OPT-IN VS. OPT-OUT: SETTLING THE DEBATE OVER DEFAULT FIDUCIARY DUTIES IN DELAWARE LLCS

ABSTRACT

Limited liability companies have made a quick ascension to the top of the business entity pyramid. In step with the national trend as the most popular business form, Delaware's LLC formations outpace corporations three-to-one. This feat is unsurprising when considering the many benefits offered by this business form—namely, its limited liability, eligibility for pass-through taxation, and particularly significant for the purposes of this Note – its contractual flexibility. Unlike corporate investors who lack any meaningful opportunity to negotiate for the protection of their investments, LLC members, through their LLC operating agreement, can meticulously craft an entity exclusively tailored to meet their personal business needs. As a result, the protections afforded to corporate investors in the form of non-waivable, default fiduciary duties are unnecessary in the LLC context. In fact, the 2004 amendment to the Delaware Limited Liability Company Act expressly permits LLC members to eliminate such fiduciary duty protections. While it is clear that fiduciary duties may be removed from LLC agreements, one issue garnering feverish attention throughout the Delaware bench and bar, still remains: whether traditional default fiduciary duties exist where an LLC agreement does not explicitly eliminate, or is silent regarding, the duties owed.

In an effort to resolve this ambiguity, two divergent schools of thought have emerged. Heralded by the Chief Justice Steele of the Delaware Supreme are the "opt-in" supporters, also referred to as "contractarians." Opt-in proponents argue that courts should conduct a contractual analysis rendering fiduciary duties applicable only if the LLC members affirmatively opt-in for their application, as opposed to superimposing them where the parties have not contracted for those protections in the LLC agreement. In sharp contrast, a recent string of Delaware Court of Chancery dispositions—namely, Kelly v. Blum*,* Bay Center Apartments Owner, LLC v. Emery Bay PKI LLC*,* In re Atlas Energy Res., LLC*, and most recently,* Auriga Capital Corp. v. Gatz Properties*—reflect the "opt-out" standard. Opt-out supporters, referred to as "traditionalists," reject fundamental contract principles and instead inject traditional default fiduciary duties into LLC agreements unless there is an explicit and unambiguous provision in the LLC agreement opting-out of these duties. The Delaware judiciary's divergent*

methodologies, compounded by the immense popularity of LLCs and the potential degree of harm that may result from a breach of fiduciary duties claim, make this debate—opt-in vs. opt-out—ripe for the Delaware Supreme Court's review and/or amendment by the General Assembly.

First, to establish context, this Note examines the contractual underpinnings and rise to prominence of the LLC, and presents a brief primer on fiduciary duties and their applicability in the corporate governance, partnership, and LLC frameworks. Second, it analyzes the opposing rationales that underlie the opt-in vs. opt-out debate, as well as Delaware courts' representative dispositions. Third, this Note attempts to glean the Delaware Supreme Court's eventual disposition gathered from an examination of its recent affirming of Chancery's Auriga *decision (and its rejection of the dicta contained therein on default fiduciary duties) and comparable areas of law. Fourth, this Note argues that Delaware courts should adopt the opt-in standard, thereby adhering to the LLC's strong "freedom of contract" foundation. Fifth, it proposes an amendment to DLLCA section 18-1101(c) that, if incorporated, this Note suggests, would end this debate. Sixth, in addition to illustrating numerous deficiencies inherent in the opt-out standard, this Note explains other negative ramifications of adoption of such a standard. Finally, this Note provides helpful recommendations for Delaware practitioners to adhere to until the debate over default fiduciary duties in the LLC context is settled.*

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I. INTRODUCTION

The limited liability company's ("LLC") designation as the nation's most popular business entity is not surprising.[1] In Delaware alone, the creation of more than 500,000 LLCs in the past two decades[2] outpaces corporate formations three-to-one.[3] In addition to offering the best of

[1] *See* Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) ("The LLC is an attractive form of business entity because it combines corporate-type limited liability with partnership-type flexibility and tax advantages."); 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, 460 (2010) ("Rising from near obscurity in the 1990s, the LLC has now taken its place as the new 'king-of-the-hill' among business entities, utterly dominating its closest rivals.").

[2] James G. Leyden, Jr. & Laura Dietrich, *Delaware Limited Liability Companies and Limited Partnerships*, *in* INSTITUTIONAL INVESTOR FORUM 2011, at 319, 323 (PLI Corp. Law & Practice, Course Handbook Series No. 1873, 2011).

[3] Chrisman, *supra* note 1, at 460.

both worlds—limited liability and pass-through taxation[4]—an "[LLC is] a powerful economic vehicle that . . . allows for *ultimate contractual customization* among its owners and management."[5]

Unlike corporate investors who lack any meaningful opportunity to negotiate for the protection of their investments, LLC members, through their LLC operating agreement ("LLC agreement"), can meticulously craft an entity exclusively tailored to meet their personal business needs.[6] As a result, the protections afforded to corporate investors in the form of non-waivable, default fiduciary duties are unnecessary in the LLC context.[7] In fact, the 2004 amendment to the Delaware Limited Liability Company Act ("DLLCA")[8] expressly permits LLC members to *eliminate* such protections.[9] While it is clear that fiduciary duties may be removed from LLC agreements, one issue garnering feverish attention throughout the Delaware bench and bar, still remains: whether traditional default fiduciary duties exist where an LLC agreement does not explicitly eliminate, or is silent regarding, the duties owed.[10]

As to the resolution of this issue, there are two divergent schools of thought. Chief Justice Steele of the Delaware Supreme Court and other "opt-in" supporters, referred to as "contractarians,"[11] argue that

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[4]*See id.* at 466.

[5]Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 221-22 (2009) (emphasis added).

[6]*See id.*

[7]*See id.* at 233-34.

[8]DEL. CODE ANN. tit. 6, §§ 18-101 to 18-1109 (2005).

[9]*See id.* § 18-1101(c).

[10]*Compare* Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 4 (2007) ("[A]lthough current judicial analysis seems to imply that fiduciary duties engrained in the corporate law readily transfer to limited partnerships and limited liability companies as efficiently and effectively as they do to corporate governance issues, that conclusion is flawed."), *with* Kelly v. Blum, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) (quoting Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009)) ("[D]espite the wide latitude of freedom of contract afforded to contracting parties in the LLC context, 'in the absence of a contrary provision in the LLC agreement,' LLC managers and members owe 'traditional fiduciary duties of loyalty and care' to each other and to the company.").

[11]*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, 1469 n.2 (2005).

courts should conduct a contractual analysis rendering fiduciary duties applicable only if the LLC members affirmatively opt-in for their application, instead of superimposing them where the parties have not contracted for those protections in the LLC agreement.[12] In sharp contrast, a recent string of Delaware Court of Chancery dispositions reflect the "opt-out" standard, whose supporters, referred to as "traditionalists,"[13] reject fundamental contract principles and instead inject traditional default fiduciary duties—engrained in partnership law and corporate governance—into LLC agreements unless there is an explicit and unambiguous provision in the LLC agreement opting-out of these duties.[14] The Delaware judiciary's divergent methodologies, compounded by the immense popularity of LLCs and the potential degree of harm that may result from a breach of fiduciary duties claim, make this debate—opt-in vs. opt-out—ripe for the Delaware Supreme Court's review and/or amendment by the General Assembly.[15]

First, to establish context, this Note examines the contractual underpinnings and rise to prominence of the LLC, and presents a brief primer on fiduciary duties and their applicability in the corporate governance, partnership, and LLC frameworks. Second, it analyzes the opposing rationales that underlie the opt-in vs. opt-out debate, as well as Delaware courts' representative dispositions. Third, this Note attempts to glean the Delaware Supreme Court's eventual disposition gathered from an examination of its recent affirming of Chancery's *Auriga* decision (and its rejection of the dicta contained therein on default fiduciary duties) and comparable areas of law. Fourth, this Note argues that

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[12] *See* Steele, *supra* note 5, at 223-24; Steele, *supra* note 10, at 4-5 (both arguing that principles of freedom of contract, upon which the LLC statute is premised, mandate a default standard where traditional fiduciary duties do not apply unless specifically included in the parties' LLC agreement).

[13] *See* Altman & Raju, *supra* note 11, at 1469 n.2.

[14] Members and managers of LLCs are subject to traditional fiduciary duties in the absence of language effectively eliminating those duties. *E.g.*, *In re* Atlas Energy Res., LLC, 2010 WL 4273122, at *7 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823, 834 (2011); *Bay Ctr. Apartments Owner*, 2009 WL 1124451, at *8; *Kelly*, 2010 WL 629850, at *10. *But see* Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *11 (Del. Ch. May 7, 2008) (holding that the contract's express language defines any duties owed amongst parties involved in an LLC), *aff'd*, 984 A.2d 124 (Del. 2009).

[15] Ann E. Conaway, *Why No Respect? The Contractual Duties of Good Faith and Fair Dealing in Delaware*, *in* DELAWARE LAW DEVELOPMENTS 2010: WHAT ALL BUSINESS LAWYERS NEED TO KNOW, at 783, 788 (PLI Corp. Law & Practice, Course Handbook Series No. 1808, 2010) ("These two conflicting areas of law have caused confusion to attorneys litigating these cases due to the two differing models of unincorporated entity law that presently underscore our default rules of entity governance.").

Delaware courts should adopt the opt-in standard, thereby adhering to the LLC's strong "freedom of contract" foundation. Fifth, it proposes an amendment to DLLCA section 18-1101(c) that, if incorporated, this Note suggests, would end this debate. Sixth, in addition to illustrating numerous deficiencies inherent in the opt-out standard, this Note explains other negative ramifications of adoption of such a standard. Finally, this Note provides helpful recommendations for Delaware practitioners to adhere to until the debate over default fiduciary duties in the LLC context is settled.

II. NECESSARY UNDERPINNINGS TO THE OPT-IN VS. OPT-OUT DEBATE

A. *The Rise of Delaware LLCs and Freedom of Contract*

Although a fairly new entity,[16] the LLC's significant impact on the business organization market, specifically in Delaware, is undeniable.[17] This is due, in part, to its unique makeup, which encompasses desirable features from both partnership and corporate forms.[18] In addition to offering both limited liability[19] and pass-through taxation,[20] arguably the most attractive attribute is the "statutory freedom granted to [LLC] members to shape, by contract, their own approach to common business

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[16]Larry E. Ribstein, *LLCs: Is the Future Here? A History & Prognosis*, BUS. L. TODAY, Nov./Dec. 2003, at 11 (explaining that in 1977, Wyoming became the first state to adopt an LLC statute).

