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*221 FREEDOM OF CONTRACT AND DEFAULT CONTRACTUAL DUTIES IN DELAWARE LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

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FOREWORD [FNaa1]

Once again, in his inimitable style, Chief Justice Myron Steele has directed his judicial scrutiny to a critical issue of alternative entity law that others have either assumed or ignored. The issue that Chief Justice Steele focuses on is whether, given a clearly stated public policy of freedom of contract and the maximization of enforceability of alternative entity agreements, fiduciary law should serve as the default standard governing parties' internal agreements or whether the implied contractual covenant of good faith and fair dealing should supply the appropriate default standard. Chief Justice Steele examines the issue through several avenues and concludes, economically and statutorily, that rationality obliges a default contractual standard.

I. INTRODUCTION

Since its introduction, the Delaware Limited Liability Company Act (DLLCA) has been a powerful economic vehicle that, unlike its corporate ***222** counterpart, allows for ultimate contractual customization among its owners and management. [FN1] As evidence of the Delaware limited liability company's (LLC) prowess, the Delaware Secretary of State reports that nearly 112,000 new LLCs were formed in 2007, compared to just 43,000 new formations in 2001. [FN2] One reason for the success of the LLC is the carte blanche flexibility Delaware's legislature seemingly provided owners in crafting the LLC operating agreement, allowing the parties to contract between themselves. This flexibility made the LLC form ideal for those wanting to craft a highly specialized and customized vehicle, specifying the duties and benefits among owners and managers. [FN3]

Ronald Regan famously said: "If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it." [FN4] Reagan's truism proved all too true for LLCs. The carte blanche some believed to be contemplated by the Delaware legislature gave way to judicially imposed mandatory and unwaivable fiduciary duties. [FN5]

In 2004, though, Delaware's legislature amended the LLC statute to clarify that, to the extent that default fiduciary duties [FN6] exist, as determined ***223** by Delaware courts, those duties can be entirely eliminated. [FN7] Today, Delaware courts are free to determine whether to apply default fiduciary duties at all. [FN8] It is clear from the language of the LLC statute that Delaware's legislature wishes the courts to answer the policy question of whether default fiduciary duties exist in the first instance.

Even with this statutory permission--and perhaps mandate--to make the policy decision of whether to apply default fiduciary duties, Delaware courts have still commonly accepted default fiduciary duties, without engaging in a

thorough policy analysis. [FN9] Since the 2004 statutory amendment, one case, though, does question the long-held assumption that default fiduciary duties apply to LLCs. [FN10]

In this article, rather than embrace the commonly accepted puritanical default fiduciary duty norm, I analyze default fiduciary duties of LLCs from two different policy perspectives to determine whether courts should apply default fiduciary duties at all. First, I argue that default fiduciary duties violate the strong policy favoring freedom of contract enunciated by Delaware's legislature. [FN11] Considering Delaware's strong policy favoring freedom of contract, Delaware courts should analyze mutually bargained-for LLC agreements that define the parties' conduct without any application of default***224** fiduciary duties, even if the parties have not specifically provided for the elimination of fiduciary duties. Where an operating agreement provides for a specific set of conduct, the court should not read any default fiduciary duties into the agreement because the parties' prescribed and proscribed conduct contains the entire agreement that the parties intend and expect. Courts should favor the contracting parties' ex ante calculation of costs and benefits of fiduciary duties, and courts should not, on their own, endeavor to reassess that (albeit perhaps now imprudent) decision ex post.

Second, I analyze the different economic rationales for and against default fiduciary duties, concluding that the costs of default fiduciary duties outweigh the minimal benefits that they provide. I contend we have no reason to assume that parties to an LLC agreement would have provided for fiduciary duties in the contract. As an elaboration on that point, I also argue that default fiduciary duties add significant contracting and litigation costs. When courts assume default fiduciary duties, parties bear the costs of those judicially created fiduciary duties. In the nebulous universe of default fiduciary duties, [FN12] speculating on whether the court will apply default fiduciary duties creates an inconsistency, making it more difficult for parties to effectively eliminate those default duties.

Moreover, the wholly Byzantine approach, whereby parties must define the duties and rights they intend to keep while simultaneously disclaiming other duties that the parties wish to exclude, adds unnecessary chaos into the parties' contract negotiations, thereby increasing their contracting costs. Instead, assuming a clean slate where the organic agreement crafts the rights and duties owed among and between members and managers gives the parties clear expectations about which duties will apply and clear expectations about the other parties' conduct.

Finally, from the prospect of potential litigation cost, without default duties, parties will focus their arguments specifically on the agreements they made, and not on default norms imposed on them by courts. To the extent that an answer to a party's contractual duty is not clear, parties will focus their litigation on contract interpretation rather than fiduciary duties, which will eliminate litigation on claims that the parties never intended to include in their agreements.

***225** Before beginning my analysis of the issues I address in this article, I must first establish some relevant ground rules. This article specifically discusses the relationships among and between member, managers, and the LLC in an LLC and among partners, limited partners, and the limited partnership (LP) in LPs. Those relationships are governed by the relevant Delaware LP and LLC statutes, [FN13] which are in turn interpreted by Delaware courts. Because of the unique judicial system in Delaware, I do not imply that my analysis can or should be extended to other jurisdictions. Further, I assume that each partner, member, and manager had a bargained-for exchange when entering the relationship. By this I assume that the parties' organic agreement is not an agreement imposed on, for instance, a passive LLC member who simply purchased units in the LLC. Likewise, I assume that partners bargained for and received a benefit from the partnership agreement that they reached.

II. BACKGROUND

A. Delaware LP and LLC Law

In 2004, Delaware's legislature amended Delaware's LP and LLC statutes to clarify that the relationships among members, managers, partners, and their organizations may be governed exclusively under contract law, that is, without any fiduciary duties. [FN14] That amendment changed the rule established under *Gotham Partners* that an LP or an LLC agreement could not entirely eliminate fiduciary duties. [FN15] In the four years after that statutory amendment, Delaware courts have decided some cases involving LPs or LLCs that have modified or eliminated fiduciary duties. [FN16] Two cases have addressed what the initial default position is on fiduciary duties, that is, ***226** whether the fiduciary duties must be eliminated or whether they must be built into the parties' internal agreement. [FN17] A third case decided by the Delaware Supreme Court did not address the issue of default fiduciary duties because the entity's agreement expressly disclaimed fiduciary duties. [FN18]

B. Delaware's Statutory Provisions

Any analysis of the duties owed in an LP or an LLC begins with the relevant statutory provisions. Both statutes similarly provide: "It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." [FN19] The statutes also provide:

> To the extent that, at law or in equity, a partner or other person had duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing. [FN20]

Finally, the statutes also provides that the "rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter." [FN21]

***227** Of course, notably absent, and actually implicit in the sections above, the statutes do not provide any fiduciary duties, default or mandatory. The 2004 statutory amendments clarified that common law fiduciary duties could be expanded, restricted, or *eliminated* in a partnership agreement, whereas, the statute previously provided that the common law fiduciary duties could only be "modified," a term the Delaware Supreme Court chose to conclude allowed only for expansion or restriction-- not elimination.

Before the 2004 amendments, the Delaware Supreme Court held that LPs applied unwaivable, mandatory fiduciary duties, even in the face of an LP agreement's attempt to eliminate those duties. [FN22] In an earlier article published shortly after the 2004 amendment, I argued that parties should be able to eliminate fiduciary duties, contrary to the holding in *Gotham Partners*. [FN23] Today, the statutes make it abundantly clear that any common law fiduciary duties can be waived. However, the statutes themselves do not establish any default fiduciary duties. [FN24] Instead, the statutes provide that "to the extent that" a partner has any duties, those duties may be modified or eliminated. [FN25] Of course, that same statutory language does not explicitly disclaim the application of default fiduciary duties. Thus, the statute leaves that issue wholly for the courts to decide.

***228** *C. Delaware Case Law*

Before the 2004 statutory amendment clarified that all fiduciary duties could be disclaimed, Delaware courts accepted, as a matter of course, default fiduciary duties. The Supreme Court, in *Gotham Partners*, "note[d] the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly." [FN26] The Supreme Court, of course, assumed that there were default fiduciary duties to escape. A treatise on Delaware LLCs explains:

> The [Delaware] LLC Act does not state whether, to what extent, or under what circumstances a member or manager or other person possessing management authority in regard to a Delaware limited liability company owes fiduciary duties to other members, managers, holders of limited liability company interests, the company itself, or others. The statute leaves such matters to development in the Delaware case law. It seems clear that, in the absence of appropriate provisions in the limited liability company agreement, there are circumstances in which a member or manager or other person holding management power owes fiduciary duties. [FN27]

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In another case decided before the statutory amendments, a vice chancellor explained:

> As a practical matter, the defendants' contractual argument ignores the implications that the specific terms of the LLC Agreement have on the managers' fiduciary duties. Obviously, one of an LLC manager's duties is to govern the LLC in accordance with the LLC Agreement. If an LLC manager knowingly permitted the LLC to violate a contractual duty owed to one of the company's members, that would, as I find later, constitute a breach of fiduciary duty. [FN28]

He further explained that:

> the [defendants'] proposition that the managers of an LLC have no fiduciary duty at all to ensure that the LLC lives up to its contractual duties is one that is difficult to accept and that is certainly not supported by prior precedent. How can an LLC perform a contract except through its managers and officers? [FN29]

***229** The statutes, as I explained above, do not prescribe any default fiduciary duties. Rather, the legislature deferred to the courts to determine the policy choice of applying default fiduciary duties. It is not entirely clear why these cited cases assumed default fiduciary duties, nor is it clear that the courts chose to apply default fiduciary duties because of a thorough policy analysis. [FN30] But, with new statutory language in tow, making it abundantly clear that any common law fiduciary duties may be eliminated, the Delaware courts can now reassess the application of default fiduciary duties-- and in two different cases, the Court of Chancery has split on this issue.

In *Fisk Ventures, LLC v. Segal*, [FN31] Chancellor Chandler used some broad language that indicates that LLC duties are implicitly contractual and, therefore, fiduciary duties must be affirmatively included in the LLC agreement. [FN32] He wrote: "Contractual language defines the scope, structure, and personality of limited liability companies." [FN33] Moreover, he stated:

> In the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC ***230** Agreement or some other contract. Because [the plaintiff's] counterclaims and third-party claims fail to allege breaches of duties found in the [LLC] agreement, the Court must dismiss Count I .... [FN34]

The agreement provided that "no member shall have any duty to any [m]ember of the Company except as expressly set forth herein or in other written agreements." [FN35]

On one hand, one could argue that this language provided a clear and unambiguous elimination of fiduciary duties. However, this language is somewhat ambiguous because it speaks only generally of "duty." It does not specifically reference fiduciary duties. Rather, the language may mean only that no member has any contractual duty other than those enumerated in the LLC agreement, without any regard to what fiduciary duties they owe. In light of Chancellor Chandler's strongly worded general language--that the agreement is the only source of any duties owed--it appears that he believes, in an agreement that fully fleshes out the conduct of the parties, no default duties should be assumed. This, of course, is a stark departure from *Gotham Partners'* language explaining the "historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty" should be "scrutinized searchingly." [FN36] To the contrary, Chancellor Chandler decided that the language of the contract created instead of escaped all of the duties owed.

In another recent LLC case decided by Chancellor Chandler, the court's opening remarks are telling: "For Sha-

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kespeare, it may have been the play, but for a Delaware limited liability company, *the contract's the thing*. Ultimately, it is the contract that compels the Court's decision in this case because it is the contract that 'defines the scope, structure, and personality of limited liability companies.'" [FN37]

The case, *R&R Capital, LLC v. Buck & Doe Run Valley Farms LLC*, [FN38] presented the court with two New York LLCs that sought dissolution and winding up of nine Delaware LLCs. In the alternative, petitioners sought the appointment of a receiver for the Delaware entities. The Delaware ***231** LLCs responded that the petitioners were neither members nor managers under sections 18-802 and 18-803 and therefore lacked standing to seek dissolution. Finding the petitioners were neither members nor managers in some of the Delaware LLCs, the court granted the motion to dismiss these claims. The remaining claims centered upon the judicial appointment of a receiver under section 18-805. [FN39]

At the core of this case, an issue of first impression in Delaware, were provisions in Delaware LLC operating agreements that waived *judicial* dissolution and the appointment of a liquidator. Petitioners claimed the waivers were invalid even if bargained for by sophisticated parties on the grounds that: (1) *judicial* dissolution should not be a waivable provision and (2) as a matter of public policy, waivers of *judicial* intervention at dissolution should not be modifiable. [FN40]

The Chancellor, citing Delaware's strong public policy favoring freedom of contract and noting the sophistication of the parties to the bargain, held that the waivers were enforceable. In the Chancellor's words:

> [i]t is the unwaivable protection of the implied covenant [of good faith and fair dealing] that allows the vast majority of the remainder of the LLC Act to be so flexible. There is no threat to equity in allowing members to waive their right to seek dissolution because there is no chance that some members will be trapped in a limited liability company at the mercy of others acting unfairly and in bad faith. [FN41]

Not only is this case insightful for its ruling on judicial dissolution, it is important for its absence of analysis of fiduciary duties. Throughout the opinion, the Chancellor makes clear that the entity is contractual, the parties'***232** relationship is contractual, and that any "bad acting" will be ferreted out by the parties' bargain and the implied covenant of good faith and fair dealing. This is the contractual construct anticipated by the Delaware legislature when the *statutory* policy of freedom of contract was adopted in the LLC statute.

