FIDUCIARY PRELUDES: LIKELY ISSUES FOR LLCs

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In the last act of The Tempest, Miranda exclaims:
O, wonder!
How many goodly creatures are there here!
How beauteous mankind is! O brave new world,
That has such people in't!1

I. INTRODUCTION

This article examines selected circumstances likely to give rise to claims of breach of fiduciary duty in the organizational brave new world of the limited liability company ("LLC") and explores likely resolutions under a number of LLC statutory regimes. For purposes of comparison, the article draws on patterns of dispute that are common in the older organizational forms that limited liability companies may supersede, specifically general and limited partnerships and closely held corporations.2 The article is not comprehensive in its treatment; it concentrates on circumstances that test the force of norms and illustrate interrelationships among bodies of legal doctrine. Despite their differences, many LLC statutes defer substantially to the terms of the parties' agreement, a fact that makes the craft of drafting organizational documents more important than in an organization that is more invasively structured by statute. In a contract-dominated organization, drafting failures—glitches, snafus, failures to anticipate the risk of opportunistic conduct—may well shape the resolution of subsequent disputes among participants that implicate fundamental aspects of their relationship. The article explores problems in the fit between contract law doctrine and issues likely to arise under

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1. WILLIAM SHAKESPEARE, THE TEMPEST act 5, sc. 1.
2. I leave to others the project of predicting the ultimate fate of these distinct organizational forms. For a wide-ranging assessment, see Wayne M. Gazur, The Limited Liability Company Experiment: Unlimited Flexibility, Uncertain Role, 58 LAW & CONTEMP. PROBS. (forthcoming Summer 1995).
LLC agreements, based on recent litigation involving comparable questions under limited partnership agreements.

Specifics aside, the question underlying much of the discussion in the article is the relationship between organizational form and the risk of opportunistic conduct within an organization. Regardless of the form they choose, human actors in all organizations may be tempted to seek unbargained-for advantage in their relationships with the organization and its other participants. Unlike Miranda, we know that the move to a brave new world does not necessarily reform human conduct; organizational form may specify the consequences of opportunistic behavior, but it does not remove the temptation to shirk one’s agreed upon duties, or to cheat, lie, dissemble, expropriate another’s property or, more generally, to act in ways that disappoint others’ expectations.

LLCs, additionally, may be especially popular in small business ventures in which market constraints on opportunistic conduct are weaker than in larger ventures tied to public capital markets. Moreover, in closely held firms, participants may not fully explore in contractual negotiations the downside risks of their future association; the participants may be unable to identify all of the contingencies that would enable opportunistic conduct or, having identified such possibilities, may be reluctant to articulate them because they fear destroying the

3. Robert B. Thompson, The Law’s Limits on Contracts in a Corporation, 15 J. CORP. L. 377, 392 (1990). Professor Thompson notes that while shareholders in a close corporation are not dispersed, and thus could coordinate to contract with managers to address risks of managerial misconduct, the lack of an “efficient, developed market for the shares that can provide a check on management misconduct” underlies the function of legal rules applicable to such corporations. Id. at 392-93. Another constraint on opportunistic conduct is its anticipated impact on reputation. Gillian K. Hadfield, Weighing the Value of Vagueness: An Economic Perspective on Precision in the Law, 82 CAL. L. REV. 541, 552 (1994). The efficacy of reputational constraints may be weaker in smaller enterprises where a reputation for opportunistic conduct does not imperil access to public capital markets. The opportunism of a smaller enterprise may not be communicated as quickly, or as readily, as that of an enterprise tied to underwriters, stock analysts and other participants in public capital markets who collect, process and disseminate information. For an explication of the general weaknesses of reputation effect mechanisms, see Oliver E. Williamson, Economic Institutions: Spontaneous and Intentional Governance, 7 J.L. ECON. & ORG. 189, 187-72 (Special Issue 1991).

deal underway. The LLC population, in short, may emerge as one in which legally mandated norms have a dominant role in constraining opportunistic behavior.

II. DISCRETIONARY AUTHORITY

A basic function of an organizational statute or agreement is to specify and allocate discretionary authority to make decisions implicating the organization's assets and activities. Corporation statutes clearly allocate such authority to a board of directors, subject to specific shareholder prerogatives and, to some extent, to contrary provision in corporate charters and shareholder agreements. Corporation statutes also mandate some aspects of a business entity's internal governance—for example, by requiring an annual shareholder meeting to elect directors—that in other organizational forms, like partnerships, would be more substantially controlled by the organizational agreement. Allocations of discretionary authority inevitably lead to questions about legal limits on particular uses of authority, questions answered by the large corpus of fiduciary doctrine applicable to corporations and partnerships.