[17]*See* Linda O. Smiddy & Lawrence A. Cunningham, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS: CASES, MATERIALS, PROBLEMS 162 (7th ed. 2010) ("The limited liability company has become, in a few short years, one of the most popular business organization forms.").

[18]*Id.* at 160 ("Limited liability companies are among the latest efforts to achieve favorable tax treatment while combining the best of partnership and corporate forms.").

[19]*See* Leyden & Dietrich, *supra* note 2, at 324 (observing that an LLC member's limited liability is analogous to that of a Delaware corporation stockholder); *see also* David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 476 (1998) ("In contrast to a limited partner in an LP, the limitation of liability of an LLC member is not jeopardized, in fact or theory, when the member participates in the management or control of the business of a Delaware LLC.").

[20]*See* Chrisman, *supra* note 1, at 466-78 (noting that the IRS "check-the-box" regulations gave LLCs the option to be taxed as a partnership and demonstrating through statistical analysis the positive impact it had on LLC formation).

'relationship' problems."[21] An LLC, unlike its corporate brethren, "is a powerful economic vehicle that . . . allows for *ultimate contractual customization* among its owners and management."[22]

Both the Delaware courts and legislature are clear—LLCs are "*creatures of contract*."[23] Specifically, the DLLCA states, "[i]t is the policy of [the DLLCA] to give maximum effect to the principle of *freedom of contract* . . . ."[24] Emphasizing the Delaware General Assembly's intent to distinguish LLCs from traditional corporate forms, the DLLCA warns courts that "[t]he rule that statutes in derogation of the common law are to be strictly construed *shall have no application to* [*the DLLCA*]."[25] Likewise, Delaware courts recognize that "[LLCs] are . . . 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility of the parties involved.'"[26]

According to the Delaware Supreme Court, LLC agreements are the "cornerstone" to Delaware LLCs.[27] Likewise, the Delaware Court of Chancery opined that an LLC agreement is sufficiently authoritative to displace statutory default rules by stating, "LLC members' rights begin with and typically end with the [LLC agreement]."[28] This entity-defining instrument enables Delaware LLC members to bargain and contract for the terms in the agreement regarding their relationship to the LLC and to one another.[29] This includes specifying certain rights and privileges, and of particular importance to this Note, fiduciary duties.[30]

Unlike corporate investors who have no meaningful opportunity to negotiate for specific rights and protections, LLC members "can easily . . . structure[] [LLC agreements] to carve out safe harbors for

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[21]R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, 2008 WL 3846318, at *4 (Del. Ch. Aug. 19, 2008) (quoting Haley v. Talcott, 864 A.2d 86, 88 (Del. Ch. 2004)).

[22]Steele, *supra* note 5, at 221-22 (emphasis added).

[23]*In re* Atlas Energy Res., LLC, 2010 WL 4273122, at *6 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823, 832 (2011) (emphasis added). Other courts also have described the LLC as a creature of contract. *See* Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 880 (Del. Ch. 2009); Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008), *aff'd*, 984 A.2d 124 (Del. 2009); *see also* DEL. CODE ANN. tit. 6, §§ 18-1101(a)-(b) (2005) (providing maximum effect to the freedom of contract).

[24]DEL. CODE ANN. tit. 6, § 18-1101(b) (2005) (emphasis added).

[25]*Id.* § 18-1101(a) (emphasis added).

[26]TravelCenters of Am., LLC v. Brog, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (quoting *In re* Grupo Dos Chiles, LLC, 2006 WL 668443, at *2 (Del. Ch. Mar. 10, 2006)).

[27]Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999).

[28]Walker v. Res. Dev. Co., 791 A.2d 799, 813 (Del. Ch. 2000).

[29]*See* Steele, *supra* note 5, at 231-32.

[30]*See id.* at 222.

self-dealing by managers where the parties . . . agree in writing."[31] As a result, the protections automatically afforded to corporate investors in the form of non-waivable, default fiduciary duties are unnecessary in the LLC context where members, pursuant to DLLCA section 18-1101(c), are expressly permitted to bargain and contract for their "expan[sion], restrict[ion], or *eliminat*[*ion*]," provided that the implied contractual covenant of good faith and fair dealing is not removed.[32]

B. *Fiduciary Duties Generally*

Fiduciary law is meant to help equalize the tension between the "social benefits [derived] from fiduciary relationships and the high risk of these relationships to entrustors."[33] Thus, where a fiduciary relationship exists, protections are superimposed to "induce[] [entrustors] to enter the relationship by assurances that overcome their concern for the safety of their assets."[34] For purposes of this Note, the term "fiduciary duties" refers only to the duties of loyalty[35] and care,[36] due to the Delaware Supreme Court's recent pronouncement that good faith[37] is merely part and parcel of the duty of loyalty.[38]

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[31]Steele, *supra* note 10, at 6.

[32]DEL. CODE ANN. tit. 6, § 18-1101(c) (2005) (emphasis added).

[33]Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1223 (1995).

[34]*Id.*

[35]*See* Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 132 (2006) ("[T]he duty of loyalty [is] . . . a strict duty not to act contrary to [the LLC's and its members'] interests."). Notably, the duty of loyalty is frequently labeled as a "duty of unselfishness." *Id.* However, it is really best defined, as the author points out, by Justice Cardozo's *Meinhard v. Salmon* holding, where he described the duty in a joint venture context as "[n]ot honesty alone, but the punctilio of an honor the most sensitive." Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). Justice Cardozo further noted that the duty of loyalty mandates "something stricter than the morals of the market place." *Id*.

[36]*See* Gold, *supra* note 35, at 132 ("The duty of care requires that the business manager follow a decisionmaking [sic] process that is not grossly negligent and consider all material information that is reasonably available.").

[37]*See id.* at 133 (discussing the meaning of good faith). Of the three duties, good faith warrants the most uncertainty. *See id.* ("The fiduciary duty of good faith is a source of potential confusion."). Without a fully clear definition, "this duty may cover instances where a fiduciary acts egregiously, intentionally abdicating their obligations in ways that do not implicate gross negligence or conflicts of interest." *Id.*

[38]*See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006) (holding that violations of the fiduciary duty of loyalty also encompass situations where

Interestingly, the DLLCA and the Delaware Revised Uniform Limited Partnership Act ("DRULPA")[39] are silent as to the aforementioned "triad."[40] In sharp contrast, Delaware jurisprudence is entrenched with common law interpretations of fiduciary duties in both partnership law and corporate governance.[41] This disparity of applicable law, combined with the LLC's rapid rise in popularity, arguably caused the Delaware courts to both hastily and unfoundedly "superimpose an overlay of common law fiduciary duties . . . where [non-corporate, alternative entities such as LLCs] have not contracted for those governance mechanisms."[42] For this reason, a brief examination of the rationale underlying common law fiduciary duties in both partnership law and corporate governance is appropriate.

1. Fiduciary Duties in Corporate Governance

Common law fiduciary duties in corporate governance are derived from agency, trust, and partnership law principles.[43] Generally, the corporation's directors are agents who must act for the benefit of the principal, the corporation, and its shareholders.[44] While no Delaware statute codifies a corporate director's requisite conduct,[45] the judiciary has been, and continues to be, relied upon to articulate such standards.[46] As a result, Delaware courts enjoy a plethora, albeit an imprecise one, of common law precedent derived from voluminous amounts of dispositions rendered by its esteemed judiciary.

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the fiduciary fails to act in good faith, and that the duty of good faith is a subsidiary of the duty of loyalty).

[39]DEL. CODE ANN. tit. 6, §§ 17-101 to 17-1111 (2005).

[40]Steele, *supra* note 10, at 5 (referring to the duties of care, loyalty, and good faith).

[41]*Id.* at 6 ("Delaware does . . . have an extensive body of common law addressing fiduciary duties imposed on managers, i.e., directors and officers, in the corporate structure.").

[42]*Id.* at 4.

[43]*Id.* at 8.

[44]*See* B. Ellen Taylor, *On New and Unjustified Restrictions on Delaware Directors' Authority*, 21 DEL J. CORP. L. 837, 871-72 (1996). *But see* Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 137 (2009) ("Even if [directors] do not act selfishly, they may lack strong invectives to maximize shareholder wealth.").

[45]Steele, *supra* note 10, at 6.

[46]*See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("[D]irectors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders."); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders.").

The rationale for imposing fiduciary duties in the corporate governance arena is simple. Corporate shareholders (the entrustors) have no bargaining power and are solely dependent on corporate directors, managers, officers, and controlling shareholders to act on their behalf to maximize their investment.[47] As a result, "fiduciary duties are mandatory constraints, the existence of which is necessary to curtail the possibility of abuse by [the corporation and its] directors."[48] In the absence of a fully enforceable breach of fiduciary duties claim against them, directors may lack motivation to maximize shareholders' wealth.[49] For this reason, fiduciary duties of corporate directors, managers, officers, and controlling shareholders are to remain unaltered and fully-enforceable in a court of equity to help balance the tension between the social benefits derived from investing in corporations and the high risk of this relationship to the investing public.[50] In short, "corporations need fiduciary duties, despite their indeterminacy, to address the misalignment of managers' incentives with those of their [shareholders]."[51]

2. Fiduciary Duties in Partnerships

In arguably the most fêted court decision involving business associations, *Meinhard v. Salmon*,[52] the court held that co-adventurers in a partnership arrangement owe to one another "the duty of the finest loyalty," a standard articulated by Justice Benjamin Cardozo as "the punctilio of an honor most sensitive."[53] Moreover, Justice Cardozo's pronouncement that this duty be enforced by the courts with an

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[47]*See* MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1126-27 (Del. 2003) (discussing the allocation of power between shareholders and a board of directors).

[48]David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 494 (2004); *see also* E. Norman Veasey with Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1413 (2005) ("Directors are fiduciaries, duty-bound to protect and advance the best interests of the corporation. When those interests conflict—or may conflict—with the personal interests of the fiduciaries, the fiduciaries' interests must be sublimated to those of the corporation.").

[49]Ribstein, *supra* note 44, at 137.

[50]*See* Frankel, *supra* note 33, at 1223.

[51]Ribstein, *supra* note 44, at 142-43.

[52]164 N.E. 545 (N.Y. 1928).

