 U.L.A. at 288.

## III

## RUPA'S BLEND OF CONTRACT AND FIDUCIARY LAW

## A. A Perspective on RUPA's Fiduciary Duty Rules

RUPA is an unprecedented statutory attempt to specify those aspects of fiduciary law that reflect mandatory rules, and to distinguish them from aspects that reflect merely default rules. RUPA reflects a compromise between those individuals who wanted to eliminate completely the language of fiduciary obligation and those who insisted that it be preserved without change. The compromise perpetuates the language of fiduciary obligation but confines it within the language of freedom of contract. Stated somewhat differently, RUPA is an attempt to add more determinacy to language that is often indeterminate.

RUPA is a compromise that will not fully satisfy either the paternalists or the contractarians. Paternalists will not relish the elimination of the duty to be selfless or the near complete freedom RUPA gives to partners to define their relationship. They will find it offensive, whether they agree with the substantive outcomes or not, to read an exclusive statement of the fiduciary duties among partners that includes within it an exclusive statement of the components of the duty of loyalty.<sup>20</sup> On the other hand, contractarians will also suffer several disappointments. They will be disappointed that RUPA continues the language of fiduciary law. Some of them are likely to be disappointed that RUPA mandates a minimum level of fiduciary obligation. Many contractarians are likely to be disappointed that RUPA requires partners to share certain information "without demand,"<sup>21</sup> thus eliminating the "on demand" requirement of the UPA.<sup>22</sup>

RUPA's fiduciary duty rules initially are difficult to read because they do not state a coherent definition of a partner's fiduciary duties. RUPA states: "The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c)."<sup>23</sup> An examination of these and other provisions of RUPA reveals a definition of fiduciary duties that is at times underinclusive and at times

20. *Id.* § 404(b), 6 U.L.A. at 313.

21. *Id.* § 403(c), 6 U.L.A. at 311, provides:

Each partner and the partnership shall furnish to a partner . . .

(1) without demand, any information concerning the partnership's business and affairs reasonably required for the proper exercise of the partner's rights and duties under the partnership agreement or this [Act] . . . .

Because this rule is not listed in RUPA § 103(b), 6 U.L.A. at 288, it is a default rule rather than a mandatory rule.

22. UPA § 20, 6 U.L.A. at 157, provides: "Partners shall render on demand true and full information of all things affecting the partnership . . . ." The UPA does not state whether this is a default rule or a mandatory rule.

23. RUPA § 404(a), 6 U.L.A. at 313 (Supp. 1995).

overinclusive. Aspects of the partnership relationship that many would deem to be at the heart of a partner's fiduciary duties are included in RUPA but excluded from RUPA's statement of the fiduciary duties of partners.<sup>24</sup> Most importantly, a partner's rights and duties with respect to information are stated separately,<sup>25</sup> even though they have the same type of mandatory minimum that applies to the duties RUPA classifies as fiduciary.<sup>26</sup> Moreover, a partner's "obligation of good faith and fair dealing" is separately stated,<sup>27</sup> even though it is subject to essentially the same mandatory minimum as the duty of loyalty.<sup>28</sup> By contrast, a partner's duty of care is stated to be a fiduciary duty, even though RUPA's "gross negligence" standard is essentially a rule that partners mutually insure against their own simple negligence.<sup>29</sup>

As Professor Hynes suggests, the discussions about the fiduciary duty rules were open, extensive, and controversial. The result is a completely new statutory statement of the fiduciary obligations among partners. Professor Hynes asserts that the new statement does not offer enough change; he argues that RUPA should give greater deference to the partnership agreement by eliminating fiduciary minima or by stating them in terms of unconscionability. He would take us further toward a contractarian extreme. Therefore, it is important to analyze RUPA's move toward a contractarian statement before explaining why it should go no further.

## B. RUPA's Embrace of the Contractarians

The work of contractarians has had a powerful and salutary influence on RUPA. In particular, the contractarians persuaded the Drafting Committee and the Conference that vague statements of fiduciary obligation impose increased costs on partnerships. The oft-quoted and oft-revered statements of the

24. Compare *id.* with ALAN BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 389 (1968):  
Fiduciary duties are among the most important aspects of partnership . . . .

We often say that a partner is accountable . . . as a fiduciary. This means a number of different things:

- (1) He must keep accounts or books . . . .
- (2) He must render information . . . .
- (3) He must submit to financial review . . . .
- (4) He must answer for any breach of any fiduciary duty.

25. See RUPA § 403(b), 6 U.L.A. at 311 (Supp. 1995) (in conjunction with RUPA § 103(b)(2), 6 U.L.A. at 288, providing a mandatory minimum access to books and records); *id.* § 403(c), 6 U.L.A. at 311 (a default rule providing for disclosures that must be made on demand and those that must be made without demand). A much more limited information right is contained in RUPA § 105(e), 6 U.L.A. at 291, which is subject to RUPA § 103(b)(1), 6 U.L.A. at 234.

26. RUPA § 103(b)(2), 6 U.L.A. at 288, states that the partnership agreement may not "unreasonably restrict the right of access to books and records under Section 403(b)."

27. RUPA § 404(d), 6 U.L.A. at 313 (Supp. 1995).

28. Compare *id.* § 103(b)(3)(i), 6 U.L.A. at 288 with *id.* § 103(b)(5), 6 U.L.A. at 288.

29. *Id.* § 404(c), 6 U.L.A. at 313 ("(c) A partner's duty of care . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."). The gross negligence standard is explained in Donald J. Weidner and John W. Larson, *The Revised Uniform Partnership Act: The Reporters' Overview*, 49 BUS. LAW. 1, 21-23 (1993).

fiduciary law of partners, most notably stated in *Meinhard v. Salmon*,<sup>30</sup> are vague to the point of being misleading. Courts do not always intend the consequences that appear to flow from their powerful statements of the fiduciary duties of partners—their *dicta* promise more than their holdings deliver.<sup>31</sup>

A basic tenet of contractarians is that the costs of agency relationships can be reduced if they are structured to give the participants convergent interests. At no point does contractarian analysis require participants to be selfless. Contractarians, therefore, object to the vague and powerfully worded statements of fiduciary law asserting that a partner must be selfless. Persuaded by this point of view and believing that it is compatible with existing case law, the drafters of RUPA undertook to ensure that partners would no longer be described as disinterested trustees.<sup>32</sup>

RUPA's fundamental change to the statement of the fiduciary obligations among partners is the elimination of the duty to be selfless. RUPA section 404(e) provides: "A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest."<sup>33</sup> To emphasize: *this language changes the basic statement of the default rule among partners*. RUPA section 404(e) sets aside both partnership case law<sup>34</sup> and basic agency doctrine<sup>35</sup> requiring abnegation of self. However, the change in statement may have little operative

30. 164 N.E. 545 (N.Y. 1928).

31. See Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 458 (1987) (citations omitted):

Although colorful, the judicial rhetoric inevitably overstates the standard of conduct the law actually imposes on partners. If partners truly are fiduciaries, they are a unique species of this group and cannot be subjected to traditional standards applicable to other types of fiduciaries. The very concept of "fiduciary" connotes undivided loyalty and disinterested representation. In theory, a fiduciary is a principal to whom another entrusts money. The fiduciary as joint owner, although not unknown, is something of a contradiction in terms. Partners, on the other hand, are always joint owners. Partners are not disinterested trustees, and the likelihood that most partners operate under a "punctilio of an honor the most sensitive" standard is remote.