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6. A derivative question is the identity of the fiduciary personae, that is, the natural or legal persons to whom the obligation applies. In many limited partnerships, the general partner is itself a corporation; the questions are whether and under what circumstances the general's shareholders, officers or directors would be in a fiduciary relationship with limited partners. Similar questions will arise in LLCs because LLC statutes do not require either members or managers to be natural persons. See, e.g., DEL. CODE ANN. tit. 6, § 18-101(12) (Supp. 1994) (definition of "person" inclusive of variety of business entities); see also id. §§ 18-301, 401 ("persons" may be members or managers). Jurisdictions vary in how they answer these questions in the limited partnership context. Delaware treats directors of an incorporated general partner as fiduciaries toward the limiteds simply by virtue of the director's position in an incorporated fiduciary, on analogy to duties owed by directors of a corporate trustee to beneficiaries of a trust. See In re USA Cafes, L.P. Litig., 600 A.2d 43, 48-49 (Del. Ch. 1991). Jurisdictions do not agree on whether a general partner's shareholders should be liable if, for example, the plaintiff can establish facts sufficient to pierce the corporate veil. Compare Maywalt v. Parker & Parsley Petroleum Co., 808 F. Supp. 1037, 1059 (S.D.N.Y. 1992) (applying Texas law to permit corporate veil to be pierced) and Harper v. Delaware Valley Broadcasters, Inc., 743 F. Supp. 1076, 1085 (D. Del. 1990), aff'd, 932 F.2d 959 (3rd Cir. 1991) (stating in dictum that Delaware would permit corporate veil to be pierced to reach shareholders of general partner on showing of "fraud or something like fraud," and more recently, on alter ego theory) with Estate of Hall, 535 A.2d 47, 54 (Pa. 1987) (declining to pierce veil when limiteds knew general partner was incorporated).
LLC statutes contemplate that any LLC agreement will allocate discretionary authority by choosing management either by LLC members or by a designated manager. Member management requires rules for voting; manager management requires some specification of the process for choosing the manager and the relationship between the manager's prerogatives and powers retained by the members. LLC statutes vary somewhat in the legal standard or body of doctrine applicable to disputed uses of discretionary authority.

A. Discretion to Direct the Use of Assets

Consider first a provision that confers discretion over an entity's cash distributions to members, a discretion that may in turn enable those exercising it to manipulate the entity's value to their advantage. The LLC agreement might confer such discretion on a designated manager or on a majority of the members. In Labovitz v. Dolan, the partnership agreement gave the general partner "complete discretion in the management and control of the business and affairs of the partnership." The general partner under the agreement had sole discretion to determine the cash flow available for distribution to limited partners; the general made only nominal distributions for two years and then offered through an affiliate to buy the limited partners' interests at two-thirds of their book value. The court held that the limited partners' complaint stated a triable claim for breach of fiduciary obligation because, despite the "sole discretion" language, the general partner had a "duty

Closely related questions concern whether the fiduciary and professional duties of lawyers who represent limited partnerships extend as well to limited partners. One recent case held that such a lawyer, as a lawyer for a fiduciary, owes fiduciary duties to those persons "in privity" with the client-fiduciary. Arpadi v. First MSP Corp., 628 N.E.2d 1335 (Ohio 1994). Even if no attorney-client relationship exists, a lawyer may become a fiduciary toward a person--like a shareholder or partner--who reposes trust and confidence in the lawyer. See Fasshi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C., 309 N.W.2d 645 (Mich. Ct. App. 1981). The ABA Ethics Committee has recognized that, although Model Rule of Professional Conduct 1.13 treats a partnership as an "entity" for purposes of determining the identity of a lawyer's client, limited partnerships may require different treatment. ABA Comm. on Ethics and Professional Responsibilities, Formal Op. 91-361 n.1 (1991) (representation of a partnership).

2. Id. at 306.
as general partner to exercise the highest degree of honesty and good faith in his handling of partnership assets . . . .9

Comparable disputes in LLCs should reach the same outcome. Paths toward that outcome differ, however, depending on the applicable statute. Under the Uniform Limited Liability Company Act ("ULLCA"), both managers and members exercising managerial functions have a nonwaivable duty to account to the company for any benefit derived from the use of company property,10 language that tracks the language in partnership statutes holding partners to a fiduciary standard.11 That is, of course, the standard applied by the court in Labovitz.

Some LLC statutes, in contrast, draw on corporation statutes for mandatory standards applicable to managers' conduct, including the conduct of members exercising a management function. Drawing on a comparable provision in the Revised Model Business Corporation Act ("RMBCA"), one LLC statute requires the manager to discharge his duties "in good faith . . . and in the manner the manager reasonably believes to be in the best interests of the limited liability company."12 Although the RMBCA drafters abjured using the word "fiduciary" to characterize this standard, on its face it requires managerial decisions to be based on a reasonable belief that they further the corporation's interests.13 The general partner's conduct in Labovitz would be hard to justify under this standard. Even if the general partner had a reasonable belief that the partnership's best interests would be served by conserving cash rather than distributing it to limited partners, that belief appears to have been dominated by the general partner's interest in effecting a buy-out of the limited partners at a low price.

9. Id. at 310. Accord Knopke v. Knopke, 837 S.W.2d 907, 915 (Mo. Ct. App. 1992) (holding that general partner's "unqualified authority" to make all decisions relating to the financial affairs of the partnership is always subject to general partner's fiduciary obligation to deal prudently and honestly with partnership and other partners and, in particular, to invest surplus partnership funds so as to make a reasonable return).