On the other hand, in *Twin Bridges Limited Partnership v. Draper*, Vice Chancellor Parsons employed the more traditional notion of default provisions. [FN42] He wrote:

> Consistent with the underlying policy of freedom of contract espoused by the Delaware Legislature, limited partnership agreements are to be construed in accordance with their literal terms. "The operative document is the limited partnership agreement and the statute merely provides the 'fall-back' or default provisions where the partnership agreement is silent." Only "if the partners have not expressly made provisions in their partnership agreement or if the agreement is inconsistent with mandatory statutory provisions .... will [a court] look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence." In other words, unless the partnership agreement is silent or ambiguous, a court will not look for extrinsic guidance elsewhere .... [FN43]

Specifically on the issue of fiduciary duties, Vice Chancellor Parsons concluded:

> Under Delaware law, a general partner in a limited partnership has a duty to "exercise the utmost good faith, fairness and loyalty" and such duty is often compared to that of corporate directors. Unless the partnership agreement preempts fundamental fiduciary duties, "a general partner is obligated to act fairly and prove fairness when making self-interested decisions." [FN44]

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Vice Chancellor Parsons' language in *Twin Bridges* differs drastically from Chancellor Chandler's language in *Fisk* and *R&R Capital*. Under the *Twin Bridges* approach, fiduciary duties are fundamental and must be unambiguously eliminated in the partnership agreement. *Fisk* and *R&R Capital*, rather than speak in terms of fundamental duties, talk of contractual duties and, presumably under Chancellor Chandler's approach, the court would look only to common law fiduciary duties in the absence of a bargained-for agreement regulating the conduct in operating agreements.

***233** Given this existing inconsistency in the Court of Chancery, the remainder of this article sets out several different reasons why Delaware courts should eschew their addiction to default fiduciary duties and instead adopt a policy of no default fiduciary duty.

III. POLICY ANALYSIS

Delaware's prominent position in corporate chartering, and more recently LLC chartering, is due in part to wise policy choices adopted by the legislature and the expertise of Delaware courts. Part of the Delaware courts' expertise involves the judges' experience with and willingness to apply logical and economically rational rules. To determine whether to apply default fiduciary duties, a Delaware court should engage in a thorough economic analysis of this issue. [FN45] As Cooter and Ulen explain, "replacing inefficient default terms with efficient default terms creates a surplus." [FN46] Thus, in this article, I set out some important economic rationales for a court to consider in finding an efficient default duty for Delaware LLCs and LPs.

A. Freedom of Contract

As discussed above, Delaware's legislature tipped its hat to the courts, allowing the courts to apply principles of fiduciary duties so long as parties could, by contract, eliminate any of those duties. Although the legislature has not provided an answer to the question of default fiduciary duties, one way or the other, the legislature has guided the courts by instructing them to give full effect to the freedom of contract between the parties. [FN47] I contend***234** that this general principle of freedom of contract annunciated by the legislature indicates that courts should not assume that default fiduciary duties apply.

First, the legislature provided the strongest possible indication of its public policy to effectuate the parties' contracts, here the LP or the LLC agreement. Going back to *Fisk*, *R&R Capital*, and cases that pose similar situations, [FN48] suppose that the members agreed to an LLC agreement that proscribed a specific list of conduct. However, the agreement never provided an explicit elimination of fiduciary duties. Further assume that one member engaged in conduct, not proscribed, but clearly self-interested. Another LLC member sued based upon a theory of breach of fiduciary duty. The question becomes: how will the court resolve this issue?

Had the agreement been a typical bargained-for commercial contract, a Delaware court would have examined the conduct under the lens of the contractual language, with magnification from the many useful tools for contract interpretation. As noted in Cooter and Ulen's textbook, "economic efficiency requires enforcing a promise if the promisor and promisee both wanted enforceability when it was made." [FN49] Not surprisingly, if the parties agreed to the duty of loyalty, it would certainly be enforced.

If, however, a fulsome contract interpretation analysis revealed no provision of a *fiduciary* duty of loyalty, the court would not apply a default term. As Cooter and Ulen note, a court should only "impute the terms to the contract that the parties would have agreed to if they had bargained over all the relevant risks." [FN50] In Cooter and Ulen's terms, contracting parties may leave "rational gaps," [FN51] or perhaps even conscious ambiguity, so that courts can apply default rules. Under Delaware contract jurisprudence, Delaware courts have limited their application of default

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duties to the implied contractual duty of good faith and fair dealing. Thus, Delaware courts have apparently concluded that the parties would have agreed only to the implied contractual duty of good faith and fair dealing. Notably, the ***235** Delaware courts, in the contracts context, have determined that parties would not provide the fiduciary duty of loyalty. [FN52] Absent specific language in the contract creating a fiduciary relationship, a court would be loathe to revert to a fiduciary duty of loyalty and hold the defendant liable for acting in his own best interest--so long as the implied contractual duty of good faith and fair dealing was met.

But, under Delaware's approach to LLC agreements, the answer to whether the court will apply default fiduciary duties is not so clear. Applying *Fisk* or *R&R Capital*, a Delaware court would look to the LLC agreement and find that the conduct in this hypothetical was not explicitly covered by the agreement and, thus, not explicitly prohibited. [FN53] But, in other cases, because the agreement did not eliminate fiduciary duties, the court, under *Twin Bridges*, [FN54] would decide to apply the common law fiduciary duty of loyalty.

To resolve this split, my answer is simple: treat it like a contract. The legislature has announced the clear public policy to enforce the parties' freedom of contract. Delaware courts have already determined what default duties, in fact also codified in the statute, [FN55] apply in the context of contracts, thus courts should simply apply those same default duties, but no more, to LLCs and LPs.

Further, default fiduciary duties run the risk of creating a shortcut whereby a court might look to default fiduciary duties rather than conduct ***236** a complete and potentially difficult contract interpretation. This, of course, further violates the statutory principle "to give maximum effect to the principle of freedom of contract." [FN56] The danger in applying default fiduciary duties is that, rather than determining the ex ante intent of the parties as contemplated by their agreement, a court might be wooed by plaintiffs' fiduciary duty claims and accept their proposal to apply an ex post fiduciary duty analysis.

B. Economic Analysis

Although, as I argued above, the freedom of contract principle articulated by the statutes suggests that the court eliminate default fiduciary duties, it is also unquestionable that the legislature authorized the courts to apply default fiduciary duties, if they so choose. Cooter and Ulen describe a simple, economically rational rule for determining default terms: "Impute the terms to the contract that the parties would have agreed to if they had bargained over all the relevant risk." [FN57]

Of course, as explained above, Delaware courts have already provided a default duty for contracts the implied contractual duty of good faith and fair dealing. [FN58] Courts, presumably, have eschewed applying the corporate fiduciary duty of loyalty to all contracts for good reason. [FN59] In the next section, I argue that Delaware courts should conform default duties for LLCs to those default duties applied in contract and depart from the default duties announced under our corporate jurisprudence. To make my point, I explain why, from an economic policy perspective, default fiduciary duties should not be the norm, and instead Delaware courts should assume no default fiduciary duties apply.

***237** 1. The Hypothetical Bargain

In determining which default duties should apply, courts seeking to adopt economically sensible default duties might begin by considering whether the parties to an LLC would provide for fiduciary duties if they had bargained over all of the risks--that is, the hypothetical bargain. [FN60] To help answer this question, it is important to note that sophisticated parties bargain for the obligations and duties provided in an LLC agreement. [FN61] The choice of the LLC form was an intentional form, chosen by sophisticated parties because that form provides the contracting parties

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with the maximum ability to customize their relationship. Understanding this key difference between LLCs and corporations points us away from adopting default corporate-like fiduciary duties and, instead, applying only Delaware's default contractual duties. To understand this point, in the context of LLC contracting by sophisticated parties, we can assume that the parties' choice to *not* provide fiduciary duties is a conscious and deliberate choice--rather than a "rational gap."

Whether parties imprudently chose the LLC form, or whether it appears that ex post the parties ineffectively bargain for their rights and obligations, [FN62] should be of no moment for the court. The only time the court ***238** can intervene to add terms to the LLC contract is if the parties' intent can be implied from the agreement or other law fills in those terms. [FN63] In the alternative, a court may strike terms to an agreement if it finds some indicia of fraud, undue influence, or adhesion. Simply because, on occasion, parties may ineffectively bargain, ex ante, does not require the courts to swoop in as a protector for ill-advised contract makers.

2. Economic Costs and Benefits to Fiduciary Duties

A more nuanced approach to the hypothetical bargain requires the court to determine what the economic costs and benefits are of applying fiduciary duties to LLCs. Professor Larry Ribstein has written extensively on ***239** the economic costs and benefits of fiduciary duties. [FN64] Professor Ribstein explains that "the existence of default fiduciary duties depends solely on the structure of the parties' relationship that is, on the terms of their express or implied contract -- and not on any vulnerability arising other than from this structure." [FN65] Specifically, for LLCs, Ribstein sets forth three economic rationales to narrowly define fiduciary duties.

First, according to Ribstein, even where fiduciary duties have some benefits, those benefits are outweighed by costs such as "effect on the purported fiduciary's incentives and the reduction of trust or reciprocity from substituting legal duties for extralegal constraints." [FN66] In particular, Ribstein notes, "courts often ignore the costs of fiduciary duties perhaps because these costs matter most in the cases that do not get to court, and therefore seem insignificant compared to the unfairness in the case being litigated." [FN67] Second, Ribstein argues that "there are benefits to clearly delineating the situations in which fiduciary duties apply, including minimizing litigation and contracting costs and effecting extralegal conduct norms." [FN68] Third, and finally, Ribstein concludes that "a narrow approach to fiduciary duties inheres in the contractual nature of such duties." [FN69] Ribstein warns that "[a]pplying fiduciary duties broadly threatens to undermine parties' contracts by imposing obligations the parties do not want or expect." [FN70]

Professor Ribstein's thoughtful analysis also applies to default fiduciary duties. In particular, the cost of applying any default fiduciary duty is outweighed by its benefit. First, default fiduciary duties add unnecessary ***240** costs to contracting. Second, default fiduciary duties also add unexpected litigation costs. Finally, any benefit to default fiduciary duties is limited because the LLC, by its nature, is designed to be a highly customized vehicle, determined primarily by contract. A critic to my cost-benefit analysis will invariably argue: (1) there is no cost to default fiduciary duties because the LLC statute provides that parties may eliminate any default duties and (2) parties benefit from fiduciary duties because they expect them and need not contract for them. However, I will demonstrate why those criticisms are misplaced.

First, default 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. Although I agree that a wholesale elimination of duties in an LLC agreement comes at little cost, the costs rise dramatically when the parties intended to keep some, but not all, duties. Imagine that the parties intend to include a provision proscribing self-dealing but intend to eliminate any other aspect of the duty of loyalty. It is difficult for parties to contract for this if there are default fiduciary duties. Part of the default fiduciary duties would certainly include a ban on self-dealing, but the default duties

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will also contain other aspects of the duty of loyalty. In order for the parties to achieve their objective, provisions in the contract will necessarily appear contradictory - that is, part of the contract will disclaim the duty while another provision will provide for that duty--and thus require the parties to spend additional resources to assure that the LLC agreement appropriately provides for a self-dealing ban while eliminating all other potential fiduciary duties.

If we assume no default fiduciary duties, the parties need only explicitly provide for a self-dealing proscription. The contract is much easier to draft, and the parties have more confidence that they adequately provided for that ban without also introducing other unwanted fiduciary duties.

A question remains: how often will parties want to remove the default fiduciary duties? If, for the most part, parties simply intend to keep the default fiduciary duties, then it would be less costly for parties to contract. However, if we proceed from the baseline of no default fiduciary duty, adding in a wholesale provision adopting Delaware's fiduciary duty principles could also be easily achieved -- without much cost. As I described in the last paragraph, this will benefit the parties who intend to adopt a discrete number of those duties because it will be less costly to contract for those limited duties. Moreover, by adopting an LLC, the parties have consciously***241** chosen to use a highly customizable vehicle--in so choosing, we naturally infer that the parties intend customization. [FN71]

Second, default fiduciary duties introduce unexpected litigation expenses. Without default fiduciary duties, the parties' litigation will focus solely on the agreement between them--and not on fiduciary duty principles outside of the contract. Simply put, default fiduciary 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. Moreover, if the parties intended, but failed because of contractual complexity, to limit default fiduciary duties or if the LLC agreement were ambiguous, the parties might be forced to litigate a claim they never intended to facilitate in the original agreement. In light of the heightened contracting cost with default fiduciary duties, this result might frequently occur.

In light of those potential costs, the courts must also weigh them against any benefits to applying default fiduciary duties. Professor Ribstein explains that "[i]n general, this is a matter of articulating standard form terms to minimize contracting costs. It is difficult and expensive for parties to enter into customized contracts covering all of the details of a long-term agency-type relationship." [FN72] However, it is important to remember that in the context of an LLC that the parties have specifically chosen to use an LLC agreement, which provides contractual flexibility, and have bargained for the relevant provisions in this agreement. Thus, it does not necessarily follow that default fiduciary duty principles will more accurately reflect the parties' intent rather than principles of contract interpretation. Instead, because the parties chose a Delaware LLC and because the Delaware judiciary is skilled in resolving difficult issues of contract interpretation, the opposite conclusion is likely true, that is, parties would prefer Delaware courts to determine their rights and duties in accordance with the terms of the contract and not an unbargained-for default fiduciary principle. Moreover,***242** if the parties intended to apply traditional fiduciary duties to their relationship, they could easily add a provision stating precisely that in the agreement.

A final point is necessary in evaluating costs of fiduciary duties in LLCs and LPs in Delaware. As I noted in prior sections, the Delaware LP and LLC acts are silent on fiduciary duties. Although Vice Chancellor Parsons in *Twin Bridges* assumed fiduciary duties applied by default in an LP agreement, no discussion or analysis was undertaken as to *what* those fiduciary duties encompass. Stated differently, if Delaware courts continue to infuse fiduciary duties in LPs and LLCs, what will be the compass for those duties where LPs and LLCs live and thrive in a purely contractual regime? Surely *corporate* fiduciary principles do not fit a bargained-for contractual venture where parties have structured their rights and duties, including management, voting, distribution, exit, and other rights. Even in LLCs with management vested in a board of managers, the LLC, unlike its corporate counterpart, has planned this *contractual* managerial style without any recourse to gap filling by the LLC statute. The operating agreement controls every action of the board of managers. In other words, the LLC may look like a corporate duck but it quacks like a

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contract.