32. See also 1993 Tex. Sess. Law Serv. 917, § 4.04(f) (Vernon) ("TRUSTEE STANDARD INAPPLICABLE. A partner, in that capacity, is not a trustee and is not held to the same standards as a trustee.").

33. RUPA § 404(e), 6 U.L.A. at 313 (Supp. 1995).

34. See, e.g., *Birnbaum v. Birnbaum*, 539 N.E.2d 574, 576 (N.Y. 1989) (citations omitted): [I]t 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 . . . requiring avoidance of situations in which a fiduciary's personal interest possibly conflicts with the interest of those owed a fiduciary duty . . . [A] fiduciary . . . is bound to single mindedly pursue the interests of those to whom a duty of loyalty is owed.

35. See RESTATEMENT (SECOND) OF AGENCY § 387 (1958) ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency.").



effect, given decisional holdings recognizing the legitimate pursuit of self-interest.<sup>36</sup>

RUPA section 404(f) contains a supplemental and more specific recognition of a partner's legitimate pursuit of self-interest: "A partner may lend money to and transact other business with the partnership, and as to each loan or transaction the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law." Section 404(f) is consonant with longstanding state law and tax law stating that a partner may act in a "dual capacity": a partner may enter into transactions with a partnership on the same terms as a third party.<sup>37</sup> Stated somewhat differently, even within an intimate, cooperative relationship, partners may behave as adversaries to the extent they have agreed specifically to do so. In particular, the goal of this rule is to confirm that a person may be both a partner and a lender.<sup>38</sup> When a partner is wearing the hat of a lender, lender remedies may be pursued.<sup>39</sup> For example, a partner who is also a mortgagee of the partnership has the right of a nonpartner to rely on an acceleration clause in the note and mortgage. Because of the specific *ex ante* agreement authorizing adversarial behavior,<sup>40</sup> the lender-partner is constrained only by the obligation of good faith and fair dealing.<sup>41</sup>

### C. RUPA's Mandatory Minima

RUPA rejects the position of more extreme contractarians by continuing the language of fiduciary obligation and by providing a mandatory minimum of

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36. See, e.g., *Meehan v. Shaughnessy*, 535 N.E.2d 1255 (Mass. 1989); *Cude v. Couch*, 588 S.W.2d 554 (Tenn. 1979); see also RESTATEMENT (SECOND) OF AGENCY § 13 cmt. a (1958) ("The agreement to act on behalf of the principal causes the agent to be a fiduciary, that is, a person having a duty . . . to act *primarily* for the benefit of another in matters connected with his undertaking." (emphasis added)).

37. See, e.g., I.R.C. § 707(a) (1954).

38. For an additional rule specifically designed to give comfort to institutional lenders, see RUPA § 202(c)(3)(v), 6 U.L.A. at 295 (Supp. 1995), which makes it more difficult to classify shared-appreciation and certain other mortgagees as partners.

39. In *Westminster Properties, Inc. v. Atlanta Assocs.*, 301 S.E.2d 636 (Ga. 1983), the court rejected the argument that a partner's duties prevented it from exercising rights as a secured creditor. On the other hand, a partner cannot wrongfully cause a default merely to activate its nonpartner rights. See, for example, *Natpar Corp. v. E.T. Kassinger, Inc.*, 365 S.E.2d 442 (Ga. 1988), in which the court granted an interlocutory injunction prohibiting a partner named Natpar from foreclosing on certain property mortgaged to Natpar by its own partnership:

The essence of [the] complaint is that Natpar has wrongly brought about the default of the partnership to Natpar by failing to comply with its obligations under the partnership agreement to pay its share of operating expenses. Obviously, although the partnership granted Natpar a security deed, the partnership did not grant Natpar the right to refuse to pay its obligation to the partnership. We find that equitable relief is appropriate . . . and is not inconsistent with our decision in *Westminster Properties*, in which it was undisputed that Westminster took no wrongful action which precipitated the default to it.

*Id.* at 444-45.

40. RUPA § 404(b)(2), 6 U.L.A. at 313 (Supp. 1995), requires informed consent before a partner can deal adversely with the partnership.

41. *Id.* § 404(d), 6 U.L.A. at 313; *id.* § 103(b)(5), 6 U.L.A. at 288.

fiduciary obligation. The basic lesson of RUPA is that a partnership is a contractual relationship of a special sort.<sup>42</sup> Because of the nature and extent of their interdependence, partners are fiduciaries who owe one another a duty of loyalty that is not present in more adversarial relationships. Unlike the UPA, which only uses the word “fiduciary” in the title to one section<sup>43</sup> and never uses it in statutory text, RUPA states that partners owe one another the fiduciary duties of loyalty and care.<sup>44</sup>

As indicated earlier, the duty of loyalty is the key fiduciary duty. Under RUPA section 404(b), unless the partnership agreement provides otherwise, a partner may not appropriate partnership opportunities, deal with the partnership as or on behalf of an adverse party, or compete with the partnership:

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

(1) to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use 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.<sup>45</sup>

These rules are drawn from the UPA and from the *Restatement (Second) of Agency*.

The only mandatory aspect of the duty of loyalty is the rule that the partnership agreement may not

eliminate the duty of loyalty under Section 404(b) or 603(b)(3), but:

(i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or

(ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that would otherwise violate the duty of loyalty . . . .<sup>46</sup>

This section distinguishes agreements made before an alleged breach of a duty of loyalty from those made later.

42. See generally Eileen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897 (1993).

43. UPA § 21, 6 U.L.A. at 159.

44. RUPA § 404(a), 6 U.L.A. at 313 (Supp. 1995) (“[A] partner owes to the partnership and the other partners . . . the duty of loyalty and the duty of care . . . .”).

45. *Id.* § 404(b), 6 U.L.A. at 313. A partner’s duty of loyalty under RUPA § 404(b)(3), 6 U.L.A. at 313 (to refrain from competing), terminates when the partner dissociates. *Id.* § 603(b)(2), 6 U.L.A. at 327. A partner’s duty of loyalty under RUPA §§ 404(b)(1), 6 U.L.A. at 313 (to account for all profits) and (2), 6 U.L.A. at 313 (to avoid adverse interests) continues after dissociation “only with regard to matters arising and events occurring before the partner’s dissociation, unless the partner participates in winding up the partnership business . . . .” *Id.* § 603(b)(3), 6 U.L.A. at 327.

46. *Id.* § 103(b)(3), 6 U.L.A. at 288. RUPA § 103(b)(5), 6 U.L.A. at 288 also uses the “manifestly unreasonable” standard in connection with the obligation of good faith and fair dealing. It provides that the partnership agreement may not eliminate the obligation, but “may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.” *Id.* § 103(b)(5), 6 U.L.A. at 288.

After-the-fact agreements can be disposed of quickly. It is probably unnecessary to provide that partners may waive their right to bring an action after full disclosure of all material facts. Informed *ex post* waivers are effective not only under the law of partnership but also under general law.