10. See UNIF. LTD. LIAB. CO. ACT § 409(b)(1), (b)(2) (1994) (draft approved at 1994 annual meeting of the National Conference of Commissioners on Uniform State Laws) [hereinafter ULLCA].


12. N.C. GEN. STAT. § 57C-3-22(b) (1993); see also VA. CODE ANN. § 13.1-1024.1 (Michie 1993).

13. REV. MODEL BUSINESS CORP. ACT § 8.30 (1994); see also id. cmt. 1.
In contrast, the ABA Prototype LLC Act and the Delaware statute permit the LLC agreement to specify the duties applicable within a particular LLC. Although the ABA Prototype Act has language comparable to the ULLCA provision quoted above, the specified duties are operative "[u]nless otherwise provided in an operating agreement . . ." The text of the statute specifies no limits on the permissible extent of contractual provision otherwise. The Delaware LLC statute, closely modeled on Delaware’s limited partnership legislation, states that its policy is “to give the maximum effect to the principle of freedom of contract and to the enforceability” of LLC agreements.\textsuperscript{15} The statute provides more specifically that “good faith reliance on the provisions” of the LLC agreement shall preclude liability for a member or manager acting under that agreement and further provides that the agreement may expand or restrict a member’s or manager’s duties.\textsuperscript{16}

These statutes should not change the outcome of a Labovitz-like dispute when the LLC agreement confers unqualified discretion in the use of company assets. Under the Delaware statute, the dispositive question would be whether the defendant relied “in good faith” on the “sole discretion” language in the agreement.\textsuperscript{17} Recent disputes over good faith reliance adjudicated under the Delaware limited partnership statute suggest that the claim of good faith reliance would fail. Interestingly, although the language of the ABA Prototype Act


\textsuperscript{15} Del. Code Ann. tit. 6, § 18-1101(b) (1993); see also id. § 17-1101(c) (counterpart provision in limited partnership statute).

\textsuperscript{16} Id. § 18-1101(c). An experienced Delaware litigator recently noted that the failure of the statute “to state specifically that fiduciary duties exist or to define them should not be interpreted as meaning that fiduciary duties in LLCs are nonexistent,” noting that Delaware’s corporation statute does not state, either, that majority or controlling shareholders owe fiduciary duties to minority shareholders, duties repeatedly recognized by courts. Elizabeth M. McGeever, Hazardous Duty?, Bus. Law Today, Mar.-Apr. 1995, at 51, 53.

\textsuperscript{17} Another question would be whether the language in question “eliminates” rather than “restricts” a party’s duties; on its face the statute does not permit duties to be eliminated, only restricted. If the party retains some duty—for example, to maintain records and make reports—its duties have not formally been eliminated. But if the language eliminates all duties that constrain the exercise of discretion in making substantive decisions, the implicit statutory distinction between restriction and elimination would be vitiated if the language is given literal effect.
does not itself impose a good faith standard, the drafters’ commentary acknowledges that “members, like other contracting parties, must exercise their powers in good faith,” and that, for example, expelling a member “solely or primarily” to appropriate the value of the member’s interest may constitute bad faith. The drafters do not specify circumstances that transmute “may constitute” into “would constitute.” With that caveat, under this standard a power would not appear to be used in good faith if the use were motivated by the powerholder’s own interests, as in Labovitz.

B. Developments on the Delaware Front

The evolving Delaware jurisprudence of good faith reliance has qualities of a brave new world peopled by concepts drawn from contract and tort doctrine that potentially constitute a distinctive doctrine. At present, much of this doctrine is at best skeletal; its further evolution seems inevitable. Perhaps unsurprisingly, the most fully elaborated aspects of the doctrine are procedural. The party challenging the act or transaction has the burden of rebutting a presumption of good faith by alleging bad faith. Although mere speculation will not suffice, bad faith—unlike fraud—need not be alleged with particularity. Bad faith hinges solely, held the Delaware Supreme Court, on a party’s “tortious state of mind,” and a plaintiff would likely be unable at the pleadings stage to describe the defendant’s state of mind sufficiently and adequately. By raising essentially a question of fact, that is, the presence of the tortious state of mind, a plaintiff who successfully pleads bad faith will survive the defendant’s motion to dismiss prior to discovery. Finally, courts decline to bless conduct as good faith reliance prior to its occurrence, observing that the facts in such disputes are not static.
The fullest elaboration of the substance of good faith reliance appears in the Delaware Supreme Court’s opinion in *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P.*\(^{24}\) In *Desert Equities*, a limited partner alleged that the general partner acted in bad faith in its use of discretionary authority to exclude the limited from further participation in partnership investments. The limited partner alleged that the general partner exercised its power to exclude the limited in retaliation for the limited’s earlier institution of litigation against the general alleging breaches of fiduciary duty in prior investments. The court held that the limited’s allegation raised enough of an issue of fact—whether the general acted with a tortious state of mind—to survive the general’s motion for summary judgment. Implicitly this outcome treats as bad faith conduct a use of discretionary authority that furthers a non-partnership objective personal to the general partner, when circumstances of the use would indicate a tortious state of mind. The court’s analysis does not delve into a number of issues, most obvious among them the relationship between the defendant’s state of mind and the body of torts defined by Delaware law. Whether a free-standing tort of retaliation exists under Delaware law is not an element of the court’s analysis. Moreover, the court’s reading of “good faith” is at odds with many contemporary contract cases, a point explored below.

