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## Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies

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# WAIVING FIDUCIARY DUTIES IN DELAWARE LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

Winnifred A. Lewis\*

*In corporations, like most other business associations, fiduciary duties exist to deter management from abusing their power over the owners' property. In Delaware limited partnerships and limited liability companies, this protection can be waived in the operating agreement. This Note explores the effects of retaining or waiving fiduciary duties and how this plays out in the interpretation of operating agreements. It argues that default fiduciary duties exist for limited liability companies and limited partnerships, including those that are member managed, and it proposes a combination of disclosure and signature requirements from each limited partner or member in order for waiver of fiduciary duties to be effective.*

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#### INTRODUCTION

In 1997, Gatz Properties LLC, Auriga Capital Corporation, and several minority investors formed Peconic Bay, a Delaware limited liability company (LLC).<sup>1</sup> Peconic Bay was created to develop a golf course.<sup>2</sup> To do so, it leased property from the Gatz family and then sublet to American Golf Corporation, a golf course development company.<sup>3</sup> Peconic Bay was governed by an LLC agreement that designated Gatz Properties as manager and allocated voting in such a way as to give Gatz Properties control.<sup>4</sup> Gatz Properties, in turn, was managed and controlled by William Gatz.<sup>5</sup>

The golf course venture was never profitable.<sup>6</sup> By 2005, Gatz knew American Golf would elect to terminate the sublease in 2010,<sup>7</sup> effectively ending Peconic Bay’s only source of revenue. In 2007, in anticipation of American Golf’s decision, Gatz commissioned an appraisal of the

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1. *Gatz Props., LLC v. Auriga Capital Corp. (Auriga II)*, 59 A.3d 1206, 1208 (Del.), *aff’g* 40 A.3d 839 (Del. Ch. 2012).

2. *Id.*

3. *Id.* at 1209.

4. *Id.* at 1208–09.

5. *Id.* at 1208.

6. *Id.* at 1209.

7. *See id.*

property.<sup>8</sup> The appraiser valued the land with golf course improvements at \$10.1 million and as vacant land available for development at \$15 million.<sup>9</sup>

Later that year, another golf course development company, RDC Golf Group, expressed interest in acquiring Peconic Bay's long-term lease.<sup>10</sup> Gatz refused to permit due diligence and criticized RDC's revenue projections as overly optimistic.<sup>11</sup> RDC submitted a nonbinding offer to acquire Peconic Bay's ground lease and American Golf's sublease for \$3.75 million.<sup>12</sup> The offer was rejected by a membership vote, controlled by Gatz, as was a second offer of \$4.15 million.<sup>13</sup> RDC again raised its level of interest, this time to \$6 million,<sup>14</sup> but Gatz did not respond to this approach.<sup>15</sup>

Instead, Gatz offered to purchase Peconic Bay's minority interests himself for the amount the minority investors would receive if Peconic Bay's assets were sold for \$5.6 million.<sup>16</sup> Gatz did not inform the minority investors of his failure to respond to RDC's offer of \$6 million.<sup>17</sup> The minority holders nonetheless rejected Gatz's offer.<sup>18</sup>

Gatz then hired an appraiser for Peconic Bay, but he gave the appraiser incomplete information.<sup>19</sup> Using only American Golf's historical financial data, the appraiser found that Peconic Bay had no net positive value.<sup>20</sup> Gatz then proposed to sell Peconic Bay at auction.<sup>21</sup> After a desultory marketing effort, Gatz was the only bidder, and he purchased Peconic Bay.<sup>22</sup> The minority members collectively received \$20,985.<sup>23</sup> The auctioneer received \$80,000 for his services.<sup>24</sup>

After the auction, the minority investors brought suit against Gatz based on his active mismanagement of Peconic Bay.<sup>25</sup> Intuitively, it would seem Gatz should be held liable. Under either a partnership or a corporate law schema of fiduciary duties, Gatz had clearly breached his duty of loyalty to the minority members;<sup>26</sup> under LLC law, however, the success of such a

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8. *Id.*

9. *Id.*

10. *Id.*

11. *Id.*

12. *Id.*

13. *Id.* at 1209–10.

14. *Id.* at 1210.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.* at 1211.

22. *Id.*

23. *Id.* at 1212. Compare this to the \$734,131 the minority investors would have received had they accepted Gatz's earlier offer to buy them out, which presumably was already a low bid. *Id.* at 1210.

24. *Id.* at 1212.

25. *See id.*

26. *See infra* notes 49, 77–84, 112–19 and accompanying text.

suit depended on the LLC agreement.<sup>27</sup> Peconic Bay, as a Delaware LLC, could eliminate all fiduciary duties in the operating agreement,<sup>28</sup> but Peconic Bay's LLC agreement arguably did not directly address the existence or contours of the fiduciary duties that Gatz owed to Peconic Bay's members.<sup>29</sup> In the face of silence or ambiguity, what, if any, legal duties constrained Gatz's conduct?

Clarity and predictability of these duties has grown in importance as LLCs and limited partnerships (LPs) have grown increasingly popular.<sup>30</sup> There is now a significantly greater number of LLCs being formed annually than corporations, both nationally,<sup>31</sup> and in Delaware.<sup>32</sup> In Delaware, in 2011, three times as many LLCs as corporations were formed.<sup>33</sup> There is an increasing number of LPs in Delaware as well, although the jump is not as dramatic.<sup>34</sup>

Not only is the increasing number making these entities more important, but so is the amount of capital and type of firm which typically selects these as their form of organization. Limited partnerships are increasingly the organization of choice for private equity firms, venture capital firms, and hedge funds.<sup>35</sup> As of the first quarter of 2012, the hedge fund industry was comprised of approximately 7,659 firms, with an aggregate capital of more than two trillion dollars.<sup>36</sup> Publicly traded LPs and LLCs have billions of dollars in assets.<sup>37</sup> As a result of this growth, the legal contours of fiduciary

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27. See DEL. CODE ANN. tit. 6, § 18-1101(c) (2005).

28. See *id.*

29. See *Auriga Capital Corp. v. Gatz Props., LLC (Auriga I)*, 40 A.3d 839, 856 (Del. Ch.), *aff'd*, 59 A.3d 1206 (Del. 2012).

30. See Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractability and Legal Indeterminacy*, 52 B.C. L. REV. 189, 191 & n.10 (2011).

31. See Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 473 tbl.I-D (2010) (providing empirical data illustrating that, compared to corporations, two times more LLCs were formed in 2007 in the United States).

32. See DEL. DIV. OF CORPS., 2011 ANNUAL REPORT 1 (2011), *available at* <http://corp.delaware.gov/2011CorpAR.pdf> (providing a graph of New Business Formations from 2009–2011, showing formation of Delaware LLCs outpacing that of corporations three to one in 2011).

33. See *id.*

34. See *id.*

35. See Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 298–300 (2009).

36. See Eric Uhlfelder, *Best 100 Hedge Funds*, BARRON'S (May 19, 2012), [http://online.barrons.com/article/SB50001424053111904571704577404264215025458.html#articleTabs\\_article%3D1](http://online.barrons.com/article/SB50001424053111904571704577404264215025458.html#articleTabs_article%3D1).

37. In 2012, Delaware was home to eighty-five publicly traded LPs and LLCs. See Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 598 (2012). These are primarily oil and gas companies and coal, mineral, and timber companies, although there are also a few investment and financial management firms. See *id.* at 599–603 app.A; see also *PTPs Currently Traded on U.S. Exchanges*, NAT'L ASS'N OF PUBLICLY TRADED P'SHIPS, <http://napt.org/PTP101/CurrentPTPs.htm> (last visited Oct. 21, 2013) (listing all currently publicly traded partnerships, totaling 101 limited partnerships and fourteen limited liability companies).

duties in these entities are gaining increasing significance.<sup>38</sup> When someone like Gatz is managing billions of dollars, there is arguably more at stake, both for the investors and the market at large.

In Delaware, the applicability of fiduciary duties to these entities depends on the language of the operating agreement.<sup>39</sup> The Delaware Court of Chancery has emphasized the existence of so-called “default” fiduciary duties—shorthand for duties arising from equity and common law that exist in the absence of contractual modification by the parties.<sup>40</sup> The Chancery Court found Gatz liable for violating his fiduciary duties to Peconic Bay’s minority members,<sup>41</sup> but the Delaware Supreme Court did not share this view.<sup>42</sup> While the Delaware Supreme Court held Gatz liable for his conduct, it did so on contractual grounds.<sup>43</sup>

The Delaware Supreme Court’s ruling raised questions of whether, when, and how default fiduciary duties apply to limited liability companies.<sup>44</sup> The debate over the wisdom of implying these duties continues.<sup>45</sup> While recent Delaware legislation seems to have clarified the existence of default fiduciary duties, at least in certain circumstances, the applicability of these duties remains undefined.

This Note explores recent Delaware case law regarding fiduciary duties in LPs and LLCs. Part I begins by reviewing the origins of fiduciary duties and their application in Delaware business law. It then outlines the history of LPs and LLCs and examines how fiduciary duties function in the context

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38. According to at least one list, two recent cases concerning default fiduciary duties in LLCs and LPs made the top five key corporate and commercial cases of 2012. See Francis G.X. Pileggi & Kevin F. Brady, *Key Delaware Corporate and Commercial Decisions in 2012*, DEL. CORP. & COM. LITIG. BLOG (Jan. 2, 2013), <http://www.delawarelitigation.com/2013/01/articles/annual-review-of-cases/key-delaware-corporate-and-commercial-decisions-in-2012/>.

39. See *infra* notes 106–11 and accompanying text.

40. See *Auriga Capital Corp. v. Gatz Props., LLC (Auriga I)*, 40 A.3d 839, 849–56 (Del. Ch.), *aff’d*, 59 A.3d 1206 (Del. 2012).

41. *Id.* at 875.

42. The Delaware Supreme Court’s opinion was passionate enough to make the news. See, e.g., *Del. High Court to Chancery Chief: Keep World Views to Yourself*, REUTERS.COM (Nov. 7, 2012, 8:04 PM), <http://www.reuters.com/article/2012/11/08/delaware-law-strine-idUSL1E8M7P8620121108>; Peter Lattman, *In Unusual Move, Delaware Supreme Court Rebukes a Judge*, N.Y. TIMES DEALBOOK (Nov. 9, 2012, 8:29 PM), <http://dealbook.nytimes.com/2012/11/09/in-unusual-move-the-delaware-supreme-court-rebukes-a-judge/>; Gordon Smith, *Delaware Infighting*, CONGLOMERATE (Nov. 10, 2012), <http://www.theconglomerate.org/2012/11/delaware-infighting.html>.

43. *Auriga II*, 59 A.3d at 1208.

44. See, e.g., Michael C. Hefter & Ryan M. Philip, *The Debate Rages on Regarding Whether Default Fiduciary Duties Apply to LLC Managers Under Delaware Law*, NAT’L L. REV. (Jan. 7, 2013), <http://www.natlawreview.com/article/debate-rages-regarding-whether-default-fiduciary-duties-apply-to-llc-managers-under->; Carl Neff, *Delaware Supreme Court Declines To Hold that Default Fiduciary Duties Are Owed in LLCs*, DEL. CT. OF CHANCERY PRAC. BLOG (Dec. 30, 2012), <http://delawarechancery.foxrothschild.com/fiduciary-duties/delaware-supreme-court-declines-to-hold-that-default-fiduciary-duties-are-owed-in-llcs/>.

45. See, e.g., *On-Line Symposium: Default Fiduciary Duties in LLCs and LPs*, WIDENER L., <http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/> (last visited Oct. 21, 2013).

of these unincorporated firms. Part II outlines the conflicting arguments regarding whether default fiduciary duties should apply in LLCs and LPs, contrasting the traditionalist view with the contractarian. Part III argues that default fiduciary duties apply to both LLCs and LPs, including those that are member managed. This Note then contends that a combination of disclosure and signatures should be required in order to waive fiduciary duties.

#### I. FROM FUNDAMENTAL TO DISPOSABLE: FIDUCIARY DUTIES, LLCs, AND LPs

Part I discusses the origins of fiduciary duties and outlines their application in the context of Delaware business law. Next, it explains the history and structure of LLCs and LPs. It then explores how fiduciary duties apply to these entities.