[53]*Id.* at 546 ("Joint adventurers, *like copartners*, owe to one another, while the enterprise continues, the duty of the finest loyalty.") (emphasis added).

"uncompromising rigidity"[54] was indicative of the twentieth century jurisprudential approach to fiduciary duties.[55] Over eighty years later, this standard still applies where a partner plays a managerial role in a centrally-managed firm.[56]

The rationale for imposing fiduciary duties in the partnership context is based on the notion that although partners are motivated to properly manage the partnership because they are personally liable for its debts, their ability to delegate managerial power increases the need for fiduciary duties, and they are, in a sense, at each other's mercy.[57] Nevertheless, an ongoing debate exists as to whether such duties are waivable in the partnership context.[58] Regardless of the express allowance of waiver under Delaware's partnership acts,[59] "there is broad consensus that fiduciary duties, absent waiver, apply by default in the partnership context."[60]

3. Fiduciary Duties in Delaware LLCs

Significantly, the DLLCA was modeled from the widely accepted DRULPA.[61] As a result, case law interpreting limited partnerships ("LPs") under DRULPA is extremely relevant for the purposes of analyzing the DLLCA and LLCs. Because Delaware courts routinely intertwine rationales between the two alternative entities, this Note does the same.

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[54]*Id.*

[55]Scott Gordon Wheeler, Comment, *LLC Fiduciaries: Where Has All the Good Faith Gone?*, 59 U. KAN. L. REV. 1063, 1066 (2011).

[56]*See* Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 240 (2005).

[57]*See id.* (discussing fiduciary duties as applied to partners who act as managers or agents of the partnership).

[58]*See* Wheeler, *supra* note 55, at 1067 (highlighting the divergent viewpoints). In brief, one view holds that prior to RUPA, common law considerably restricted the modification of fiduciary duties. *Id.* An opposing view, however, holds that RUPA's mandatory fiduciary duties oppose the common law view that such duties were not compulsory. *Id.*

[59]DEL. CODE ANN. tit. 6, § 17-1101(d) (2005).

[60]Wheeler, *supra* note 55, at 1067.

[61]Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) ("The [DLLCA] has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP Act. Under the Act, a member of an LLC is treated much like a limited partner under the LP Act.") (footnotes omitted); *see also* Cohen, *supra* note 19, at 476 ("The LLC Act was modeled on Delaware's popular limited partnership (LP) statute.").

While a cloud of confusion has always hovered over the application of fiduciary duties,[62] in no context do they cause more head-scratching than LLCs.[63] Perpetuating this confusion is the Delaware Court of Chancery's proclivity to "refer by analogy, where appropriate, to the large body of corporate decisions" rather than conducting a purely contractual analysis, specifically, where an LLC agreement is silent or ambiguous regarding the fiduciary duties owed.[64] As a result of this conundrum, two distinct views exist—"opt-in" and "opt-out" discussed *infra*—making this issue ripe for the Delaware Supreme Court's review and/or amendment by the General Assembly.[65]

The uncertainty surrounding the role of fiduciary duties in the LLC context dates back to the DLLCA's enactment in 1992. At that time, section 18-1101(c) stated in its pertinent part, "[t]o the extent that . . . a member or manager has duties (including fiduciary duties) . . . [those] duties may be *expanded or restricted* by provisions [of the LLC] agreement."[66] Notably, like DRULPA,[67] the DLLCA did not explicitly permit the elimination of fiduciary duties. Absent explicit authorization, Delaware courts routinely held that fiduciary duties in the LLC context applied by default and were non-waivable, even where parties to the LLC agreement bargained and contracted for the ability to do so.[68]

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[62]*See* Ribstein, *supra* note 56, at 211 (summarizing that fiduciary duties have resulted in confusion over issues such as "the relationship between 'good faith' and fiduciary duties, distinguishing the duties of influence, knowledge and sophistication, and whether a fiduciary can contract out of default duties") (footnotes omitted).

[63]*Id.* at 211-12.

[64]Francis G.X. Pileggi & Sophia Siddiqui, *Benefits of Being a Delaware Company and Recent Developments in the Governance of LLCs*, DEL. CORPORATE AND COMMERCIAL LITIG. BLOG 7 (July 30, 2008), http://www.delawarelitigation.com/uploads/file/int98.PDF.

[65]Interestingly, this conundrum is wholly inconsistent with related judicial dispositions. With the exception of fiduciary duties, LLC contractual provisions have trumped corporate governance and common law principles in all other areas of the LLC. *See* CML V, LLC v. Bax, 28 A.3d 1037, 1046 (Del. 2011) (concluding that derivative standing did not have to be granted to a creditor seeking a derivate suit against an LLC solely because it would be granted in a similar situation under corporate law); R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, 2008 WL 3846318, at *4, *8 (Del. Ch. Aug. 19, 2008) (holding contractual provisions specifying the terms of dissolution trumped corporate common law principles); *see also* Wood v. Baum, 953 A.2d 136, 141 (Del. 2008) (noting that LLC bylaws do not have to conform to corporate norms).

[66]DEL. CODE ANN. tit. 6, § 18-1101(c) (Supp. 1992) (emphasis added).

[67]*See id.* § 17-1101(d).

[68]*See* Gold, *supra* note 35, at 142-43.

A few Delaware Court of Chancery LP decisions, however, held oppositely, noting that fiduciary duties were not only subject to restriction and expansion but were also subject to *elimination*.[69] In 2002, however, the Delaware Supreme Court rejected this notion in *Gotham Partners L.P. v. Hallwood Realty Partners L.P.*[70] In reaching this conclusion, the Court criticized the lower court's "questionable statutory interpretation,"[71] by stating that "[t]here is no mention in [section] 17-1101(d)(2), or elsewhere in DRULPA . . . that a limited partnership agreement may *eliminate* the fiduciary duties or liabilities of a general partner."[72] The *Gotham Partners* decision was a result of the Court's characterization of the LP parties as "dependent"—such as an agent to a principal—in rationalizing its application of traditional fiduciary duties.[73]

In reaction to *Gotham Partners*' restrictive interpretation of DRULPA section 17-110(d),[74] the Delaware General Assembly amended it in 2004 to provide that fiduciary duties in the LP context may be "expanded or restricted or *eliminated*."[75] The DLLCA followed suit, incorporating by amendment its corresponding section 18-1101(c).[76] In doing so, the Delaware legislature signaled that LLC members may contract for the elimination of fiduciary duties.

III. OPT-IN VS. OPT-OUT: ANALYZING BOTH SCHOOLS OF THOUGHT

The rationale behind the Delaware legislature's 2004 amendment to DLLCA section 18-1101 is clear: unlike in corporate governance, LLCs are "creatures of contract" whose members, if they so choose, are

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[69]Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 795 A.2d 1, 31 (Del. Ch. 2001), *aff'd in part*, *rev'd in part*, 817 A.2d 160 (Del. 2002); Sonet v. Timber Co., 722 A.2d 319, 323 (Del. Ch. 1998) (noting that § 17-1101(d) "apparently [allows] broad license to enhance, reform, or *even eliminate* fiduciary duty protections") (emphasis added). Similar freedom of contract manifestations were made in LLC holdings. *See* Elf Atochem N. Am. Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999) (explaining that the DLLCA grants members with "the broadest possible discretion in drafting their [LLC] agreements . . . [and] [o]nce [members] exercise their contractual freedom in their [LLC] agreement, the [members] have a great deal of certainty that their [LLC] agreement will be enforced in accordance with its terms").

[70]817 A.2d 160, 167-68 (Del. 2002).

[71]*Id.* at 167.

[72]*Id.* at 168.

[73]*See* Steele, *supra* note 10, at 13.

[74]*See id.* at 10-11.

[75]DEL. CODE ANN. tit. 6, § 17-1101(d) (2005) (emphasis added).

[76]*Id.* § 18-1101(c).

free to *eliminate* traditional fiduciary duties.[77] So, while it is clear that LLC agreements may eliminate fiduciary duties, one issue still remains: whether traditional default fiduciary duties, engrained in partnership law and corporate governance, exist where an LLC agreement does not explicitly eliminate or is silent regarding fiduciary duties owed.

As a result, two divergent schools of thought have emerged in Delaware. Relying on the freedom of contract policy underlying the DLLCA, "opt-in" supporters argue that "[c]ourts should recognize the [LLC members'] freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties . . . where the parties have not contracted for those governance mechanisms in the [LLC agreement]."[78] In sharp contrast, "opt-out" supporters disregard fundamental contract principles and instead insert default fiduciary duties into LLC agreements unless there is an explicit and unambiguous provision in the LLC agreement opting-out of these duties.[79]

A. *The Opt-in Standard*

1. Opt-in: The "Contractarian" Approach

> "For Shakespeare, it may have been the play, but for a Delaware limited liability company, *the contract's the thing*."[80]

Chief Justice Steele of the Delaware Supreme Court[81] and other opt-in supporters, referred to as "contractarians," focus on the underlying "freedom of contract" policy inherent in the DLLCA.[82] Accordingly, opt-

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[77]Christopher Hanno, *The Other "F" Word: Fiduciary Duties, Fiduciary Waivers, and the Delaware Limited Liability Company*, 52 S. TEX. L. REV. 101, 104, 106 (2010).

[78]Steele, *supra* note 10, at 4.

[79]*See* Twin Bridges Ltd. P'ship v. Draper, 2007 WL 2744609, at *18 (Del. Ch. Sept. 14, 2007) (quoting Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999)) ("A court will superimpose statutory default rules onto a written agreement 'only in situations where the partners have not expressly made provisions in their partnership agreement,' or where the agreement is inconsistent with mandatory statutory provisions.").

[80]R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, 2008 WL 3846318, at *1 (Del. Ch. Aug. 19, 2008).

[81]*See generally* Steele, *supra* note 5; Steele *supra* note 10 (positing the Chief Justice's view that focuses on the freedom of contract inherent in the DLLCA).