IV. CONCLUSION

Delaware's legislature has provided Delaware courts with the opportunity--if not mandate--to engage in a thorough policy analysis of default fiduciary duties. To date, Delaware courts have addressed this issue in only limited circumstances. But at some point, the courts will have to address, head on, whether default fiduciary duties should apply. In order to answer this policy question. Delaware courts will invariably look to an economic analysis to determine whether to apply default fiduciary duties. I conclude that an economic analysis mandates that the courts reject default fiduciary duties. Instead, the courts should analyze LLC agreements by the parties' agreement alone. Default fiduciary duties introduce unnecessary confusion to contracting and add undesired litigation costs without providing any substantial benefit. Who can conscionably say no to reducing confusion and litigation costs?

[FNa1]. Chief Justice of the Supreme Court of Delaware Before serving as the chief justice, he served as a justice on the Supreme Court of Delware, a vice chancellor for the Court of Chancery of Delware, and a judge on the Superior Court of Delaware. Chief justice Steele is the author of many significant opinions in alternative entity law. Thanks to John Allen Eakins for his invaluable assistance and Professor Ann E. Conaway for her review.

[FNaa1]. Ann E. Conaway, Professor of Law, Widener University School of Law, Wilmington, Delaware authored the Foreword.

[FN1]. The Delaware General Corporation Law (DGCL), DEL. CODE ANN. tit. 8, §§ 101(h)(7) & 122(17) (2009), provides substantially less freedom in contracting for fiduciary duties than the DLLCA, DEL. CODE ANN. tit. 6 § 18-1101 (2009), and the Delaware Revised Uniform Limited Partnership Act (DRULPA), DEL. CODE ANN. tit. 6. § 17-1101.

[FN2]. Over the same time period, the per annum number of new corporations has decreased.

[FN3]. Both DRULPA, DEL. CODE ANN. tit. 6, § 17-1101, and DLLGA. DEL. CODE ANN. tit. 6, § 18-1101, originally gave full effect to freedom of contract principles between the parties and, further, allowed for the modification of any judicially created fiduciary duties.

[FN4]. Remarks to State Chairpersons of the National White House Conference on Small Business (Aug. 15, 1986), *available at* http:// www.reagan.utexas.edu/archives/speeches/1986/081586e.htm.

[FN5]. *See* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002), *See also* Myron T. Steele, *Judicial Srrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1 (2007) (holding "that, while a limited partnership agreement could provide for contractually created fiduciary duties substantially mirroring corporate common law fiduciary duties, a limited partnership agreement could not 'eliminate' the fiduciary duties or liabilities of a general partner.").

[FN6]. Throughout this article, when I refer to fiduciary duties, I refer to the corporate-like fiduciary duties of loyalty and care that have been applied to LPs and LLCs by Delaware courts. Fiduciary duty, in this article, does not refer to the implied contractual duty of good faith and fair dealing. Instead. I specifically identify when I do discuss that implied contractual duty. *Compare* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 795 A.2d 1 (Del. 2001), *aff'd*, 840 A.2d 641 (Del. 2003) *and* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., C.A. No. 15754-NC, 2000 Del. Ch. LEXIS 141 (Sept. 27, 2000) *with Gotham Partners*, 817 A.2d 160.

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[FN7]. DEL. CODE ANN. tit. 6, §§ 17-1101(d) & 18-1101(c).

[FN8]. The statute provides that, "[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement ...." *Id.* § 18-1101(c). The legislature, here, did not provide for any default fiduciary duties. Instead, the legislature provided the court with the task of determining whether to apply any default fiduciary duties.

[FN9]. *See, e.g.*, Twin Bridges L.P. v. Draper, No. 2351-VCP, 2007 WL 2744609, at *20 (Del. Ch. Sept. 14, 2007) ("Unless the partnership agreement preempts fundamental fiduciary duties, a general partner is obligated to act fairly and prove fairness when making self-interested decisions.").

[FN10]. Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 Del. Ch. LEXIS 158, at *28 (Del. Ch. May 7, 2008) ("In the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC agreement or some other contract.").

[FN11]. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.").

[FN12]. *See, e.g.*, Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1045 (1991) ("Fiduciary relationships have occupied a significant body of Anglo-American law and jurisprudence for over 250 years, yet the precise nature of the fiduciary relationship remains a source of confusion and dispute.").

[FN13]. DEL. CODE ANN. tit. 6, §§ 17-101-17-111 & 18-101-18-1109.

[FN14]. *See supra* note 7 and accompanying text discussing fiduciary duties.

[FN15]. *See* Steele, *supra* note 5, at 10 ("In August 2004, the General Assembly amended the Delaware Revised Uniform Limited Partnership Act to express its intent to establish legislative policy in derogation of the common law's fiduciary duty principles and to give maximum effect to the principle of freedom of contract.").

[FN16]. *See* Wood v. Baum, 953 A.2d 136 (Del. 2008); Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 Del. Ch. LEXIS 158, at *28 (Del. Ch. May 7, 2008); Twin Bridges L.P. v. Draper, No. 2351-VCP, 2007 WL 2744609, at *20 (Del. Ch. Sept. 14, 2007).

[FN17]. *Fisk Ventures*, 2008 Del. Ch. LEXIS 158; *Tiem Bridges*, 2007 WL 2744609.

[FN18]. *Wood*, 953 A.2d 136.

[FN19]. DEL. CODE ANN. tit. 6, § 17-1101. The identical language is found in the DLLCA. *Id.* § 18-1101(b) ("It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.").

[FN20]. *Id.* § 17-1101(d). The identical language is found *id.* § 18-1101(c) ("To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.").

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[FN21]. *Id.* § 18-1101(a). The same language is found in DRULPA. *Id.* § 17-1101(b) ("The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.").

[FN22]. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002).

[FN23]. *See* Steele *supra* note 5 and accompanying text.

[FN24]. The only Delaware alternative entity statute to provide for standards of conduct is the Delaware Revised Uniform Partnership Act (DRUPA), which is modeled after the Revised Uniform Partnership Act of 1994. Although Delaware adopted standards of conduct at DEL. CODE ANN. tit. 6, § 15-404, Delaware deviated from the Uniform Partnership Act with its enactment of section 15-103(f) specifying that the partnership agreement may:

> provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including breach of fiduciary duties) of a partner or other person to a partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

Subsection (d) of title 6 also states that: "It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." DEL. CODE ANN. tit. 6, § 15-103(d).

[FN25]. DEL. CODE ANN. tit. 6, § 18-1101(c).

[FN26]. *Gotham Partners*, 817 A.2d at 167.

[FN27]. ROBERT L. SYMONDS, JR. & MARTHEW J. O'TOOLE, SYMONDS & O'TOOLE ON DELAWARE LIMITED LIABILITY COMPANIES 9-47 - 9-48 (Aspen Publishers ed., 2007).

[FN28]. Metro Comm'n Corp. v. Advanced Mobilecomm. Tech., Inc., 854 A.2d 121, 141 (Del. Ch. 2004).

[FN29]. *Id.* at 142.

[FN30]. As one commentator has explained:

> Courts typically do not attempt to explain why fiduciary duties are imposed in formal fiduciary relationships. Many of these relationships have been considered fiduciary in nature for centuries, and any attempt to explain that status seems unnecessary. By contrast, courts are incessantly attempting to rationalize the law governing informal fiduciary relationships.

D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1413 (2002). Another commentator has suggested that the standards of conduct set forth in DRUPA at best articulate "degrees of accountability for partners" that may be modified by contract. *See* 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; Godo Faith and Trust Law*, 10 DEL. L. REV. 89-112 (2008).

This commentator has also challenged the "creation" of a fiduciary "duty of loyalty" by Justice Cardozo in

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Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928). *Meinhard* is the seminal partnership case in which Justice Cardozo, without citing to any relevant partnership statute - although New York had adopted the UPA in 1914, at the time the lease was being renegotiated articulated a "duty of finest loyalty." *Id.* at 546. As this commentator surmised, "the outcome must be explained by the court's reference to the actions of 'agents.'" *See* ROBERT R. KEATINGE & ANN E. CONAWAY, KEATINGE AND CONAWAY ON CHOICE OF BUSINESS ENTITY: SELECTING FORM AND STRECTURE FOR A CLOSELY-HELD BUSINESS (2008).

[FN31]. No. 3017-GG, 2008 Del. Ch. LEXIS 158 (May 7, 2008).

[FN32]. *Id.* at *41-43.

[FN33]. *Id.* at *1.

[FN34]. *Id.* at *28.

[FN35]. *Id.* at *34.

[FN36]. *Gotham Partners*, 817 A.2d at 167.

[FN37]. *Fisk Ventures*, 2008 Del. Ch. LEXIS 158.

[FN38]. No. 3803-CC, 2008 Del. Ch. LEXIS 115 (Aug. 15, 2008).

[FN39]. DEL. CODE. ANN. tit. 6, § 18-805.

[FN40]. Petitioners also argued that the waiver should be unenforceable under Delaware law. DEL. CODE. ANN. tit. 6, § 18-109(d) (2009) provides:

> In a written limited liability company agreement or other writing, a manager or member may consent to be subject to the nonexclusive jurisdiction of the courts of, or arbitration in, a specified jurisdiction, or the exclusive jurisdiction of the courts of the State of Delaware, or the exclusivity of arbitration in a specified jurisdiction or the State of Delaware, and to be served with legal process in the manner prescribed in such limited liability company agreement or other writing. Except by agreeing to arbitrate any arbitrable matter in a specified jurisdiction or in the State of Delaware, a member who is not a manager may not waive its right to maintain a legal action or proceeding in the courts of the State of Delaware with respect to matters relating to the organization or internal affairs of a limited liability company. *Id.*

[FN41]. *R&R Capital*, 2008 Del. Ch. LEXIS, at *28-30.

[FN42]. 2007 WL 2744609 at *20.

[FN43]. *Id.* at *12.

[FN44]. *Id.* at *20.

[FN45]. I argue that Delaware courts did not previously engage in this analysis because, in *Gotham Partners*, the Supreme Court of Delaware concluded that statutes prescribed the default fiduciary duties. The 2004 amendment changed that entire calculus and it is now incumbent upon the courts to engage in this policy analysis. The courts, thus

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far, have had only limited opportunity to readdress this new language. Under the appropriate circumstance, which has not arisen yet, I postulate that a Delaware court would apply an economic analysis to determine whether any default fiduciary duties apply.

[FN46]. ROBERT COOTER & THOMAS ULEN. LAW AND ECONOMICS 201 (3d. ed. 2000).

[FN47]. DEL. CODE ANN. tit. 6, § 18-1101(b). *See* Ann E. Conaway, *Why No Respect: The Contractual Duties of Good Faith and Fair Dealing in Delaware*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=994624# ("If freedom of contract in unincorporated entity law means anything, then business courts must be willing to jettison entrenched corporate principles and embrace the aged tenets of contract law ... including the contractual duty of good faith and fair dealing ... and other policing techniques permitted under a contractual regime.").

[FN48]. *See supra* notes 31-38 and accompanying text.

[FN49]. GOOLER & ULEN, *supra* note 46, at 484.

[FN50]. *Id.* at 202.

[FN51]. *Id.* at 199.

[FN52]. *Compare* Amerisource Bergen Corp. v. LaPoint, 956 A.2d 642 (Del. 2008) (interpreting a merger agreement, even where arguably self-interested conduct, under contract principles and not fiduciary duties), *with* Jack B. Jacobs, *Entity Rationalization: A Judge's Perspective*, 58 BUS. LAW. 1043 (2003) ("[I]n cases where the governing instrument displaces fiduciary duty principles in their entirety, the court will employ contract law principles, but will apply them in a manner that protects the interests of investors.").

[FN53]. *See generally Fisk Ventiores*, 2008 Del. Ch. LEXIS 158.

[FN54]. 2007 WL 2744609 at *20.

[FN55]. DEL. CODE ANN. tit. 6, § 18-1101(c) ("the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing."); DEL. CODE ANN. tit. 6, § 18-1101(e) ("a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."); DEL. CODE ANN. tit. 6, § 17-1101(d) ("the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing."); DEL. CODE ANN. tit. 6, § 17-1101(f) ("a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.").

[FN56]. DEL. CODE. ANN. tit. 6, § 18-1101(b).

[FN57]. COOTER & ULEN, *supra* note 46, at 202.

[FN58]. See Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469 (2005).

[FN59]. Professor Smith establishes a framework for understanding what relationships give rise to fiduciary duties. Although fiduciary duties would not apply to a traditional contract, he argues that "strategic alliances," potentially in

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the form of an LLC, is a hard case under his model. Smith, *supra* note 30, at 1476. The central theme of my article, though, focuses on the fact that, by choosing the LLC form and not contracting for fiduciary duties, the parties determined, for themselves, that no fiduciary duty is necessary. I argue that it is improper for the court, in a paternalistic fashion, to apply default fiduciary duties despite the parties' deliberate and bargained-for choice.

[FN60]. COOTER & ULEN, *supra* note 46, at 202.

[FN61]. Notably, LLCs do not always fall into the definition proposed by Smith that "fiduciary relationships form when one party (the 'fiduciary') acts on behalf of another party (the 'beneficiary') while exercising discretion with respect to a critical resource belonging to the beneficiary." Smith, *supra* note 30, at 1402. In some situations, the members may only rarely exercise discretion, leaving the entire task of management up to a third party.