##### A. *Fiduciary Duties and Their Role in Business Associations*

This section first describes the equitable origins of fiduciary duties and then gives an overview of their application in the context of corporations.

##### 1. The Equitable Origins of Fiduciary Duties

At their foundation, fiduciary relationships are characterized by one person placing special trust in and reliance on the judgment of another.<sup>46</sup> Typical examples of such relationships are trustees managing assets for beneficiaries,<sup>47</sup> agents acting on behalf of principals,<sup>48</sup> and partners working together on a joint venture.<sup>49</sup>

The law recognizes each of these as a special circumstance and provides protection by imposing special duties on the person acting on the other's behalf.<sup>50</sup> The law imposes a heightened duty of care and fidelity on this person.<sup>51</sup> This was famously articulated by Justice Cardozo, writing that business partners are "held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most

46. *See, e.g.*, *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 661 (Del. Ch. 2012) (quoting *Metro Ambulance, Inc. v. E. Med. Billing, Inc.*, No. 13929, 1995 WL 409015, at \*2 (Del. Ch. July 5, 1995)).

47. *See, e.g.*, *Keech v. Sandford*, (1726) 25 Eng. Rep. 223 (Ch.) (imposing heightened duties on a trustee managing a lease for beneficiary); A. SCOTT, *THE LAW OF TRUSTS* § 17.2.7 n.2 (5th ed. 2006) (discussing application of *Keech* in the United States).

48. *RESTATEMENT (THIRD) OF AGENCY* § 1.01 cmt. e (2006) (discussing fiduciary character of agency relationship).

49. *See, e.g.*, *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties.").

50. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1046 (1991); *see also id.* at 1046 n.3 (discussing paradigmatic forms of fiduciary relationships).

51. DEBORAH A. DEMOTT, *FIDUCIARY OBLIGATION, AGENCY, AND PARTNERSHIP: DUTIES IN ONGOING BUSINESS RELATIONSHIPS* 2 (1991); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 882.

sensitive, is then the standard of behavior.”<sup>52</sup> These fiduciary duties can never be waived—they are an intrinsic part of each of these legal relationships.<sup>53</sup>

While to an extent there is a moral aspect to the imposition of these duties<sup>54</sup>—to not damage, steal, or waste what was given in trust—there are economic reasons for these duties, as well.<sup>55</sup> A result of trust in, and reliance on, another is the separation of ownership and control.<sup>56</sup> The person who owns the property gives it to another person to manage.<sup>57</sup> The manager thus controls the property and does what he must in order to make the property productive.<sup>58</sup> His obligations are open ended, as each decision that would make the property productive cannot be thought of in advance.<sup>59</sup> The owner, by contrast, is not involved; he holds legal ownership, but that is all.<sup>60</sup> What is difficult for the owner to know is what the manager is doing day to day.<sup>61</sup> How then can the owner keep the manager from misconduct?

Fiduciary duties are “formulated . . . proscriptive rules of fiduciary conduct.”<sup>62</sup> Thus the manager knows ahead of time what he can and cannot do. Since both manager and owner know from the outset that fiduciary rules govern, these duties deter managerial abuse.<sup>63</sup> By deterring managerial abuse, these duties decrease agency costs—the costs of monitoring management in these relationships.<sup>64</sup>

## 2. Corporate Directors Are Fiduciaries

The directors of a corporation are fiduciaries because they manage the corporation for the benefit of the shareholders.<sup>65</sup> In their managerial roles,

52. *Meinhard*, 164 N.E. at 546.

53. *See supra* notes 48–50 and accompanying text.

54. *See* TAMAR FRANKEL, *FIDUCIARY LAW* 104 (2011).

55. *See* Cooter & Freedman, *supra* note 49, at 1046.

56. *See* FRANKEL, *supra* note 54, at 4–6.

57. Cooter & Freedman, *supra* note 49, at 1048.

58. *Id.*

59. *Id.* at 1046–47, 1059 (“Because asset management necessarily involves risk and uncertainty, the specific behavior of the fiduciary cannot be dictated in advance.”).

60. *Id.* at 1048.

61. *See id.* at 1047.

62. *Id.* at 1054; *see also* DEMOTT, *supra* note 51, at 9 (“The fiduciary principle is an alternative to direct monitoring.”).

63. DEMOTT, *supra* note 51, at 8–9.

64. *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 432 (1993); *see also* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976), *available at* [http://business.illinois.edu/josephm/BA549\\_Fall%202012/Session%205/5\\_Jensen\\_Meckling%20\(1976\).pdf](http://business.illinois.edu/josephm/BA549_Fall%202012/Session%205/5_Jensen_Meckling%20(1976).pdf) (defining and discussing agency costs).

65. Jensen & Meckling, *supra* note 64, at 309; *see also* ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119–31 (rev. ed. 1968) (discussing the rise of the modern corporation and the separation of ownership and control).

directors have fiduciary duties to the corporation and its shareholders.<sup>66</sup> While the proscriptive rules of conduct under general fiduciary law are fairly broad and undefined,<sup>67</sup> Delaware has a sophisticated and developed body of case law addressing corporate directors' fiduciary duties.<sup>68</sup> These duties generally fall into two categories: the duty of care and the duty of loyalty.<sup>69</sup>

*a. The Duty of Care*

The duty of care requires directors to manage the business with the "care which ordinarily careful and prudent men would use in similar circumstances."<sup>70</sup> The Delaware Supreme Court has construed this to mean directors must consider "all material information reasonably available to them" before making a business decision.<sup>71</sup> Under the business judgment rule, courts presume that a director's business judgment was made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."<sup>72</sup> Thus, a director must commit an act of gross negligence before he will have breached the duty of care.<sup>73</sup>

Corporations may adopt a charter amendment that exculpates directors from monetary liability arising from a breach of the duty of care.<sup>74</sup> While this would remove the deterrent penalty of personal liability, adoption of a charter amendment requires a shareholder vote—the managers cannot unilaterally exculpate themselves without the owners' informed consent.<sup>75</sup> Such an amendment would still leave the shareholders with nonmonetary, equitable remedies.<sup>76</sup>

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66. 1 EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2.1 (5th ed. Supp. II 2011); see FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 90 (1991).

67. See Cooter & Freedman, *supra* note 50, at 1045–46; see also EASTERBROOK & FISCHER, *supra* note 66, at 90–91.

68. See 1 WELCH ET AL., *supra* note 66, § 141.2 (discussing directors' fiduciary duties under Delaware law).

69. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (noting that the duty to act in good faith is not separate from the two core duties of loyalty and care).

70. *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

71. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

72. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

73. See, e.g., *id.* at 881.

74. See DEL. CODE ANN. tit. 8, § 102(b)(7) (2005). The board is also statutorily protected when relying on records and on opinions from specialists in the ordinary course of business in order to discharge their duties. *Id.* § 141(e).

75. See *id.* § 242(b)(1).

76. See *id.* § 102(b)(7).

*b. The Duty of Loyalty*

The duty of loyalty is the duty of fidelity to the corporation and its shareholders.<sup>77</sup> This includes the duty to act in good faith.<sup>78</sup> Though generally shareholders owe no duties to each other, controlling shareholders (ones that can control a necessary vote) are also subject to the duty of loyalty.<sup>79</sup> Under the duty of loyalty, directors and controlling shareholders must avoid “any conflict between duty and self-interest.”<sup>80</sup> Any self-dealing on the part of a director or a controlling shareholder will be subject to careful scrutiny of intrinsic fairness.<sup>81</sup> For example, in a merger, the duty of loyalty requires the transaction to pass a two-prong entire fairness test consisting of fair price and fair dealing.<sup>82</sup> A conflicted transaction can be ratified by a vote of disinterested directors or by a vote of the shareholders.<sup>83</sup> Liability for breaches of the duty of loyalty can never be exculpated, even with shareholder consent.<sup>84</sup>

*B. The History and Structure of LPs and LLCs*

This section will review the genesis and characteristics of limited partnerships and limited liability companies.

1. Limited Partnerships

In contrast to corporations, which originally had to be chartered by the monarch in order to exist,<sup>85</sup> partnerships originated as agreements among individuals.<sup>86</sup> In that respect, their origins resemble contracts.<sup>87</sup> Partnerships are associations of two or more persons who are co-owners of a business.<sup>88</sup> There is an agency relationship between partners to act on

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77. 1 WELCHET AL., *supra* note 66, § 141.2.1.2.

78. *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (finding no independent fiduciary duty of good faith that is separate from care and loyalty).

79. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

80. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987).

81. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

82. *Id.* at 711.

83. DEL. CODE ANN. tit. 8, § 144(a) (2005).

84. *See id.* § 102(b)(7)(i).

85. Corporations have their roots in medieval England, where the monarchy alone could charter a corporation, allowing the organization to exist beyond the life of the parties to an agreement. *See* 1 STEWART KYD, A TREATISE ON THE LAW OF CORPORATIONS 40 (London, J. Butterworth 1793).

86. The partnership can be traced back to early English mercantile courts in the form of the *societas*, an early form of business enterprise. J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW & PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 1:2 (2012). *Societas* had similar characteristics to partnerships: the right to an accounting between partners, the agency relationship between partners to act on behalf of the partnership, and liability of each partner for the obligations of the partnership. *See id.*

87. *See id.*; EUGENE ALLEN GILMORE, HANDBOOK ON THE LAW OF PARTNERSHIPS, INCLUDING LIMITED PARTNERSHIPS 1 (1911).

88. UNIF. P'SHIP ACT (1914) § 6(1) (amended 1997), 6 U.L.A. 393 (2001); *see also* UNIF. P'SHIP ACT (1997) § 101(6), 6 U.L.A. 61 (2001).

behalf of the partnership, as each has the power to act on its behalf,<sup>89</sup> and all partners are liable for its obligations.<sup>90</sup>

The innovation of the limited partnership was to limit such liability to the general partners.<sup>91</sup> A limited partnership consists of an association of at least one general partner and one limited partner.<sup>92</sup> While the general partner continues to be personally liable for the obligations of the partnership,<sup>93</sup> the limited partners are liable only to the extent of their capital contributions.<sup>94</sup> With this protection, they relinquish direct control over the management of the partnership.<sup>95</sup> Like the relationship between a corporation's board and its shareholders, the general partner manages the business for the limited partners.<sup>96</sup> Partnerships are also attractive business forms because they have significant tax benefits compared to corporations.<sup>97</sup>

## 2. Limited Liability Companies

The LLC is a relatively new option for business organization.<sup>98</sup> A hybrid form, it developed from a variety of sources, including limited partnerships, business trusts, and statutory close corporations.<sup>99</sup> The Delaware LLC Act is modeled on the Delaware LP Act, and the two statutes contain

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89. See CALLISON & SULLIVAN, *supra* note 86, § 1:2.

90. See UNIF. P'SHIP ACT (1997) § 306(a), 6 U.L.A. 117 (2001).

91. See DEMOTT, *supra* note 51, at 492; GILMORE, *supra* note 87, at 592-93. The Uniform Limited Partnership Act was created in 1916. See UNIF. LTD. P'SHIP ACT (1916) (superseded 1976), 6B U.L.A. 405 (2008). Delaware has now also authorized limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs). See DEL. CODE ANN. tit. 6, § 15-1001 (2005 & Supp. III 2012) (requirements for formation of LLP); *id.* § 17-214 (limited partnerships as limited liability limited partnerships).

92. *Id.* § 17-101(9).

93. *Id.* § 17-403(b) (stating that general partners have the liabilities of partners under the Delaware Uniform Partnership Act).

94. See *id.* § 17-303(a).

95. *Id.* ("A limited partner is not liable for the obligations of a limited partnership unless . . . he or she participates in the control of the business."). There are, however, several exceptions enumerated in the statute. *Id.* § 17-303(b)(1)-(10) (listing activities that do not constitute participating in control of the business within the meaning of section 17-303(a)).

96. See *id.* § 17-403(a) (stating that general partners have the rights and powers of partners under the Delaware Uniform Partnership Act).