The essence of RUPA's mandatory fiduciary duty rule concerns *ex ante* agreements. First, RUPA provides that a categorical waiver of the duty of loyalty is unenforceable.<sup>47</sup> Thus, for example, a provision that a partner "waives any and all right to bring a claim against another partner on the ground that there has been a breach of the duty of loyalty" is unenforceable. Furthermore, waivers that are too vague will not be enforced.<sup>48</sup>

More specific *ex ante* agreements are enforceable. They need not be transaction specific.<sup>49</sup> A waiver of the duty of loyalty in connection with "specific types or categories of activities" is effective "if not manifestly unreasonable."<sup>50</sup> For example, in a real estate partnership, a provision that "any partner may acquire interests in competing real estate projects without violating the partnership agreement or the duty of loyalty" is enforceable. I disagree with Professor Hynes that RUPA would change the result in *Riviera Congress Associates v. Yassky*.<sup>51</sup> RUPA section 103(b)(3)(i) provides statutory

47. See *Wartski v. Bedford*, 926 F.2d 11, 20 (1st Cir. 1991) ("The fiduciary duty of partners is an integral part of the partnership agreement whether or not expressly set forth therein. It cannot be negated by the words of the partnership agreement."); see also *Labovitz v. Dolan*, 545 N.E.2d 304, 313 (Ill. App. Ct. 1989):

Defendants cite no authority, and we find none, for the proposition that there can be an *a priori* waiver of fiduciary duties in a partnership—be it general or limited. Nor is the practice of imposing purported advance waivers of fiduciary duties in limited partnership enterprises to be given judicial recognition on the basis of the facts developed in this case. Defendants' argument that the good faith doctrine protects only the reasonable expectations of the contracting parties is, we think, aptly answered by plaintiffs' statement to the trial judge at the hearing on defendants' motion to dismiss: "the risk we took was that the business would not succeed. We did not take the risk that the business would succeed so well that the general partner would squeeze us out and take the investment for himself," an argument . . . that sets forth . . . the exact issue in this case.

48. *Cf.* the prohibition of similar waivers in the attorney-client relationship.

49. See RUPA § 103 cmt. 2, 6 U.L.A. at 288 (Supp. 1995):

RUPA attempts to provide a standard that partners can rely upon in drafting exculpatory agreements. It is not necessary that the agreement be restricted to a particular transaction. That would require bargaining over every transaction or opportunity, which would be excessively burdensome. The agreement may be drafted in terms of types or categories of activities or transactions, but it should be reasonably specific.

50. *Id.* § 103(b)(3)(i), 6 U.L.A. at 288.

51. 223 N.E.2d 876, 880 (N.Y. 1966) (citations omitted):

Ordinarily . . . self-dealing would render the defendants incapable, as general partners . . . from releasing themselves from liability on the lease . . . . However, partners may include in the partnership articles practically "any agreement they wish" and, if the asserted self-dealing was actually contemplated and authorized, it would not, *ipso facto*, be impermissible and deemed wrongful . . . . [T]he limited partners were fully apprised in the prospectus that the defendant general partners intended to lease the premises to their own [thinly capitalized] corporation . . . . This clear statement of purpose has the effect of "exonerating" the defendants, at least in part, "from adverse inferences which might otherwise be drawn against them" simply from the fact that they dealt with

support for *Yassky's* specific authorization of leasing transactions with a thinly capitalized controlled corporation.

*Singer v. Singer*<sup>52</sup> is more problematic. *Singer* involved a family oil and gas partnership named Josaline that was almost fifty years old and that owned a variety of leasehold interests. The partners were highly sophisticated investors. Prior to a partnership meeting, the plaintiff partner suggested to his partner Stanley that he look into the possibility of the partnership acquiring a specific parcel. The acquisition was discussed at the partnership meeting, but the decision whether to purchase was deferred. After the meeting, with no further notice to the partnership, Stanley and his sister Andrea, who was also a partner, purchased the parcel for their own account.

The trial court ruled that Stanley and Andrea held the parcel they purchased in a constructive trust for the benefit of the partnership. The Oklahoma Court of Appeals reversed, saying that the partnership agreement gave Stanley and Andrea "a contract right to do precisely what they did, namely compete with the partners of Josaline and with Josaline itself 'as if there never had been a partnership.'"<sup>53</sup> Paragraph 8 of the contract provided:

Each partner shall be free to enter into business and other transactions for his or her own separate individual account, even though such business or other transaction may be in conflict with and/or competition with the business of this partnership. Neither the partnership nor any individual member of this partnership shall be entitled to claim or receive any part of or interest in such transactions, it being the intention and agreement that any partner will be free to deal on his or her own account to the same extent and with the same force and effect as if he or she were not and never had been members of this partnership.<sup>54</sup>

By this language, "Josaline contracted away its right to expect a noncompetitive fiduciary relationship with any of its partners."<sup>55</sup>

We find paragraph 8 is designed to allow and is uniquely drafted to promote spirited, if not outright predatory competition between the partners. Its strong wording leaves no doubt in our minds that its drafters intended to effect such a result. This is reinforced by the fact that the partners repeated the same clause in two successive contracts. We construe it to legitimize and extend free competition between the partners to partnership prospects and opportunities . . .<sup>56</sup>

Professor Hynes is correct in asserting that, under RUPA, the language of paragraph 8 would not automatically validate the purchase by Stanley and Andrea. Paragraph 8 fails to "identify specific types or categories of activities that do not violate the duty of loyalty."<sup>57</sup> The specificity requirement must be

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themselves.

*See also* *Bassan v. Investment Exchange Corp.*, 524 P.2d 233 (Wash. 1974) (suggesting that, if the partner is to enter into a transaction with the partnership, the extent of the partner's profit should be disclosed).

52. 634 P.2d 766 (Okla. Ct. App. 1981).

53. *Id.* at 772.

54. *Id.* at 768.

55. *Id.* at 772.

56. *Id.*

57. RUPA § 103(b)(3), 6 U.L.A. at 288 (Supp. 1995).

met to reach the question whether the specifics are “manifestly unreasonable.” It certainly is not clear that paragraph 8 was intended to apply to facts like those in *Singer*. If the mandatory minimum means anything, it is that doubt must be resolved in favor of requiring disgorgement.

On the other hand, it would be possible for a post-RUPA court to validate *Singer*. The court could find the requisite specificity in the context of the partnership business or in the behavior of the partners. The court could find that paragraph 8 was intended to apply to the acquisition of mineral interests in the area of partnership operations. Further, the court could find that paragraph 8 was intended to apply to situations like the one before it—situations in which a partner diverted an opportunity the partner learned of in the partner’s capacity as a partner. In *Singer*, there was almost fifty years of partnership history to inform the interpretation of paragraph 8.<sup>58</sup> If the requisite specificity were found in the business context or in prior behavior, RUPA would next ask whether the agreement was “manifestly unreasonable.” It would not be manifestly unreasonable for each of the highly sophisticated partners to retain the right to divert mineral interests from the partnership. A somewhat different approach to validating *Singer* would be to define the scope of the partnership more narrowly. That is, a post-RUPA court could conclude that the partnership existed only for the purpose of pursuing and managing those opportunities that the partners declined to pursue separately.