[FN62]. In many situations, parties imprudently form contracts and Delaware courts do not meddle in the process to provide fiduciary duties to correct for ill-advised contract terms. For instance, imagine if Delaware courts, to the horror of negotiated acquisition lawyers, began applying fiduciary duty concepts to merger agreements between sellers and acquirers. Instead, Delaware courts, loathe interpreting contracts using extrinsic evidence beyond the specific terms included in an agreement itself. *See* United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 835 (Del. Ch. 2007) ("The Court must emphasize here that the introduction of extrinsic, parol evidence does not alter or deviate from Delaware's adherence to the objective theory of contracts. As I recently explained to counsel in this case, the private, subjective feelings of the negotiators are irrelevant and unhelpful to the Court's consideration of a contract's meaning, because the meaning of a properly formed contract must be shared or common. That is not to say, however, that a party's subjective understanding is never instructive. On the contrary, in cases where an examination of the extrinsic evidence does not lead to an obvious, objectively reasonable conclusion, the Court may apply the forthright negotiator principle. Under this principle, the Court considers the evidence of what one party subjectively 'believed the obligation to be coupled with evidence that the other party knew or should have known of such belief.'" (citations omitted).

[FN63]. The ability of a court to "add" terms to a contract is known as an "implied in fact" contract and is solely determined by the parties' intent. *See* RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981). This section is titled, "Supplying an Omitted Essential Term." It provides: "When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court." The Commentary to section 204 further provides:

> The process of supplying an omitted term has sometimes been disguised as a literal or a purposive reading of contract language directed to a situation other than the situation that arises. Sometimes it is said that the search is for the term the parties would have agreed to if the question had been brought to their attention. Both the meaning of the words used and the probability that a particular term would have been used if the question had been raised may be factors in determining what term is reasonable in the circumstances. But where there is in fact no agreement, the court should supply a term which comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process.

Id. Terms may also be added by the default provisions of the applicable organic law governing the entity, for example, DLLCA or DRLUPA. Once terms are set in a contract, the contractual covenant of good faith and fair dealing *attaches to the performance and enforcement* of those terms. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its *performance and its enforcement*." (emphasis added)). The contractual duty of good faith and fair dealing does not provide a method for courts to add terms to contracts. For an explanation that the implied covenant of good faith and fair dealing *cannot* provide the basis for "adding or implying" terms to a contract, see Ann F. 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, 96-109 (2008).

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[FN64]. *See, e.g.*, Larry E. Ribstein, *A New Age?: Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209 (2005) [hereinafter Ribstein I]; Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997).

[FN65]. Ribstein I, *supra* note 64, at 212.

[FN66]. *Id.* at 212-13.

[FN67]. *Id.* at 213.

[FN68]. *Id.*

[FN69]. *Id.* Professor Conaway makes an interesting argument that the fiduciary duties being applied by business courts in the alternative entity context are not "partnership" or "LLC" fiduciary duties but are instead corporate duties that are being misapplied. *See* Conaway, *supra* note 63, at 110-14. Certainly at this juncture, no business court has undertaken a principled examination of what a "fiduciary duty" encompasses in the LLC context.

[FN70]. Ribstein I, *supra* note 64, at 213.

[FN71]. One empirical analysis, based upon a questionnaire mailed to practitioners in different states, demonstrates that many LLCs, across the country, are formed without adequate legal representation. Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609 (2006). In this article, I focus only on sophisticated parties entering into a Delaware LLC. I do not imply that this analysis would apply to all members, specifically passive investors, who are not involved in the formation of the LLC nor does this analysis apply to other states.

[FN72]. Ribstein, I, *supra* note 64, at 214.

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*279 POLICING LIMITED LIABILITY COMPANIES UNDER CONTRACT LAW

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I. INTRODUCTION

In 2004, Delaware amended its limited liability company (LLC) law to allow for the contractual elimination of fiduciary duties. [FN1] The Delaware Act seeks to emphasize the contract basis of LLCs. It does this by providing the legal support for the incorporation of clauses that eliminate the traditional duties of care and loyalty (elimination clauses) found in corporate, agency, and trust law. The only immutable principle enunciated by the Delaware Act is the covenant of good faith. [FN2] The statute also provides for the enforceability of full indemnification clauses that shield manager-members from any personal liability. The primary focus of this article will be on the ability of contract law to police the management and operation of LLCs.

This article will analyze whether the good faith obligation can act as a substitute for fiduciary duties in the policing of LLCs. The focus will be on the application of good faith to operating agreements and their enforcement. Other areas of contract law will also be investigated as alternative policing tools. Part II will briefly review the current status of elimination and full indemnification clauses in LLC governance. This will include a review of the Delaware approach and some alternative LLC governance models.

Part III will analyze the role of good faith in contract law. The ultimate conclusion will be that the meaning of good faith remains ill defined ***280** by the courts. This supports the view that good faith is a purely contextual undertaking used by courts to remedy contractual injustice. From a utilitarian perspective, system-wide rules in the area of good faith differ among the state court systems. For example, a good faith exception to employment at will has been recognized and applied in some states, but not in others. Will state courts that do not allow for the elimination of fiduciary duties and full indemnification be tempted to use the good faith doctrine to render use of such liability shields in certain contexts as acts of bad faith?

Part IV will look at other contract law rules and doctrines that could be used to police LLCs under the contractarian model (Delaware Act). The rules and doctrines that will be explored include the doctrine of unconscionability and the enforcement of exculpatory clauses. It will also review the contract law-- related concepts of discretionary contract power, relational contract theory, standard form contracting, and the importance of disclosure. Part Vargues for the retention of fiduciary duties as immutable principles. Any limitation of fiduciary duties and personal liability should be resolved through application of the contextual methodology espoused by Professor Sandra K. Miller. [FN3]

II. LLC GOVERNANCE

The two major paradigins of LLC governance are the fiduciary-based or communitarian approach borrowed from

corporation and partnership law and the freedom of contract empowering elimination/full indemnification approach. [FN4] An example of the freedom of contract approach to LLC governance***281** is the Arkansas LLC statute. It states that "maximum effect" should be given to "the principle of freedom of contract [in the interpretation] and the enforceability of Operating Agreements." [FN5] This is the approach taken by the Delaware Act. [FN6]

The fiduciary-based approach includes numerous hybrids that range from different degrees of fiduciary obligation with partial to full indemnification. [FN7] Some states couple the good faith requirement with the prudent person standard of care taken from fiduciary duty law. [FN8] A variation of this approach allows indemnification only for acts or conduct that are in the best interests of the LLC or not opposed to the best interests of the LLC. [FN9] This approach is something less than the prohibition against self-dealing without full disclosure found in corporation or partnership law. Self-dealing is given more space to operate as long as it does not work against the best interests of the LLC.

The main difference in the fiduciary-based approaches is the presumption/burden of proof requirements. Under corporation law, the burden is on the officer-director to prove adequate disclosure, consent, and the fairness of the bargain. Under some LLC statutes, the burden rests on the minority or outside member to prove that the transaction was not in the best interests of the LLC. Other states provide a measuring standard lower than that represented by the reasonable care standard. These states apply a gross negligence or willful misconduct standard to manager-member duties. These statutes may or may not allow full indemnification for breach of the standard. Still other states leave the issue of full indemnification unanswered. [FN10] They do not expressly allow for full indemnification ***282** nor provide express restrictions on indemnification clauses. The underlying model of LLC governance--whether contractarian or traditional, fiduciary duty based--will likely determine the enforceability of such clauses.

A. Models of LLC Governance

The role of fiduciary duties in LLC governance is determined by the model of governance that is applied. The contractarian approach has been advanced by the Delaware legislature. Under this approach, such duties have no special status in the interpretation and enforcement of operating agreements. As such, the duties can be fully disclaimed and eliminated. Along the same lines of thought, lack of care, self-dealing, self-interested opportunistic behavior, and other forms of misconduct can be expressly indemnified by the operating agreement.

It has not been definitively decided, even under Delaware law, whether the rules of corporate governance and partnership law dealing with fiduciary duties and personal liability should act as default rules in LLC governance. However, it has been noted that the "most extreme contractarians deny that fiduciary duties are default rules at all; they would require that parties affirmatively adopt fiduciary obligations as part of their contract." [FN11] The stronger argument is that fiduciary duties and personal liability should act as default rules. Courts are likely to see such implication as the recognition of good faith or commercially reasonable terms. The latter argument is supported by the extensive literature and case law applying fiduciary duties in the governance of organizations, trusts, and agency relationships. [FN12] The focus in this article is not the use of fiduciary duties as default rules to fill in gaps in the operating agreement. Rather, the focus in this article is on the enforcement of elimination/full indemnification clauses. The next two sections will briefly review the enforcement of such clauses under the two models of LLC governance.

***283** 1. Delaware's Freedom of Contract Regime and the Analogous Nature of the Common Law

Many state LLC statutes do not allow for the complete elimination of fiduciary duties or the enforceability of full indemnification clauses. But, Delaware is not just any state. The role of Delaware in the development of the law of organizations is firmly established. The more interesting question concerns the way in which the Delaware statute will be interpreted and applied by the courts of other states. Will the good faith obligation be more aggressively used by other state courts in applying the Delaware Act?

Instead of simplifying LLC governance, the Delaware Act may work to complicate it. The Delaware Act is premised upon giving maximum effect to the principle of freedom of contract and to the enforceability of operating agreements. But, how does one define the principle of freedom of contract in the context of LLC governance? Freedom of contract in modern contract law is restricted by immutable rules, such as reasonableness, unconscionability, good faith, and fair dealing. Furthermore, specific contract clauses are highly regulated, including limitations of liability, liquidated damages, limitation of remedy, and exculpatory clauses. Because the Delaware Act fails to define freedom of contract or provide standards of conduct, the jurisprudence of the entire common law of contracts should be used in the interpretation of operating agreements. Parts III and IV will review some of these contract rules and project their application to LLC operating agreements.

The argument that Delaware's freedom of contract--based LLC statute provides unfettered private autonomy through contract is overstated. As noted above, the implication of contract law as the governing paradigm for LLCs invites use of all of common law contracts, and not just the good faith doctrine, in the interpretation and enforcement of operating agreements. One commentator notes that:

> Parties can expect great freedom in drafting their LLC operating agreements and judicial deference to them, yet an LLC agreement is a contract that avails itself of a state-provided governance structure. Parties to an LLC agreement generally understand that the contract includes a certain amount of equitable court supervision of the governance structure, as distinct from [strict] legal enforcement of the benefit of the bargain. [FN13]

***284** From a contract law perspective, unadulterated freedom of contract in the LLC context will likely give way to the dictates of justice and fairness. An analogy is found in employment law. State laws, at least historically, strongly enforced employment at will as the default rule in employment termination. But, over time, many states have recognized common law exceptions to termination at will. These include implied-in-law (good faith) and implied-in-fact exceptions. Courts may be tempted in the future to recognize a modification or implied duty in conflict with a "no fiduciary duties" provision in an operating agreement. Just as in some states where an express termination-at-will clause in an employment contract may not shield an employer from an action for bad faith discharge, some courts are likely to fashion good faith exceptions to prevent the full enforcement of elimination and full indemnification clauses.

An example of the role of the common law in the regulation of business organizations is the piercing of the corporate veil doctrine. [FN14] Veil piercing in the corporate arena has been primarily used by courts to prevent abuses in the governance of the closely held corporation. Many small LLCs can be analogized to the closely held corporation. The ability of member-managers to avoid fiduciary duties will eventually impact the viability of the LLC form. If corporate or partnership history is a guide, then courts, in the long term, will intercede to correct abuses.

2. Alternative LLC Governance Models

The vast majority of states provide alternative governance structures to that represented by the Delaware Act. Most state LLC statutes do not permit the elimination of fiduciary duties. Under North Carolina law, fiduciary duties may be limited, but cannot be eliminated. The North Carolina LLC statute does, however, allow for the limitation of personal liability of a manager-member for improperly obtained personal benefits. [FN15] It does not allow for indemnification for "acts or omissions that the manager,***285** director, or executive knew at the time of the acts or omissions were clearly in conflict with the interests of the limited liability company." [FN16]

As is found in corporation law, the LLC in most states is not allowed to eliminate the duty to act in the best interest of the LLC. The best interest standard is used to distinguish between permissible self-dealing and impressible conduct, such as usurping a company opportunity. [FN17] The Virginia LLC statute [FN18] provides a general standard of conduct for LLC managers. It provides that a "manager shall discharge his or its duties as a manager in accordance

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with the manager's good faith business judgment of the best interests of the limited liability company." [FN19]

In sum, the Delaware approach has not been widely accepted in that most states do not allow for the elimination of fiduciary duties. About a dozen and a half of the states require the manager-member to exercise the care of a prudent person, [FN20] others prohibit grossly negligent conduct, [FN21] and some require that for indemnification to be granted the member-manager must have believed that she was acting in the best interests of the LLC. [FN22] Nonetheless, what may result is a race to the bottom. This phenomenon has occurred before, given the popularity of the Delaware corporation statute. The difference is that despite the pro-corporation liberality of Delaware corporation law, Delaware law retains a mandatory core of fiduciary duties in corporate governance. The question is whether the Delaware LLC Act's rejection of immutable fiduciary duties will result in a net social welfare loss. Will the result be an unregulated business form ***286** that will be subject to abuse undisciplined by the mechanisms of the public market or by law-imposed fiduciary duties?

B. "Creatures of Statutes" and Common Law

Justice Steele notes that "limited liability companies, like corporations, are creatures of statute, and do not exist at common law. The policy direction from the legislature carries the day over even the most clearly defined doctrinal common law principles." [FN23] The Delaware Act attempts to shift the emphasis of the LLC as a creature of statute to the LLC as a creature of contract. [FN24] The preemption of statute over common law doctrine is a basic principle of American law. However, this is an oversimplified statement of our legal system. First, all creatures of statutes need to be interpreted and applied by courts. Thus, a necessary jurisprudence is developed, subject to preemption by amended or new statutes, whether it be the Uniform Commercial Code (UCC) or an LLC statute. It will be difficult, over the long term, for courts to disregard common law fiduciary duties and do a purely contractual analysis in cases where gross negligence in the governance of LLCs causes catastrophic losses to member-investors.