97. See ROBERT J. HAFT & PETER M. FASS, TAX-ADVANTAGED SECURITIES HANDBOOK § 2A.01 (1997) (pass through taxation). Partners can also benefit from partnership losses because losses also pass through and therefore can be used as deductions for individual partners. See I.R.C. § 469 (2006) (passive activity losses); see also *infra* note 102 and accompanying text.

98. 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1.06 (1992) (discussing the emergence and history of LLCs); see also Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459 (1998). The LLC was approved for partnership taxation by the I.R.S. in 1988. See Rev. Rul. 88-76, 1988-2 C.B. 361; see also 1 CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.01[1] (2005). The Delaware Limited Liability Company Act was passed in 1992. Limited Liability Company Act, 68 Del. Laws 1329 (1992) (codified as amended at DEL. CODE ANN. tit. 6, §§ 18-101 to -1109).

99. 1 RIBSTEIN & KEATINGE, *supra* note 98, § 1.06; 1 BISHOP & KLEINBERGER, *supra* note 98, ¶ 1.01[1].

substantially identical wording.<sup>100</sup> The primary characteristics of LLCs are that they are taxed as partnerships, members and managers all enjoy limited liability, and the relationship of the members, managers, and entity is governed by the operating agreement.<sup>101</sup>

Limited liability companies thus combine corporate limited liability with partnership tax advantages<sup>102</sup> and governance flexibility.<sup>103</sup> Unlike a limited partnership, the LLC does not need to have any general partners,<sup>104</sup> and it can have a centralized or decentralized management structure, with members and managers maintaining limited liability whether or not they participate in control of the business.<sup>105</sup>

### 3. Operating Agreements Are Contracts

The nature and structure of each individual LP and LLC, are largely dependent on the operating agreement.<sup>106</sup> Both statutes provide only the contours of the entities, giving parties the “broadest possible discretion in

100. See Martin I. Lubaroff & Paul M. Altman, *Delaware Limited Liability Companies*, in 2 DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 20.3 (R. Franklin Balotti & Jesse A. Finkelstein eds., Supp. 2011).

101. See 1 RIBSTEIN & KEATINGE, *supra* note 98, § 1.02; Lubaroff & Altman, *supra* note 100, § 20.4.

102. See 1 RIBSTEIN & KEATINGE, *supra* note 98, § 2.02; Lubaroff & Altman, *supra* note 100, § 20.1. The development of business association forms has been largely driven by two goals: minimizing taxes and limiting personal liability. See, e.g., Hamill, *supra* note 98, at 1463–64. Historically, the two options were corporations, which provided limited liability but were taxed in their own right—known as double taxation—and limited partnerships with the general partner as a corporation, which provided limited liability and single taxation, since partnerships are not taxed in their own right. See *supra* note 97 and accompanying text. The other possibilities for minimizing taxes are S Corporations and zeroing out a regular C Corporation. 1 BISHOP & KLEINBERGER, *supra* note 97, ¶ 1.01[2][b]–[c]. While S corporations also offer flow-through taxation, the LLC is less restrictive. *Id.* ¶ 1.01[2][b]; see I.R.C. § 704(a)–(b) (2006). Even when successful, zeroing out does not provide any of the other advantages of pass-through tax status. 1 BISHOP & KLEINBERGER, *supra* note 97, ¶ 1.01[2][c].

At first, the I.R.S. required that the LLC lack two corporate characteristics, and if it did not, it would be taxed as a corporation. See 1 RIBSTEIN & KEATINGE, *supra* note 98, § 16.12, at 39. This changed with the advent of “check-the-box” classification, and the IRS began taxing LLCs as partnerships even if the entity otherwise resembled a corporation. *Id.* § 16.03. The federal tax regulations, known as the “check-the-box” rules, became effective on January 1, 1997. See Treas. Reg. §§ 301.7701-1 to -3 (1996).

Note that publicly traded LLCs and LPs lose the partnership status for tax purposes and are instead taxed as corporations. See I.R.C. § 7704(a) (2006). The exception to this rule occurs when at least 90 percent of the LLC or LP’s income is generated from passive asset management activities, such as collecting interest, dividends, rent on real property, or particular oil, gas, timber, and other natural resources activities. See *id.* § 7704(c)–(d).

103. LLCs are not constrained by corporate formalities or boards of directors required by statute. 1 RIBSTEIN & KEATINGE, *supra* note 98, § 2.02. LLCs also lack the financial constraints that corporations have, which place limitations on the dividends corporations can distribute. *Id.* § 1.03.

104. *Id.* § 1.04. (“Because the members of LLCs have limited liability . . . LLC statutes usually protect creditors through rules regarding disclosure, distributions, and dissolution that are not waivable in an agreement solely among the members.”).

105. *Id.* § 1.05.

106. See *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 & n.27 (Del. 1999).

drafting their . . . agreements.”<sup>107</sup> In addition, both the LP Act and the LLC Act explicitly incorporate the principle of freedom of contract.<sup>108</sup> The statutes read, “It is the policy of [the LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”<sup>109</sup> This means that Delaware courts will enforce the product of the parties’ negotiations,<sup>110</sup> as long as the provision does not conflict with statutory requirements.<sup>111</sup> In other words, “[t]he operative document is the limited partnership [or limited liability company] agreement and the statute merely provides the ‘fall-back’ or default provisions where the partnership [or limited liability company] agreement is silent.”<sup>112</sup>

### C. Fiduciary Duties in Delaware LPs and LLCs

The prior section detailed the history and structure of limited partnerships and limited liability companies and discussed their similarities. This section will examine the application of fiduciary duties in these entities.

#### 1. The Default

In limited partnerships, the general partner owes fiduciary duties to the limited partners.<sup>113</sup> The Delaware Court of Chancery has also held that when the general partner is a corporation, that corporation’s board of directors owes fiduciary duties to the limited partners.<sup>114</sup> Limited partners generally do not owe fiduciary duties, but they assume fiduciary duties if they take an active role in the management of the partnership.<sup>115</sup>

In limited liability companies, much the same rules apply.<sup>116</sup> Each member owes fiduciary duties to the LLC, its investors, and the manager,<sup>117</sup> with one qualification—Delaware courts differentiate between passive

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107. *Id.* at 291 n.27 (comparing limited liability companies to limited partnerships that both have “maximum flexibility”).

108. *See* DEL. CODE ANN. tit. 6, § 18-1101(b) (2005) (explicitly incorporating the principle of freedom of contract for LLCs); *id.* § 17-1101(c) (same for LPs).

109. *Id.* § 18-1101(b); *id.* § 17-1101(c).

110. *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at \*8 n.33 (Del. Ch. May 7, 2008) (“Contractual language defines the scope, structure, and personality of limited liability companies.”).

111. *See Elf Atochem, 727 A.2d* at 290 (“[An LLC] permits members to engage in private ordering with substantial freedom of contract to govern their relationship, provided they do not contravene any mandatory provisions of the Act.”).

112. *Twin Bridges Ltd. P’ship v. Draper*, No. Civ. A. 2351-VCP, 2007 WL 2744609, at \*12 (Del. Ch. Sept. 14, 2007).

113. *See Boxer v. Husky Oil Co.*, 429 A.2d 995, 997 (Del. Ch. 1981).

114. *See In re USACafes, L.P. Litig.*, 600 A.2d 43 (Del. 1991).

115. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 662 (Del. Ch. 2012) (citing *Cantor Fitzgerald, L.P. v. Cantor*, No. 16297, 2000 WL 307370, at \*22 (Del. Ch. Mar. 13, 2000)).

116. *Id.*

117. *VGS, Inc. v. Castiel*, No. 17995, 2000 WL 1277372, at \*4–5 (Del. Ch. Aug. 31, 2000), *aff’d*, 781 A.2d 696 (Del. 2001).

members and managing members,<sup>118</sup> with only managers and managing members owing fiduciary duties.<sup>119</sup> In addition, Delaware courts have found that “controlling members in a manager-managed LLC owe the traditional fiduciary duties that directors and controlling members in a corporation would.”<sup>120</sup>

## 2. Elimination Permitted

As discussed above, fiduciary duties in general partnerships, trusts, and corporations are part of the structure of those entities and cannot be waived.<sup>121</sup> The same is not true of Delaware limited partnerships and limited liability companies.<sup>122</sup> At first, this flexibility was limited to expansion or restriction of fiduciary duties.<sup>123</sup> In *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, the Delaware Supreme Court stated that while parties to a limited partnership could expand or restrict fiduciary duties, they could not fully eliminate them.<sup>124</sup> In arriving at this conclusion, the court reasoned that it could not override the doctrinal importance of fiduciary duties in Delaware business law, and it emphasized the “underlying general principle in [Delaware] jurisprudence that scrupulous adherence to fiduciary duties is normally expected.”<sup>125</sup>

In 2004, the Delaware General Assembly amended the Delaware LP and LLC Acts to explicitly permit parties to eliminate fiduciary duties.<sup>126</sup> The Delaware Limited Partnership Act now provides,

To the extent that, at law or in equity, a partner or other person has duties (*including fiduciary duties*) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner’s or other person’s duties *may be* expanded or restricted or *eliminated* by provisions in the partnership agreement . . . .<sup>127</sup>

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118. *Feeley*, 62 A.3d at 662 (“Under the LLC Act, there are two basic types of members: members who are also managers and exercise managerial functions in a member-managed LLC, and members who are passive investors like limited partners.” (citations omitted)).

119. *Id.*

120. *Kelly v. Blum*, No. 4516-VCP, 2010 WL 629850, at \*1, \*13 (Del. Ch. Feb. 24, 2010).

121. *See supra* notes 48–50, 65–84 and accompanying text.

122. *See* DEL. CODE ANN. tit. 6, § 17-1101(d) (2005) (permitting expansion, restriction, or elimination of fiduciary duties in limited partnerships); *id.* § 18-1101(c) (same in limited liability companies); *cf. supra* notes 70–84 and accompanying text (discussing the constraints of the corporate form).

123. *See Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del. 2002).

124. *See id.* at 167. *But see Sonet v. Timber Co.*, 722 A.2d 319, 323 (Del. Ch. 1998) (stating that the Limited Partnership Act “apparently [allows] broad license to enhance, reform, or even eliminate fiduciary duty protections”).

125. *Gotham Partners*, 817 A.2d at 167.

126. *See* 74 Del. Laws 612 (2004) (amending the LLC Act); *id.* at 589 (amending the LP Act).

127. DEL. CODE ANN. tit. 6, § 17-1101(d) (emphasis added).

The relevant language of the Delaware Limited Liability Company Act is identical.<sup>128</sup>

Again recall that corporations can *never* eliminate fiduciary duties.<sup>129</sup> Corporations can adopt charter amendments exculpating directors from liability for breach, but only for breaching the duty of care<sup>130</sup>—never for liability arising from breaching the duty of loyalty.<sup>131</sup> Like corporations, LPs and LLCs can exculpate their fiduciaries from all monetary liabilities for breaches of all fiduciary duties,<sup>132</sup> but unlike corporations, they can completely remove fiduciary duties in the first place.<sup>133</sup>

Even total exculpation of fiduciaries' liability may leave a remedy extant:

By limiting or eliminating the prospect of liability but leaving in place the duty itself, [such] a provision . . . restricts the remedies that a party . . . can seek. Monetary liability may be out, but injunctive relief, a decree of specific performance, rescission, the imposition of a constructive trust, and a myriad of other non-liability-based remedies remain in play.<sup>134</sup>

Elimination of all fiduciary duties, however, arguably leaves no remedy for manager misconduct.<sup>135</sup> The Delaware Supreme Court has upheld these provisions even when the LLC was publicly traded.<sup>136</sup>

#### *a. Good Faith and Fair Dealing*

The remaining statutory safeguard against manager misconduct, assuming all fiduciary duties have been eliminated, is the implied covenant of good faith and fair dealing. Both statutes state that “the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”<sup>137</sup> The implied covenant is a contractual principle that inheres in every contract,<sup>138</sup> and it likewise applies in LP and LLC

128. *Id.* § 18-1101(c) (“[D]uties may be expanded or restricted or eliminated by provisions in the limited liability company agreement . . .”).