#### IV

#### RESPONDING TO RUPA’S CRITICS

##### A. Responding to Professor Hynes’s “Unconscionability” Alternative

Professor Hynes takes exception to the “manifestly unreasonable” standard. He fears that this standard is “too intrusive” in the sense that it invites courts to intervene to upset the partners’ agreement. He would upset only those agreements that are “unconscionable.” In effect, he would abandon the language of fiduciary obligation and adopt instead the standard that applies to contracts for the sale of goods.

As Professor Hynes recognizes, the fundamental purpose of the “manifestly unreasonable” test is to preserve an opportunity for judicial intervention. Given the prevalence of alternative dispute resolution, which frequently follows from contractual provisions mandating arbitration, it is also important to consider how rules will be applied in the hands of arbitrators. With that qualification in mind, the core question is the type of language that should be used to authorize the remedy of disgorgement to the partnership. I have four basic responses to Professor Hynes’s assertion that RUPA provides too ready a remedy.

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58. *See id.* § 101(5), 6 U.L.A. at 285 (“‘Partnership agreement’ means the agreement, whether written, oral, or implied, among the partners concerning the partnership including amendments to the partnership agreement.”).

First, it is important to give some context to the suggestion that RUPA encourages too much judicial intervention. RUPA is an unprecedented statutory attempt to state, albeit at a high level of generality, the outer limits of the fiduciary obligations of partners. It is an attempt to restrain judicial activism in the context of partnership agreements. Professor Hynes does not fault RUPA for creating new doctrine to *encourage* judicial activism; his precise criticism is that RUPA does not go far enough in its move to *discourage* such activism.

Second, few results are likely to change if the limitation on specific waivers is couched in terms of unconscionability as opposed to manifest unreasonableness. The prevailing judicial philosophy of either activism or strict constructionism is likely to take the application of either standard in the same direction. To this extent, Professor Hynes argues more about labels than about law. No matter what the language of the minima, for example, the courts of California are far more likely to intervene than are the courts of Florida.

Third, to the extent that Professor Hynes is animated by a mistrust of judges, it should be pointed out that the involvement of judges generally can be drafted away. Partnership agreements commonly require arbitration in the hope that arbitrators will be more understanding and respectful of business agreements than are judges. The controlling philosophy, therefore, may be determined more by arbitrators than by judges. The question is whether a simple statement can be made to guide them. They are far less likely than judges to parse statutes or to ponder their interstices.

Finally, and most importantly, the language of manifest unreasonableness is superior to the language of unconscionability because it sets partnerships apart from other contracts. The language of unconscionability has emerged as part of the general law of contracts, which has developed largely in the context of adversarial relationships. Indeed, the language of unconscionability has been applied primarily in the narrow context of purchases of consumer goods under the UCC.<sup>59</sup> It was not designed to govern relationships with the characteristics of partnership.

The language of contract law, as it appears in the UCC, generally declares the existence of mandatory rules by distinguishing between the "agreement"<sup>60</sup> of the parties and the "contract"<sup>61</sup> that results. The contract of the parties is a function of the agreement that they make, as modified by mandatory rules. The most basic mandatory rule in the UCC is the obligation of "good faith," or

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59. See, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965).

60. U.C.C. § 1-201(3);

"Agreement" means the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance . . . . Whether an agreement has legal consequences is determined by the provisions of this Act, if applicable; otherwise by the law of contracts . . . (compare "Contract").

61. *Id.* § 1-201(11) ("'Contract' means the total legal obligation which results from the parties' agreement as affected by this Act and any other applicable rules of law.").

“good faith and fair dealing” in the case of a merchant.<sup>62</sup> In addition, the UCC specifically authorizes courts to set aside the provisions of agreements that are “unconscionable.”<sup>63</sup>

The terse language of “unconscionability” fails to reflect the richness of contract doctrine that exists outside the UCC. Contract law has struggled in particular to respond to the difficulty in contracting for long-term relationships. Within these relationships are gradations of paternalistic concern. Relationships of confidence and trust receive more attention than those that are clearly adversarial.<sup>64</sup> Fiduciary relationships require the greatest level of attention, and in the context of these relationships, contract doctrine has supplied mandatory minima far more rigorous than the “unconscionability” standard.<sup>65</sup>

The relationship of partnership has a powerful cooperative dimension that is not present in many fiduciary relationships. Each partner is a general agent of the partnership,<sup>66</sup> empowered to expose every other partner to unlimited personal liability.<sup>67</sup> Minima in the partnership area must address the discretion among agents, which the general law of contracts does not and which is the classic province of the law of fiduciary obligation.<sup>68</sup> The essence of fiduciary

62. *Id.* § 1-203 (“Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.”). In general, “good faith” means “honesty in fact in the conduct or transaction concerned.” *Id.* § 1-201(19). In the case of a merchant, good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” *Id.* § 2-103(1)(b).

63. *Id.* § 2-302(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.

64. See RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. f (1979) (“Even where a party is not, strictly speaking, a fiduciary, he may stand in such a relation of trust and confidence to the other as to give the other the right to expect disclosure.”). See generally Scallen, *supra* note 42.

65. See RESTATEMENT (SECOND) OF CONTRACTS § 173 (1979):

If a fiduciary makes a contract with his beneficiary relating to matters within the scope of the fiduciary relation, the contract is voidable by the beneficiary, unless

(a) it is on fair terms, and

(b) all parties beneficially interested manifest assent with full understanding of their legal rights and of all relevant facts that the fiduciary knows or should know.

With respect to fairness, see RESTATEMENT (SECOND) OF CONTRACTS § 173 cmt. b (1979):

What is required is not merely the absence of unconscionability, as is the case for contracts in general. The contract is voidable unless it is shown to be on fair terms in light of the circumstances at the time of its making.

66. RUPA § 301(1), 6 U.L.A. at 299 (Supp. 1995) (“Each partner is an agent of the partnership for the purpose of its business.”).

67. *Id.* § 305, 6 U.L.A. at 305.

68. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976):

We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal . . . [I]t is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal

obligation is a duty of loyalty that confines partners more strictly than if they were mere adversaries.<sup>69</sup>

One also might respond to Professor Hynes with the *mantra* the contractarians use against RUPA when it suits them—that it increases transaction costs to change well-settled law.<sup>70</sup> Partners have been classified as fiduciaries all this century and longer. To abandon the language of fiduciary obligation and replace it with that of unconscionability would be inefficient because it would impose unnecessary transaction costs resulting from setting aside a century of well-established case law. Because I do not think this *mantra* is any more persuasive when issuing from my lips rather than from those of others, I raise it simply to set the record straight and move on to address more specifically where and why I part company with the contractarians.

## B. Responding to More Fundamental Contractarian Objections

1. *Assaults on the Language of Fiduciary Law.* The legal system knows how to impose the highest possible level of trust: it designates a person a fiduciary. In recent years, there has been an extraordinary assault on the very language of fiduciary law. Neither the Model Business Corporation Act nor the Uniform Limited Partnership Act uses the word “fiduciary.” Limited liability company acts typically avoid the term. Even codes of ethics suppress the term. The American Bar Association’s Model Rules of Professional Conduct (“Model

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decisions from the principal’s viewpoint. Agency law uses the language of fiduciary obligation to limit the divergences. See RESTATEMENT (SECOND) OF AGENCY § 1(1) (1957), which defines “agency” as “the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.”