Indeed, the tortious state of mind standard represents a venture into relatively uncharted territory, at least from the standpoint of general contract doctrine. It is not clear whether or to what extent the doctrine applied in *Desert Equities* turns on the defendant’s subjective motivation for acting in a particular way or on the degree to which the defendant’s conduct departs from customary practice. These issues are relevant to determining the content of the doctrine and the duties it imposes. On the good faith front, contract theory draws a conventional distinction between subjective and objective good faith, a distinction exemplified by the two separate definitions of good faith in the Uniform Commercial Code ("U.C.C."). The U.C.C. definition construed as a subjective standard for good faith is “honesty in fact in the conduct or

\(^{24}\) 624 A.2d 1199 (Del. 1993).
transaction concerned." The U.C.C. definition construed as an objective standard for good faith is "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." The operative difference between the two definitions is nicely illustrated by the limits on a lender's ability to deem itself insecure, relying on a provision in a loan agreement giving it the right to do so, and to accelerate the borrower's obligation to repay the principal amount of the loan. A lender would contravene the subjective definition if it misrepresented to the borrower its reasons for accelerating, while it would contravene the objective definition if it accelerated unreasonably, under circumstances when other lenders would not.

The doctrine of good faith reliance applied in Desert Equities diverges from these familiar aspects of contract doctrine. The general partner's conduct was not necessarily dishonest; indeed the limited partner did not allege that the general misrepresented its reasons for excluding the limited from further investment participation. Likewise, having a tortious state of mind does not always accompany a failure to follow reasonable commercial standards. A general partner may, for example, depart from standard commercial practice due to unintentional mismanagement.

Finally, as it evolves, the "tortious state of mind" doctrine may merge into the jurisprudence of bad faith breach of contract, and its principal effect may thus be to augment available remedies. In bad faith breach cases, the defendant's breach of contract is accompanied by an independent tort or by conduct that falls short of tort but is nevertheless objectionable. The principal consequence of the bad faith breach concept is that it justifies the award of extracontractual or punitive damages. Whether this consequence will follow in the Delaware cases awaits further developments.

25. See Watake First Nat'l Bank v. Ruda, 552 N.E.2d 775, 778-80 (III. 1990) (construing U.C.C. § 1-201(19)).
26. See id. (construing U.C.C. § 2-103(1)(b), a standard applicable to merchants).
27. See id.
C. Fundamental Transactions

Claims of breach of fiduciary duty abound in disputes arising from fundamental transactions—such as mergers, share exchanges, and sales of assets—involving corporations and partnerships. In small business entities, the claim is frequently made that such a transaction shifts ownership of an entity's assets to another entity owned or controlled by persons in control of the first entity, at a price that does not represent the assets' fair value. The transaction is thus detrimental to noncontrolling members.29 Many LLC statutes are structured in a fashion that does not minimize the likelihood of such claims, particularly in connection with merger transactions.

Most LLC statutes explicitly authorize merger transactions in which an LLC is a constituent or surviving entity.30 While some statutes, such as Delaware's, authorize a range of interspecies mergers between LLCs and other types of business associations, such as partnerships, real estate investment trusts, and corporations,31 other statutes are more restrictive in specifying acceptable types of merger partners for LLCs.32 LLC statutes also vary dramatically in the extent to which they specify procedures or remedies applicable to mergers, including the vote by members requisite to approve the transaction and statutorily mandated appraisal rights.

While some statutes specify a mandatory minimum number of members necessary to approve a merger,33 other statutes appear to make any statutory specification a default rule, subject to contrary provision in an LLC agreement or other

31. See DEL. CODE ANN. tit. 6, § 18-209(a) (Supp. 1994).
32. See, e.g., N.C. GEN. STAT. § 57C-9-01 (1990) (domestic LLC may merge into domestic or foreign LLC).
33. See, e.g., ULLCA § 904(c)(1) (percentage of members specified in operating agreement, but no fewer than the members holding a majority of interests).
organizational document. The question then is the efficacy of a less-than-majority rule in an organizational document, which is not a prospect expressly ruled out by some statutes. To be sure, this question should be answered—one hopes in the negative—in litigation, but the lack of a statutory minimum may invite agreements that challenge conventional norms applicable to voting.

Statutorily mandated appraisal rights are rare in LLC statutes. One explanation is that appraisal becomes a less valuable right when any member can disassociate from the LLC, cause it to dissolve and receive the value of his or her interest. LLC statutes also vary on the availability of dissolution or disassociation. Under the ULLCA, any member may disassociate at will at any time, even wrongfully in contravention of a term in the LLC agreement. In contrast, under the Delaware statute, unless the LLC agreement provides otherwise, a member's power to dissolve the entity requires the assent of a majority of members unless the member petitions the court to wind up the LLC's affairs.