129. *See supra* notes 74, 84 and accompanying text.

130. *See supra* notes 74, 84 and accompanying text.

131. *See supra* notes 74, 84 and accompanying text.

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

133. *See id.* §§ 17-1101(d), 18-1101(c).

134. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 664 (Del. Ch. 2012) (citing *Arnold v. Soc’y for Savs. Bancorp, Inc.* 678 A.2d 533, 541–42 (Del. 1996) (interpreting the effect of a similar exculpatory provision under DEL. CODE ANN. tit. 8, § 102(b)(7)); *Leslie v. Telephonics Office Techs., Inc.*, C.A. No. 13045, 1993 WL 547188, at \*9 (Del. Ch. Dec. 30, 1993) (same); *see also Lonergan v. EPE Holdings LLC*, 5 A.3d 1008, 1011 (Del. Ch. 2010) (considering a plaintiff’s complaint seeking to enjoin the proposed merger).

135. *See Feeley*, 62 A.3d at 664.

136. *See Wood v. Baum*, 953 A.2d 136 (Del. 2008).

137. DEL. CODE ANN. tit. 6, § 17-1101(d). The relevant section of the LLC Act again contains identical language. *See id.* § 18-1101(c).

138. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

agreements.<sup>139</sup> It is a mechanism that courts use to protect an agreement between parties, and it is only applied to matters not explicitly addressed in the agreement.<sup>140</sup>

The implied covenant is not intended to do more than protect “the spirit of what was *actually bargained and negotiated for*.”<sup>141</sup> The implied covenant is applied when one party has acted “arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected.”<sup>142</sup> The covenant does not impose separate duties, and therefore, to successfully argue that the implied covenant of good faith and fair dealing implies extracontractual responsibilities, the plaintiff must identify specific contractual provisions on which his claim is based.<sup>143</sup>

### 3. What Remedy If Silence?

It has not been entirely clear whether fiduciary duties apply as a default to LPs and LLCs in absence of language in the operating agreement that states otherwise.<sup>144</sup> The Chancery has repeatedly affirmed the existence of default fiduciary duties,<sup>145</sup> but the Delaware Supreme Court has not ruled on the issue, and there were some indications that, if the court were to address such an issue, it might not find default fiduciary duties to exist.<sup>146</sup>

A recent episode of the dialogue between the Supreme Court and the Chancery on this subject occurred in *Auriga Capital v. Gatz Properties*.<sup>147</sup> Though the Chancery has repeatedly held that default fiduciary duties apply, *Auriga Capital* is notable because it is the first time the Chancery discussed the topic in some depth.<sup>148</sup> Its conclusion was a resounding

139. See DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c). For further discussion of the implied covenant of good faith and fair dealing’s scope in the alternative entity context, see Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469 (2005).

140. *Kuroda v. SPJS Holdings, LLC*, 971 A.2d 872, 888 (Del. Ch. 2009) (citing *Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc.*, 622 A.2d 14, 23 (Del. Ch. 1992)).

141. *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at \*10 (Del. Ch. May 7, 2008) (footnotes omitted).

142. *Lonergan v. EPE Holdings LLC*, 5 A.3d 1008, 1018 (Del. Ch. 2010) (quoting *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010)).

143. *Id.*

144. See H.B. 126, 147th Gen. Assemb. (Del. 2013); see also *Gatz Props., LLC v. Auriga Capital Corp. (Auriga II)*, 59 A.3d 1206 (Del. 2012) (disagreeing with the lower court’s interpretation of identical language).

145. See, e.g., *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. 5502-CS, 2011 WL 3505355, at \*31 (Del. Ch. Aug. 8, 2011) (holding the general partner liable for breaching her fiduciary duties because no provision in the partnership agreement modified traditional fiduciary duties); *Kelly v. Blum*, No. 4516-VCP, 2010 WL 629850, at \*1 (Del. Ch. Feb. 24, 2010) (“[The] LLC agreement does not explicitly alter those default fiduciary duties and . . . consequently, [the] managers and controlling members owe Plaintiff the traditional duties of loyalty and care.”); see also *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 660 (Del. Ch. 2012) (noting the “long line of Chancery precedents holding that default fiduciary duties apply”).

146. See *Auriga II*, 59 A.3d at 1206.

147. *Auriga I*, 40 A.3d at 839.

148. *Id.* at 849–56.

statement that, “where the core default fiduciary duties have not been supplanted by contract, they exist.”<sup>149</sup>

On appeal, the Delaware Supreme Court, referring to the Chancery’s position on default fiduciary duties, said such a discussion was “dictum without any precedential value.”<sup>150</sup> The Delaware Supreme Court affirmed the Chancery’s holding but did so “exclusively on contractual grounds.”<sup>151</sup> As in previous cases that were appealed on this issue,<sup>152</sup> the Delaware Supreme Court found that the circumstances in *Auriga Capital* did not require directly addressing whether default fiduciary duties applied and, therefore, did not require addressing whether default fiduciary duties existed.<sup>153</sup>

A few weeks later, in *Feeley v. NHAOCG, LLC*, the Chancery reaffirmed its prior rulings regarding the existence of default duties.<sup>154</sup> In *Feeley*, the existence of default fiduciary duties was directly presented to the court—this ruling was not dictum.<sup>155</sup> Given the insistence and length of the Chancery’s discussion in *Auriga Capital*,<sup>156</sup> the strength of the Supreme Court’s disagreement on the appeal,<sup>157</sup> and the contractual bent of Justice Steele’s private writings on the topic,<sup>158</sup> practitioners seem to have been

149. *Id.* at 852.

150. *Auriga II*, 59 A.3d at 1218.

151. *Id.* at 1214.

152. Of the dozen or so cases addressing breach of fiduciary duties in LPs and LLCs since the amendment in 2004, few have been appealed to the Delaware Supreme Court. *See, e.g.*, *William Penn P’ship v. Saliba*, 13 A.3d 749 (Del. 2011); *Wood v. Baum*, 953 A.2d 136 (Del. 2008).

153. *See Auriga II*, 59 A.3d at 1206 (finding defendant breached *contractually stipulated* duties); *William Penn P’ship*, 13 A.3d at 749 (finding *parties agreed* that traditional fiduciary duty analysis applied); *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010) (finding defendants had merely exercised a contractual right, which did not implicate any equitable analysis); *Wood*, 953 A.2d at 136 (finding defendant’s conduct was exculpated by the relevant agreement to the extent that it was not fraudulent or illegal).

154. *See Feeley v. NHAOCG, LLC*, 62 A.3d 649, 659 (Del. 2012); *see also* David Marcus, *Laster Has Strine’s Back*, DEAL PIPELINE (Dec. 3, 2012, 4:19 PM), <http://www.thedeal.com/content/regulatory/laster-has-strines-back.php> (discussing Vice Chancellor Laster’s opinion in *Feeley* and the dialogue between Chancellor Strine and Justice Steele regarding default fiduciary duties). In *Feeley*, a managing member of a real estate investment firm organized as a Delaware LLC was alleged to have acted grossly negligently and to have taken business opportunities that belonged to the company. *Feeley*, 62 A.3d at 653–54. The Chancery found there to be no “contractual obligation in the Operating Agreement that would require . . . exercis[ing] due care or abjur[ing] intentional wrongdoing,” *id.* at 659, but the court still denied the motion to dismiss the breach of fiduciary duty claim. *Id.* at 666.

155. *See id.* at 660. No appeal was filed.

156. *See Auriga Capital Corp. v. Gatz Props., LLC (Auriga I)*, 40 A.3d 839, 849–56, 855 n.65 (Del. Ch.), *aff’d*, 59 A.3d 1206 (Del. 2012).

157. *See supra* note 42 and accompanying text.

158. *See* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009) [hereinafter Steele, *Freedom of Contract*] (disputing the necessity of default fiduciary duties for LPs and LLCs); Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007) (same).

justified in being wary of relying on default fiduciary duties.<sup>159</sup> This discussion seems also to have motivated the General Assembly to amend the relevant statute.<sup>160</sup>

*a. Statutory Interpretation*

The full provision permitting elimination of fiduciary duties reads:

To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.<sup>161</sup>

From one perspective, this provision establishes default fiduciary duties.<sup>162</sup> The statutes read that fiduciary duties can be “expanded or restricted or eliminated.”<sup>163</sup> Logically, these duties must exist as a default in order for that language to make sense.<sup>164</sup> The statutes also presuppose the existence of default fiduciary duties in the language referring to duties “at law or in equity.”<sup>165</sup> This language incorporates the long history of fiduciary duties existing at common law, particularly in the partnership context.<sup>166</sup> Moreover, both Acts specify that when in doubt, equity governs.<sup>167</sup> Because fiduciary duties are equitable doctrines, such a provision would seem to lend force to a reading of the statutes that finds that default fiduciary duties are statutorily imposed.<sup>168</sup>

From another perspective, the provision abrogates default fiduciary duties.<sup>169</sup> Both Acts include a codification of the principle of freedom of

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159. See, e.g., Paul D. Ginsberg et al., *Delaware Supreme Court Interprets Contractual Fiduciary Duties of LLC Manager As Requiring Entire Fairness Review*, PAUL WEISS (Nov. 9, 2012), <http://www.paulweiss.com/practices/transactional/mergers-acquisitions/publications/delaware-supreme-court-interprets-contractual-fiduciary-duties-of-llc-manager-as-requiring-entire-fairness-review.aspx?id=11824> (“Following [*Auriga II*], the question of whether the Act imposes fiduciary duties on parties to an LLC agreement by default remains an open issue under Delaware law.”).

160. See *infra* Part I.C.3.b.

161. DEL. CODE ANN. tit. 6, § 17-1101(d) (2005).

162. *Auriga Capital Corp. v. Gatz Props., LLC (Auriga I)*, 40 A.3d 839, 850 n.34 (Del. Ch.), *aff'd*, 59 A.3d 1206 (Del. 2012).

163. DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c).

164. *Auriga I*, 40 A.3d at 850 n.34.

165. *Id.*

166. See *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 659–63 (Del. Ch. 2012) (discussing fiduciary duty precedent in the LLC and LP context).

167. DEL. CODE ANN. tit. 6, § 17-1105 (“In any case not provided for in this chapter . . . the rules of law and equity . . . shall govern.”); *id.* § 18-1104 (incorporating substantially the same language).

168. See *Auriga I*, 40 A.3d at 849, 852 (“The statute incorporates equitable principles.”).

169. See *Gatz Props., LLC v. Auriga Capital Corp. (Auriga II)*, 59 A.3d 1206, 1219 (Del. 2012); *supra* note 158.

contract,<sup>170</sup> and they further include a provision that “[t]he rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.”<sup>171</sup> Taken together, these provisions could be read as permitting the freedom of contract policy to override the common law tradition of fiduciary duties.<sup>172</sup> According to this reading of the statutes, no duties exist unless written in by the parties.<sup>173</sup>

*b. New Legislation*

Perhaps in response to this confusion, the Delaware General Assembly recently amended the LLC Act, explicitly establishing that fiduciary duties govern where not otherwise addressed by the statute.<sup>174</sup> The text of the amendment reads, “In any case not provided for in this chapter, the rules of law and equity, *including the rules of law and equity relating to fiduciary duties* and the law merchant, shall govern.”<sup>175</sup> The General Assembly did not amend the LP Act, which, as noted before, had previously contained identical language on the applicability of fiduciary duties.<sup>176</sup>

The synopsis of the bill states that the amendment serves to confirm circumstances in which fiduciary duties apply even when not explicitly addressed in the operating agreement.<sup>177</sup> One such circumstance, the synopsis notes, is “a manager of a manager-managed limited liability company[, who] would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties.”<sup>178</sup> Assuming courts will take this statement into account when interpreting the language of the amendment itself, this amendment still leaves open whether default duties apply in member-managed LLCs and LPs.<sup>179</sup>

#### 4. Operating Agreements in Practice

This section explores courts’ treatment of fiduciary duties in LLC and LP operating agreements.

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170. DEL. CODE ANN. tit. 6, §§ 17-1101(c), 18-1101(b) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract.”).