[82]*See* Hanno, *supra* note 77, at 104.

in supporters conduct *contractual* analyses—rather than apply common law partnership or corporate governance principles—to determine, among other things, the duties owed amongst the LLC members.[83] Essentially, opt-in supporters believe that "[c]ourts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties . . . where the parties have not contracted for those governance mechanisms in [its] [LLC agreements]."[84]

The opt-in supporters' rationale is simple. Sophisticated parties[85] enter into LLCs—as opposed to corporations or other business associations—due to their desire to contractually create an entity exclusively tailored to meet their business needs, and the DLLCA allows them to do just that.[86] As such, LLC members vigilantly bargain and contract for the terms in their LLC agreement that they deem necessary based on a cost/benefit analysis.[87] Stated differently, if a prospective LLC member does not want to spend a premium to receive certain rights or protections, he or she may decline to do so. The resulting LLC agreement, therefore, is an all-inclusive contract that defines the "scope, structure, and personality of [the LLC]."[88] Moreover, "LLC members' rights begin with and typically end with the [LLC agreement]."[89]

In regard to fiduciary duties, for example, opt-in supporters contend that LLC agreements "can easily be structured to carve out safe harbors . . . where the parties . . . agree in writing."[90] As a result, they contend that no default fiduciary duties exist where the LLC agreement is silent or ambiguous as to the duties owed because "implicit in [the]

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[83]Steele, *supra* note 10, at 4.

[84]*Id.*

[85]*See, e.g.*, Arby Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1063 (Del. Ch. 2006) ("In the alternative entity context, *where it is more likely that sophisticated parties have carefully negotiated the governing agreement*, the General Assembly has authorized even broader exculpation, to the extent of eliminating fiduciary duties altogether.") (emphasis added).

[86]Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) ("The [LLC] Act can be characterized as a 'flexible statute' because it generally 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.").

[87]*See, e.g.*, *Arby Partners V*, 891 A.2d at 1063.

[88]Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *1 (Del. Ch. May 7, 2008), *aff'd*, 984 A.2d 124 (Del. 2009).

[89]Walker v. Res. Dev. Co., 791 A.2d 799, 813 (Del. Ch. 2000).

[90]Steele, *supra* note 10, at 6.

process [of drafting the *specific terms* of the LLC agreement] were considerations of fee arrangements and investment entry costs."[91]

Additionally, opt-in supporters like to hang their contractual, non-fiduciary duty hat on the Delaware General Assembly's oft repeated freedom of contract policy.[92] DLLCA section 18-1101(b), for example, states, "[i]t is the policy of [the DLLCA] to give the maximum effect to the principle of *freedom of contract* . . . ."[93] As a result, opt-in supporters contend that traditional fiduciary duties engrained in corporate governance are irrelevant in the LLC context.[94] The fact that the Delaware General Assembly made no mention of default fiduciary duties, they contend, further supports this notion,[95] especially when read in concert with section 18-1101(a), which states, "[t]he rule that statutes in derogation of the common law are to be strictly construed *shall have no application to* [*the DLLCA*]."[96] Opt-in supporters are quick to point to the Delaware legislature's sudden reaction—with its amendment allowing for the elimination of fiduciary duties—to the Delaware Supreme Court's holding in *Gotham Partners*,[97] as symbolic of the legislature's desire to eradicate any notion that fiduciary duties are to be applied by default.[98]

Chief Justice Steele noted:

> If the import of the language of the August 2004 amendment [to the LLC Act], by its reference to "restricted or eliminated by provisions in the [LLC] agreement," was not clear enough, the *quintessential contract reference*, "provided that the [LLC] agreement may not eliminate the *implied contractual covenant of good faith and fair dealing*," should make the legislature's intent abundantly clear. This language, carefully borrowed from contract law,

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[91] *Id.* (emphasis added).

[92] *See* Hanno, *supra* note 77, at 104.

[93] DEL. CODE ANN. tit. 6, § 18-1101(b) (2005) (emphasis added).

[94] *See, e.g.*, Steele, *supra* note 10, at 4.

[95] *Id.* at 10.

[96] DEL. CODE ANN. tit. 6, § 18-1101(a) (2005) (emphasis added).

[97] Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 795 A.2d 1, 1 (Del. Ch. 2000), *aff'd in part, rev'd in part*, 817 A.2d 160 (Del. 2002).

[98] *See, e.g.*, Steele, *supra* note 10, at 13 ("The General Assembly clearly established, in response to *Gotham*, that contractual relationships and not status relationships control the duties and liabilities of parties to a contractual entity agreement.").

> as distinguished from corporate law, to set the parameters of action deemed to be in "good faith," must be read as an affirmation that the three-legged stool—the "triad" or "troika" of corporate fiduciary duty—is not the lens through which the action of parties to a . . . limited liability company agreement will be viewed.[99]

Additionally, Chief Justice Steele has explained that the DLLCA's prohibition against eliminating the implied contractual covenant of good faith and fair dealing[100] strongly suggests that the legislature intends the courts use these covenants—not traditional fiduciary duties—to police LLC agreements.[101]

2. Opt-in: Delaware Court of Chancery's Representative Dispositions

The Delaware Court of Chancery has, on occasion, applied contractarian principles to determine whether default fiduciary duties exist where an LLC agreement is silent as to the duties owed. In *Fisk Ventures, LLC v. Segal*,[102] for example, the court held that "[b]ecause the [a]greement does not expressly articulate fiduciary obligations, they are eliminated."[103] In reaching this conclusion, then-Chancellor Chandler[104] noted that, pursuant to DLLCA section 18-1101(c), an "LLC [a]greement eliminates fiduciary duties to the maximum extent permitted by law by flatly stating that members have no duties other than those expressly articulated in the [a]greement."[105] A noted contractarian,[106] then-

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[99]*Id.* at 14 (first emphasis added) (footnote omitted).

[100]DEL. CODE ANN. tit. 6, § 18-1101(c) (2005).

[101]Steele, *supra* note 10, at 14.

[102]2008 WL 1961156 (Del. Ch. May 7, 2008), *aff'd*, 984 A.2d 124 (Del. 2009).

[103]*Id.* at *11.

[104]Chancellor Chandler has since retired and his vacancy was filled by Chancellor Strine. *See Judicial Officers of the Court of Chancery*, DEL. STATE COURTS, http://courts.delaware.gov/Chancery/judges.stm (last visited Feb. 10, 2012). Clearly, Chief Justice Steele has lost a powerful opt-in ally from the Court of Chancery.

[105]*Fisk Ventures*, 2008 WL 1961156, at *11.

[106]Even before the 2004 amendment, then-Chancellor Chandler expressed the viewpoint that the contracted-for terms in the parties' alternative entity agreement should always prevail. *See* Kahn v. Icahn, 1998 WL 832629, at *3 (Del. Ch. Nov. 12, 1998), *aff'd*, 746 A.2d 276 (Del. 2000), *reprinted in* 24 DEL. J. CORP. L. 738, 745 (1999) (dismissing a claim against a general partner in an LP for breached fiduciary duties by denying the argument that the duty of loyalty applied irrespective of clear and unambiguous modification provided in the agreement); *see also* Sonnet v. Timber Co., 722 A.2d 319, 327 (Del. Ch. 1998) (dismissing a claim based on a general partner in an LP receiving an unreasonably large number of shares, reasoning the LP agreement plainly spelled out that the general partner had uninhibited

Chancellor Chandler applied a strict contractual analysis, stating, "[t]o find that the Court must decide whose business judgment was more in keeping with the LLC's best interests[,] would cripple the policy underlying the LLC Act promoting freedom of contract."[107] Moreover, he stressed that fiduciary duties must be expressly added into the LLC agreement because "[c]ontractual language defines the scope, structure, and personality of limited liability companies."[108]

Similarly, the Court of Chancery has, on occasion, applied contractarian principles in refusing to superimpose fiduciary duties where the LLC agreement is "inconsistent with the contractual bargain struck by parties to an LLC."[109] In *Related Westpac LLC v. JER Snowmass LLC*,[110] for example, the court rejected a breach of fiduciary duties claim alleged against defendant for "unreasonably" declining a capital call.[111] The LLC agreement did not contain an explicit waiver of fiduciary duties, though it stated that capital calls were not to be "unreasonably withheld or delayed, *except with respect to* [*the defendant*] . . . ."[112] In analyzing this contractual provision, the court implied that the defendant *could* unreasonably deny or delay capital calls, and emphasized that the parties' "contractual choice governs and cannot be supplanted by the application of inconsistent fiduciary duty principles . . . ."[113] In reaching its decision, the court noted that this fiduciary duties claim must fail; otherwise, "the primacy of contract law over fiduciary law in matters involving . . . contractual rights and obligations [would be undermined]."[114]

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discretion to secure mergers).

[107] *Fisk Ventures*, 2008 WL 1961156, at *9.

[108] *Id.* at *1.

[109] Related Westpac LLC v. JER Snowmass LLC, 2010 WL 2929708, at *8 (Del. Ch. July 23, 2010).

[110] *Id.* This holding runs counter to other Court of Chancery opinions where fiduciary duties were imputed when terms were similarly ambiguous. However, this judicial pronouncement is somewhat limited because the defendant was largely a passive investor with few managerial powers outside of veto rights of material actions. *Contra* Wheeler, *supra* note 55, at 1074. As of yet, the Court of Chancery has not yet applied this precedent to a case where significant managerial power have been invested in the defendant. *Id.*

[111] *Related Westpac LLC*, 2010 WL 2929708, at *1.

[112] *Id.* at *3.

[113] *Id.* at *8.

[114] *Id.* (quoting Madison Realty Partners 7, LLC v. Ag ISA, LLC, 2001 WL 406268, at *6 (Del. Ch. Apr. 17, 2001)) (internal quotations marks omitted) (alteration in original).

B. *The Opt-out Standard*

1. Opt-out: The "Traditionalist" Approach

Opt-out supporters are often referred to as "traditionalists" due to their belief that notwithstanding the fact that firms are formed through contract, the manager-to-firm relationship remains intrinsically fiduciary.[115] At the same time, they do not deny that DLLCA section 18-1101(c) permits the elimination of fiduciary duties.[116] This conflict of two distinct concepts produces a bifurcated analysis when determining the existence (or lack thereof) of fiduciary duties in LLC agreements. Similar to contractarians, opt-out supporters begin their analysis by conducting a contractual analysis, looking to the LLC agreement to determine if fiduciary duties have either been (1) sufficiently articulated, or (2) explicitly eliminated.[117] If it is determined that the LLC agreement does not explicitly eliminate these duties, opt-out supporters abandon the contractual analysis and revert to a status relationship analysis.[118] As a result, traditional fiduciary duties of loyalty and care are superimposed into the LLC agreement, regardless of the fact that the LLC members may very well have bargained and contracted for the elimination of such protections.[119]

The opt-out supporters' rationalization of this position is straightforward. First, they believe that within the relationship of managers and members to the LLC entity, "despite the wide latitude of freedom of contract afforded to contracting parties,"[120] a fiduciary relationship exists analogous to that which a director owes a corporation and its shareholders.[121] Second, for the above stated reason, they see no

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[115]Hanno, *supra* note 77, at 105.