Claims of breach of fiduciary duty are at least as likely to flourish in the wake of LLC mergers as in the wake of mergers and other fundamental transactions involving limited partnerships and closely held corporations. Like LLC statutes, most limited partnership statutes contain little that discourages problematic conduct in connection with fundamental transactions by the parties who control the partnership's business. Statutorily mandated appraisal rights are rare in limited

34. See, e.g., N.C. GEN. STAT. § 57C-9-03(a) (1990) (noting that a proposed plan of merger shall be approved by the members' unanimous consent, 'unless the articles of organization or a written operating agreement provide otherwise').

35. See id. § 57C-3-03 (requiring unanimity for specific actions taken by members "[e]xcept as provided in the articles of organization or a written operating agreement"). In contrast, under the same state's corporation statute, the number of shares required to approve a merger may be increased but may not be reduced below a majority of shares entitled to vote. Id. § 55-11-03(e) (Supp. 1994).

36. Cf. 1 RIBSTEIN & KEATINGE, supra note 30, at 8-5 (discussing possible default rules when LLC agreement is silent on voting).


38. See ULLCA § 602(a).

39. See DEL. CODE ANN. tit. 6, § 18-803(a) (1983). Dissolution is an alternate remedy available, on a member's petition, if an LLC that has publicly traded LLC interests is treated as a corporation for purposes of United States income taxation.
partnership statutes. More generally, limited partnership statutes do not require that the terms of the transaction be negotiated or even evaluated by parties comparable to member-elected directors. In many instances, limited partner litigation appears to be the only force of significance constraining blatant self-dealing by general partners. This prospect is no less likely for manager-managed LLCs. In member-managed LLCs, the relevant point of comparison is the closely held corporation, in which mergers and other fundamental transactions have long been identified as a vehicle for opportunist conduct by controlling groups of shareholders. The relevant statutory regimes differ significantly, however. In particular, the absence of statutorily mandated appraisal rights in LLCs removes one statutory disincentive to structuring a merger transaction in a manner that is disproportionately favorable to owners who control the LLC. For noncontrolling owners, the sole remedy would be litigation in which the applicable legal standard may be unsettled.

III. EXPRESS TERMS AND IMPLIED COVENANTS

Many LLC statutes expressly contemplate that the LLC agreement, like many partnership agreements, will contain provisions permitting actions that would constitute breaches of


41. For recent examples, see MacLane Gas Co. v. Enserch Corp., No. CIV.A.10760, 1992 WL 368614 (Del. Ch. Dec. 9, 1992) (in connection with exchange offer, unit holders had no independent representation, price was based on majority shareholder's determination of what it was willing to pay, and investment bank of questionable independence gave fairness opinion on basis that acceded to management's wishes; court found circumstances highly persuasive of unfair dealing), aff'd, 633 A.2d 369 (Del. 1993) (table), reh'g denied, 647 A.2d 381 (Del. 1993) (table); Trustees of Gen. Elec. Pension Trust v. Levenson, No. CIV.A.12,014, 1992 WL 41820 (Del. Ch. Mar. 3, 1992) (holding that in merger transaction in which limited partnership converted to corporate form, general partner proposed terms of exchange on basis of projections not verified by investment bank that gave fairness opinion; result of conversion increased general's proportionate ownership interest from 25.3% to 61%).

42. See O'NEAL & THOMPSON, supra note 29, at §§ 5:01-5:36.

fiduciary duty in the absence of the provision. If limited partnership litigation is indicative, the drafter's art has not reached a state of perfection in crafting permissive provisions. The question then is the import of a permissive provision that is itself ambiguous or that conflicts with a contrary provision elsewhere in the same agreement. In particular, under Delaware's statutory standard, is such a provision supportive of reliance in good faith? And, more broadly, how robustly should the contract law doctrine of good faith operate in relationships defined by LLC agreements?

A. Ambiguity and Inconsistency In Waivers

One might suppose that unsophisticated parties make up the population most likely to enter into agreements containing inconsistent or ambiguous provisions. Recent limited partnership cases illustrate that sophisticated business parties are not immune to technically flawed agreements, in particular ones that, in the same agreement, give but take away when specifying the parties' individual prerogatives. In United States Cellular Investment Company v. Bell Atlantic Mobile Systems,44 one provision in the limited partnership agreement provided that any limited partner could freely provide cellular phone service outside the Allentown Standard Metropolitan Statistical Area ("SMSA"), the service area designated by the agreement.45 Another provision, however, provided that the general partner would be deemed to be acting on behalf of the partnership if the general partner provided cellular service in areas adjoining the Allentown SMSA. As it happened, Bell Atlantic was both a general and a limited partner; US Cellular sued when Bell Atlantic commenced its own service in an SMSA adjoining Allentown. The agreement itself specified no hierarchy between the two differing permissive provisions, both applicable to Bell Atlantic as a limited and a general partner. The court dismissed the plaintiff's complaint alleging breach of fiduciary duty, holding that Bell Atlantic had not acted in a manner...
indicative of bad faith and that its interpretation of the agreement was not unreasonable. The court’s resolution is problematic in several respects.