69. Robert C. Clark, *Agency Costs versus Fiduciary Duties*, in *Principals and Agents: The Structure of Business* 76 (J. Pratt & R. Zeckhauser eds., 1985):

Fiduciary law is stricter on fiduciaries than contract law is on ordinary contracting parties in at least four fundamental respects. There are stricter rules about disclosure, more open-ended duties to act, tighter delineations of rights to compensation and to benefits that could flow from one’s position, and more intrusive normative rhetoric. These elements of strictness do not arise from actual contracts but have been created by judges in the common law tradition.

70. See, e.g., Larry E. Ribstein, *A Mid-Term Assessment of the Project to Revise the Uniform Partnership Act*, 46 BUS. LAW. 111, 114 (1991):

[T]he drafters should consider carefully both the costs and benefits of changing the law. Certainty of the law helps the parties know whether and how to draft around it, encourages the parties to settle rather than litigate disputes, and decreases the costs of resolving legal issues in court. Because the [UPA] has been in existence for 76 years and has been adopted in all but one of the states, a considerable body of national case law is in place interpreting the statute’s provisions. While many of the UPA’s provisions could be improved, the benefits of such improvements should be weighed carefully against the costs of unsettling the law with new statutory provisions.

See also, Ribstein, *supra* note 3, at 80 (arguing that RUPA’s changes “may encourage firms to organize as limited liability companies or corporations, and may increase litigation costs for firms that do adopt the partnership form”).



Rules”), for example, are stunning in their refusal to characterize a lawyer as a “fiduciary.”<sup>71</sup>

The failure of these assaults on the language of fiduciary obligation is as striking as their persistence. The replicated conspiracy of silence has been to no avail. Officers, directors, shareholders, partners in limited partnerships, and attorneys continue to be classified as fiduciaries by the courts. The same can safely be predicted for proprietors in limited liability companies. Aided and inspired by the work of Professor DeMott,<sup>72</sup> among others, new generations of lawyers are likely to arrest any further swing of the pendulum toward the contractarians.

2. *The Position of Contractarian Extremists.* Extremist contractarians continue to press the notion that fiduciary duties are and should be simply short-form contracts—default rules the parties should be permitted to draft away, even in the partnership context.<sup>73</sup> They persist without mentioning that the law of contracts features its own set of mandatory rules, as indicated above. And they persist even though no statute has been so bold as to declare fiduciary duties merely default rules. The Delaware limited partnership act comes close, but even the perennial winner in the race to laxity has failed to reach the contractarian finish-line.<sup>74</sup>

71. The Comments to the Model Rules use the word “fiduciary” only a few times. Ironically, one of these rare statements indicates that the beneficiary of a fiduciary obligation should not abuse the person who is the fiduciary. (“[T]he beneficiary of a fiduciary relationship may not exploit it to the detriment of the fiduciary.” MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6. cmt. para. 18.) *But see* Rule 1.2 cmt. para. 8 (“Where the client is a fiduciary, the lawyer may be charged with special obligations in dealing with a beneficiary.”).

72. *See* DEBORAH A. DEMOTT, *FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP* (1991).

73. ALAN R. BROMBERG & LARRY E. RIBSTEIN, *PARTNERSHIP* 6:68 (1994) (“Fiduciary duties are essentially part of the standard form contract that governs partnerships in the absence of contrary agreement.”). This is a narrow view of fiduciary duties that does find some support in recent case law. *See Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 485 U.S. 901 (1988). In *Jordan*, Judge Easterbrook stated: “Because the fiduciary duty is a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly, parties may contract with greater specificity for other arrangements.” *Id.* at 436. On the other hand, *Jordan* has been described as unprecedented:

The definition of fiduciary obligation articulated in the *Jordan* opinion appears to be literally unprecedented in prior Anglo-American caselaw. The opinions define fiduciary obligation as the court’s guess about what the parties would have agreed to had they bargained over the matter. To the extent that the *Jordan* opinions suggest that this definition is anything other than a novel departure from prior caselaw, the representation is not accurate.

Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 885 (1988).

74. 67 Del. Laws 348 § 27 (1990) (amending DEL. CODE ANN. tit. 6, § 17-1101 (1974)):

(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

(d) To the extent that, at law or in equity, a partner has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner (i) any such partner acting under a partnership agreement shall not be liable to the limited partnership or to any such other partner for the partner’s good faith reliance on the

The basic contractarian argument against mandatory minima is that individuals are in the best position to allocate rationally their own resources. Accordingly, they should not be forced to buy or sell unwanted entitlements in the form of mandatory minima. The extremists argue that mandatory fiduciary duties are inefficient because they force the parties to engage in the unwanted purchase and sale of entitlements. The beneficiary is forced to incur the cost of an unwanted entitlement, and the fiduciary is forced to incur the cost of avoiding or insuring against the entitlement.<sup>75</sup> Within the same industry and the same business form, the cost is shared among similar businesses and does not result in competitive disadvantage. The loss to society, therefore, is the misallocation of resources caused by transactions the market does not want.

In the partnership context, unnecessary cost is said to be imposed when partners are forced to take steps to avoid fiduciary duties they would draft away. More specifically, the indeterminacy of fiduciary obligation is said to increase transaction costs by creating uncertainties concerning the lawfulness of business conduct. Because courts have proven themselves incapable of reducing the costs imposed by their own rules, the argument concludes, the legislature should permit partners to avoid judicial rules and rely solely on contract and market mechanisms.<sup>76</sup>

### 3. *In Defense of Mandatory Minima.*

*a. Imperfections in bargaining for long-term relationships.* Contractarians believe that some agreements should be set aside. I know of no one who objects to laws protecting individuals from agreements induced by fraud.<sup>77</sup> It would be optimal if a statute could identify and prohibit those provisions that result from fraud. Prohibiting such agreements would prevent theft from the defrauded party and would avoid the social costs of the fraudulent behavior. To invalidate the agreement *ab initio* would be useful because an agreement

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provisions of such partnership agreement, and (ii) the partner's duties and liabilities may be expanded or restricted by provisions in a partnership agreement.

75. See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 431 (1993):

Fiduciaries may charge for their services, driving hard bargains at the outset. Competition among fiduciaries leads to higher prices that just cover the lesser of (a) the extra costs of fulfilling any duties required by law, or (b) obtaining the beneficiary's assent to some different way of doing things. By hypothesis, method *b* will be costly (recall that it is the difficulty of negotiating and monitoring express contracts that lead to the characterization of the arrangement as "fiduciary"). So most of the time the fiduciary will charge for the extra service, or the opportunity cost of an option foregone. A beneficiary who does not value the new service or higher degree of loyalty at more than the cost of providing it is worse off, the opposite of the court's objective; if the beneficiary does value the extra service at more than its cost, then the parties would have provided for this service by contract in a transaction-cost-free world.