Second, Delaware's freedom of contract approach results in the application of the entire common law of contracts to govern an otherwise statutorily controlled area of law. As will be discussed at length later in this article, the statute's explicit adoption of the doctrine of good faith as the major (only) policing mechanism for LLC governance opens up such governance to the dense case law applying the doctrine to different contractual contexts. But, the freedom of contract approach does more than apply contract law's good faith duty; it opens LLC governance to the entire realm of common law contracts. This allows courts to apply, by analogy, other doctrines of contract law, along with more specific contract law rules. Thus, courts will be able to use the unconscionability doctrine to regulate substantive fairness concerns or develop more area-specific rules such as those related to the enforceability of exculpatory clauses.

***287** Case law limiting the reach of exculpatory clauses or the enforceability of limitations of remedy or liability could be used in the enforcement of analogical terms found in operating agreements. An elimination clause may be judged as an unacceptable exculpatory clause when it protects grossly negligent or willful conduct. Indemnification clauses may be challenged as unreasonable limitations of liability or remedies. Will most courts fully enforce such clauses when they essentially leave a party without any remedy? Will courts enforce such clauses that are supported by statutory mandate? Or will they be tempted to view such clauses from the context of the operating agreement as a whole? If, for example, an operating agreement eliminates all fiduciary duties, provides full indemnification, possesses no exit mechanism for minority interests, and removes the right of dissolution, will courts attempt to provide some level of protection to the nonmanaging, noncontrolling members?

Assuming that in the long term courts will attempt to align the interests of controlling or managing members and noncontrolling members, contract law provides different avenues for such a realignment. First, the full utilization of all pro-managing member provisions for repeated acts against minority interests could be determined to be performance in bad faith or a bad faith squeeze-out. Second, the courts may fully enforce the elimination/full indemnifica-

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tion provisions (as mandated by the LLC statute), but imply certain protective rights to the noncontrolling members. Courts could avoid the implication of duties prohibited by the statute by reframing the analysis as the implication of rights to LLC members. An example of this approach would be the implication of a right to dissolve or exit the LLC. [FN25] Even where the operating agreement contains a "no-exit" provision, a court will be tempted to imply some protective limitation, such as where a member may obtain dissolution when the LLC's business can no longer serve its purpose. [FN26] The court can then narrowly or broadly define purpose in determining whether or not to grant dissolution in a given case.

***288** III. THE CONTRACTUAL DUTY OF GOOD FAITH IN THE LLC CONTEXT

The *Restatement (Second) of Contracts* (*Restatement*) [FN27] and the UCC [FN28] discuss both good faith enforcement and good faith performance. Even in the case where there is an express elimination provision, good faith enforcement may prevent the exercise of contract rights under such a provision or the use of it as an exculpatory defense. The concept of good faith performance is found in the civil law in its "abuse of rights" doctrine [FN29] which has been described as the "purported exercise of a certain right 'contrary to its economic or social purpose.'" [FN30] The conceptualization of good faith as a duty "makes clear that the doctrine of good faith serves to do justice whenever performance has been formally delivered." [FN31] It acts as a default rule "applying when relevant aspects of performance have not been contemplated in the express terms." [FN32] But it also applies when there is a bad faith exercise of express contract rights.

Professor Farnsworth notes that the standard of good faith applied to fiduciaries is more exacting than that applied in contracts' good faith performance doctrine. [FN33] The simplest distinction is the role of self-interest. In contract performance, the self-interest of the performing party is still the core perspective. However, that self-interest is limited by the reasonable self-interests of the other party. The reasonable self-interest of the other party can be described as the party's reasonable expectations or reasonable ***289** reliance. An alternative description is that the basis of the bargain should not be disturbed by the bad faith acts or opportunistic behavior of a party to the contract. In contrast, the focus in the fiduciary relationship is the self-interest of the other party. What is not bad faith in a contract (party advances self-interest, but does not encumber the self-interest of the other party as determined by the basis of the bargain) is bad faith in the fiduciary relationship. For example, an agent who usurps an opportunity for herself while working on behalf of another violates the duty of loyalty. In contract law, a party does not owe a duty of loyalty to the other party, other than not to perform in bad faith. Other than the duty to cooperate in order to allow for the performance of the other party, a contracting party is free to pursue its own self interests. If this entails a certain level of loyalty it is a loyalty to the contract. The loyalty in fiduciary duties is a loyalty to the other party or principal.

Even though the UCC and the *Restatement* fail to provide a definition of good faith, they do provide guidance as to the breadth and flexibility of the doctrine. A Comment to Section 205 of the *Restatement* states that

> [s]ubterfuges and evasions violate the obligations of good faith in performance even though the actor believes its conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasions of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of power to specify terms, ... [FN34]

The above Comment uses an antonym-like approach to framing the definition of good faith. It indicates that good faith is the opposite of bad faith and then gives examples of bad faith. This approach reflects the scholarship of Robert Summers' "excluder analysis." [FN35] The "norms" of reasonable ***290** behavior are used as a vehicle for determining bad faith. [FN36] If the behavior of a contracting party so widely varies from the norm, then the result is an act of bad faith.

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Summers' approach has particular salience to the LLC as contract. His approach incorporates a moral element to the good faith duty. [FN37] As such, the duty of good faith is a separate obligation outside the particulars of the specific contract. [FN38] Professor Gold explains that "good faith is, under this theory, 'a piece with explicit requirements of contractual morality such as the unconscionability doctrine and various general equitable principles.'" [FN39] As an independent obligation, the duty of good faith can be used to limit the operation of an express clause in a contract.

Professor Burton's alternative approach to the good faith doctrine can also be used to monitor the behavior of a member-manager in the context of an LLC. The freedom provided by an elimination provision should not be viewed as a right to "recapture lost opportunities." [FN40] The question for LLC governance is what are the lost opportunities attempting to be recaptured in the act of bad faith? Acts of self-dealing may be specifically covered by an elimination clause, but they still may be acts of bad faith. At the least, the elimination clause should describe the types of lost opportunities that the controlling member or member-manager is allowed to recapture.

It may be easier for a court to intercede under the good faith doctrine where the elimination clause uses language that is general in nature. This idea will be more fully explored later in the discussion on unconscionability and standard form contracts. It is a more difficult case were the operating ***291** agreement describes with specificity the types of conduct or actions that are allowed. Nonetheless, the elimination clause cannot protect the member-manager from bad faith acts. The question then becomes what norm will be used to determine if an act is in bad faith? The problem with Delaware's adoption of the covenant of good faith and fair dealing is that there is little case law applying the covenant to the performance and interpretation of operating agreements. The only readily available norms are the fiduciary norms found in the governance of other business organizations. [FN41]

Justice Steele cautions that courts will be "lure[d to] the case law from the corporate governance context" and that will "cause the courts to misfocus, particularly in a vacuum, especially where the conduct of the defendant may appear so inequitable that the court will look to the fiduciary relationship between the parties and not to their contractual arrangement." [FN42] The fear is that over time the good faith doctrine in the contexts of LLC governance will come to mimic the fiduciary duties it was intended to supplant. [FN43] This is the case despite the fact that the fiduciary duty of loyalty requires a manager to act in the best interests of the entity, while the covenant of good faith more readily permits a manager to act in his or her own self-interest. [FN44]

The meaning of good faith and fair dealing in relationship to operating agreements containing elimination and full indemnification clauses is still to be determined. This determination will be critical to seeing whether the duty of good faith and fair dealing can be used to provide at least a minimum of ***292** protection to minority investors. The question becomes whether, given the context of LLC governance, there is a relationship between the duties of care and loyalty and the covenant of good faith and fair dealing.

An alternate framework for understanding the duty of good faith is to concede that the definitional problem is insurmountable. Instead, the key to understanding the duty is to analyze in what contexts it should be used. Insight into the contexts in which it is used can be gained by analyzing the functions the duty is intended to serve. Professor Farnsworth notes three of these functions. [FN45] The first function of the good faith doctrine is to fill in gaps in incomplete contracts, especially in the area of performance. This is the default rule function that would be utilized when an operating agreement fails to expressly eliminate fiduciary duties. The default rule may adopt the fiduciary duties of corporate-partnership governance, something less than the fiduciary duties of corporate-partnership law (minimum core approach), or a no--fiduciary duty rule.

A second function of the duty of good faith is to police the abuse of discretion or power expressly given in an

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operating agreement. [FN46] The policing of contractual power will be more fully analyzed in Part IV. For now, it will suffice to say that good faith may be used to monitor the exercise of contractual rights. This function can be served where there is no gap in the contract, but there is a series of express provisions that grant unfettered freedom to one party to determine the level of performance required under the operating agreement. Good faith can be used to police the abuse of those performance rights.

The third function of the duty of good faith is that it can be used to mark off areas of impermissible conduct. [FN47] This function is anchored in morality, including existing and continuing business custom and usage. [FN48] It asserts that, despite express terms to the contrary, certain conduct violates "basic standards of decency." [FN49] This function of the duty of good faith, like contract law's other meta-principles (unconscionability, fair dealing, ***293** compensatory damages, excuse) serves to signal the types of terms and conduct that will not be protected under the freedom of contract rationale. This is where the Delaware recognition of elimination/full indemnification provisions conflicts with its adoption of the good faith doctrine. The legislature is recognizing such provisions as permissible. However, the actual use of those provisions in a given context may be an act of bad faith. This approach focuses not on substantive rights or duties, but on process values. The managing member may not have the duty to protect minority interests, but she may have a duty to process minority requests in a good faith manner.

IV. DEVELOPING LLC CONTRACT LAW

The common law of contracts is a thick structure of rules and doctrines. [FN50] Many of these rules and doctrines have been applied in different contract settings that evolved in the twentieth century. In some instances, new rules were developed to more adequately reflect the needs of a modern economy. [FN51] The recognition of LLCs as "mere contracts" presents a new context for the application of contract law. History shows that contract law has been flexible enough, with some adjustments, to respond to new contractual contexts.

The power of the common law's equitable principles was witnessed in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.* [FN52] Justice Steele had this to say about the Delaware Supreme Court's decision: "The supreme court apparently found it difficult to abandon the view that judicial oversight of disputes within the governance structure of limited liability unincorporated entities must invariably be from the perspective of a set of freestanding non-waivable equitable principles, drawn from the common law of ***294** corporate governance." [FN53] An associated question is whether the equitable principles of common law contracts are also waivable. The answer is in the negative. For example, the equitable doctrine of unconscionability is an immutable principle. The question analyzed in the next section is whether there is a relationship between good faith and fair dealing, unconscionability, and the notions of due care and loyalty.

A. Doctrine of Unconscionability

The difficulty with the argument that courts should ignore fiduciary law cases in the application of contract law to operating agreements is that those cases can be used in the application of contract law's unconscionability doctrine. Fiduciary law cases often provide examples of the courts' intervention to protect minority interests. In some of these cases, courts have ignored the express language of an operating agreement in order to protect the interests of a non-controlling member of the LLC. A California court in *SIVSA Entertainment v. World International Network* held that an express waiver clause could not waive the right to seek a judicial dissolution of the LLC. [FN54] An Illinois court held that a "sole discretion" clause concerning whether to distribute earnings did not prevent the court from intervening. [FN55]

LLC statutes, including contractarian-based ones, refer directly or indirectly to the unconscionability doctrine. [FN56] The RULLCA [FN57] alludes to the doctrine of unconscionability when it states that conduct authorized by

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the operating agreement should not go "manifestly beyond what a reasonable person could have contemplated." [FN58] Even with the statutory mandate***295** allowing elimination clauses, such clauses are still subject, especially when the LLC is viewed as a whole, to the immutable doctrine of unconscionability.

Recent empirical research has shown that the freedom of contract approach to LLC fiduciary duties is more likely to result in unconscionable operating agreements. Professor Miller argues that empirical research questions the foundational assumptions of the contractarian theory of LLC governance. [FN59] These assumptions include that all members execute the operating agreement, that the operating agreement is highly negotiated, and that the members are of relatively equal sophistication or have adequate legal representation. [FN60]

Fiduciary duty law challenges the above assumptions. It is premised on the belief that owners of business organizations may *not* contractually protect their interests in the formation of their organization. At the least, the contractual stripping of fiduciary duties through contract must be evidenced by a certain level of disclosure and specific consent. Substantively, even with adequate disclosure, the courts should scrutinize such clauses for unconscionability in the context of the contract as a whole.

To summarize, if an elimination clause is viewed as mere boilerplate, then it should be subject to challenge under the principle of unconscionability. The argument against such a challenge is that the legislative mandate providing for the enforceability of such clauses preempts such an application. The counterargument is that the statute at least implicitly recognizes the applicability of the common law of contracts. A contextual approach would recognize that such clauses cannot be viewed independently of the rest of the contract. Thus, the enforceability determination should include an analysis of the content of the clause, the reason or purpose behind the clause, and its use in the particular case. These factors, along with ***296** the characteristics of the parties and the contract as a whole, matter a great deal under contract law. [FN61]

The case for unconscionability gains strength when elimination/indemnification provisions are coupled with other terms, such as a no-exit clause or waiver of a right to seek dissolution. The Delaware freedom of contract paradigm will encourage the writing of overly one-sided operating agreements. The statutory acceptance of the elimination of fiduciary duties and full indemnification will act as a signal to prospective managing or controlling members that overly one-sided operating agreements will be enforced. It is an invitation to founding members to use their bargaining power [FN62] to unload the operating agreement of any minority-protective terms.

A study by Miller, Greenberg, and Greenberg provides tentative support for the one-sided signaling hypothesis. [FN63] The study established that there was a lower frequency of buyout provisions in Delaware LLCs than was found in other states. The existence of buyout provisions in an operating agreement provides some minimal level of protection to a minority member. The minority member would be able to exit the LLC in the event she felt that her interests were threatened by the use of the elimination/full indemnification provisions. One explanation for the less frequent use of buyout provisions in Delaware LLCs is that, if a party possesses the bargaining power to eliminate fiduciary duties, then it would more likely also eliminate minority buyout provisions. [FN64]

B. Discretionary Contractual Power

An elimination/full indemnification LLC gives the member-manager almost unlimited discretion in the exercise of her contractual performance. ***297** In other areas of law, specific implied rules have been developed to police discretionary contractual power. [FN65] In output-requirement contracts, for example, the law limits an express provision granting one party the right to set the quantity at her sole discretion. The law disregards the express contractual right through the implication of a reasonable quantity term.