One basic problem is how to characterize such a provision for purposes of analyzing its legal import. It is difficult to justify the court’s resolution of the dispute in United States Cellular if one characterizes the conflicting provisions as attempts to waive otherwise applicable fiduciary duties. Many commentators characterize as “waivers” the permissive provisions contemplated by the Delaware statutes described above. The application of contract doctrine to an ambiguous or conflicted expression of waiver raises several challenging questions that implicate at least three separate aspects of contract doctrine. First, an effective waiver requires a manifestation of assent, which may be expressed in words or inferred from conduct. An ambiguous expression of assent does not unequivocally signify the assenting party’s intent. As a result, it is doubtful whether a party who asserts reliance upon such an expression does so “in good faith” for purposes of the Delaware statutes discussed above. Second, contract doctrine conventionally permits ambiguities to be resolved through the introduction of parol evidence, with the objective of enabling the court to determine the parties’ intent through an examination of circumstances surrounding the agreement, including evidence of prior negotiations. Such an effort appears not to have been undertaken in United States Cellular, but in other cases, the admission of parol evidence would assist in determining intent. Third, courts often apply the doctrine of contra proferentem when one party has supplied language susceptible of more than one interpretation. Contra proferentem prefers the interpretation less favorable to the party who supplied the language, and in doing so encourages care in contract drafting. But, in contrast to the purpose served by admitting parol evidence, contra proferentem does not attempt to ascertain the parties’ intent. If provisions like that in United States

47. See, e.g., REVISED UNIF. PARTNERSHIP ACT § 103 cmt. 2 (1993); 2 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 6.07, at 6:91 (1994); Thompson, supra note 3, at 401.
48. FARNSWORTH, supra note 28, § 8.5, at 588.
49. Id. § 7.12, at 520.
50. Id. § 7.11, at 265-68.
Cellular are best characterized as waivers, contra proferentem may be applicable even when the language in question is not clearly attributable to the party who would be advantaged by a finding of waiver. Contra proferentem, that is, may be the interpretive device best suited to assuring that the language in question reflects assent to an alteration or reduction in otherwise applicable fiduciary duties.

An alternative characterization for a permissive provision is that such a provision constitutes, not a waiver of an otherwise applicable fiduciary duty, but an exclusive express specification of the duties the parties thereby undertake toward each other. Such characterization is consistent with the outcome in United States Cellular because it supports an argument that the agreement manifested no intention of the parties to undertake a duty to refrain from competitive activity that was more expansive than the least restrictive provision in the agreement. The difficulty with this characterization is that it is not compatible with the language of the relevant Delaware statutes, which expressly refers to provisions in agreements that expand or restrict a partner's, member's, or manager's duties. The statutes thus do not support the argument that, but for provisions in agreements, parties would not be under duties to each other. Thus, the commentators' characterization of such provisions as waivers correctly reflects the import of the statutory language, and the court's resolution in United States Cellular does not.

B. Thin and Robust Implied Covenants of Good Faith

Against this doctrinal backdrop, the statutory standard of good faith reliance is a complicating factor, made more complex by the concept of the "tortious state of mind" in recent Delaware cases. An inevitable question is the relationship (if any) between the "good faith" standard and the contract law duty of good faith and fair dealing. The importance of these questions is heightened by statutory provisions that, like those in Delaware, expressly permit contraction of fiduciary duties via the LLC agreement.

The implied covenant of good faith and fair dealing is imposed by every contract on each party in performance and

enforcement under the contract. An extensive body of case law and expert commentary addresses possible meanings of this very general concept and applies differing understandings of the general concept to specific types of contracts under particular factual circumstances. Contract doctrine enables the parties to limit the extent of retrospective judicial construction of the duties imposed by the covenant by explicitly and fully specifying duties under various contingencies; in contracts for the sale of goods, parties may additionally prescribe by agreement the standards against which performance of the good faith covenant shall be assessed if the standards are not "manifestly unreasonable."54

Many contemporary contract cases do not restrict the operative definition of "good faith" to an absence of a "tortious state of mind." A leading Delaware case, *Katz v. Oak Industries*, 55 observes that "[m]odern contract law has generally recognized an implied covenant to the effect that each party to a contract will act with good faith towards the other with respect to the subject matter of the contract."56 The implied covenant protects the parties' ability to receive the bargained-for fruits of their contract.57 As *Katz* defines the implied covenant, an act breaches the covenant if it is clear from the express terms of the contract that, had they thought to negotiate about the matter, the parties would have proscribed it. Establishing that the defendant breached the implied covenant does not require the plaintiff to establish the defendant's motives or tortious state of mind. To be sure, a successful plaintiff would, under the *Katz* standard, most likely have established that the defendant acted opportunistically, but opportunism may well be a broader concept than the tortious state of mind. In any event, one wonders how reliance on an express provision could be in good faith if the language of the provision itself attempts to address a question but is visibly flawed as a resolution.