76. See generally Henry M. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990).

77. UPA § 39, 6 U.L.A. at 246 provides for the situation in which "a partnership contract" is rescinded on the ground of fraud or misrepresentation. RUPA has no analogous provision, thus leaving the matter wholly to the courts.

procured by fraud is likely to be extremely difficult to monitor. In short, restrictions on the validity of agreements may be an efficient way to prevent fraud and reduce the cost of monitoring.

Because it is impossible to draft a statute that successfully isolates all agreements induced by fraud, the second-best solution is to draft mandatory minima that can serve as efficient surrogates for more precise restraints on fraudulent behavior.<sup>78</sup> Because fraud is often difficult to discover and prove, RUPA, in effect, defines a category of fraud and near-fraud in the context of the highly interdependent relationship of partnership. The remedy is disgorgement. To provide access to the category and its remedy, RUPA provides, again in general terms, a mandatory minimum access to information.<sup>79</sup> This requirement invalidates attempts to facilitate fraud by making monitoring prohibitively expensive. In short, RUPA attempts to provide maximum freedom of contract while suggesting an outer limit that is impossible to define in other than the most general terms: partners found to be opportunistic will be required to disgorge. When there is doubt, they must share. This is the essential remedial prescription of the duty of loyalty.<sup>80</sup>

Apart from the agreement that is induced by or designed to facilitate fraud, extremist contractarians and paternalists have a fundamentally different view of bargaining and the relationships that result. Some contractarians insist on an either-or dichotomy: either there is gross inequality in bargaining power or there is equality. There is no middle ground. Professor Hynes reflects this position when he states: "Persons 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."<sup>81</sup>

I disagree with this presumption of equality in three basic respects. First, I do not believe that equality should be presumed from the fact that each party has, at least at the outset, something the other wants. Second, I do not believe

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78. See Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 768 (1983) ("[I]f the entitlement can be waived, if most of the waivers that are given are procured by fraud, and if the fraud can rarely be proven, the inefficiencies of a no-waiver rule may be outweighed by the greater inefficiency of enforcing too many fraudulent bargains.").

79. RUPA § 103(b)(2), 6 U.L.A. at 288 (Supp. 1995); *id.* § 403(b), 6 U.L.A. at 311.

80. See Easterbrook & Fischel, *supra* note 75, at 441-42 (citation omitted):

Surely, though, there is a distinctive subject here, manifest in the remedy: disgorgement of all profit obtained in violation of the fiduciary duty of loyalty. This looks distinctly anticontractual. Throughout the law of contracts the presumptive remedy is based on the promisee's loss, and a large economic literature proclaims the superiority of loss-based measures because they enable the parties to avoid performance that is more costly than the benefit created. Disgorgement, by contrast, makes it unprofitable to depart from the contractual duty in any particular and so stifles even actions to which the parties would have agreed, had they been able to negotiate without transactions costs.

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Courts that award disgorgement of gain often temper that remedy by allowing the fiduciary a substantial reward for his entrepreneurial efforts.

81. Hynes, *supra* note 5, at 40; see also text accompanying note 57.

that a bright line separates equal bargainers from unequal bargainers. Instead, there is a continuum of comparative bargaining power. Third, I believe that nontraditional dimensions of the bargaining process other than traditional bargaining power ought to be taken into account. People are not one-dimensional.<sup>82</sup> Partners are so interdependent that the law should be especially vigilant over the formation and articulation of their relationship.

The process that generates a partnership agreement typically involves different behaviors and dramatic information asymmetries. Some "bargainers" are unlikely to bargain.<sup>83</sup> Some bargainers are less likely to attend to the language of an agreement or to appreciate the significance of language, even if their attention is directed specifically to it. Some bargainers are less likely to project ahead and apply the language to foreseeable situations. Some bargainers are more likely to foresee situations than others. Finally, some bargainers are likely to find the relationship almost impossible to monitor.

When such asymmetries exist, mandatory minima are most likely to be efficient.<sup>84</sup> They inject into the transaction the kind of minima that equally informed, astute, and energetic bargainers are likely to want. Once again, identifying the most appropriate minima is an empirical question.<sup>85</sup> RUPA's minima reflect the drafters' best judgment about minima likely to be contracted for in bargaining that is untarnished by fraud or by dramatic information or behavioral asymmetries.

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82. See Kronman, *supra* note 78, at 763, 797 ("The will-based theories of obligation that dominate the intellectual scene today obscure the complexity of our law of contracts by putting before us a wholly denatured conception of the person in which passion and moral obligation have no place.")

83. See John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on The Judicial Role*, 89 COLUM. L. REV. 1618, 1677 (1989):

[T]he process of contracting about a long-term business relationship in which one party must place trust and confidence in another makes it difficult to explore the "downside" possibilities that such party will be defrauded. To focus on such possibilities is to "queer" the deal. This observation goes not to cognitive limits, but to the social processes of contracting, and is probably most obvious in the kind of face-to-face individual negotiations that characterize closely held firms.

84. Cf. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 113 (4th ed. 1992):

The fiduciary principle is the law's answer to the problem of unequal costs of information. It allows you to hire someone with superior information to deal on your behalf with others having superior information. The principle does more. By imposing a duty of utmost good faith rather than the standard contractual duty of ordinary good faith, it minimizes the costs of self-protection to the fiduciary's principal. This is especially important in settings where the principal is quite helpless to protect himself

85. JOHN W. PRATT & RICHARD J. ZECKHAUSER, *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 3 (1985):

[G]iven information asymmetries . . . we cannot expect any business enterprise . . . to function as well as it would if all information were costlessly shared or if the incentives of principal and agent(s) could be costlessly aligned. This shortfall is sometimes called the *agency loss* or *agency costs*. The challenge in structuring an agency relationship is to minimize it. In economic parlance, since the first-best outcome could be achieved only in the unrealistic world of costless information flow, our goal must be to do the best we can, to achieve what is sometimes called a second-best solution.

*b. Costs and benefits of authorizing extreme relationships.* To say that parties cannot anticipate all the consequences of a long-term relationship, and hence should be protected by mandatory minima, is only a partial response to the extremists. The hard question remains: Why should informed partners be denied the right to draft agreements that will be enforced according to their terms?

The answer can be illuminated by considering the example of a partnership agreement between Investor and Manager. The agreement provides that Investor will put up money to be managed by Manager, that Investor will have no information rights, no right to monitor Manager, and no right to any return of or on the investment unless and until Manager, in its sole discretion, if ever, provides. The agreement also provides that Manager can act on Manager's own behalf, taking from and competing with the partnership without limit, and that Investor has no right to seek judicial review of the behavior of Manager, unless Manager has violated the express language of the partnership agreement. In further particular, the agreement says Investor will remain a partner until Investor is dismissed by Manager and that, under no circumstances, will Manager be treated as a fiduciary of Investor.

The basic answer to the hard question is that the costs would far exceed the benefits of enforcing this type of agreement according to its terms. The question presented by the Investor-Manager hypothetical is whether the law should enforce a mutual agency agreement providing that nothing Manager does will ever constitute a breach. The Investor-Manager agreement may be referred to as a "no entitlements" agreement, one in which the Investor is not entitled to any right to monitor or to have recourse to other protective process or substantive outcome. No entitlements agreements should be prohibited because, in the aggregate, the benefits they create are outweighed by their cost.