171. *Id.* §§ 17-1101(b), 18-1101(a).

172. *See Steele, Freedom of Contract, supra* note 158, at 227 (“[I]mplicit in the sections above, the statutes do not provide any fiduciary duties, default or mandatory.”).

173. *See id.*

174. H.B. 126, 147th Gen. Assemb. (Del. 2013).

175. DEL. CODE ANN. tit. 6, § 18-1104 (emphasis added).

176. *See id.* §§ 17-1101(d), 18-1101(c).

177. H.B. 126, 147th Gen. Assemb. (Del. 2013).

178. *Id.*

179. *See id.*

*a. Default Fiduciary Duties and Contractual Modification*

When fiduciary duties are operating, they can invalidate an explicit contractual provision.<sup>180</sup> In *Paige Capital Management, LLC v. Lerner Master Fund, LLC*, the partnership agreement did not address fiduciary duties,<sup>181</sup> and therefore the court found the manager of the fund owed default fiduciary duties to the fund and its investor.<sup>182</sup> The plaintiff, the fund's only investor, sought to withdraw its capital under an early termination option.<sup>183</sup> The manager attempted to keep the capital in the fund, pursuant to a provision limiting withdrawals of certain percentage interests in the fund.<sup>184</sup> While a strict literal reading of the provision arguably permitted the hedge fund manager to keep the investor's money in the fund, the court found reliance on such a provision to be a breach of the manager's fiduciary duty to the investor.<sup>185</sup>

The court invalidated reliance on the provision,<sup>186</sup> finding that "the [general partner's] reading of the Partnership Agreement was not that of a good faith fiduciary grappling with the meaning of an ambiguous partnership agreement, but of self-interested minds bent on protecting their own financial interests."<sup>187</sup> The court also noted that it was not a credible scenario that a first-time hedge fund manager would be able to negotiate a clause that permitted her to hold the investor's capital in order to maintain her income if she could not raise other capital.<sup>188</sup> The court found it "reasonable to conclude that the [investor] would have walked away immediately" had the manager insisted on such a clause.<sup>189</sup>

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180. See *Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC*, No. 5502 CS, 2011 WL 3505355, at \*34 (Del. Ch. Aug. 8, 2011).

181. *Id.* at \*31 ("[T]here is no provision of the Partnership Agreement that says that Paige General Partner does not owe fiduciary duties to the Fund and its investors.").

182. See *id.* ("As a matter of default law, Paige General Partner clearly owes fiduciary duties to the limited partners in the Hedge Fund.").

183. *Id.* at \*1.

184. *Id.*

185. *Id.* at \*34.

186. *Id.* at \*35.

187. *Id.* at \*34; see also DEL. CODE ANN. tit. 6, § 17-1101(e) (2005).

188. *Paige Capital*, 2011 WL 3505355, at \*34.

189. *Id.*

*b. No Fiduciary Duties, Only What Is in the Contract*

If default fiduciary duties do not exist, or if they have been fully eliminated by contract, the result is a contract that has almost no extracontractual constraints on it.<sup>190</sup> In *Nemec v. Schrader*, a claim was brought under a Stock Plan,<sup>191</sup> pursuant to which two former employees had put rights to sell their shares back to the company within two years of retirement.<sup>192</sup> Under the contract, if they did not exercise those rights, the company then could retire their stock.<sup>193</sup> Neither former employee exercised the right, and the company retired the stock.<sup>194</sup> This happened just months before a merger which would have made the stock much more valuable to the employees.<sup>195</sup>

Did the company have a duty to tell the employees about the possibility of a valuable upcoming merger before the expiration of the time period when they could exercise their put rights?<sup>196</sup> The plaintiffs thought so, but a majority of the Delaware Supreme Court did not.<sup>197</sup> The court reasoned that there was no fiduciary duty claim because the claim arose “from a dispute relating to the exercise of a *contractual* right—the Company’s right to redeem the shares of retired non-working stockholders.”<sup>198</sup> The court refused to override the express provisions of the contract by invoking either fiduciary duties or the implied covenant of good faith and fair dealing.<sup>199</sup>

Justice Jacobs, writing for the dissent, disagreed with the idea that just because defendants had bargained for the right to redeem the shares, every possible exercise of that right was permitted.<sup>200</sup> He reasoned, “The grant of an unqualified contractual right is not, nor can it be, a green light that authorizes the right holder to exercise its power in an arbitrary or unreasonable way.”<sup>201</sup>

Not all courts seem to share the sentiment expressed by Justice Jacobs.<sup>202</sup> In *Related Westpac LLC v. JER Snowmass LLC*, the Court of Chancery refused to impose a “reasonableness overlay” on the exercise of a negotiated right.<sup>203</sup> Two LLCs had gone into business together to develop

190. *Loneragan v. EPE Holdings, LLC*, 5 A.3d 1008, 1018 (Del. Ch. 2010) (“When parties exercise the authority provided by the LP Act to eliminate fiduciary duties, they take away the most powerful of a court’s remedial and gap-filling powers.”).

191. *Nemec v. Schrader*, 991 A.2d 1120, 1129 (Del. 2010).

192. *Id.* at 1123.

193. *Id.*

194. *Id.* at 1124.

195. *Id.*

196. *Id.*

197. *Id.* at 1126.

198. *Id.* at 1129.

199. *Id.* at 1126, 1129.

200. *Id.* at 1132 (Jacobs, J., dissenting).

201. *See id.* (citing *Amirsaleh v. Bd. of Trade*, No. 2822-CC, 2008 WL 4182998, at \*1 (Del. Ch. Sept. 11, 2008)).

202. *See, e.g., id.* at 1126, 1129 (majority opinion); *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at \*1 (Del. Ch. May 7, 2008).

203. *Related Westpac LLC v. JER Snowmass LLC*, No. 5001-VCS, 2010 WL 2929708, at \*1 (Del. Ch. July 23, 2010).

land in Snowmass, Colorado.<sup>204</sup> One LLC claimed the other had breached its fiduciary duties to the joint business by refusing to consent to proposals that the first thought would make the business successful but that the second thought would require each to contribute too much capital.<sup>205</sup> The court found that both LLCs had “contractually bargained to remain free to give or deny [their] consent.”<sup>206</sup> Because the agreement was “plainly written” and had “no lack of clarity,” the court refused to imply conditions.<sup>207</sup>

Another case where the parties had explicitly eliminated all fiduciary duties is *Fisk Ventures, LLC v. Segal*.<sup>208</sup> In *Fisk Ventures*, the parties formed a biomedical technology company as an LLC.<sup>209</sup> They designed the governance structure of the company to require a supermajority vote of the board for all essential decisions.<sup>210</sup> When the Class A members sued the Class B members for refusing to agree to a proposed financing plan, arguably causing the company to fail, the court found the Class B members’ refusal to cooperate to be a bargained-for right, not a breach of duty, and dismissed the claim.<sup>211</sup>

The relevant contractual provision read, “No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements.” The court considered this an explicit elimination of fiduciary duties and found no contractual provision imposing any “code of conduct”—no requirements about the exercise of their bargained-for right. The implied covenant could not function to imply fiduciary duties since they had been eliminated in negotiation.<sup>212</sup>

### c. The “Conclusively Presumed” Cases

The extent to which judicial intervention can be contractually eliminated is illustrated in a series of cases involving a conclusive presumption in a contract.<sup>213</sup> A combination of provisions in the operating agreements addressing conflicts of interest and provisions for reliance on professional opinions seemed to lead to the elimination of plaintiffs’ fiduciary duty and implied covenant claims.<sup>214</sup> These cases were brought by holders of

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204. *Id.*

205. *Id.* at \*3.

206. *Id.*

207. *Id.* at \*6.

208. *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at \*1, \*9 (Del. Ch. May 7, 2008).

209. *Id.* at \*2.

210. *Id.* at \*1.

211. *Id.*; *see also* *Dawson v. Pittco Capital Partners, L.P.*, No. 3148 VCN, 2012 WL 1564805, at \*1 (Del. Ch. Apr. 30, 2012).

212. *Fisk Ventures*, 2008 WL 1961156, at \*11.

213. *See, e.g.*, *Brinckerhoff v. Enbridge Energy Co.*, No. 5526-VCN, 2011 WL 4599654, at \*1 (Del. Ch. Sept. 30, 2011), *aff’d*, 67 A.3d 369 (Del. 2013).

214. *See, e.g.*, *In re K-Sea Transp. Partners L.P. Unitholders Litig.*, No. 6301-VCP, 2012 WL 1142351, at \*1 (Del. Ch. Apr. 4, 2012); *Gerber v. Enter. Prods. Holdings, LLC*, No.

publicly traded units of limited partnerships.<sup>215</sup> The plaintiffs were challenging merger transactions on the grounds of a duty of loyalty violation.<sup>216</sup>

Each partnership agreement had a provision governing the resolution of conflicts:

[W]henever a potential conflict of interest exists or arises between any Affiliate of the Company, on the one hand, and the Company or any Group Member, on the other, any resolution or course of action by the Board of Directors in respect of such conflict of interest shall be permitted and deemed approved by all Members, and *shall not constitute a breach of this Agreement . . . or of any duty existing at law*, in equity or otherwise, *including any fiduciary duty*, if the resolution or course of action in respect of such conflict of interest is (i) *approved by Special Approval*, (ii) approved by the vote of holders of a majority of the Outstanding Common Units (excluding Common Units held by interested parties), (iii) on terms no less favorable to the Company than those being generally available to or available from unrelated third parties or (iv) fair and reasonable to the Company, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable to the Company).<sup>217</sup>

Even if default duties existed, the effect of this provision was to preclude any breach (contractual or otherwise) if any of these four tests were met.<sup>218</sup> The primary element at issue in these provisions was the Special Approval.<sup>219</sup> The Chancery has held that merely obtaining Special Approval does not necessarily result in a judgment for the defendants,<sup>220</sup> insisting that this process remains governed by the implied covenant of good faith and fair dealing.<sup>221</sup>

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5989-VCN, 2012 WL 34442, at \*1 (Del. Ch. Jan. 6, 2012), *aff'd in part*, 67 A.3d 400 (Del. 2013).

215. *See, e.g., In re Encore Energy Partners L.P. Unitholder Litig.*, No. 6347-VCP, 2012 WL 3792997, at \*1 (Del. Ch. Aug. 31, 2012).

216. *See id.* at \*3; *In re K-Sea*, 2012 WL 1142351, at \*1; *Gerber*, 2012 WL 34442, at \*2; *Brinkerhoff*, 2011 WL 4599654, at \*4; *Lonergan v. EPE Holdings LLC*, 5 A.3d 1008, 1011 (Del. Ch. 2010); *see also supra* Part I.A.2.b (discussing the duty of loyalty).

217. *In re Atlas Energy Res. LLC*, No. 4589-VLN, 2010 WL 4273122, at \*7 (Del. Ch. Oct. 28, 2010) (alterations in original) (emphasis added). Substantially identical language was at issue in *In re Encore*, 2012 WL 3792997, at \*9, *Lonergan*, 5 A.3d at 1020, *In re K-Sea*, 2012 WL 1142351, at \*7, and *Gerber*, 2012 WL 34442, at \*9. *Brinkerhoff* similarly involved actions of a Special Committee. *See Brinkerhoff*, 2011 WL 4599654, at \*9.

218. *See Gerber*, 2012 WL 34442, at \*10 (citing *Lonergan*, 5 A.3d at 1020).

219. *See supra* note 217 and accompanying text. A Special Committee is often used by boards of directors as a method of maintaining independence in decisionmaking and thus obtaining the protection of the business judgment rule. *See generally* 1 WELCH ET AL., *supra* note 66, § 141.2.3.5 (discussing the use of committees in approving conflicted transactions). The board delegates the decision to a committee comprised of disinterested directors who then review the transaction and vote on it, binding the entire board to the result of that vote. *See id.* In this way, the committee functions as a proxy for arm's-length bargaining. *See id.*

220. *Lonergan*, 5 A.3d at 1021.