52. See *Restatement (Second) of Contracts* § 205 (1979).
53. See *Farnsworth*, *supra* note 28, § 7.17.
55. 508 A.2d 878 (Del. Ch. 1986).
56. Id. at 880.
A separate question is the robustness with which the implied covenant should operate in a contractual relationship that is based upon a partnership or LLC agreement. As it happens, Katz typifies a group of cases rejecting a robust reading, all involving the relationship between issuers and holders of debt securities. In adjudicating disputes arising in such relationships, courts emphasize the need for fixity in an issuer’s obligations as an ingredient in market stability and in a market’s ability to price the financial product that debt securities represent.\(^{58}\) Courts hold issuers of debt securities to only those obligations clearly and unambiguously assumed; the issuer is not bound by a duty expressed in language susceptible to a reading that vitiates the issuer’s duty.\(^{59}\) As a consequence, the issuer is free to exploit loopholes, even when the language creating the loophole was otherwise understood by the issuer and underwriter at the time the securities were sold.\(^{60}\) In such relationships, the implied covenant has primarily a ministerial function. For example, it would oblige an issuer to give debtholders notice sufficient to enable them to exercise their rights, when the contract expressly provides only a skeletal or unelaborated right to notice.\(^{61}\)

In contrast, in general contract law and the law of sales, the implied covenant often operates more robustly. In particular, in contracts defining long-term relationships of mutual interaction or cooperative endeavor, courts have long given the duty a relatively expansive reading. For example, output and requirements contracts, because they repose in one party discretion over the quantity that can be demanded of the other party, moderate the demands of the quantity-setting party with a good faith requirement.\(^{62}\) A similar constraint operates in license relationships involving literary or artistic properties; unless the

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58. See, e.g., id. at 1520.
60. See id.
61. See Van Gemert v. Boeing Co., 520 F.2d 1373, 1383-85 (2d Cir. 1975), cert. denied, 423 U.S. 947 (1975) ("Absent such advice as to the specific notice agreed upon by the issuer and the trustee for the debenture holders, the debenture holders' reasonable expectations as to notice should be protected.").
agreement explicitly reserves the licensor’s right to do so, the licensor is constrained from licensing the same property to another licensee in a competing medium that would destroy the value of the initial license.\textsuperscript{63}

LLC agreements, similarly, should attract a robust version of the implied covenant even when the parties have expressly restricted by agreement the operation of fiduciary obligation. The contract-dominated view of duties within LLCs, typified by the Delaware statute, presumably encompasses the universe of established contract doctrine, including the duty of good faith and fair dealing. The statute does not specify alternate doctrines or rules applicable as contract doctrine to such agreements. An LLC agreement creates a relationship that typifies, in intense form, a relational contract as defined by Professor Goetz and Dean Scott. The relationship is “characterized by uncertainty about factual conditions during performance and [by] an extraordinary degree of difficulty in describing specifically the desired adaptations to contingencies.”\textsuperscript{64}

Virtually full contingent contracting, in contrast, underlies the relationship between holders of debt securities and their issuer. In a relational contract, complexity and uncertainty both operate to preclude precise specification of standards for performance in the parties’ express agreement. Applicable legal norms, in turn, presuppose that each party intended to benefit through a cooperative endeavor, and those norms operate toward that end to supplement the parties’ express agreement.

The presupposition of mutual intent to benefit, which in turn produces mutual obligation, is an inevitable offspring of founding contract doctrine in exchange-based consideration.\textsuperscript{65} In consequence, an agreement is not enforceable as a contract

\textsuperscript{63} For a venerable example, see Kirke La Shelle Co. v. Paul Armstrong Co., 188 N.E. 163 (N.Y. 1933). See generally RESTATEMENT (SECOND) OF CONTRACTS § 204 (1979) (“When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court.”).


\textsuperscript{65} Cf. Wood v. Lucy, Lady Duff-Gordon, 118 N.E. 214 (N.Y. 1917) (enforcing a contract for a celebrity’s exclusive endorsement of manufacturer’s goods because manufacturer impliedly promised to use reasonable efforts to market her designs, and noting that without such an implied promise, transaction would lack “such business efficacy as both parties must have intended” it to have) (citations omitted).
unless it contemplates mutuality of obligation. Put differently, an LLC or limited partnership agreement that completely abjured fiduciary obligation would, in the absence of a robust implied obligation of good faith, resemble a gift of members’ property to those in control of the enterprise who would be free to use the entity's property as they saw fit. Anglo-American contract doctrine has not enforced executory promises to make gifts because such promises do not contemplate an exchange. Moreover, persons who invest or participate in business ventures lack donative intent toward those who control the venture; it strains credulity excessively to characterize membership in an LLC or a limited partnership, once formed, as indicative of intention to execute a gift transaction.