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An elimination clause acts as a sole discretion clause in that it grants complete discretionary power to one party to determine the level of performance required. As noted above, in other areas of contract law, courts have implied a standard of reasonableness in the face of such discretionary power. As a New York court explained, there is an implied duty in the exercise of contractual discretion or power "not to act arbitrarily or irrationally in the exercise of that discretion." [FN66] Another example of the role of contract law in policing discretionary contractual power is in the enforcement of subjective satisfaction clauses. [FN67] These clauses provide that a buyer's duty to perform is conditional on its satisfaction (at the buyer's sole discretion) with the seller's performance. Contract law fails to enforce the sole discretion right in favor of objectively (good faith) limited discretion.

The core principle of contract law is that contracting parties should be able to allocate rights and powers as they see fit. This is the facilitative function that underlies most of contract law. But, contract law also serves a regulatory function and that includes controlling the exercise of the powers that contract rights create. [FN68] An example of this function is the implied duty of best efforts found in agency law. The relationship of investor to member-manager in an LLC is akin to the exclusive agency relationship. The investor is completely dependent upon the member-manager to act in a way that will benefit the investor's interests. In agency law, the duty of best efforts is implied to align the interests of principal and agent. [FN69] Some ***298** have viewed this duty as stemming from the good faith doctrine; others have asserted it as something separate from good faith. [FN70] In any event, if the member-manager is an agent of the investor, and the law implies a duty of best efforts, how does the elimination of fiduciary duties change the obligations of the member-manager as agent?

Courts, over time, will be tempted to intercede in LLC cases involving the abuse of contractual power. One avenue of such intercession is the implication of reasonable performance standards, whether within or outside of the good faith doctrine. In a typical fiduciary relationship, the agent is given power to act on behalf of the interests of others. Implicit in the use of such power is the reasonable use of discretion. Such discretion is subject to abuse, especially when the agent's interests are not properly aligned with those of the principals. [FN71] A framework for policing such abuse is to focus on the purposes for the creation and use of discretionary power "created within the organization." [FN72] The most plausible purpose of an LLC is to benefit all its members. The use of discretionary contractual power, behind the shield of elimination/full indemnification clauses, to advance personal or member-management interests to the detriment of minority members is an abuse of power and will need to be policed.

C. Importance of Disclosure in a No--Fiduciary Duties LLC

Justice Steele asserts that elimination clauses should be enforced if voluntarily agreed to and after full disclosure: "Limited liability companies should be free given a full, clear disclosure paradigm--to adopt or reject any fiduciary duty obligation by contract." [FN73] The question here is what is to be considered full disclosure? Professor Miller suggests that, in the elimination/full indemnification LLC, at the very least, the law (LLC statute) ***299** should require "language that would alert investors to possible curtailments of fiduciary duties." [FN74] Another commentator discusses the relationship between minimum fiduciary duties as default rules and the importance of full disclosure in the enforcement of elimination clauses:

> The rules seeking to preserve a minimal core of fiduciary duties can be best understood as intent-implementing or contract-enforcing. Rather than impose upon parties a regime that they disdain, the main purpose of these rules is to ensure that parties understand the effects of the abrogation of fiduciary duties. It is precisely because the parties' ability to specify the best regime for every contingency is at best limited (not only by transaction costs, but also by their limited foresight) that the law requires opting out of gap fillers to be done in a careful and informed manner. [FN75]

The fact that the Delaware statute allows the elimination of fiduciary duties without full disclosure is beside the point. If an operating agreement is a contract it will need interpretation like any other contract. As such, the general law of contracts will be applied, directly or indirectly, by analogy. The point being that a freedom of contract paradigm, allowing the elimination of fiduciary duties, should incorporate the notions of full disclosure and informed consent.

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The importance of disclosure is that the market policing argument, as found in securities and corporation laws, for the prevention of overreaching is missing from private LLCs. In the corporate setting, law and economics scholars argue that minority interests are protected by the discipline of an efficient market. [FN76] This argument breaks down in the context of the private, closely held corporation or private LLC. The market is not available in the squeeze-out scenario to protect minority interests. [FN77]

***300** *D. Relational Contract Theory*

Relational contract theory implies that there are different norms and degrees of good faith in different contractual contexts. If the duty of good faith means something different in different contractual contexts, then how does this inform the application of the good faith principle in the context of the LLC? Relational contract theory provides a framework for the analysis of the good faith principle in the policing of LLC operating agreements. The viewing of the operating agreement as a part of an overarching relational contract allows the use of relational norms to supplement the enforcement of an elimination provision. [FN78]

Delaware's contract paradigm fails to recognize the relational element of contract law and of business organizations. The Delaware Act views the operating agreement as a discrete, transaction-type contract. The contract sets the obligations among the different parties to the contract (member to member). In fact, the operating agreement begins a long-term, relational contract. The alignment of interests found at the time of the initial contract formation may be unaligned later in the relationship. Modern contract law provides a highly context-dependent framework for realigning such interests in the interpretation and enforcement of operating agreements. The operating agreement establishes the member-to-member relationship, but it does so in the context of the creation of a separate legal entity. Thus, it also creates a relationship between the member and the LLC. It is this relationship that fiduciary duties in other business organizations seek to govern.

A relational-contextual view of contract law sees the interpretation and enforcement of an operating agreement as not a mere enforcement of express terms. Instead, this view would look to context--the particular characteristics and relationship of the parties to that contract when interpreting the written terms. The relational perspective sees the contract not just as the express terms of the operating agreement, but also as an agreement based upon the reasonable expectations of the parties. The reasonable expectations model of contractual obligation is discussed in the review of consent in the standard form scenario in the next section.

***301** *E. Standard Form Analogy*

In the standard form contract scenario, the reasonable expectations of the form-receiving party plays an important role in the enforcement of the contract's fine print or boilerplate terms. [FN79] If the elimination and indemnification clauses in an operating agreement are considered boilerplate terms, then the standard form analogy can be drawn. Karl Llewellyn's approach to standard form contracts only allows for the enforcement of standard or fine-print terms based upon a permissibility standard. [FN80] The contract terms are those that the parties specifically assented to and those fine-print or general terms that the form-receiving party would have reasonably expected to be incorporated into such a transaction. In Llewellynian terms, the investor-member gives specific consent to the substantive, dickered terms of the operating agreement and blanket assent to other reasonable terms. [FN81] The enforcement of the "other" terms can be bolstered through the use of specific or particularized consent. Specific consent can be obtained through actual discussion or negotiation of the term and through reasonable disclosure as discussed earlier.

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F. Specialized Bodies of Contract Rules

Inside contract law there are a number of express contract terms in which specific nonenforceability rules have been established, such as exculpatory, limitation of remedy, and limitation of liability clauses. If LLCs are to be considered mere contractual undertakings, then numerous analogies can be drawn to this specialized, clause-specific body of rules. The inside alternative would argue for the fabrication of rules akin to those developed in other areas of contract law, such as the enforceability of exculpatory clauses.

The rationale for the nonenforcement of exculpatory clauses is to discourage grossly negligent behavior. The need to discourage grossly negligent behavior is anchored in the public policies against the ***302** encouragement of welfare-harming conduct and unconscionable contracts. [FN82] The same public policy concerns present themselves in an LLC elimination clause that exempts a member-manager from liability for gross negligence. This public policy rationale can be seen at work in LLC statutes. For example, the Arkansas LLC statute provides that a manager-member is liable for any "act or omission [that] constitutes gross negligence or willful misconduct." [FN83] However, this admonishment is prefaced by the phrase "unless otherwise provided in an Operating Agreement." [FN84] This prefatory language is subject to two interpretations. The less reasonable interpretation is that the operating agreement could eliminate the duty not to act in a grossly negligent or willful way that is against the interest of the LLC or its members. The more reasonable interpretation is that the operating agreement may only prohibit conduct that is less than the threshold that would render it grossly negligent or willful. [FN85] Also, in order to enforce most exculpatory clauses, courts often require that "the term [be] fairly bargained." [FN86] The importance of bargain and consent to contract law was addressed above in the discussion of unconscionability and standard form contracts.

V. SUPERIORITY OF FIDUCIARY DUTIES AND A CONTEXT-BASED, MANDATORY CORE APPROACH

The relationship between contractual good faith and fiduciary duties remains unsettled. [FN87] The courts will decide whether the application of good faith to the LLC context is something less than the requirements of fiduciary duties or whether good faith can be used to mimic those duties. This ***303** article has argued that courts could use the flexibility of the good faith doctrine to mimic fiduciary-like duties in policing operating agreements. But such an argument is yet to be borne out and therefore, the clearer and safest approach is the mandatory fiduciary duties approach. Given the indeterminate relationship between good faith and fiduciary duties in the LLC context, the argument here is that fiduciary duties are more clearly delineated in the law as compared to the more amorphous doctrine of good faith. [FN88] Also, fiduciary duties focus on relational issues at the core of governance. The well-developed case law and literature in the areas of fiduciary duties and corporate governance have provided hard and fast rules that operate to apply the more vague fiduciary duties concepts. [FN89] In contrast, the duty of good faith remains a flexible, but open principle.

The intended purpose of Delaware's freedom of contract paradigm is to provide for greater certainty by allowing the parties to expressly delineate the scope of duties and liabilities. Under the statute, however, good faith becomes the only means for judicial intervention. As such, the well-defined fiduciary duties of corporate governance are replaced by an inherently flexible, but vague principle. The cost of increased flexibility is greater uncertainty. Over time, courts will develop a common law defining areas of misconduct that violate the good faith doctrine in the context of LLC governance. In the end, these operative rules may resemble those provided under fiduciary duty law.

A. Superiority of Fiduciary Duties

Fiduciary duties are superior to the implied doctrine of good faith for a number of reasons. First, as discussed above, they are better delineated in the case law. [FN90] This is especially true in the context of a business organization. ***304** Second, they serve an important signaling role in alerting officers, directors, or members of a business entity

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of what is considered to be appropriate or permissible conduct. As Karl Llewellyn noted, the purpose of law is primarily the "marking off of the impressible." [FN91] Others have referred to this role of law as the expressive function of law. [FN92] Professor Miller has argued that the law of fiduciary duties serves such an expressive function in corporate and LLC governance. [FN93] The expressive function of law recognizes that law influences behavior. An LLC governance law based on unfettered freedom of contract is likely to result in an abuse of that freedom. The recognition of minimum mandatory fiduciary duties encourages the exercise of conduct that advances the interests of the different members of the LLC.

The expressive or signaling function of law recognizes the moral-normative dimension of contract law. Professor Shiffrin parallels contract law with the morality of promise. She notes that the morality of promise should be used to gauge the quality of contract law. She states that "the premise that law must be made compatible with the conditions for moral agency to flourish --both because the intrinsic importance of moral agency to the person and because a just political and legal culture depends on a social structure in which moral agency thrives." [FN94] Shiffrin asserts that the morality of law shapes the individual's use of that law. Allowing parties to eliminate fiduciary duties and personal liability for acts of self-dealing and personal opportunism increases the likelihood that otherwise decent persons will commit such acts.

Contract law's policing doctrines will likely work against injustice in the enforcement of elimination and indemnification clauses. Nonetheless, the more specific rules developed in fiduciary duty law provide a more efficient method for discouraging contractual injustice in the area of LLCs.

B. Somewhere Between Breach of Good Faith and Fiduciary Duties

The courts may enforce an elimination clause to shield a member-manager from liability for individual acts of misconduct, but could treat accumulated ***305** acts as bad faith subject to judicial intervention. The Eighth Circuit states that a court should consider "the totality of the conduct and ask whether it constituted a freeze-out." [FN95] This type of analysis could recognize a pattern of exempted acts that cumulatively, but not individually, violate the doctrine of good faith or core fiduciary duties. In the alternative, a court may look at the context of a given action as one in a series of actions and determine that the individual act was a breach of good faith. However, a court not restrained by the law of fiduciary duties is less likely to make such a contextual inquiry.

Professor Miller advocates a Mandatory Core Approach for LLC governance. [FN96] Miller suggests that the primary core of LLC governance should be based on freedom of contract, but that complete elimination of fiduciary duties should be prohibited. The restriction-permitted approach recognizes the flexibility allowed in the LLC business organization. It also recognizes the principal--agent relationship that underlies all business organizations. The level of fiduciary duties may be lowered below what is required by other forms of association (limitation clauses), but not eliminated. [FN97] The freedom of contract paradigm allows the organizing members to define the type of conduct that would be allowed. This freedom to reduce but not eliminate fiduciary duties strikes the right balance between freedom and protection. Just as the doctrine of unconscionability prevents ***306** grossly one-sided contracts, core fiduciary duties will prevent overreaching by a member-manager.

Numerous LLC statutes provide a good faith *plus* core fiduciary duties approach. Oregon's LLC statute provides an extensive list of duties, including the duties of care, loyalty, and good faith, that apply to member-managers. [FN98] The duty of loyalty prohibits usurpation of company opportunities, self-dealing or representing another entity with an interest adverse to that of the LLC, and competing with the LLC in any way. Under the duty of care, the member-manager is precluded from "grossly negligent or reckless conduct" [FN99] and must "exercise any rights consistent with the obligation of good faith and fair dealing." [FN100] Elsewhere, the statute states that a member-manager who "exercises some or all of the rights of a manager in the management and conduct of the limited

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liability company's business is held to the [above] standards of conduct." [FN101] This is an extension of the implied limitation of discretionary power found throughout contract law. [FN102] In the LLC context, the member-manager can be guilty of violating the duty of care or loyalty by exercising, possibly even in good faith, "some or all" of the managerial rights provided in the operating agreement.