221. *Id.* at 1021–22. The issue in this case may have been one of pleading. The court notes, “The complaint cites conflicts faced by directors who did not serve on the Audit

The Special Approval in these agreements was novel in that all contained a provision providing,

[The general partner] may consult with legal counsel, accountants, appraisers, management consultants, investment bankers and other consultants and advisors selected by it, and any act taken or omitted to be *taken in reliance upon the opinion* (including an Opinion of Counsel) of such Persons as to matters that [the general partner] reasonably believes to be within such Person's professional or expert competence *shall be conclusively presumed to have been done or omitted in good faith* and in accordance with such opinion.<sup>222</sup>

This provision affords less protection than the relevant Delaware corporations statute, pursuant to which the general partner is protected only if he relies *in good faith* on an opinion.<sup>223</sup> The partnership agreement provided that such good faith is conclusively presumed.<sup>224</sup>

The Chancery indicated that the conclusive presumption did not necessarily bar an implied covenant claim.<sup>225</sup> In *Brinckerhoff v. Enbridge Energy Co.*, when a committee of disinterested directors approved a joint venture, the court found that because the committee relied on an investment banker's opinion that had found the venture was representative of an arm's-length transaction, the general partner was entitled to a conclusive presumption of good faith.<sup>226</sup> Fiduciary duties had not been explicitly contractually eliminated, but the agreement contained clauses exculpating the general partner from monetary liability unless it acted in bad faith.<sup>227</sup> The Chancery held that the claim was precluded based on the facts alleged, not on the contractual provision itself.<sup>228</sup>

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Committee . . . but does not raise *any* challenge to the disinterestedness or independence of the members of the Audit Committee." *Id.* at 1022.

222. *Gerber*, 2012 WL 34442, at \*11 (emphasis added). This provision goes further than the applicable statutes, which provide:

A general partner . . . *shall be fully protected from liability* to the limited partnership, its partners or other persons party to or otherwise bound by the partnership agreement *in relying in good faith* upon the records of the limited partnership and upon information, opinions, reports or statements presented by another general partner of the limited partnership, an officer or employee of the limited partnership, a liquidating trustee, or committees of the limited partnership, limited partners or partners, or by any other person as to matters the general partner reasonably believes are within such other person's professional or expert competence . . . .

DEL. CODE ANN. tit. 6, § 17-407(c) (2005) (emphasis added); *see also id.* § 18-406 (providing the same protection to members and managers of LLCs).

223. DEL. CODE ANN. tit. 6, § 17-407(c).

224. *Gerber*, 2012 WL 34442, at \*11; *see also Brinckerhoff v. Enbridge Energy Co.*, No. 5526-VCN, 2011 WL 4599654, at \*9 (Del. Ch. Sept. 30, 2011), *aff'd*, 67 A.3d 369 (Del. 2013); *Lonergan*, 5 A.3d at 1022.

225. *See Lonergan*, 5 A.3d at 1022 ("On the present allegations, the grant of Special Approval must be conclusively presumed to have been . . . in good faith." (emphasis added) (internal quotation marks omitted)).

226. *Brinckerhoff*, 2011 WL 4599654, at \*9.

227. *Id.*

228. *Id.*

While the Chancery found that there were situations in which the contractual provision did bar an implied covenant claim, the Delaware Supreme Court reversed that holding. In *Gerber v. Enterprise Products Holdings, LLC* and *In re K-Sea Transportation Partners L.P. Unitholders Litigation*, the Chancery found that the plaintiffs had alleged bad faith,<sup>229</sup> absent a conclusive presumption in the contracts at issue.<sup>230</sup> Because of the contractual provision, in both cases the defendants were entitled to the conclusive presumption of good faith.<sup>231</sup>

In *Gerber*, the allegation was that the general partner had acted in bad faith when choosing to use the Special Approval process, abusing its discretion by taking advantage of the duty limitations in the operating agreement.<sup>232</sup> The court held that the plaintiff could not “plead that a defendant breached the implied covenant when the defendant is conclusively presumed by the terms of a contract to have acted in good faith.”<sup>233</sup>

The Delaware Supreme Court reversed and remanded, holding that plaintiffs had sufficiently pleaded a claim for breach of the implied covenant of good faith and fair dealing.<sup>234</sup> Relying on a distinction between good faith as a fiduciary duty and good faith with regards to the implied covenant,<sup>235</sup> the court found that since the statute prohibited the

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229. *Gerber*, 2012 WL 34442, at \*11.

230. *See id.* at \*12 (“Absent contractual modifications, Gerber could plead a breach of the implied covenant.”).

231. *See id.*; *see also In re K-Sea Transp. Partners L.P. Unitholders Litig.*, No. 6301-VCP, 2012 WL 1142351, at \*9 (Del. Ch. Apr. 4, 2012). In *In re K-Sea*, the allegation was that the general partner had incentivized the otherwise independent Conflicts Committee members to approve the merger. *In re K-Sea*, 2012 WL 1142351, at \*9.

The court held that once the committee relied on the expert opinion, it was entitled to the contractually stipulated presumption of good faith and no breach of fiduciary duty or implied covenant could be alleged. *Id.* at \*9–10. The court found that approval by the Special Approval process in the operating agreement was conclusive and had no requirement that it be “fair and reasonable to the Partnership.” *Id.* at \*8.

The court went on to say that such reliance would probably benefit unaffiliated shareholders. *Id.* at \*10 (“On its own, Section 14.2 endows [the general partner] with unfettered discretion to consent to a merger and submit it for unitholder approval. [The conclusive presumption,] however, incentivized [the general partner] to obtain a fairness opinion and rely upon it in connection with its approval of the merger.”). Because the unitholders had a right to veto the merger by vote, “to the extent that unitholders are unhappy with the proposed terms of the merger . . . their remedy is the ballot box, not the courthouse.” *Id.* at \*8.

232. *Gerber*, 2012 WL 34442, at \*11.

233. *Id.* at \*12; *see also In re Encore Energy Partners LP Unitholder Litig.*, No. 6347-VCP, 2012 WL 3792997, at \*1 (Del. Ch. Aug. 31, 2012) (rejecting claims of bad faith based on reliance on an expert opinion that contractually entitled the general partner to a conclusive presumption of good faith, even though plaintiffs had alleged that the controlling unitholder had intentionally driven down the company’s trading price before proposing the merger).

234. *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400, 421 (Del. 2013).

235. *Id.* at 418–19 (“Under a fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong. . . . An implied covenant claim, by contrast, looks to the past.” (citing *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440 (Del. Ch. 2012))).

elimination of the implied covenant, the parties intended a conclusive presumption of good faith in terms of fiduciary duty.<sup>236</sup>

*d. Ambiguity*

The Court of Chancery has stated that the operating agreement must state explicitly that fiduciary duties have been waived in order for them not to apply.<sup>237</sup> When the agreement is ambiguous on the point, the Chancery applies traditional contract interpretation rules.<sup>238</sup> In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, Emery Bay was an LLC organized to pursue a joint venture to renovate certain apartment buildings, with Bay Center and PKI as its only two members.<sup>239</sup> PKI was designated the managing member, and Alfred Nevis, in turn, was the sole owner and manager of PKI.<sup>240</sup> Nevis was alleged to have secretly caused Emery Bay's credit facility to be renegotiated several times to its detriment but to his personal advantage.<sup>241</sup> Bay Center asserted that such action was a breach of Nevis's fiduciary duties.<sup>242</sup>

The relevant operating agreement addressed fiduciary duties, but it was not clear as to whether they applied.<sup>243</sup> Section 6.1 of the agreement read, "*The Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other.*"<sup>244</sup> Potentially in contradiction to Section 6.1, Section 6.2 read, "*Except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind . . .*"<sup>245</sup> As with any ambiguity in a contract, the Chancery permitted the claim based on these sections to survive a motion to dismiss.<sup>246</sup>

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236. *Id.* at 419.

237. *See, e.g., Gerber*, 2012 WL 34442, at \*3–4 (finding no explicit alteration of the traditional duties of loyalty and care and that therefore the managers and controlling members owe those duties); *In re Atlas Energy Res., LLC Unitholder Litig.*, No. 4589-VCN, 2010 WL 4273122, at \*10 (Del. Ch. Oct. 28, 2010) (finding the same between a controlling unitholder and minority unitholders of a publicly traded LLC).

238. *See, e.g., Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. 3658-VCS, 2009 WL 1124451, at \*8 (Del. Ch. Apr. 20, 2009).

239. *Id.* at \*2.

240. *Id.*

241. *Id.* at \*1.

242. *Id.*

243. *Id.*

244. *Id.* at \*8.

245. *Id.* (alterations in original).

246. *Id.*

*e. Substitution or Partial Waiver*

There have been few cases that involve restriction, expansion, or substitution of fiduciary duties, as opposed to the elimination of them.<sup>247</sup> *Auriga Capital* is one of them.<sup>248</sup> *Auriga Capital* involved a dispute between the controlling member-manager, William Gatz, and the minority investors of a Delaware LLC, Peconic Bay.<sup>249</sup> Peconic Bay owned a long-term lease of a golf course owned by Gatz's family.<sup>250</sup> In 2009, Gatz arranged for Peconic Bay to be sold to him in what the courts later found to be a sham auction,<sup>251</sup> leaving the minority members with an aggregate of \$20,985, a fraction of the company's true value.<sup>252</sup> The minority members then filed a claim of breach of fiduciary duties, attempting to hold Gatz liable for his conduct.<sup>253</sup>

Peconic's LLC agreement contained two provisions relevant to the analysis of the minority members' breach of fiduciary duty claim against Gatz.<sup>254</sup> The first, section 15, provided a standard for entering agreements with affiliates<sup>255</sup>:

Neither the Manager nor any other Member shall be entitled to cause the Company to enter . . . into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members.<sup>256</sup>

Gatz was an affiliate and never obtained a majority of the minority vote approving the transaction.<sup>257</sup>

The second, section 16, was a liability exculpation clause, reading:

*No Covered Person* [defined to include "the Members, Manager and the officers, equity holders, partners and employees of each of the foregoing"] *shall be liable to the Company, [or] any other Covered Person* or any other person or entity who has an interest in the Company *for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority*

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247. See, e.g., *Gatz Props., LLC v. Auriga Capital Corp. (Auriga II)*, 59 A.3d 1206, 1212 (Del. 2012).

248. See *id.*

249. *Id.*, 59 A.3d at 1212.

250. *Id.* at 1208.

251. *Auriga Capital Corp. v. Gatz Props., LLC (Auriga I)*, 40 A.3d 839, 873 (Del. Ch. 2012) ("[T]he Auction process used by Gatz was a bad faith sham. The process used was so far short of minimally responsible as to render Gatz's continued defense of it frivolous and burdensome."), *aff'd*, 59 A.3d at 1206.

252. *Auriga II*, 59 A.3d at 1212.

253. *Id.*

254. See *id.* at 1212, 1216.

255. *Auriga I*, 40 A.3d at 857.

256. *Id.*

257. See *id.* at 856–57.

*conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person's gross negligence, willful misconduct or willful misrepresentation.*<sup>258</sup>

Based on these provisions and Gatz's egregious conduct, the Delaware Supreme Court affirmed the Chancery's ruling that held Gatz liable.<sup>259</sup> While the Chancery had done so on the basis that default fiduciary duties applied, since the agreement had not eliminated them, the Delaware Supreme Court found Gatz liable on what it said were purely contractual grounds.<sup>260</sup> The Chancery, employing an equitable interpretation, had found the "arm's length terms and conditions standard" to impose "the equivalent of the substantive aspect of entire fairness review, commonly referred to as the 'fair price' prong."<sup>261</sup> The Chancery essentially imposed the fair dealing prong as well, noting that the process "bears importantly on the price determination."<sup>262</sup> The court went on to analyze Gatz's disloyal conduct, focusing on the value of the company, and found that he had the burden to prove fairness and did not do so.<sup>263</sup> Because of its default fiduciary duty interpretation, the Chancery Court applied the exculpation provision, section 16, to the totality of Gatz's conduct—not just the auction or the question of fair price.<sup>264</sup>

The Supreme Court reached the same conclusion, also imposing the two-prong entire fairness standard, as articulated in *Weinberger v. UOP, Inc.*,<sup>265</sup> on Gatz.<sup>266</sup> The Supreme Court did not require a contractual statement imposing a "fiduciary duty," such as "entire fairness standard," or "duty."<sup>267</sup> The court stated that the inquiry was one of function, not of form.<sup>268</sup> The Delaware Supreme Court analyzed whether the exculpation provision covered Gatz's conduct in the auction.<sup>269</sup> Like the Chancery, the

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258. *Id.* at 858.