[116]*See, e.g.*, *In re* Atlas Energy Res., LLC, 2010 WL 4273122, at *6 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823, 834 (2010) ("One aspect of this flexibility [provided by LLCs] is that parties to a limited liability agreement can contractually expand, restrict, modify, or *fully eliminate the fiduciary duties* owed by the company or its members, subject to certain limitations.") (emphasis added).

[117]*Id.* at *7, 36 DEL. J. CORP. L. at 834 ("When interpreting the LLC Agreement, the Court must, as with any contract, begin the analysis with an examination of the plain language.").

[118]*See infra* Part II.B.2.

[119]*Atlas Energy Res.*, 2010 WL 4273122, at *7, 36 DEL. J. CORP. L. at 834 ("The Court is especially wary of eliminating such duties in the context of a publicly traded limited liability company without sufficient evidence within the contractual language of the parties' intent to do so.").

[120]Kelly v. Blum, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010).

[121]*Atlas Energy Res.*, 2010 WL 4273122, at *6, 36 DEL. J. CORP. L. at 832.

danger in applying traditional partnership and corporate law principles, such as default fiduciary duties, to LLCs.[122] Third, opt-out supporters assert that a plain reading of DLLCA § 18-1101(c), which includes the word "duties," clearly indicates that default fiduciary duties do exist in the LLC context.[123] Finally, they argue that fiduciary duties must apply because the residual implied contractual covenant of good faith and fair dealing is manifestly insufficient to protect the interests of the contracting parties—especially unsophisticated ones—in comparison with the traditional fiduciary duties entrenched in corporate governance.[124]

In 2009, a string of Delaware Court of Chancery holdings emphasized an opt-out-type analysis, two of which are discussed below.[125] Examined immediately after this line of cases is a 2012 Chancery decision involving a manager-managed LLC utilizing similar rationales and adding additional justifications supporting the opt-out viewpoint.

2. Opt-out: Delaware Court of Chancery's Representative Dispositions

The Delaware Court of Chancery, in *Kelly v. Blum*, held that LLC managers owe fiduciary duties where the LLC agreement does not explicitly eliminate such duties.[126] In reaching this conclusion, Vice Chancellor Parsons abandoned a contractual analysis of the LLC

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[122] *Id.* at *7, 36 DEL. J. CORP. L. at 834 (applying analogous "traditional fiduciary duties [to LLC members] that controlling shareholders owe minority shareholders").

[123] *See* Hanno, *supra* note 77, at 106 ("One can argue that the plain language of section 18-1101 reveals that the drafters contemplated that inherent fiduciary duties exist in any LLC agreement . . . [and the] [u]se of the word [duties] *may* lead[] one to believe that the parties who create the LLC have sole discretion to determine which fiduciary duties will apply.").

[124] *See generally* 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 (2004) (suggesting that self-interested behavior will be better checked under fiduciary duties for a variety of reasons, including better protection of unsophisticated parties, providing a broader standard than under the contractual covenants for more effective judicial enforcement, and setting a higher code of ethics for the business community).

[125] *See In re* Atlas Energy Res., LLC, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823 (2010); Kelly v. Blum, 2010 WL 629850 (Del. Ch. Feb. 24, 2010); Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

[126] *Kelly*, 2010 WL 629850, at *12.

agreement because it did not include an explicit waiver of such duties.[127] Staying true to the opt-out approach, the initial contractual analysis was replaced by one that focused on the *status* of the parties to the LLC agreement.[128] As a result, the court superimposed by default the traditional fiduciary duties of loyalty and care.[129] In fact, the Vice Chancellor expressly wrote, "LLC's managers and controlling members . . . owe the traditional fiduciary duties that directors and controlling shareholders in a corporation would."[130]

Similarly, where an LLC agreement contained contradictory terms regarding fiduciary duties, the Delaware Court of Chancery has, on occasion, applied the opt-out standard to determine whether the parties to the agreement sufficiently eliminated such duties.[131] For example, in *Bay Center Apartments Owner, LLC v. Emery Bay PKI LLC*, the court held that fiduciary duties applied to both the LLC and its managing member[132] because the LLC agreement contained two contradictory statements regarding fiduciary duties and therefore did not unambiguously eliminate them.[133] In this breach of fiduciary duties claim, plaintiff-LLC member alleged that co-defendants, the LLC and its managing member, secretly diverted cash flow with a third-party loan provider.[134] Chancellor

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[127] *Id.* at *11 ("Because no clause in the 2008 LLC Agreement explicitly restricts or eliminates the default applicability of fiduciary duties, I find that [defendant managers] were required to treat [plaintiff member] in accordance with such traditional fiduciary duties.").

[128] *Id.*

[129] *See id.* at *10-*11.

[130] *Kelly*, 2010 WL 629850, at *1.

[131] *See, e.g.*, Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, *8-*9 (Del. Ch. Apr. 20, 2009).

[132] *Id.* at *9-*11. The court reasoned that the defendant managing member also owed fiduciary duties through relying on the analysis found in the infamous *In re USA Cafés, L.P. Litigation* opinion, a limited partnership case that held "those affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners." *Id.* at *9-*10 (internal quotation marks and citation omitted). The court stated this premise applies in limited circumstances—either where the affiliate exerts direct control over the entity property or uses the entity property to his self-benefit—and that the plaintiffs had plead sufficient facts to meet both of these scenarios. *Id.*

[133] *Id.* at *8 ("[T]he LLC Agreement states . . . that the members of Emery Bay both owe each other the default fiduciary duties that exist between members of an LLC absent alteration in an LLC agreement, and at the same time owe each other no duty of any kind not imposed by the LLC Agreement itself.").

[134] *Id.* at *1-*2. The LLC agreement designated an individual—a later joined defendant to the case—as the managing member and granted him sizeable authority to manage the project's affairs. *Id.* at *2. The agreement also detailed certain transactions requiring the plaintiff's consent, such as the refinancing or restructuring of any loan. *Id.*

Strine[135] focused on the status relationship of the parties (rather than applying a contractual analysis), stating that the "interpretive scales . . . tip in favor of preserving fiduciary duties under the rule that drafters of chartering documents must make their intent to eliminate fiduciary duties plain and unambiguous."[136]

In addition to the aforementioned line of Chancery dispositions, Chancellor Strine most recently utilized the opt-out analysis in *Auriga Capital Corp. v. Gatz Properties*.[137] Confronted with a manager-managed LLC,[138] the Chancellor held that fiduciary duties apply by default, noting that "the LLC agreement here does not displace the traditional duties of loyalty and care that are owed by *managers* of Delaware LLCs to their investors in the absence of a contractual provision waiving or modifying those duties."[139] In this lengthy opinion, Chancellor Strine provided several justifications for applying fiduciary duties by default in the LLC context. First, the court turned to the catch-all "law and equity" provision contained in the DLLCA, indicating that fiduciary duties, which are grounded in equity, should apply to LLC managers.[140] Second, the Chancellor posited that a manager-managed LLC shares many of the same characteristics as its corporate counterpart; therefore, according to the court, "it seems *obvious* that . . . a manager of an LLC would qualify as a fiduciary of that LLC and is members."[141] Third, Chancellor Strine, referencing the 2004 DLLCA amendment which permits the elimination of fiduciary duties in LLC agreements,[142] reasoned that LLC agreements cannot eliminate fiduciary duties if there

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[135]*See supra* note 104.

[136]*Bay Ctr. Apartments Owner*, 2009 WL 1124451, at *9.

[137]40 A.3d 839 (Del. Ch. 2012), *aff'd* 2012 WL 5425227 (Del. Nov. 7, 2012).

[138]Notably, the manager-managed LLC is not the default LLC form. *See* DEL. CODE ANN. tit. 6, § 18-101(6) (2005) (defining a Delaware LLC as "a limited liability company formed under the laws of the State of Delaware and having 1 or more *members*.") (emphasis added). "Thus, in the first instance, for the Court to attempt to resolve the important question of the existence of default fiduciary duties for members or managers of Delaware LLCs upon the facts of this case must necessarily muddy the waters of any judicial analysis." Ann E. Conaway & Peter I. Tsoflias, *Challenging Traditional Thought: No Default Fiduciary Duties in Delaware Limited Liability Companies After* Auriga, J. BUS. & SEC. L. (forthcoming) (manuscript at 26), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1969053.

[139]*Auriga*, 40 A.3d at 843 (emphasis added).

[140]*Id*. at 849-50; DEL. CODE ANN. tit. 6, § 18-1104 ("In any case not provided for in this chapter, the rules of law and equity, including the law merchant, shall govern.").

[141]*Auriga*, 40 A.3d at 850-51.

[142]*See supra* Part II.B.3.

are no duties to eliminate in the first place.[143] Finally, the Chancellor provided several policy justifications for applying fiduciary duties by default, namely, that the implied covenant cannot adequately protect investors in the unicorporated world.[144]

C. *Preview by Analogy: Delaware Supreme Court's Disposition in* Auriga *and Similar Contexts*

Although not explicitly addressing the issue of default fiduciary duties, the Delaware Supreme Court, writing *per curiam*, recently affirmed the Court of Chancery's holding in *Auriga* that such duties were owed (and in fact, breached) "solely on contractual grounds."[145] In reaching its conclusion that such duties were owed, the Supreme Court looked to the "plain language" of the disputed provision contained in the parties' LLC agreement and "construe[d] its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons."[146] Conversely, the Supreme Court took issue with Chancery's discussion on the existence of default fiduciary duties, and chastened that it should not have been decided.[147] The Supreme Court reasoned that because issue could have been "decided solely by reference to the LLC agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction."[148] Moreover, the Supreme Court also noted the existence of fiduciary duties under the LLC agreement was no longer even being argued by the parties.[149] Accordingly, the Supreme Court labeled Chancery's discussion on the application of default fiduciary duties as "dictum without any precedential value."[150]

In attempting to ascertain the Delaware Supreme Court's likely disposition regarding the issue of whether default fiduciary duties apply

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[143] *Auriga*, 40 A.3d at 851-52.

[144] *Id.* at 853-56. Other policy justifications include the alteration of LLC agreements drafted in reliance upon equitable default duties and the erosion of Delaware's credibility amongst investors. *Id*.