The Oregon LLC statute acknowledges the flexibility of the LLC form by allowing parties to the operating agreement to lower, but not to eliminate, the above duties and standards. [FN103] It provides examples of the types of fiduciary duty limitations that are acceptable. In the area of the duty of loyalty, the statute states that the operating agreement may allow the member-manager to possess interests in other companies that may compete against the LLC. [FN104] The statute also provides that the operating agreement can provide a lower standard to measure the duty of care. [FN105] To summarize, the Oregon LLC statute adopts a Mandatory Core Approach ***307** that prohibits the complete elimination of the duty of loyalty and the "unreasonable" reduction of the duty of care. This is a middle ground between applying the full corporate and partnership-like duties found in most states and the elimination of all fiduciary duties allowed under the Delaware Act. The middle-ground approach includes the recognition of a minimum core of fiduciary duties and the use of good faith to prevent the repetitive use of manager-member contract rights to oppress minority interests.

C. Role of Context

Commentators have argued that the duty of good faith and fair dealing is not a substitute for fiduciary duties. [FN106] However, through the lens of a contextual analysis, principal--agent principles, and the misuse of discretionary power, fiduciary duties could be implied as a matter of good faith and fair dealing. [FN107] This good faith--in-context analysis allows courts the leeway to mimic fiduciary duties in examining member-manager conduct despite the existence of an elimination clause. [FN108] They could use the good faith doctrine to mimic fiduciary duties by labeling member-manager conduct as an act of bad faith. A negative consequence of such an approach is that it may lead "to the use of highly aggressive clauses to strip investors of the expectation that discretion must be exercised reasonably." [FN109] However, incorporating a litany of such clauses into the operating agreement would open the agreement to attack on unconscionability grounds.

Professor Miller's Mandatory Core Approach builds on the notion of the LLC as a "social enterprise." [FN110] In the social enterprise, duties vary ***308** depending on the relationship of the parties. A similar notion of common enterprise or purpose is also found in the good faith doctrine. [FN111] Comments to Section 205 of the *Restatement* notes that good faith includes the "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party." [FN112] As such, the level of duties owed between members of a business organization, whether through a minimum fiduciary or good faith approach, vary depending on the characteristics of the relationship. The relationship would be framed based on contextual factors including sophisticated--less sophisticated parties, bargaining power inequalities, public--private company, one-sidedness of contractual terms, types of relationship (controlling member or managing member versus minority member), and the existence of disclosure or particularized consent.

The major problem of the contract model of LLCs is that it begins and ends at a point that reflects out-of-date contract law theory. Its premise is that the enforcement of operating agreements should begin and end with the express terms. This is the realm of legal formalism and classical legal theory. It is the world of the plain meaning rule and formalistic application of contract law. Modern contract interpretation has adopted a more contextual understanding of contract law as applied to the many species of contracts. It also acknowledges that plain meaning is a vacuous concept. Instead, the interpretation of a contract is always a contextual undertaking. Ian Macneil notes that "[s]tarting with the express terms and the classical contract approach almost invariably skews the analysis of the circumstances in which they are embedded." [FN113] The superiority of the Mandatory Core Approach is that it provides a starting point for the contextual analysis. The Mandatory Core Approach provides a framework for judging the enforceability of the

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limitation clause. In contrast, the freedom of contract/good faith (Delaware Act) approach requires a more covert type of analysis. Under the Delaware approach, interpretation of the express ***309** term is truncated by the statutory mandate of enforceability. The judicial regulatory role is limited to aggregating the acts permitted under the elimination clause to support a case of bad faith governance. However, judicial concern with contractual justice issues are likely to search the context at the time of formation to determine if a threshold of disclosure/consent was obtained relating to the limitation or elimination of fiduciary duties.

An alternative framework for the role of context in the application of good faith to LLC governance is recognizing that good faith and fiduciary duties are not distinct concepts. In a given context, the application of good faith or fiduciary duties will produce the same result. Easterbrook and Fischel have argued that there is a good faith-fiduciary duty continuum:

> When transaction costs reach a particularly high level, some persons start calling some contractual relations "fiduciary," but this should not mask the continuum. Contract law includes a principle of good faith in implementation honesty in fact under the Uniform Commercial Code, plus an obligation to avoid (some) opportunistic advantage taking. Good faith in contract merges into fiduciary duties, with a blur and not a line. [FN114]

The governance of an LLC in total disregard for the benefits of the LLC or its minority members may be the place where good faith and fiduciary obligations merge. Llewellyn's thesis that the law is a contextual undertaking bears directly on whether the good faith doctrine will be used to covertly apply fiduciary duties to LLC governance. In Llewellyn's notion of "situation-sense," [FN115] if the freedom of contract approach produces contractual justice problems in LLC governance structures, then courts will recognize LLC operating agreements as a peculiar type of contract and respond accordingly.

***310** VI. CONCLUSION

The enforceability of an elimination of fiduciary duties clause in LLC operating agreements rests upon the assumption that investors or minority members and controlling or managing members of the LLC freely negotiated the clause. Under this contractarian model of LLC governance, such clauses should be fully enforced subject only to contract law's good faith doctrine. This article argues that the adoption of the contractarian model subjects such clauses to all of the policing doctrines and rules of contract law and not just the good faith doctrine. For example, operating agreements can be analyzed as contracts of adhesion. As such, elimination clauses can be aggregated with other one-sided terms in the operating agreement to render the agreement unenforceable on unconscionability grounds.

This article also analyzes the notion of discretionary contractual power as an alternative policing mechanism. This concept distinguishes between enforceable contractual rights and the abuse of those rights in the performance of the contract. Here again, the court could view the challenged act within a series of acts. It could determine that, even though the individual acts do not rise to the level of bad faith, the series of acts taken together supports a finding of bad faith. Other contract law concepts are also explored in the context of LLCs, such as the importance of disclosure, relational contract theory, and specialized bodies of contract rules.

This article makes the assertion that courts could use the flexibility of the good faith doctrine, as well as other contract doctrines, to mimic fiduciary-like duties in policing operating agreements containing elimination clauses. However, this would be a more covert way of ensuring contractual justice in the LLC context. The article concludes that the Mandatory Core Approach advocated by Professor Miller and others is the best means to prevent overreaching and abuse of power in LLC governance.

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[FN1]. DEL. CODE ANN. tit. 6, § 17-1101(c) & (d) (2007).

[FN2]. An operating agreement "may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing." DEL. CODE ANN. tit. 6, §18-1101(e) (2007).

[FN3]. Sandra K. Miller, *Fiduciary Duties: Theoretical Underpinnings and the Mandatory Core Approach* (unpublished manuscript, on file with the author) [hereinafter *Mandatory Core*]; Sandra K Miller, *Developing a Conceptual Framework for a Model LLC Statute* (unpublished manuscript, on file with the author) [hereinafter *Conceptual Framework*]; Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243 (2009); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565 (2007) [hereinafter *Fiduciary Duties*].

[FN4]. There is a growing body of literature directed at the contractarian-communitarian (traditionalist) debate. *See, e.g.*, Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990); Frances S. Fendler, *A License to Lie, Cheat, and Steal? Restriction or Elimination of Fiduciary Duties in Arkansas Limited Liability Companies*, 60 ARK. L. REV. 643 (2007). Miller, *Fiduciary Duties*, *supra* note 3: Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537 (1997).

[FN5]. ARK. CODE ANN. § 4-32-1304(a) (2006).

[FN6]. *See* DEL. CODE ANN. 6-1101(d) (2007); DEL. CODE ANN. 6-18-1101 (2007).

[FN7]. *See* ARK. CODE ANN. § 4-32-404 (2006).

[FN8]. *See* GA. CODE ANN. § 14-11-305(1) (2007); MICH. COMP. LAWS ANN. § 450.4404(1) (2007); MINN. STAT. ANN. § 322B.69 (West 2006).

[FN9]. NEV. REV. STAT. ANN. §§ 86.411 & 86.421 (2007) (permitting indemnification if in the best interests of the company or not opposed to the best interests, or if in a criminal suit, there was no reasonable cause to believe the conduct was unlawful); N.Y. LTD. LIAB. CO. LAW § 420 (Consol. 2007) (prohibiting indemnification if had faith, deliberate dishonesty, or personal gain not entitled to); VA. CODE ANN. § 13.1-1025 (2007) (prohibiting indemnification if there was willful misconduct or a knowing violation of law).

[FN10]. *See* ARIZ. REV. STAT. ANN. § 29-610 (2006); N.J. STAT. ANN. § 42.2B-10 (2006).

[FN11]. Fendler, *supra* note 4.

[FN12]. Delaware courts have tapped into this case law pertaining to other types of business organizations as an aid in the interpretation of LLC operating agreements. For example, in *NAMA Holdings, LLC v. World Market Center Venture, LLC*, 948 A.2d 411, 421 (Del. Ch. 2007), the Delaware Court of Chancery, relying on Delaware corporation law, construed an ambiguous inspection rights clause in an LLC operating agreement to require reasonable access.

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[FN13]. *See* Meghan Gruebner, *Delaware's Answer to Management Deadlock in the Limited Liability Company: Judicial Dissolution*, 32 J. CORP. L. 641, 649-50 (2007).

[FN14]. *See* Rebecca J. Huss, *Revamping Veil Piercing for all Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95 (2001); 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 (1998).

[FN15]. "[A]ny transaction from which the manager, director, or executive derived an improper personal benefit ... *except that indemnification ... may be provided if approved by all the members*." N.C. GEN. STAT. § 57C-3-32(b) (2007) (emphasis added).

[FN16]. *Id.*

[FN17]. Morris v. Hennon & Brown Props., 2008 U.S. Dist. LEXIS 55963 (M.D.N.C. 2008) (quoting RUSSELL M. ROBINSON II, ROBINSON ON NORTH CAROLINA LAW § 34.04[3], at 34-23-34-24.1 (7th ed. 2007)).

[FN18]. VA. CODE ANN. §§ 13.1-1000 (2008). Sections 13.1-1022-13.1-1028 are silent regarding fiduciary obligations among LLC members. VA. CODE ANN. §§ 13.1-1022-13.1-1028 (2008).

[FN19]. VA. CODE ANN. § 13.1-1024.1 (2008).

[FN20]. *See, e.g.*, GA. CODE ANN. § 14-11-305(1) (2007); IOWA CODE. ANN. § 490A.706(1) (2006); OHIO REV. CODE ANN. § 1705.29(B) (2007).

[FN21]. *See, e.g.*, FLA. STAT. ANN. § 608.4225(1)(b) (West 2007); IND. CODE. ANN. § 23-18-4-2 (West 2007); WASH. REV. CODE ANN. § 25.15.155(1) (West 2007).

[FN22]. *See, e.g.*, MASS. GEN. LAWS ch. 156C, § 8 (2007); NY LTD. LIAB. CO. LAW § 420 (Consol. 2007); VA. CODE ANN. § 13.1-1025 (2007).

[FN23]. Myron T. Steele, *Judicial Scruting of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORE L. J. 5 (2007).

[FN24]. *See generally* Revised Uniform Limited Liability Company Act, cont., § 110 (2006), http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act_ final.htm [hereinafter RULLCA] (adopting the Delaware model, noting "limited liability is as much a creature of contract as of statute").

[FN25]. *See* Haley v. Talcott, 864 A.2d 86, 98 (Del. Ch. 2004) (where the LLC operating agreement did not expressly provide a standard for dissolving the LLC, the court granted dissolution under Section 243 of the Delaware General Corporation Law).

[FN26]. *See, e.g.*, 6 DEL. CODE ANN. 17-802 (2008) (authorizing the dissolution of the partnership whenever it is no longer reasonably practicable to carry on the business). *See also* 6 DEL. CODE ANN. 18-802 (2008) (authorizing the dissolution of the LLC whenever it is no longer reasonably practicable to carry on business). *See* Gruebner, *supra* note 13, at 652-53.

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[FN27]. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

[FN28]. U.C.C. § 1-304 (2001).

[FN29]. RAYMOND YOUNGS, ENGLISH, FRENCH & GERMAN COMPARATIVE LAW 55 (1998). In some cases, courts "have been prepared to prevent contracting parties exercising their right where it would be unfair to do so." *Id.* at 421-22. Despite its modern iteration in the U.C.C., the doctrine of good faith is traceable to the Roman law principle of *bona fides*. *See* HAROLD J. BERMAN, LAW AND REVOLUTION THE FORMANION OF THE WESTERN LEGAL TRADITION 34 (1983).

[FN30]. Lnigi Russi, *Can Good Faith Performance be Unfair? An Economic Framework for Understanding the Problem*, 29 WILITHER L. REV. 565 (2008) (quoting Simon Whittaker & Reinhard Zimmermann. *Good Faith in European Contract Law Surveying the Legal Landscape, at* GOOD FAITH IN EUROPEAN CONTRACT LAW 34 (Reinhard Zimmermann & Simon Whittaker eds., 2000)).

[FN31]. *Id.*

[FN32]. *Id.*

[FN33]. E. ALLAN FARNSWORTH, GOOD FAITH AND FAULTION CONTRACT LAW 154 (Jack Bearson & Daniel Friedman eds., 1995).

[FN34]. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981).

[FN35]. Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 5 VA L. REV. 195 (1968) [hereinafter *Good Faith*]. *See also* Robert S. Summers, *The General Duty of Good Faith--Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982) [hereinafter *General Duty*]; RESTATEMENT (SECOND) CONTRACTS § 205 (1981). *Compare* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980) (indicating that the discretion-exercising party exercises good faith when exercising discretion within the reasonable contemplation of the parties but exercises bad faith when using discretion to recapture lost opportunities) *with* Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984).

[FN36]. Daniel B. Bogart, *Good Faith and Fair Dealing in Commercial Leasing: The Right Doctrine in the Wrong Transaction*, 41 JOHN MARSHALL L. REV. 275, 289 (2008).

[FN37]. The moral basis for the good faith doctrine has much in common with the moral underpinnings of fiduciary duties imputed in governance law: "The traditionalists, by contrast, start from the premise that fiduciary principles are grounded in moral standards that concern society as a whole." *See* Fendler, *supra* note 4, at 652.

[FN38]. *See* Robert S. Summers, *Good Faith, supra* note 35, at 198. For a conceptualization of the moral-independent obligation approach to the obligation of good faith see Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WARE FOREST L. REV. 123, 136 (2006).