259. *Auriga II*, 59 A.3d at 1216.

260. *Id.* at 1213 (recognizing "the contracted-for entire fairness standard").

261. *Auriga I*, 40 A.3d at 857 (citing *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 795 A.2d 1, 27 (Del. Ch. 2001), *aff'd*, 817 A.2d 160 (Del. 2002), and *Flight Options Int'l, Inc. v. Flight Options, LLC*, No. Civ. A. 1459-N, 2005 WL 2335353, at \*7–8 (Del. Ch. Sept. 20, 2005)).

262. *Id.* (citing *Flight Options*, 2005 WL 2335353, at \*7 n.32).

263. *Id.* at 860–73.

264. *Id.* at 873.

265. 457 A.2d 701 (Del. 1983).

266. *See Auriga I*, 40 A.3d at 856; *see also Gatz Props., LLC v. Auriga Capital Corp. (Auriga II)*, 59 A.3d 1206, 1213–1214, 1214 n.27 (Del. 2012).

267. *Auriga II*, 59 A.3d at 1213 ("To impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words.").

268. *Id.* ("Viewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.").

269. *Id.* at 1216–18.

Delaware Supreme Court found Gatz had acted in bad faith, and both courts imposed liability.<sup>270</sup>

## II. DEFAULT OR NOT? THE TRADITIONALISTS VERSUS THE CONTRACTARIANS

Part I described the origins of fiduciary duties and their role in corporations. It went on to give a brief history of the genesis and characteristics of LPs and LLCs. Lastly, it examined courts' approach to fiduciary duties in these entities when analyzing parties' operating agreements. Part II examines the reasoning regarding default fiduciary duties. It addresses the traditionalist arguments for default fiduciary duties and then compares the opposing contractarian arguments.

### A. *There Should Be Default Fiduciary Duties: The Traditionalists*

Traditionalists advocate default fiduciary duties, focusing on the extracontractual nature of fiduciary duties, their grounding in equity, and their foundational doctrinal existence in business law.<sup>271</sup> Traditionalists maintain that to completely eliminate fiduciary duties as the default standard of review for general partners or managers runs sharply against precedent,<sup>272</sup> is founded on an idealistic view of the bargaining and contract-formation process,<sup>273</sup> and ignores the necessity for regulation of manager conduct.<sup>274</sup>

Fiduciary duties are hundreds of years old and are foundational to partnership law doctrine.<sup>275</sup> Traditionalists argue that contractarians ignore the rights and responsibilities that arise "when people join their property

270. See *id.* at 1216; *Auriga I*, 40 A.3d at 873 ("The Auction process was not a good faith effort to generate bids at a good price for Peconic Bay. Rather, the sham Auction was the culmination of Gatz's bad faith efforts to squeeze out the Minority Members.").

271. See, e.g., FRANKEL, *supra* note 54, at 195–96 (discussing the main features of a fiduciary relationship); Reza Dibadj, *The Misguided Transformation of Loyalty into Contract*, 41 TULSA L. REV. 451, 452 (2006); Lyman Johnson, *Delaware's Non-waivable Duties*, 91 B.U. L. REV. 701, 702 (2011).

272. See J. William Callison & Allan W. Vestal, "They've Created a Lamb with Mandibles of Death": *Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, 76 IND. L.J. 271, 282–91 (2001); Daniel S. Kleinberger, *Delaware Dissolves the Glue of Capitalism: Exonerating from Claims of Incompetence Those Who Manage Other People's Money*, 38 WM. MITCHELL L. REV. 737, 767 (2012).

273. Callison & Vestal, *supra* note 272, at 295, 296 n.125; Johnson, *supra* note 271, at 709, 713.

274. Kleinberger, *supra* note 272, at 767; Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609, 1611–12 (2004).

275. See *supra* Part I.B.; see also Johnson, *supra* note 271, at 709–13; Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract As Deity*, 14 FORDHAM J. CORP. & FIN. L. 445, 460 (2008) ("It has been hornbook law for centuries that a partnership inherently and inescapably involves fiduciary duties among the partners." (citing JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP §§ 172, 174–81 (William S. Hein & Co. 1980) (1841), and NATHANIEL LINDLEY, LAW OF PARTNERSHIP, INCLUDING ITS APPLICATION TO JOINT-STOCK AND OTHER COMPANIES 412 (15th ed. 1984))).

and their efforts in a common business enterprise.”<sup>276</sup> The “legal reality is that the manager of an LLC or general partner in a partnership *is* in a fiduciary relationship, as Delaware law conceives that relationship.”<sup>277</sup> Traditionalists thus see this movement to contract law as a significant departure from established doctrine<sup>278</sup> and argue that precedent should not be lightly rejected.<sup>279</sup>

Traditionalists contend that contractarians rely on a simplistic view of the contract formation process,<sup>280</sup> which does not incorporate transaction costs and certain institutional realities.<sup>281</sup> Moreover, traditionalists argue, contractarians overestimate not only the prescience of those drafting contracts,<sup>282</sup> but also the extent to which precision is beneficial.<sup>283</sup> Ambiguity in contracts is likely both necessary and inevitable.<sup>284</sup> Fiduciary law is left purposely indeterminate so as to confer the judicial flexibility required to deal with a variety of situations that might not be encompassed in a single rule.<sup>285</sup>

Traditionalists also urge the importance of constraining managerial abuse of discretion.<sup>286</sup> The argument is that abuse undermines both individual

276. Kleinberger, *supra* note 275, at 466.

277. Johnson, *supra* note 271, at 723–24; see J. William Callison & Allan W. Vestal, *Contractarianism and Its Discontents: Reflections on Unincorporated Business Organization Law Reform*, 42 SUFFOLK U. L. REV. 493, 501 (2009) (“Historically, the status of ‘partner’ has inherently involved fiduciary duties among the partners.”).

278. Callison & Vestal, *supra* note 277, at 499; Kleinberger, *supra* note 275, at 466–67.

279. See Johnson, *supra* note 271, at 713. Johnson sees the elimination of fiduciary duties as stripping the Delaware Chancery Court of equity jurisdiction, something that was granted to it in the Delaware constitution and thus cannot be abrogated absent constitutional amendment. *Id.* The statute must thus be read as “not alter[ing] the traditional jurisdiction or power of the Chancery Court to interject and apply fiduciary duties in noncorporate businesses.” *Id.*

280. Dibadj, *supra* note 271, at 464–70; Sandra K. Miller, *Legal Realism, the LLC, and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing*, 45 WAKE FOREST L. REV. 729, 732–40 (2010).

281. Dibadj, *supra* note 271, at 467–68.

282. Callison & Vestal, *supra* note 277, at 504 (“[C]ontractarianism incorrectly assumes human prescience.”); Dibadj, *supra* note 271, at 466–67. *But see* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 556 (2003) (“Given the limits on cognitive competence, as implied by ‘bounded rationality,’ incomplete contracts are the inevitable result of the uncertainty and complexity inherent in ongoing business relationships. In turn, incomplete contracts leave greater room for opportunistic behavior.” (footnotes omitted)).

283. Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043, 1044–45 (1995) (“[T]he participants may be unable to identify all of the contingencies that would enable opportunistic conduct or, having identified such possibilities, may be reluctant to articulate them because they fear destroying the deal underway.” (footnote omitted)).

284. See *id.*

285. See Johnson, *supra* note 271, at 722 (“The dilemma is the usual one in designing and interpreting categorical legal rules.”).

286. See Callison & Vestal, *supra* note 277, at 504–05; Dibadj, *supra* note 271, at 472 (arguing that fiduciary duties are important because they “provide a legal incentive for the parties to get along by forgoing opportunistic conduct” (internal quotation marks omitted)).

investor confidence and the strength of the general economy.<sup>287</sup> The market alone does not afford sufficient protection.<sup>288</sup> A pure contractarian approach would impose costs from mismanagement on third parties who rely on or transact with alternative entities.<sup>289</sup>

*B. There Should Not Be Default Fiduciary Duties: The Contractarians*

Contractarians contend that limited partnership agreements and limited liability company operating agreements should be treated as pure contracts.<sup>290</sup> They assert that this approach promotes economic efficiency<sup>291</sup> and that the sophisticated parties that use alternative entities can protect themselves through negotiation.<sup>292</sup>

Contractarians argue that the benefits of fiduciary duties are outweighed by the costs.<sup>293</sup> These costs include enforcement,<sup>294</sup> impediments to the manager's discretion,<sup>295</sup> and litigation of fiduciary duties.<sup>296</sup> A reduction in agency costs is accomplished through particular governance devices in alternative entities that differ from corporate governance: mandatory distributions, limited lifetime ending in mandatory liquidation, and managers as owners.<sup>297</sup> These serve to align manager and investor interests, thus providing the discipline and incentive necessary to minimize agency costs.<sup>298</sup> Customizability of fiduciary duties fits with the flexibility

287. See Johnson, *supra* note 271, at 722; Kleinberger, *supra* note 272, at 737–38; Sandra K. Miller, *The Duty of Care in the LLC: Maintaining Accountability While Minimizing Judicial Interference*, 87 NEB. L. REV. 125, 134–37, 169–78 (2008).

288. Kleinberger, *supra* note 272, at 767 (“Once courts stop thinking about managers as handling other people’s money, the way is open to abandon ‘the punctilio of an honor the most sensitive’ and decay into ‘the morals of the market place.’” (quoting *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928))).

289. *But see* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 548–50, 557–559 (1997) (disputing traditionalists’ arguments about the costs of waiving fiduciary duties).

290. See Ribstein, *supra* note 289, at 541–50; Steele, *Freedom of Contract*, *supra* note 158, at 242; *see also* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-contractarians*, 65 WASH. L. REV. 1 (1990) (arguing for a contractarian approach to corporations).

291. See Steele, *Freedom of Contract*, *supra* note 158, at 233; *cf.* Cooter & Freedman, *supra* note 50, at 1067–68 (arguing that while a contract for the purchase of goods “provide[s] perfect incentives, [and therefore] the fiduciary relationship is replaced by market exchange,” otherwise, “profit sharing alone cannot overcome the deterrence problem”).

292. See Steele, *Freedom of Contract*, *supra* note 158, at 237.

293. See Ribstein, *supra* note 289, at 546–58; *see also* Cooter & Freedman, *supra* note 50, at 1064 (“The legal burdens on fiduciaries increase the cost of their services.”).

294. Ribstein, *supra* note 289, at 546.

295. *Id.* at 549.

296. Steele, *Freedom of Contract*, *supra* note 158, at 239.

297. Ribstein, *supra* note 35, at 290–98; Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 136–43.

298. Steele, *Freedom of Contract*, *supra* note 158, at 239 (observing the “effect on the purported fiduciary’s incentives and the reduction of trust or reciprocity from substituting legal duties for extralegal constraints” (quoting Larry E. Ribstein, *A New Age?: Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 212–13) (internal quotation marks omitted)).

of the form that can be tailored to a wide variety of businesses that have different structural requirements.<sup>299</sup>

Contractarians also worry that implementation of default fiduciary duties would distort the parties' bargain because courts might not do thorough enough contract interpretation, and instead rely on fiduciary duties to cover any conduct that does not immediately fall within the contract provisions.<sup>300</sup> Moreover, fiduciary duties are not clearly defined and thus keeping some of them but eliminating others might not be fully effective.<sup>301</sup> Contractarians suggest that fiduciary duties should instead be treated as a contractual element.<sup>302</sup>

Contractarians note that the parties who make use of alternative entities are generally sophisticated<sup>303</sup> and are involved in the bargaining that results in the operating agreement that defines the entity.<sup>304</sup> Contractarians reason that including or not including fiduciary duties in an operating agreement is a "conscious choice,"<sup>305</sup> and is not a "rational gap" that needs to be filled by the judiciary.<sup>306</sup>

### III. DEFAULT FIDUCIARY DUTIES, DISCLOSURE, AND WAIVER

Part II outlined the debate between traditionalists and contractarians regarding the wisdom of requiring default fiduciary duties. Part III first argues that precedent and risk are the same in member-managed and manager-managed LLCs and LPs, and therefore default fiduciary duties should apply to both. Part III then recommends a combination of disclosure

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299. See Cooter & Freedman, *supra* note 50, at 1062 ("[D]ifferent levels of risk are appropriate in different fiduciary relationships. For example, a trustee often is required to be prudent and conservative in managing an asset, whereas a director of a start-up company may be encouraged to take risks." (footnotes omitted)); Ribstein, *supra* note 35, at 299–305 (discussing three different types of firms that tend to use the partnership structure and the different fiduciary duty structures they require).