[145] Gatz Props., LLC v. Auriga Capital Corp., No. 148, 2012, slip op. at 16 (Del. Nov. 7, 2012) (per curiam).

[146] *Id.* at 13.

[147] *Id.* at 24.

[148] *Id.*

[149] *Auriga*, No. 148, 2012, slip op. at 24.

[150] *Id.*

in LLC agreements, it is also helpful to examine holdings in analogous contexts where the court applies similarly-applicable legal concepts. Below are examples of such dispositions. Both, it should be noted, exhibit strong contractarian undertones.

In line with Chief Justice Steele and other opt-in supporters, the Delaware Supreme Court has held, in the LLC context, contractual provisions trump traditional partnership and corporate law provisions involving: bylaws, dissolution, and derivative standing limitations.[151] In September 2011, for example, the Delaware Supreme Court in *CML V, LLC v. Bax*[152] affirmed the Court of Chancery's holding that the plaintiff-creditor lacked standing under the DLLCA to bring a derivative suit.[153] The plaintiff-creditor argued, on appeal, that derivative standing should be granted because it is permissible in similar circumstances under corporate law.[154] The Supreme Court disagreed—and did so *unanimously*.[155] In doing so, it recognized that the Delaware General Assembly had the authority to formulate a different derivative standing limitation for LLCs than corporations, and it had done so here.[156] Further distinguishing the two business association types, the Delaware Supreme Court noted that statutorily-created LLCs did not exist at common law, and therefore, the DLLCA should always take precedence over any borrowed common law principles.[157] Finally, in dicta, the Court stated

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[151] *See* cases cited *supra* note 65.

[152] 28 A.3d 1037 (Del. 2011), *aff'g* 2010 WL 4517795 (Del. Ch. Nov. 3, 2010).

[153] *Id.* at 1039.

[154] *Id.* at 1043.

[155] *See id.* at 1039.

[156] *CML V, LLC*, 28 A.3d at 1043. In describing the Delaware General Assembly's ability to create new legal standards, the Delaware Supreme Court stated:

> [T]he General Assembly is free to elect a statutory limitation on derivative standing for LLCs that is different than that for corporations, and thereby preclude creditors from attaining standing. The General Assembly is well suited to make that policy choice and we must honor that choice. In this respect, *it is hardly absurd for the General Assembly to design a system promoting maximum business entity diversity. Ultimately, LLCs and corporations are different*; investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights.

Id. (emphasis added).

[157] *Id.* at 1045 ("Limited liability companies, unlike corporations, did not exist at common law. . . . Consequently, when adjudicating the rights, remedies, and obligations associated with Delaware LLCs, courts must look to the LLC Act because it is only the statute that creates those rights, remedies, and obligations.").

only "where the General Assembly has not defined a right, remedy, or obligation with respect to an LLC, courts should apply the common law" and where a right has been defined, "courts *cannot* interpret the common law to override the express provisions the General Assembly adopted."[158]

The *CML V, LLC v. Bax* decision certainly was not the first time Delaware's highest court emphasized the potency of parties' contractual rights. In April 2010, the Delaware Supreme Court sitting *en banc* in *Nemec v. Shrader*,[159] with Chief Justice Steele and Justices Holland and Ridgely for the majority,[160] held that the alleged breaches of fiduciary duties were futile because the directors had the exclusive contractual right in their governing agreement to redeem retired stockholders' shares.[161] Here, plaintiff-investors alleged that defendant-corporation breached its fiduciary duties when shares of two retiring shareholders were redeemed prior to a merger, resulting in an additional $60 million in proceeds for the transaction.[162] Consequently, "[a]ny separate fiduciary duty claims that might arise out of the [c]ompany's exercise of its contract right, therefore, were foreclosed."[163] The holding in *Nemec* bolsters opt-in supporters' contention that contractual rights trump default fiduciary duties—even in the *corporate* context.

IV. THE PROPER STANDARD: DELAWARE MUST ADOPT THE "OPT-IN" STANDARD WHERE THE LLC AGREEMENT IS SILENT AS TO THE FIDUCIARY DUTIES OWED

Superimposing default fiduciary duties into LLC relationships, *ex post*, is contrary to legislative intent in at least two respects: (1) LLCs are "creatures of contract" whose relationships must be governed solely by the LLC agreement's terms; and (2) the DLLCA, while not explicitly stating such, strongly suggests the inapplicability of default fiduciary duties in the LLC context. Notably, the statutory language found in the

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[158] *Id.* (emphasis added).

[159] 991 A.2d 1120 (Del. 2010).

[160] The Justices who signed onto the majority were Chief Justice Steele, Justice Holland, and Justice Ridgely. Justice Jacobs filed a dissenting opinion joined by Justice Berger. *See id*. at 1122.

[161] *Nemec*, 991 A.2d at 1129 ("Even though the [d]irectors caused the [c]ompany to redeem the plaintiffs' shares when it did, the fiduciary duty claim still arises from a dispute relating to the exercise of a *contractual* right—the [c]ompany's right to redeem the shares of retired nonworking stockholders.").

[162] *Id.* at 1124-25.

[163] *Id.* at 1129.

DLLCA, and the intended force behind it, is particularly significant because the LLC was created exclusively by statute.[164]

A. *The Delaware General Assembly's Policy of "Freedom of Contract" in the LLC Context*

The Delaware General Assembly's intent is clear: LLCs are "creatures of contract."[165] Additionally, the DLLCA provides, "[i]t is the policy of the [DLLCA] to give the maximum effect to the principle of *freedom of contract* . . . ."[166] This concept is endorsed specifically for the purpose of allowing parties to create a "highly specialized and customized vehicle, specifying the duties and benefits among owners and managers."[167] Finally, if one is not persuaded by the aforementioned reasons, the DLLCA's "quintessential contract reference, . . . [prohibiting the elimination of] the *implied contractual covenant of good faith and fair dealing* . . . , to set the parameters of actions deemed to be in 'good faith,'"[168] is a ringing affirmation that LLCs are, in fact, "creatures of contract."[169]

In the first instance, the unambiguous legislative intent to "give the maximum effect to the principle of freedom of contract" read in tandem with the statutory authorization permitting the elimination or modification of fiduciary duties, ostensibly displaces any reliance upon the catch-all "law and equity" provision referenced in the Court of

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[164] *See* CML V, LLC v. Bax, 28 A.3d 1037, 1045 (Del. 2011) ("[T]he General Assembly passed the LLC Act as a broad enactment in derogation of the common law, and it acknowledged as much. Consequently, when adjudicating the rights, remedies, and obligations associated with Delaware LLCs, courts must look to the LLC Act because it is only the statute that creates those rights, remedies, and obligations.") (citation omitted). The *CML V* rationale—that corporations and the statutorily created LLC are distinct entities—runs contrary to Chancellor Strine's argument in *Auriga* that traditional fiduciary duties must carry to a manager-managed LLC because it shares many characteristics with a corporation. *See supra* note 141 and accompanying text.

[165] *See* cases cited *supra* note 23.

[166] DEL. CODE ANN. tit. 6, § 18-1101(b) (2005) (emphasis added).

[167] Steele, *supra* note 5, at 222.

[168] Steele, *supra* note 10, at 14.

[169] *Id.* at 31 ("This statutory policy makes sense because it focuses the court on the contractual relationship of parties to a negotiated agreement, and because it comes with an established frame of reference for resolving a dispute supported by case law that is clear, consistent, and flexible enough to address any dispute.").

Chancery's *Auriga* decision.[170] To be sure, section 18-1104 states: "*In any case not provided for in this chapter*, the rules of law and equity . . . govern."[171] In other words, this section means that "if any provision in the Delaware LLC Act speaks to fill the void of 'law and equity,' then § 18-1104 is rendered moot as to that issue."[172] Thus, because the DLLCA broadly permits the contractual modification and elimination of fiduciary duties (to the extent they exist), the "law and equity" provision is moot as to fiduciary duties.

In the same vein, an LLC agreement is the sole contract that governs the relationship between the LLC and its members; every word, term, and standard used to govern the management of the business and their corresponding relationships are bargained for with monetary and/or other costs accounted for.[173] The LLC agreement, like any bargained-for commercial contract, must be examined "in a way that gives effect to every term of the instrument, and that, if possible, reconciles all of the provisions of the instrument when read as a whole."[174] Where the LLC agreement is silent, courts must assume that those "who authorize, in the unincorporated business entities' enabling documents, the elimination or restriction of one or more fiduciary duties, are fully informed of the risks and benefits."[175] As a result of the legislature's clear intent, fiduciary duties are only applicable if they were bargained for and contained within the four corners of the LLC agreement.

Based on the contractual foundation inherent to LLCs, the contractual analysis should not be supplanted by a status-based analysis that injects default fiduciary duties simply because the LLC agreement is silent as to the fiduciary duties owed.[176] Doing so is contrary to legislative intent because the terms of the contract—meticulously negotiated by the parties—are not being given the "maxim of the freedom of contract."[177] Instead, courts must "favor the contracting parties' *ex ante* calculation of costs and benefits of fiduciary duties"[178] and realize that informed, sophisticated parties have entered into the agreement fully aware of such risks.

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[170] *See supra* note 140 and accompanying text.
[171] DEL. CODE ANN. tit. 6, § 18-1104.
[172] Conaway & Tsoflias, *supra* note 138 (manuscript at 26).
[173] *See supra* notes 27-32 and accompanying text.
[174] Council of the Dorset Condo Apartments v. Gordon, 801 A.2d 1, 7 (Del. 2002).
[175] Steele, *supra* note 10, at 9.
[176] *See supra* Part III.A.1.
[177] Steele, *supra* note 5, at 234-35.
[178] *Id.* at 224 (italics added).