The benefit of enforcing no-entitlements agreements is that, in a very limited class of situations, highly-informed, extraordinarily thoughtful, and forward-thinking individuals would be permitted to place their investments and personal fortunes in the hands of individuals who make no promises in return.<sup>86</sup> These individuals would be spared the cost of mandatory transactions in entitlements. It is hard to understand why, as a matter of fairness, such a specific group of perfectly informed and farsighted individuals should not be permitted to enter such a contract.

The costs of a particular no-entitlements investment are difficult to identify. Viewed in isolation, the cost of a particular investment appears to be that an unaccountable manager is more likely to invest in opportunistic behavior.<sup>87</sup>

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86. Indeed, it is not clear why the transmission of wealth in this situation does not involve an aleatory contract or a gift.

87. Cf. POSNER, *supra* note 84, at 109-10 ("The liar makes a positive investment in manufacturing and disseminating misinformation. This investment is completely wasted from a social standpoint, so naturally we do not reward him for his lie.").

That so much is left to speculation is unsatisfying, as is the nagging suspicion that the agreement fails to reflect true investor expectations.<sup>88</sup>

The cost of enforcing this type of agreement becomes clear when the hypothetical group of perfectly-informed investors is set aside. The larger issue is how the legal system as a whole will function if no-entitlement investments are a legitimate possibility. Recognizing and enforcing a category of no-entitlement partnerships would entail four basic costs in addition to the cost of managerial investment in opportunistic behavior. First, some individuals with less sophistication and foresight would seek out and gain access to this category of partnership. If their investments were appropriated, they would have no remedy absent proof of a claim such as fraud, duress, or unconscionability. Second, some uninformed individuals would gain admission to such a partnership without understanding it. They, too, could wind up with appropriated investments and no remedy. Third, individuals informed of the existence of such partnerships would be forced to incur costs to avoid them or to modify them.<sup>89</sup> Fourth, the legal system would be left to untangle relationships that

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88. See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1091 (1981):

A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.

89. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1751-52 (1994) (trying to explain why key employees prefer corporations to partnerships):

One hypothesis as to why management might get "spooked" by partnership interests involves employee risk aversion, and the information costs and signaling behavior the use of such interests might entail. Broadly speaking, [in addition to the risk that the venture will not succeed, a] second risk is that the venture itself will succeed, but that the fruits of success will be expropriated by the venture capitalist and other investors. A number of founders and other key employees . . . felt that the risk of expropriation was as great as the risk that the venture itself would not succeed . . . .

[F]ear of investor expropriation of gain makes employees suspicious of venture capitalists. This, in turn, makes it more difficult for a venture capitalist to adopt a new organizational structure . . . . As a result, the change in organizational structure might dramatically increase informational costs, as the employee seeks reassurance from other sources. To the extent that the employee does not or cannot seek reassurance from other sources, the change of organization might increase the perceived risk of the venture.

Cf. POSNER, *supra* note 84, at 110 ("So here is another reason for forbidding sellers to lie: to save the expense of the self-protective measures that buyers would have to take if there were no legal remedies against sales misrepresentation.").

See generally Coffee, *supra* note 83, at 1677-78:

Opting out can impose costs on third parties, which ultimately will be spread throughout society. For example, increasing the range of contractual innovations that may be introduced into the corporate charter affects not only investors in corporations that do opt out, but also those in corporations that do not, because there is always the prospect that their corporations may do so in the future. . . . Put simply, standardization of contract terms through the use of mandatory legal rules reduces information costs for investors.

result in disappointment.<sup>90</sup> Significant social costs would inevitably be incurred to identify whether an informed choice had been made.

The presence of these costs suggests that the law should not assume the existence of a significant number of perfectly informed people who would enter into no-entitlement partnerships. Indeed, it seems safe to assume that very few sophisticated partners would wish to enter into such a relationship. If this assumption is correct, the costs of authorizing such a relationship far exceed the benefits of doing so. Nor is it persuasive to say that a market for managers is likely to constrain managers who are contractually unaccountable.

In summary, no balanced policy of partnership relationships is possible without mandatory minima. Even if particular bargains were free from blemish, it would be far too costly to operate a system that would permit investors to waive all information and other rights necessary to monitor managers and hold them accountable. Contracts that deprive people of all information, remedy, and dignity, and laws that insulate the drafters of such contracts from judicial review are to be prohibited rather than enabled.<sup>91</sup> They offer only abstract benefit to a very limited class, and invite widespread opportunistic behavior with all its individual and social costs.<sup>92</sup> Individuals must bear the cost of avoiding such contracts, and society must bear the cost of picking up the pieces when they fall apart. Certainly they have no place in a default relationship that involves little ability to diversify and joint and several liability for a mutual agency.

*c. The optimal level of indeterminacy.* As indicated above, RUPA meets the contractarians more than half way by making the language of fiduciary law significantly less indeterminate. This is not based on the assumption that all indeterminacy is bad. Some indeterminacy is not only unavoidable, but desirable.

The efficiency of different levels of indeterminacy is a matter of debate.<sup>93</sup> The proper question is what are the costs and the benefits of the indeterminacy that has been mandated. In the case of a mandatory rule, the task is to

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90. Cf. *KE Property Management Inc. v. 275 Madison Management Corp.*, No. CIV.A.93-12683, 1993 WL 285900, at \*1 (Del. Ch. July 27, 1993) (“The case is a procedural nightmare and is an example of the burden often placed on the Delaware courts by litigation arising from convoluted limited partnerships that have been formed in Delaware for a token fee.”). See generally *Coffee*, *supra* note 83, at 1678 (“[P]ublic costs would be imposed on the judicial system, as a higher rate of litigation becomes likely in response to ambiguous or novel contract terms. Uncertainty about the interpretation courts would give to novel provisions is also predictable.”).

91. See *State v. Shack*, 277 A.2d 369, 372 (N.J. 1971) (“[T]he needs of the [agents] may be so imperative and their strengths so weak, that the law will deny [them] the power to contract away what is deemed essential to their health, welfare or dignity.”).

92. See generally OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTION OF CAPITALISM* (1985); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981).

93. See generally Gillian Hadfield, *Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law*, 82 CAL. L. REV. 541 (1994).

compare the relative costs and benefits of a particular minimum with the costs and benefits of withholding judicial review.<sup>94</sup>

The cost of eliminating mandatory minima is the cost of authorizing lawlessness in business relationships. How much that elimination would cost is an empirical question that has no answer. Similarly, there is no empirical determination of the cost of mandatory minima. Neither the contractarians nor the paternalists have developed a calculus to prove their solution is correct. The proper solution is a matter of judgment.

There is minimal cost to RUPA's rather low mandatory minima of fiduciary duty. Indeed, the cost of the minima is far less than the cost of creating a business form that permits unaccountable managers. The cost is not as great as the cost of increasing a level of competence or of improving a product. The cost is much lower because it is essentially a decision to refrain from opportunistic behavior.<sup>95</sup> Even if there is the cost of deliberation about the decision to refrain, it is desirable to insist that managers incur some cost to monitor their own behavior and that of their colleagues. It is desirable to make them pause, if only briefly, to consider whether they are honoring the letter and the spirit of their interdependent relationship. An ounce of prevention, after all, can be worth a pound of cure. Some behavior will be deterred,<sup>96</sup> and some injured partners will be compensated.