300. See Steele, *Freedom of Contract*, *supra* note 158, at 235–36.

301. *Id.* at 240 ("The nebulous nature of default fiduciary duties makes it difficult for parties to eliminate some, but not all, potential fiduciary duties.").

302. See Ribstein, *supra* note 289; see also EASTERBROOK & FISCHER, *supra* note 66, at 1–39 (arguing that fiduciary duties are contractual in nature).

303. Compare how securities regulation law accounts for the sophistication of parties. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.24[1] (6th ed. 2009) (discussing *SEC v. Ralston Purina Co.*, 346 U.S. 119, 127 (1953) ("The focus of inquiry should be on the need of the offerees for the protections afforded by registration.")); see also *SEC v. Kenton Capital, Ltd.*, 69 F. Supp. 2d 1, 11–12 (D.D.C. 1998) (stating that sophistication is not a substitute for access to information).

304. Steele, *Freedom of Contract*, *supra* note 158, at 237 ("The choice of the LLC form was an intentional form, chosen by sophisticated parties because that form provides the contracting parties with the maximum ability to customize their relationship."). Steele notes that this is a key difference between the LLC form and the corporate form. *Id.*

305. Mohsen Manesh, *What Is the Practical Importance of Default Rules Under Delaware LLC and LP Law?*, WIDENER L. (Dec. 14, 2011), <http://blogs.law.widener.edu/delcorp/mohsen-manesh-what-is-the-practical-importance-of-default-rules-under-delaware-llc-and-lp-law/> ("Sophisticated parties can and will contract to avoid undesirable default rules. And LLCs and LPs with passive (presumably unsophisticated) investors have contractually created an almost *de facto* rule eliminating fiduciary duties.").

306. Steele, *Freedom of Contract*, *supra* note 158, at 237.

and signatures be required in order for members and limited partners to waive fiduciary duties.

#### A. Statutes and Precedent

Taking into account both the history of the statutes (including the new amendment to the LLC Act) and the history of fiduciary duties at common law, default fiduciary duties apply to both LPs and LLCs.<sup>307</sup> They apply not only to managers and general partners, but also to managing members and to controlling unitholders of either.<sup>308</sup> While none of these specific duties are mentioned in the statutes, the statutes incorporate the lengthy legal precedent regarding fiduciary duties.<sup>309</sup>

The legislature specifically crafted the statute to permit elimination; it did not eliminate fiduciary duties by statute and permit parties to contractually provide for them.<sup>310</sup> The language in the statute, “parties may expand, restrict, or eliminate fiduciary duties,” explicitly contemplates the existence of those duties at common law.<sup>311</sup> It would be impossible to expand, restrict, or eliminate duties that did not exist in the first place. The debate at common law that the 2004 amendment resolved was whether fiduciary duties could be eliminated from LPs and LLCs, not whether they existed at all.<sup>312</sup>

The LP Act specifies that when in doubt, equity governs.<sup>313</sup> Fiduciary duties are equitable doctrines, and therefore the language indicates that the legislature intended default fiduciary duties to be imposed.<sup>314</sup> The incorporation of fiduciary duties has now been made explicit in the LLC Act.<sup>315</sup> This statutory emphasis on equitable doctrines and fiduciary duties echoes the approach courts have always taken with regard to fiduciary duties in business associations.<sup>316</sup> Partnerships, business trusts, corporations, and LLCs all place fiduciary duties on the manager.<sup>317</sup> The imposition of these duties continues in current Delaware jurisprudence.<sup>318</sup>

307. *See supra* Part I.C.3.a.

308. *See supra* Part I.C.1.

309. *See supra* notes 127–28 and accompanying text.

310. *See* DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1011(c) (2005).

311. *See supra* notes 127–28 and accompanying text.

312. *Compare* *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del. Ch. 2002) (stating that the Limited Partnership Act does permit restriction or expansion of fiduciary duties, but does not permit elimination), *with* *Sonet v. Timber Co.*, 722 A.2d 319, 323 (Del. Ch. 1998) (stating that the Limited Partnership Act “apparently [allows] broad license to enhance, reform, or even eliminate fiduciary duty protections”).

313. DEL. CODE ANN. tit. 6, § 18-1104.

314. *See* *Auriga Capital Corp. v. Gatz Props., LLC (Auriga I)*, 40 A.3d 839, 852 (Del. Ch.) (“The statute incorporates equitable principles.”), *aff’d*, 59 A.3d 1206 (Del. 2012).

315. DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c), 18-1104; *see also supra* Part I.C.3.b.

316. *See, e.g.*, *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928); *see also supra* Part I.A., I.C.1.

317. *See supra* notes 48–52 and accompanying text.

318. *See supra* Part I.C.

The emphasis in the statutes on the principle of freedom of contract does not address the existence of default fiduciary duties.<sup>319</sup> Some have seen the contractually leaning provisions as an indication that the freedom of contract policy overrides the common law of fiduciary duties in these entities.<sup>320</sup> But the freedom of contract principle in this context refers to the ability of the parties to tailor the business to their needs.<sup>321</sup> It does not eliminate core elements of business organizations. The LP and LLC statutes operate by providing the default but permitting parties to deviate from that default if they so agree.<sup>322</sup> It is no different for fiduciary duties.

The statute reads only “[t]o the extent that, at law or in equity, a member or manager . . . [has] fiduciary duties.”<sup>323</sup> Fiduciary duties are notoriously ambiguous and fluid, which likely accounts for the language in the statute not specifically identifying the duties that apply, but instead just incorporating common law.<sup>324</sup> This is particularly important in business organizations such as the LP and LLC, which are extremely customizable. The fiduciary obligations that are appropriate vary depending on the structure that is created by the parties. If the default duties are unspecified, that permits the appropriate level of protection for each individual organization, and it permits common law to evolve as the forms continue to develop. It also means that the application of these duties might not always be entirely predictable.

If parties want to limit these fiduciary duties, and in doing so limit the risk of unpredictable interpretation by the courts, they can limit those duties by contract in the operating agreement. If they want more protection, they can also increase the duties, again by contract. But then, the protections will be contractual terms, and therefore contractual protections. The point of having particular conduct requirements specified contractually is that parties can indicate what they want and limit any extraneous fiduciary duties that might effectively amend the contract. By limiting fiduciary duties by contract, parties obtain predictability through pure judicial enforcement of the agreement.

#### *B. Negotiation and Disclosure: Formal Waiver Required*

This section argues that default fiduciary duties apply in member-managed LLCs and LPs. It then goes on to recommend that a combination of disclosure and signatures be required to waive fiduciary duties.

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319. *See supra* notes 162–72 and accompanying text.

320. *See Steele, Freedom of Contract, supra* note 158, at 227 (“[I]mplicit in the sections above, the statutes do not provide any fiduciary duties, default or mandatory.”).

321. *See supra* Part I.B.3.

322. *See supra* Part I.B.3.

323. DEL. CODE ANN. tit. 6, § 18-1101(c) (2005); *see also id.* § 17-1101(d).

324. *See supra* notes 50–52 and accompanying text.

### 1. Consequences of Waiver

The consequences of eliminating fiduciary duties are significant,<sup>325</sup> and these consequences are a risk assumed by those not managing.<sup>326</sup> If the parties in *Bay Center* had waived all fiduciary duties, they would have assumed the risk that one of them would secretly renegotiate the LLC's loan to the LLC's detriment but to that party's gain.<sup>327</sup> The injured party would have had no legal recourse unless there was an explicit contractual provision prohibiting such conduct.<sup>328</sup> Similarly, if the parties in *Auriga Capital* had waived all fiduciary duties, the minority members would have had no grounds to hold Gatz liable for the sham auction.<sup>329</sup>

These risks apply equally in manager-managed entities and member-managed entities. While partial ownership may serve to align manager interest with the other members to an extent, it is not enough to make fiduciary duties inapplicable. All the same problems of control on one side and lack of information on the other still persist. Default fiduciary duties should therefore exist even in member-managed LLCs and LPs.

### 2. The Importance of Disclosure and Sophistication

Waiver or limitation of fiduciary duties in LPs and LLCs should be focused on disclosure. The agreement must disclose the level of risk posed to members or partners if fiduciary duties are waived or limited, and the person assessing the risk must have the capacity to do so.<sup>330</sup>

Elimination or limitation of fiduciary duties creates a serious increase in risk for members or limited partners.<sup>331</sup> Parties might wish to assume such risk if they believe they will share in the upside. But such assumption must be bargained for,<sup>332</sup> and in order to bargain fairly, it is critical that the risk be disclosed and that parties fully understand what rights they are relinquishing.

### 3. More Clarity Required

At the moment, the language required to waive fiduciary protection is relatively vague.<sup>333</sup> The extent of the waiver can be determined by the interaction between several different provisions in the agreement.<sup>334</sup> This problem can be mitigated through particular contractual requirements. The clause waiving duties should be in all capital letters. It should be required to be signed by all members or partners, and each time a member or limited

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325. *See supra* Part I.C.4.b-c.

326. *See supra* Part I.C.4.b-c.

327. *See supra* notes 237-46 and accompanying text.

328. *See supra* notes 237-46 and accompanying text.

329. *See supra* Part I.C.4.e.

330. *See supra* note 303 (discussing sophistication in the securities regulation context).

331. *See supra* notes 62-64 and accompanying text.

332. *See supra* Part I.C.4; *supra* notes 303-06 and accompanying text.

333. *See supra* Part I.C.4.c-e.

334. *See supra* Part I.C.4.

partner is added, that member or partner must also sign the clause. This provides the court with objective evidence that the bargain was negotiated and that parties understood what they were waiving. Moreover, it serves as an additional alert to the parties that they are relinquishing judicial protection.

Unitholders of publicly traded LPs and LLCs are a special situation in that they cannot engage in direct bargaining. Under federal securities laws, the fact that fiduciary duties have been fully waived is required to be disclosed, but it is not clear that prospective purchasers of these units would necessarily understand the significance of this waiver.

The disclosures therefore should also include specific risk factors identifying the consequences of the waiver.<sup>335</sup> This type of analysis is important because the waiver is not always total: for example, most investors would not understand the effect of entitling a manager to a conclusive presumption of good faith for reliance on expert opinions.<sup>336</sup> These additional disclosures would provide the court with evidence that the bargain was negotiated, through the market, and that the parties understood the consequences of waiver. While requiring individual signatures would be impractical for a public offering, these investors can protect themselves through diversification.

#### CONCLUSION

This Note explores recent decisions interpreting operating agreements on the issue of fiduciary duties. Fiduciary duties in Delaware LLCs and LPs can be eliminated in the operating agreements. There has been an ongoing debate over whether, and to what extent, default fiduciary duties apply to these entities if no contractual language specifically eliminates fiduciary duties.

This Note argues that default fiduciary duties apply to LLCs and LPs, including member-managed LLCs and LPs, and it advocates that a combination of disclosure and signatures of the members or partners be required in order to waive fiduciary duties in these entities. Such a requirement would give courts clearer evidence of waiver, and it would alert parties to the significance of such waiver.

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335. *See, e.g.*, 17 C.F.R. § 229.503(c) (2013).

336. *See supra* Part I.C.4.c.