To disregard the parties' heavily negotiated terms not only defeats the purpose of forming an LLC, but it also imposes an unexpected and heavy burden on the contracting parties.[179] Because the nature by which a party may eliminate the duties is highly speculative based on the Court of Chancery's recent holdings,[180] the contracting required to properly eliminate them necessarily increases the cost.[181]

While an indiscriminate elimination of fiduciary duties may not be as difficult to achieve contractually, the real problems and costs arise when parties wish to keep some but not all of these duties.[182] Chief Justice Steele provides a helpful example to demonstrate this issue. He explains that if a party wishes to proscribe self-dealing but eliminate all other aspects of the duty of loyalty, default duties make it more contractually difficult to achieve this.[183] This is because, while default duties would of course "include a ban on self-dealing," they would also "contain other aspects of the duty of loyalty" by default.[184] Therefore, provisions of the LLC agreement may seem contradictory—one provision would have to disclaim the duty and another provision "will provide for that duty."[185] Price limitations may even prevent some smaller firms from achieving skilled drafting, reserving the benefits of alternative entities to the most sophisticated and wealthy business persons.[186] Contracting costs aside, litigating such claims also presents unanticipated litigation costs.[187] Chief Justice Steele notes that default duties "create the opportunity to enter into litigation based upon rights not provided by the LLC agreement—even in cases where the agreement attempts to eliminate or minimize those default duties."[188] This creates a situation where the parties may have intended to limit default fiduciary

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[179] *See id.* at 240.

[180] *See supra* Part III.B.2.

[181] *See* Steele, *supra* note 5, at 240 ("[D]efault fiduciary duties add unnecessary contracting costs. The nebulous nature of default fiduciary duties makes it difficult for parties to eliminate some, but not all, potential fiduciary duties.").

[182] *Id.*

[183] *Id.*

[184] *Id.*

[185] Steele, *supra* note 5, at 240.

[186] Ribstein, *supra* note 44, at 165 ("Even a moderate insistence on careful drafting could put fiduciary duty waivers out of the reach of smaller firms.").

[187] Ribstein, *supra* note 56, at 235 ("Litigation may entail substantial expense in, among other things, parties' time, attorney's fees, and business disruption.").

[188] Steele, *supra* note 5, at 241.

duties, but because of the complexity in doing so, find themselves in the middle of a cause of action they sought to specifically avoid through their agreement.[189]

One critic of the opt-in standard suggests that "[t]he right to privately order LLC relationships is not a license to exploit, steal, or lie."[190] What this critic ignores, however, is the non-waivable implied contractual covenant of good faith and fair dealing that is implicit in every LLC agreement.[191] While this covenant is relatively "green" and in some ways limited in this context,[192] it nevertheless offers protection by requiring that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[193] This covenant has been construed to require "a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits" of the agreement.[194] Additionally, guidance in understanding the covenant's breadth can be gathered from its application in areas where it has been readily applied, such as employment and insurance law.[195] Moreover, the Court of Chancery weighed in on the covenant's application in the alternative entity context by determining that a breach of the covenant "requires the Court to extrapolate the spirit of the agreement from its express terms and based on that 'spirit,' determine the terms that the parties would have bargained for to govern the dispute had they foreseen the circumstances under which their dispute arose."[196] In short, this covenant provides a necessary and workable ceiling where, and although the courts recognize that parties are authorized to act

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[189] *Id.*

[190] Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 595 (2007).

[191] *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (2005).

[192] *See, e.g.*, Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys., Co., 708 A.2d 989, 992-93 (Del. 1998) (approving the notion that "fraud, deceit or misrepresentation" must be included to prove a breach of the covenants of good faith and fair dealing, and reasoning that, "[t]his Court should be no less cautious or exacting when asked to imply contractual obligations from the written text of a limited partnership agreement") (internal quotation marks omitted).

[193] RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

[194] Steele, *supra* note 10, at 17 (quoting Wilgus v. Salt Pond Inv. Co., 498 A.2d 151, 159 (Del. Ch. 1985)) (internal quotation marks omitted).

[195] *Id.* at 17-18 (quoting Brown v. Liberty Mut. Ins. Co., 774 A.2d 232, 245 (Del. 2001)) (emphasis added) (internal quotation marks omitted) (noting that claims for payment in insurance suits must not be delayed or denied "*without reasonable justification*").

[196] Chamison v. HealthTrust, Inc., 735 A.2d 912, 920-21 (Del. Ch. 1999) (citing Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986)).

selfishly if they wish to include such permission in their LLC agreement, "there are outer limits to the self-seeking actions they may take under a contract."[197]

Finally, the Delaware Supreme Court has repeatedly exhibited strong contractarian undertones in a wide range of dispositions involving LLCs.[198] In doing so, the Court held that, in the LLC context, contractual provisions trump traditional partnership and corporate law provisions involving: bylaws, dissolution, and derivative standing limitations.[199] In reaching these conclusions, the Court recognized that LLCs are distinct from their corporate and partnership counterparts, and as such, warrant a separate analysis.[200] Thus, judging by their previous dispositions, it is likely that the Delaware Supreme Court will, as this Note suggests, adopt the opt-in standard. Otherwise, it will create a major inconsistency in this area of Delaware business law.

B. *Injecting Default Fiduciary Duties into LLC Agreements is Contrary to Legislative Intent*

In addition to the contractual underpinnings of the LLC, the Delaware General Assembly has made it equally clear that default fiduciary duties are inapplicable in the LLC context. First, the DLLCA sets forth default protections for LLC members; however, it is the *implied contractual covenant of good faith and fair dealing*—not traditional fiduciary duties.[201] If, in fact, the General Assembly intended fiduciary duties to be applied by default, common sense says they would have simply accounted for it. Not only did the General Assembly refrain from making such an indication, the DLLCA never explicitly states whether or not such a duty even *exists*. Rather, it speaks in the context of "[*t*]*o the extent that* . . . a member or manager . . . has duties (including fiduciary duties) . . . ."[202] The mere *reference* to a potential fiduciary relationship may not seem telltale; however, more can be gleaned when

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[197]Miller, *supra* note 184, at 597 n.201 (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm'cns Corp., 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1140 (1992)).

[198]*See supra* Part III.C.

[199]*See supra* note 65.

[200]*See supra* notes 156-57 and accompanying text.

[201]*See* DEL. CODE ANN. tit. 6, § 18-1101(c) (2005).

[202]*Id.* (emphasis added).

read in concert with DLLCA section 18-1101(a), which states, "[t]he rule that statutes in derogation of the common law are to be strictly construed *shall have no application to* [*the DLLCA*]."[203]

Perhaps more telling than the aforementioned reasons, the Delaware General Assembly's sudden reaction to the Supreme Court's holding in *Gotham Partners*,[204] with its amendment to DLLCA section 18-1101(c) (allowing for the *elimination* of fiduciary duties),[205] is symbolic of its members' desire to eradicate any notion that fiduciary duties are to be applied by default.[206] More generally, this amendment shows clear intent that LLC agreements must not be viewed through the same lens as traditional fiduciary duties in the corporate context.[207]

Not only do traditional default fiduciary duties in the LLC context undermine the DLLCA's clear intent of "freedom of contract,"[208] but the *rationale* behind them is irrelevant in the context of LLCs as well. Corporate shareholders who lack any meaningful opportunity to bargain for their protections rely heavily on default fiduciary duties to protect their investment.[209] In contrast, LLCs are "creatures of contract" whose members bargain and contract for any and all terms of their LLC agreement regarding their relationship with the LLC and its members.[210] As a result, the protections afforded to corporate investors in the form of traditional default fiduciary duties are unnecessary in the LLC context.

Where the LLC agreement is silent, the courts must assume that the parties did not bargain for such protections after being fully aware of the risks associated with doing so.[211] To hold to the contrary, as the opt-out supporters suggest, would eliminate the need to ever bargain for the inclusion of fiduciary duties. In effect, it requires all LLC members to pay a fixed-cost premium for their LLC interest to cover the requisite

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[203] *Id.* § 18-1101(a) (emphasis added).

[204] Gotham Partners L.P. v. Hallwood Realty Partners L.P., 817 A.2d 160, 167-68 (Del. 2002).

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

[206] *See* Steele, *supra* note 10, at 13.

[207] *Id.* at 14.

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

[209] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) ("[D]irectors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders.").

[210] *See* Travelcenters of Am., LLC v. Brog, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (citing *In re* Grupo Dos Chiles, LLC, 2006 WL 668443, at *2 (Del. Ch. Mar. 10, 2006)); Steele, *supra* note 10, at 9-10.

[211] *See* Steele, *supra* note 10, at 9.

costs to comply with these duties.[212] Consequently, LLC members are stripped of their ability to customize a specially-tailored relationship with the LLC and its members,[213] thus hindering ultimate profit maximization, a major bedrock of Delaware LLCs.

For all these reasons, superimposing traditional fiduciary duties into LLC agreements flies squarely in the face of clear legislative intent.

C. *Incorporation of the Proposed Amendment to Section 18-1101(c) Would End the Debate*

The 2004 amendment in response to *Gotham Partners* also demonstrates that the Delaware General Assembly "remains poised to correct the courts when they get it wrong."[214] In fact, it does this on an annual basis.[215] Regardless of its clear intent,[216] two schools of thought amongst the judiciary have emerged, albeit one, the opt-out supporters, rely on nothing more than the absence of an explicit proclamation. It seems appropriate, as was the 2004 amendment, that the Delaware General Assembly affirmatively act to clarify the word "eliminate."

This amendment should be carefully crafted in a manner not to disturb the rest of the DLLCA. To do so, the amendment should specify that the absence of fiduciary duties in an LLC agreement means that fiduciary duties do not apply because none inherently exist. Thus, the amendment would state:

> Proposed Amendment to Section 18-1101(c): While an operating agreement may not eliminate the implied contractual covenant of good faith and fair dealing, *the existence and degree of fiduciary duties exist only to the extent they are explicitly set forth in the LLC operating agreement.*

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[212] *See* Steele, *supra* note 5, at 240.

[213] *See id.* at 241-42.

[214] Steele, *supra* note 10, at 22.

[215] Leyden & Dietrich, *supra* note 2, at 323 ("Delaware's commitment to updating its laws relating to limited liability companies and limited partnerships is evidenced by the fact that the DLLC Act and the DLP Act has been amended on an annual basis.").

[216] *See supra* Part IV.B.

Incorporation of this amendment would effectively end the opt-in vs. opt-out debate.