Obviously, it would be inappropriate for the law to force dysfunctional self-appraisal. Legitimate transactions should not be discouraged. RUPA's minimalist provisions against opportunistic behavior are highly unlikely to discourage such legitimate transactions. Given that virtually all specific waivers of mandatory minima will be upheld, RUPA gives extraordinary latitude to the freedom to contract. All but the tiniest bit of caution can be thrown to the wind. The idea that RUPA requires excessive self-examination, resulting in an

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94. Judge Cardozo's own opinion in *Meinhard* suggested that the law of fiduciary obligation was too indeterminate to offer much guidance: "Little profit will come from a dissection of the precedents." *Meinhard v. Salmon*, 164 N.E. 545, 547 (N.Y. 1928). His opinion did not add greater determinacy.

95. Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 83 (1973):

To increase the level of competence or quality of information involves investment of real resources both in labor and goods. On the other hand, a reduction in fraud or misrepresentation requires no additional resources but only a decision to stop. A universal adherence to honesty would thus involve a clear social gain, while an increase in competence yields social gains only to the extent that the gains are greater than the increase in resource costs.

96. Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65, 86 (1994) ("Mandated disclosure, in short, sometimes operates as a preventive measure when the party obliged to disclose might be strongly tempted to engage in socially disfavored conduct.").



excess investment in ethical<sup>97</sup> behavior, is a proposition that remains to be proved.

I know of no commentator on the current business scene who believes that our society teeters on the brink of excessive investment in business ethics. The closest parallel to general rules of business ethics is the law of fiduciary obligation. Sadly, it is rarely taught or understood that way. As a body of doctrine, it has no place of its own in most law school or business school curricula. As it has fallen from fashion in the academy, so, too, has it dropped off the legislative agenda. To the extent it makes the fiduciary dimension of the partnership relationship an explicit statutory mandate, RUPA should be praised for requiring minimal ethical considerations to confine the discretion exercised by highly interdependent people.

## V

### CONCLUSION

Contractarian extremists have argued that RUPA should permit partners to “contract” for any relationship they choose. In particular, they have stated that partnership agreements should be enforced even if they withhold from some partners all entitlements to information, right to monitor, and substantive outcome. In making these arguments, the contractarian extremists overlook that mandatory rules are an important component of contract law, particularly the obligation of good faith and fair dealing. Indeed, basic contract doctrine anticipates the special treatment of fiduciary relationships. The contractarian extremists also overlook the costs of authorizing no-entitlement partnerships. In particular, traps would be created for the unwary, opportunistic behavior would be condoned and prospective partners would be required to incur additional costs to protect against appropriation of their investments.

Professor Hynes wants the language of the sale of goods to control a relationship of great trust and vulnerability. I dissent. Let not the variation obscure the theme. Partners are entrusted with great discretion in the affairs of the business and are subject to joint and several liability for the exercise of that discretion.<sup>98</sup> Perhaps most frequently, they are not in a position to diversify. These dimensions do not exist in the usual contractual exchange. Indeed, they are not present in many “fiduciary” relationships. RUPA attempts to confine the exercise of discretion by partners with the language of fiduciary

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97. *Cf. Comm. on Prof. Ethics and Conduct v. McClintock*, 442 N.W.2d 607 (Iowa 1989) (attorney appropriated to his own use a portion of the attorneys’ fees he should have been sharing with his partners). The Grievance Commission found, among other things, that the attorney had committed “illegal conduct involving moral turpitude.” The Supreme Court of Iowa reprimanded him, stating: “Most law partnerships are founded upon a total trust and confidence among the partners. A breach of this exceedingly close relationship merits disciplinary action. Although McClintock’s conduct did not involve an attorney-client relationship, his conduct is governed by the Code of Professional Responsibility.” *Id.* at 608.

98. Easterbrook & Fischel, *supra* note 75, at 437 (“Partners owe each other greater duties because of the incomplete separation of management and risk bearing.”).

obligation, while permitting them to agree to narrow the scope of the obligation. Fiduciary minima are important precisely because they reflect the texture of the partnership relationship and hold partners to a higher standard than other contracting parties.

When approaching the most important machines in my life, I have found it useful to have in mind, and at hand, a core set of tools. My core set includes a Phillips screwdriver, a flathead screwdriver, a crescent wrench, a socket wrench, a pipe wrench, and a mirror. Each tool is best suited for a particular purpose. At times, these tools are interchangeable, but very often they are not. I would therefore resist confinement to one kind of screwdriver or one kind of wrench. For much the same reason, I resist the notion that partnership law should become as close to corporate law as possible (while, of course, still serving as a vehicle to escape corporate tax classification).

Most states now have an organizational tool kit that includes the corporation, the partnership, the limited partnership, and the limited liability company. The corporation and the limited partnership in particular serve organizations of many members, with sharply defined classes of participants. Limited liability company statutes vary; some borrow more heavily from the corporate form, and others borrow more heavily from the limited partnership form. Corporate, limited partnership, and limited liability company statutes rely heavily on structural rules that regulate the relations among classes of participants.<sup>99</sup> Provision is made for centralized management,<sup>100</sup> and members are protected from liability for debts of the organization. Because they have no personal liability and are most typically diversified, it is easier to "lock them in" to the organization. Thus, it is tolerable that neither shareholders nor limited partners have a statutory right to be bought out at will. Because these organizational forms are alternatives to the partnership form, partnership law is itself a default rule, and quibbling about the edges of the limited mandatory rules within a default rule is splitting hairs.

The partnership form should be preserved for those it is intended to serve and who do not shrink from its terms. The essence of these terms should be stated simply and clearly. The language of partnership law should capture the texture of the relationship in a way that will focus the attention of judges, arbitrators, and partners themselves. The partnership relationship is informal, involving less sharply defined or shifting classes of members, who must repose great trust in one another because they are typically less able to diversify and

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99. I borrow the term "structural" from Professor Eisenberg: "*Structural rules* govern the allocation of decisionmaking power among various corporate organs and agents and the conditions for the exercise of decisionmaking power; the allocation of control over corporate organs and agents; and the flow of information concerning the actions of corporate organs and agents." Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1462 (1989).

100. Limited liability company statutes vary on how they define the default rule on the authority of members and on how that authority may be limited by agreement. See generally CARTER G. BISHOP AND DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW*, ch. 7 (1994).

are exposed to joint and several liability for each other's behavior. To eliminate all trust is to deny the texture of their relationship. Specific opportunities may be excluded from the trust, but the trust must be honored. People who want a different relationship can choose a different form. People who are in the relationship can cash out at any time.<sup>101</sup>

The word "fiduciary" has been eliminated from the Model Business Corporation Act, the Uniform Limited Partnership Act, and, typically, from limited liability company acts. Fiduciary obligation should remain mandatory in the statute defining partnerships to require a minimal standard of ethical behavior. The law should continue to offer this island, where the landscape is both familiar and pleasing, for highly interdependent people who believe their relationship requires trust. The signal should be sent that the partnership form is a far safer harbor than it would be if no-entitlement partnerships were permitted.

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101. See RUPA § 701, 6 U.L.A. at 328 (Supp. 1995).