Limited partnerships and LLCs also resemble the situations that, under Goetz and Scott's framework, warrant a “best efforts” standard of performance, that is, a party's obligation to use best efforts to carry on an activity beneficial to another. Goetz and Scott define such situations as “cooperative contractual relationships where the parties have not specified a precise standard of required performance”; the consequence of the “best efforts” norm is to produce the largest possible net product to be divided between the parties.66 LLCs and limited partnerships create mutually interdependent relationships; the entity itself and ultimately the members are bound by the decisions of those authorized to act on behalf of the entity. Interestingly, if the parties specify a precise standard for the performance to be required from those controlling the entity, for example by specifying with precision the economic return to which members are entitled, the resulting contract resembles one between a debtor and creditor more than one contemplating an equity investment.

As it happens, from the standpoint of a manager, a legal standard for assessing performance that is grounded in an implied obligation to use best efforts may well be more onerous in many instances than a standard grounded in fiduciary duty. A manager might well exercise the “ordinary care” required by most fiduciary standards, and still fall short of the best efforts standard, which is generally understood to require a party to use resources to the degree available and reasonable under the

66. See Goetz & Scott, supra note 64, at 1149-50.
circumstances. A manager who does not contemplate self-dealing or other acts violative of the fiduciary duty of loyalty might thus prefer the fiduciary regime to the contractual one!

The speculative nature of these ventures into the application of contract doctrine to LLC and limited partnership agreements makes the project awkward in many respects. Such an intellectual exercise is necessary, however, if “contract” is to operate as anything more than a slogan in these discussions. Many LLC statutes will inevitably require that general contract doctrine be further refined to resolve disputes arising in types of relationships heretofore within the ambit of fiduciary obligation. Like fiduciary obligation itself, the elements of contract doctrine explored in this article anticipate and respond to the occurrence of opportunistic conduct in relationships in which one party exercises substantial discretion.

IV. CONCLUSION

Many brave new worlds, as they age, strongly resemble prior institutions. My prediction is that doctrines to control opportunistic conduct in LLCs will evolve toward results that resemble present doctrine developed prior to the LLC phenomenon. In particular, to the extent the flexibility afforded by some LLC statutory regimes attracts opportunistic use, legal doctrine is likely to be responsive under one doctrinal guise or another. The more malleable elements of contract doctrine, along with the construct of the “tortious state of mind,” are potential ingredients in an evolving doctrinal response.

Apart from evolution in legal doctrine, one wonders whether opportunistic exploitation of flexibility in the LLC framework may engender skepticism about LLC-structured business opportunities on the part of prospective members who would

67. See FARNSWORTH, supra note 28, § 7. If the operative standard of care for a fiduciary managing a business turns on the presence or absence of gross negligence, see McGeever, supra note 16, at 54, then the disparity between the fiduciary norm and the best efforts obligation is even more striking.

68. Intellectually plausible alternatives to fiduciary obligation and contract doctrine as basic organizing principles in such relationships do not come readily to mind. Even if one views such relationships as defined by status—treated by legal historians as a precursor to contract as a basis upon which people structure relationships—one recalls that significant legal consequences flow from status-based legal classifications. See HENRY MAINE, ANCIENT LAW 141 (Dorset Press 1966) (1861) (citing examples of infancy and guardianship as legal institutions reflective of status of persons rather than contract).
not be in control of the LLC. Skepticism paints with a broad, not a fine, brush at times, a trait that may impose significant costs. In particular, wide-reaching skepticism engenders substantial informational costs. Professor Bankman’s recent study of Silicon Valley start-ups helpfully illustrates some of skepticism’s costs; the study examines why many Silicon Valley start-ups are organized as corporations despite the clear loss of tax benefits that would be available if they were initially organized as partnerships.\textsuperscript{69} One of Bankman’s explanations is that employees are skeptical of the venture capitalists who finance start-ups. As a result, employees are reluctant to accept a contingent partnership interest comparable to the familiar stock options conventionally received by start-ups’ employees. No explanation from the venture capitalist, however internally coherent, might persuade a distrustful employee. Employee distrust would dramatically increase informational costs as the employee “seeks reassurance from other sources”\textsuperscript{70} (for example, from a tax lawyer retained by the employee). Observes Bankman, “More generally, the use of an unconventional organizational structure might be taken by an employee as a signal that a venture capitalist will not ‘play by the rules’ or follow convention in other areas as well.”\textsuperscript{71}

Novelty, when coupled with ill-crafted organizational complexity, carries other costs that jeopardize its overall benefits. If LLC agreements resemble poorly crafted limited partnership agreements, some number of them will require litigation to resolve questions raised by the parties’ conduct. Delaware courts now publicly lament the burden created by “convoluted limited partnerships that have been formed in Delaware for a token fee,”\textsuperscript{72} and one supposes that disputes involving convoluted structures are even more tedious when the organizational documents have not been carefully drawn. Just how costly or beneficial (or, for that matter, novel) the brave new world of LLCs will on balance become is impossible to predict.

\textsuperscript{69} Joseph Bankman, The Structure of Silicon Valley Start-ups, 41 UCLA L. Rev. 1727 (1994).
\textsuperscript{70} Id. at 1752.
\textsuperscript{71} Id.