D. *Other Negative Ramifications of Opt-out Methodology*

1. Superimposing Default Fiduciary Duties into LLC Agreements Creates Quasi-Corp/LLC

Categorized as an "alternative entity,"[217] LLCs, while sharing some characteristics with corporations are, in fact, quite distinguishable. Many of the distinguishing characteristics were purposefully crafted "to avoid a host of corporate common law and statutory regulations that increase the transaction costs of doing business in the corporate form."[218] One such LLC-specific demarcation is that members and managers of Delaware LLCs have "*apparent agency authority* notwithstanding the nature of the internal structure of the entity."[219] Thus, unlike the fiduciary relationship in corporate governance—where the director is an agent acting on behalf of her principal, the corporation and its shareholders—each LLC member and manager has *apparent authority* to act in their *individual* capacity.[220] Thus, LLC members and managers, unlike in the corporate form, owe no duty to one another with the exception, of course, to fulfill their contract which may or may not include fiduciary duties. So, while it may be tempting to ladle from an expansive pool of corporate common law, such analogies are hazardous.[221] This is because the intricacies that spurred the enactment and emergence of LLCs will no longer be clear, and the very problems that parties sought to escape once again exist. As a result, as opposed to remaining alternative entities, they have, in fact, mutated into a quasi-corp/LLC. Instead of drawing these groundless parallels simply as a shortcut to a wide breadth of traditional fiduciary law, the

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[217] Ann E. Conaway, *Lessons to Be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 791 n.2 (2008).

[218] *See* Cohen, *supra* note 19, at 453.

[219] Ann E. Conaway, *The Multi-Facets of Good Faith in Delaware: A Mistake in the Duty of Good Faith and Fair Dealing; a Different Partnership Duty of Care; Agency Good Faith and Damages; Good Faith and Trust Law*, 10 DEL. L. REV. 89, 113 (2008).

[220] *See id.* at 113-14.

[221] *See* Steele, *supra* note 10, at 8-9 ("But given their rapid growth and continued variety, there is also a *danger* in continuing to analogize principles of fiduciary duty as used in the corporate governance context to the internal governance of limited partnerships and limited liability companies.") (emphasis added).

courts should instead be reminded that "there is nothing absurd about different legal principles applying to corporations and LLCs."[222]

2. The Opt-out Standard Rewards Parties Who Fail to Bargain for Fiduciary Duties

Protection, in the form of default fiduciary duties, should not be afforded to parties to an LLC agreement whom either carelessly overlook such duties or simply assume that they apply by default. To provide such protections would be contrary to the notion that "ignorance of the law is no excuse . . . ."[223] In another business context, a Delaware court has stated, "a party who seeks to do business in this State has an affirmative duty to reasonably seek out those laws and regulations applicable to his business."[224] In the context of LLC agreements, therefore, prospective members should be charged with the affirmative duty to bargain and contract for fiduciary duties while negotiating their LLC agreement. Failure to do so should prevent that party from alleging a breach of fiduciary duties.

The consequences of applying default fiduciary duties far outweigh its advantages. "Simply put, default fiduciary duties create the opportunity to enter into litigation based upon rights not provided by the LLC agreements—even in cases where the agreement attempts to eliminate or minimize those default duties."[225] Therefore, the party who either was unaware or simply forgot to bargain for fiduciary duties is nevertheless reaping their benefits. Of course, if the fault is the attorney's, a malpractice action is an available remedy for that party. While some may argue that less sophisticated parties should nevertheless be protected,[226] stringent enforcement of this policy forces prospective LLC members and their counsel to act in a diligent manner. Alternatively, while the opt-out standard may not encourage sloppy drafting, it certainly provides a defense to it.

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[222]CML V, LLC v. Bax, 6 A.3d 238, 249 (Del. Ch. 2010), *aff'd,* 28 A.3d 1037 (Del. 2011).

[223]Vosters v. Del. Racing Comm'n, 1987 WL 8896, at *2 (Del. Super. Ct. Apr. 1, 1987), *aff'd*, 528 A.2d 415 (Del. 1987).

[224]Ringler v. Paintin, 1980 WL 332988, at *6 (Del. Super. Ct. July 24, 1980).

[225]Steele, *supra* note 5, at 241.

[226]*See* Hanno, *supra* note 77, at 111-13.

Suppose for example, that LLC member *A* bargained and contracted for specific rights and protections with the F.M.S. LLC. Absent in both the negotiations and the resulting LLC agreement was any reference to fiduciary duties. As such, LLC member *A*'s initial investment was relatively low. However, two years later, LLC member *A* attempted to bring a breach of fiduciary duties claim against F.M.S. LLC. LLC member *A* admits in his deposition that "during the negotiations I was focused solely on profit-maximization. F.M.S. LLC never offered to include fiduciary duties in the agreement. Truly, *I just assumed they applied*." Pursuant to the Supreme Court's holding, LLC member *A* failed "to reasonably seek out [the] laws and regulations applicable to his business."[227] In sharp contrast, the opt-out supporters would actually reward LLC member *A* for his lack of diligence by superimposing traditional fiduciary duties into the silent LLC agreement. Essentially, the opt-out methodology provides for "ignorance as a defense." Additionally, it "create[s] the opportunity to enter into litigation based upon rights not provided by the LLC agreements . . . ."[228]

E. *Advice to Practitioners in the Meantime*

Until the Delaware Supreme Court or General Assembly affirmatively act, by disposition or amendment, respectively, to settle the opt-in vs. opt-out debate, Delaware practitioners should pay heed to the following recommendations that, if incorporated, will help to protect their clients' interests.

1. Explicit Drafting

While both schools of thought agree that LLC members may eliminate fiduciary duties, the crux of the opt-in vs. opt-out debate focuses on the manner in which the elimination of such duties is expressed in the LLC agreement.[229] This uncertainty requires all

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[227] *Ringler*, 1980 WL 332988, at *6.

[228] *See* Steele, *supra* note 5, at 241.

[229] *Compare* Steele, *supra* note 5, at 235 (arguing that contractual covenants, and not default fiduciary duties, should apply where the LLC agreement does not eliminate fiduciary duties), *with* Kelly v. Blum, 2010 WL 629850, at *12-*13 (Del. Ch. Feb. 24, 2010) (holding that fiduciary duties applied where LLC agreement was silent regarding fiduciary duties owed), *and* Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, at *8-*9 (Del. Ch. Apr. 20, 2009) (holding that fiduciary duties apply where the LLC agreement was internally at war with itself).

prospective LLC members to err on the side of caution. Until this debate is settled, practitioners should emphasize the importance of defining any and all material terms to the agreement. As such, boilerplate language should be avoided at all costs. Critically, where an LLC member has chosen not to bargain for (and subsequently pay a premium for) corporate governance-type fiduciary duties, it must be explicitly set forth in the LLC agreement. Because doing so will result in some added costs to the client, it is important to explain the potential consequences of failing to do so. Following this conservative approach will eliminate potential ambiguities and prevent allegations of breach of fiduciary duties against parties who were not contractually bound to such a standard.

2. Arbitration Clauses

To reduce significant litigation costs, practitioners are advised to include arbitration clauses in their clients' LLC agreements. Unlike in the corporate context where arbitration concerning fiduciary duties has been deemed extremely problematic, Delaware courts have acknowledged its applicability in the LLC context.[230] In *Elf Atochem North America, Inc. v. Jaffari*,[231] for example, the Delaware Supreme Court explicitly approved of the arbitration clause in the parties' LLC agreement.[232] The agreement stated, "[n]o action at law or in equity [may accrue] based upon *any* claim arising out of or related to this Agreement except an action to compel arbitration or to enforce an arbitration reward."[233] Similarly, the Court of Chancery has held such clauses to be enforceable.[234]

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[230] *See* Ribstein, *supra* note 44, at 161.

[231] 727 A.2d 286 (Del. 1999).

[232] *Id*. at 293.

[233] *Id.* at 294.

[234] *See* Ribstein, *supra* note 44, at 161 (citing Douzinas v. Am. Bureau of Shipping, Inc., 888 A.2d 1146, 1150, 1152 (Del. Ch. 2006)) ("The Supreme Court's forceful approval of arbitration in *Elf* has encouraged the Court of Chancery to interpret broadly the scope of arbitration provisions to preclude default remedies in LLCs.").

V. CONCLUSION

The LLC's rise to preeminence over the past two decades is attributed to, amongst other things, affording its members with limited liability and pass through taxation.[235] Arguably, however, its most attractive feature is the LLC members' contractual freedom to strike bargains that create relationships (with the LLC and its members) tailored to meet their personal business needs. This feature is grounded in the Delaware General Assembly's clear intent: the DLLCA affords "maximum effect to the principle of *freedom of contract* . . . ."[236]

Taking a step back, the solution to the opt-in vs. opt-out debate is quite simple. The Delaware courts must adopt the opt-in approach, articulated by Chief Justice Steele, and conduct *contractual* analyses in determining whether fiduciary duties are owed in the LLC context. If the LLC agreement is silent, courts must assume that the LLC members *contracted* for—and the subsequent price they paid was solely based on—the specific terms in the agreement and those members were fully aware of the risks they chose to undertake. In support of this notion, the Delaware General Assembly's 2004 amendment to DLLCA section 18-1101(c) allowing for LLC members to *eliminate* fiduciary duties, in reaction to *Gotham Partners*, is symbolic of their desire to eradicate any notion that these duties—non-waivable in corporate governance—are *not* to be applied by default in the LLC context.

Opt-out supporters argue that strict contractual rigidity is too harsh, leaving LLC members without sufficient protection against abusive behavior, and thus, they should receive the same default fiduciary duties engrained in corporate governance. Simply put, this argument is flawed. First, given the DLLCA's underlying policy of "freedom of contract," automatically inserting common law fiduciary duties into LLC relationships where the contracting parties did not agree on their terms, flies squarely in the face of legislative intent. Second, the DLLCA, while not explicitly stating as such, strongly suggests the inapplicability of default fiduciary duties in the LLC context. Moreover, the rationale behind traditional default fiduciary law is irrelevant in the LLC context. For example, unlike corporate investors who have no meaningful opportunity to bargain for the protection of their investments, LLC members are statutorily authorized to expand, restrict, or

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[235] *See Elf Atochem*, 727 A.2d at 290.

[236] DEL. CODE ANN. tit. 6, § 18-1101(b) (2005) (emphasis added).

completely *eliminate* these protections.[237] Thus, not only are non-waivable, default fiduciary duties unnecessary in the LLC context, but the DLLCA expressly authorizes for their complete abrogation.

Moving forward, the question becomes who will settle the opt-in vs. opt-out debate: will it be the Delaware Supreme Court or the Delaware General Assembly? Regardless of which governmental body first steps up to the plate, practitioners should urge the Delaware legislature to be proactive and amend DLLCA section 18-1101(c) to settle the score once and for all.

Nicole M. Sciotto

[237] *Id.* § 18-1101(c).