[FN39]. *See* Gold, *supra* note 38, at 136 (quoting Summers, *General Duty, supra* note 34, at 811).

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[FN40]. *See* Burton, *supra* note 35, at 372. *See also* Emily M. S. Houth, *The Doctrine of Good Faith in Contract Law A (Nearly) Emply Vessel*, 2005 ULAH L. REV. 1, 8 (2005).

[FN41]. *See* Charles W. Murdock, *Fairness and Good Faith as a Precept in the Law of Corporations and Other Business Organizations*, 36 LOY. U. CHI. L.J. 551, 563 (2005) (describing the LLC as a hybrid form of organization, having both partnership and corporate characteristics and recommending the imposition of partnership fiduciary duties upon LLC members).

[FN42]. *See* Steele, *supra* note 23, at 16.

[FN43]. Professor Miller asserts that the duty of good faith and the fiduciary duty are fundamentally different: "The imposition of an implied covenant of good faith *may appear* to be interchangeable with the recognition of fiduciary duties in the partnership, corporate, or LLC relations." Miller, *Fiduciary Duties, supra* note 3, at 8. I agree that good faith and fiduciary duty are different. As stated previously, the place of self-interest as a negative norm is more pronounced in fiduciary duty law than in general contract law. Professor Miller states that good faith "may appear" the same as a fiduciary duty in a given context. This is consistent with my point that given the context of existing fiduciary duty law in corporations and partnerships, courts may be tempted to expand the current role of contractual good faith to mimic fiduciary duty law.

[FN44]. Miller, *Fiduciary Duties, supra* note 3, at 8.

[FN45]. Farnsworth, *supra* note 33, at 163.

[FN46]. *Id.*

[FN47]. Karl N. Llewellyn, *Book Review*, 52 HARV. L. REV. 700, 704 (1939) (reviewing O. PRALSNITZ, THE STANDARDS OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW (1937)).

[FN48]. *See generally* Dale Beck Furnish, *Custom as a Source of Law*, 30 AM. J. COMP. L. 31, 42-43 (1982) (noting how custom and usage serve as the basis for modern law).

[FN49]. *Id.*

[FN50]. Many of these rules and doctrines trace their origins to the nineteenth century or earlier. *See* PATRICK SELIM ATIYAH, ESSAVS ON CONTRACT (1986); JOEL P. BISHOL, COMMENTARIES ON THE LAW OF CONTRACTSS (2d ed. 1907); GRANT GILMORE, THE AGES OF AMERICAN LAW (1977). *See also* Morton J. Horwitz, *The Historical Foundations of Modern Contract Law*, 87 HARV. L. REV. 917 (1974).

[FN51]. W. DAVID SIAWSON, BINDING PROMISES: THE LATE 20TH CENTURY REFORMATION OF CONTRACT LAW (1996) (tracing the equitable adjustment). *See also* LARRY A. DIMATTEO, EQUTTABLE LAW OF CONTRACTS: STANDARDS AND PRINCIPLES (2001); Larry A. DiMatteo, *Equity's Modification of Contract: An Analysis of the Twentieth Century's Equitable Reformation of Contract Law*, 33 NEW ENG. L. REV. 265 (1999).

[FN52]. 817 A.2d 160 (Del. 2002).

[FN53]. Steele, *supra* note 23, at 12.

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[FN54]. No. B164377, 2004 Cal. App. Unpub. LEXIS 7824, at *26 (Cal. Ct. App. Aug. 25, 2004).

[FN55]. Labovitz v. Dolan, 545 N.E.2d 304, 310 (Ill. App. Ct. 1989).

[FN56]. *See, e.g.*, OR. REV. STAT. § 63.155(10)(a)(A) (2007) ("an operating agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not unconscionable").

[FN57]. *See* RULLCA, *supra* note 24. *See generally* Daniel S. Kleinberger & Carter G. Bishop, *The Next Generation, Revised Uniform Limited Liability Company Act*, 62 BUS. LAW. 515 (2007).

[FN58]. The Comment to Section 409 of the RULLCA provides: "The duty of good faith and fair dealing should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made ...." RULLCA, *supra* note 24, § 409(d). *See generally* Mark J. Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the 'Manifestly Unreasonable' Standard*, 41 TULSA L. REV. 411, 411 (2006).

[FN59]. Miller, *Decade of Experimentation, supra* note 3, at 585-86.

[FN60]. *Id.* Professor Miller argues that "the empirical research paints a picture of an imperfect and diverse contractual playing field. The LLC serves a broad constituency of businesses varying widely in sophistication, financial stature, and legal representation." *Id.* Another commentator suggests that "the vast majority of these LLCs appear to be small businesses, and many if not most of them are probably formed by persons relatively unsophisticated about the legal rules which govern the operation of LLCs." Fendler, *supra* note 4, at 643-44.

[FN61]. *See* Todd D. Rakoff, *The Law and Sociology of Boilerplate, in* BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS 200, 203 & 210 (Omri Ben-Shahar ed., 2007).

[FN62]. For an analysis of the role of bargaining power in contract law, see Daniel Barnhizer, *Inequality of Bargaining Power*, 76 U. COLO. L. REV. 139 (2005).

[FN63]. Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609 (2006).

[FN64]. The Miller et al. study found that of attorneys representing clients holding minority interests in Delaware, only 69% of these clients agreed that the agreements incorporated a buyout provision, while 83% of the attorney-respondents stated the agreements contained a buyout provision. *Id.* at 623-24.

[FN65]. *See generally* W. David Slawson, *Contractual Discretionary Power: A Law to Prevent Deceptive Contracting by Standard Form*, 2006 MICH. ST. L. REV. 853, 875-76 (2006) (asserting that the representation of the form given and the context should be viewed as the contract and the standard form as an exercise of "contractual discretionary power").

[FN66]. Dalton v. Educational Testing Serv., 663 N.E.2d (N.Y. 1995).

[FN67]. *See generally* Larry A. DiMatteo, *The Norms of Contract: The Fairness Inquiry and the 'Law of Satisfaction'--A Nonunified Theory*, 24 HOESTRA L. REV. 349 (1995).

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[FN68]. HUGH COLLINS, REGULATING CONTRACTS 254 (1999).

[FN69]. *See generally* Symposium, *The Enduring Legacy of Lucy, Lady Duff-Gordon*, 28 PACE L. REV. 161 (2008) (reviewing Justice Cardozo's opinion recognizing the implied duty of best efforts in agency contracts).

[FN70]. *See* F. Allan Farnsworth, *On Trying to Keep One's Promises: The Duty of Best Efforts in Contract Law*, 46 U. PITT. L. REV. 1 (1984) (noting that the duty of best efforts is different from the implied duty of good faith with which it is currently associated).

[FN71]. Professor Fendler notes the greater potential for abuse of discretion or power in the fiduciary relationship: "The relationship between the parties is therefore one which gives the fiduciary a special opportunity to exercise the power or discretion to the detriment of that other person." Fendler, *supra* note 4, at 646.

[FN72]. COLLINS, *supra* note 68, at 254.

[FN73]. Steele, *supra* note 23, at 4.

[FN74]. Miller, *Conceptual Framework, supra* note 3, at 9. For a theoretical examination of the duty to disclose, see Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473 (2007). *See also* J. William Callison & Allan W. Vestal, *"They've Created a Lamb with Mandibles of Death": Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Company Firms*, 76 IND. L. REV. 271 (2001).

[FN75]. Mariana Pargendler, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV. 1315, 1323-24 (2008).

[FN76]. The "efficient market hypothesis" is described in *Basic, Inc. v. Levinson*, 485 U.S. 224, 248-49 (1988). *See also* Butler & Ribstein, *supra* note 4, at 33-35.

[FN77]. Fendler, *supra* note 4.

[FN78]. *See generally* IAN R. MACNEIL, THE NEW SOCIAL CONTRACT (1980); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978).

[FN79]. *See* W. David Slawson, *The New Meaning of Contract: The Transformation of Contract Law by Standard Forms*, 46 U. PITT. L. REV. 21 (1984) (discussing how the parties' reasonable expectations imbue meaning to contracts).

[FN80]. KARL LLEWELLYN, THE COMMON LAW TRADITION 364-70 (1960). *See also* Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583 (1990) (discussing the doctrine of reasonable expectations).

[FN81]. *Id.*

[FN82]. *See* RESTATEMENT (SECOND) OF CONTRACTS § 195(1) (1981) (term exempting a contracting party from liability for gross negligence is "unenforceable on grounds of public policy").

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[FN83]. ARK. CODE ANN. § 4-32-402 (2008).

[FN84]. *Id.*

[FN85]. Even though acts of gross negligence are not exempted, the statute does allow for indemnification for such acts. ARK. CODE ANN. § 4-32-404 (2008).

[FN86]. RESTATEMENT (SECOND) OF CONIRACTS § 195(1) (1981).

[FN87]. Pargendler, *supra* note 75, at 1316 (noting that "the precise relationship between good faith and fiduciary duties remains largely unexplored").

[FN88]. *See* Steele, *supra* note 23, at 17-18 (the Hon. Myron T. Steele, Chief Justice of the Delaware Supreme Court argues that the good faith standard based in fiduciary duty law is more amorphous than the doctrine of good faith in contract law).

[FN89]. *See* Daniel S. Kleinberger, *Seven Points to Explain Why the Law Ought Not Allow the Elimination of Fiduciary Duty Within Closely Held Businesses -- Gardozo Is Dead: We Have Killed Him* (William Mitchell Legal Studies Research Paper No. 61), *available at* http://ssrn.com/abstract=948234 (last visited Apr. 13, 2009) ("To rely on the contractual duty of good faith as a substitute for fiduciary duty is akin to replacing heavy cream with skim milk.").

[FN90]. Professor Farnsworth describes the evolution of the doctrine of good faith performance as a "tangled case law that has marked the doctrine's somewhat uncertain course." Farnsworth, *supra* note 33, at 169.

[FN91]. Llewellyn, *supra* note 47, at 704.

[FN92]. *See generally* Richard H. McAdams, *The Legal Construction of Norms: A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649 (2000).

[FN93]. Miller, *Conceptual Framework, supra* note 3, at 22.

[FN94]. Seana Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 709 (2007).

[FN95]. Roemmich v. Eagle Eye Dev., LLC, 526 F.3d 343, 353 (8th Cir. 2008).

[FN96]. Professor Miller's "Mandatory Core" approach allows for: (1) the delineation, but not the elimination of the duty of loyalty and (2) prohibition against the indemnification due to conscious disregard of duties and bad faith acts. *See* Miller, *Conceptual Framework, supra* note 3, at 40. *See also* 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).

[FN97]. The Uniform Limited Liability Company Act (ULLCA) strikes a reasonable balance between freedom of contract and the mandatory core approach. *See* ULLCA, http://www.law.upenn.edu/bll/archives/ulc/fnact99/1990s/ullca96.htm (1996). The ULLCA allows the parties to modify these fiduciary duties by agreement, but only to a standard centered on reasonableness. ULLCA § 103(b)(2)-(4): "The operating agreement may specify types or categories of activities that do not violate the duty of

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loyalty, if not manifestly unreasonable" and may not "eliminate the obligation of good faith and fair dealing under Section 409(d), *but* the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable." However, the RULLCA permits the restriction *or elimination* of duties if not manifestly unreasonable. *See* RULLCA, *supra* note 24.

[FN98]. OR. REV. STAT. § 63.155(1)-(4) (2007).

[FN99]. *Id.* § 63.155(3).

[FN100]. *Id.* § 63.155(4).

[FN101]. *Id.* § 63.155(9)(c).

[FN102]. *See supra* Part IV.B.

[FN103]. OR. REV. STAT. § 63.155(10) (2007).

[FN104]. *Id.* § 63.155(11).

[FN105]. *Id.* § 63.155(10)(b).

[FN106]. *See, e.g.*, Butler & Ribstein, *supra* note 4; Farnsworth, *supra* note 33; Miller, *Fiduciary Duties, supra* note 3.

[FN107]. Sometimes, the same facts will give rise to allegations of both a breach of the implied covenant of good faith and a breach of fiduciary duties. *See* Blue Chip Capital Fund II Ltd P'ship, v. Tubergen, 906 A.2d 827, 833-34 (Del. Ch. 2006) (denying a motion to dismiss a claim of a breach of the implied covenant of good faith and fair dealing but granting dismissal of a claim for breach of fiduciary duty over allegations of directors' overpayment of sales proceeds to another class of stockholders).

[FN108]. Miller, *Mandatory Core, supra* note 3. Professor Miller states, "The imposition of an implied covenant of good faith may appear to be interchangeable with the recognition of fiduciary duties in the partnership, corporate, or LLC relations." *Id.* at 8-9.

[FN109]. *Id.* at 10.

[FN110]. *Id.*

[FN111]. This is what Hugh Collins refers to as the "social dimensions" of organizational contracts: "The organization has a social dimension, one of membership in the association, which creates expectations that go beyond the formal rules." HUGH COLLINS, REGULATING CONTRACTS 254 (1999).

[FN112]. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

[FN113]. Ian R. Macneil, *Reflections on Relational Contract Theory After a Neoclassical Seminar, in* IMPLICIT DIMENSIONS OF CONTRACT: DISCRETE, RELATIONAL, AND NETWORK CONTRACTS 207, 211 (David Campbell et al. eds., 2003).

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[FN114]. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 438 (1993). *See also* Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008).

[FN115]. KARL LLEWELLYN, THE COMMON LAW TRADITION (1960). In Llewellynian parlance, a situation-sense approach to contract law application is the use of the "type-facts in their context and at the same time in their pressure for a satisfying working result." *Id.* at 60. For an outstanding analysis of situation-sense, see Todd Rakoff, *The Implied Terms of Contract: Of 'Default Rules' and 'Situation-Sense, in* GOOD FAITH AND FAULT IN CONTRACT LAW 191 (Jack Beatson & Daniel Friedman eds., 1995).

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