

WHAT IS THE PRACTICAL IMPORTANCE OF DEFAULT RULES UNDER DELAWARE LLC AND LP LAW?

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Despite much academic debate, it is now well settled that in Delaware at least, corporate law differs from unincorporated alternative entity law in one fundamental respect. Under Delaware corporate law, fiduciary duties are *mandatory*. These duties, owed by the managers of a corporation to the shareholders of the firm, in general cannot be waived or modified by contract.¹ Under Delaware law governing limited liability companies (LLCs) and limited partnerships (LPs), however, fiduciary duties are merely *default* duties.² Although managers of these alternative entity firms owe fiduciary duties,

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¹ Under Delaware's corporate statute, corporations may eliminate managerial liability arising from breaches of the fiduciary duty of care and carve out limited exceptions to the corporate opportunity doctrine. DEL. CODE ANN. tit. 8, §§ 102(b)(7), 122(17) (2011). Corporations, however, cannot eliminate the fiduciary duty of loyalty; cannot eliminate the corporate opportunity doctrine altogether; cannot insulate all interested transactions from exacting entire fairness review; cannot eliminate so-called *Revlon* duties; and cannot protect managerial decisions from judicial scrutiny under the intermediate *Unocal* standard of review. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 102(b)(7) (prohibiting charter provisions that limit or eliminate the fiduciary duty of loyalty); *Sutherland v. Sutherland*, 2009 WL 857468, at *4 (Del. Ch. Mar. 23, 2009) (noting that "[w]hile such a provision [limiting the fiduciary duty of loyalty] is permissible under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, where freedom of contract is the guiding and overriding principle, it is expressly forbidden by the [Delaware corporate statute]"); *In re Cox Commc'ns, Inc. S'holders Litig*, 879 A.2d 604, 614-18 (Del. Ch. 2005) (explaining Delaware law requires entire fairness review of all cash-out mergers involving a controlling shareholder); *Paramount Commc'ns, Inc. v. QVC Network, Inc.* 637 A.2d 34, 51 (Del. 1994) (noting that a corporation may not contractually limit a corporate fiduciary's *Revlon* duties).

² *See, e.g.*, *Paige Cap. Mang., LLC v. Lerner Master Fund, LLC*, 2011 WL 3505355, *31 (Del. Ch. Aug. 8, 2011) (holding that "[a]s a matter of default law, [the] General Partner clearly owes fiduciary duties to the limited partners" unless the limited partnership agreement waives such duties); *Kelly v. Blum*, 2010 WL 629850, *10 (Del. Ch. Feb. 24, 2010) (noting that "default fiduciary duties apply" under

these duties may be modified or even wholly eliminated by the terms of the alternative entity governing agreement.³

Recently however, the Chief Justice of the Delaware Supreme Court, Myron Steele, has sparked a new debate. In his article “Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies,” the Chief Justice makes the provocative assertion that fiduciary duties should not apply, *even as a default*, under Delaware alternative entity law.⁴

Despite the Chief Justice’s controversial claim, the Delaware Chancery Court, the state’s lower court and the nation’s premier venue for business litigation, has repeatedly held that absent a contractual agreement to the contrary, the managers of a Delaware LLC or LP owe fiduciary duties as a default.⁵ But the Delaware Supreme Court has yet to expressly rule on this issue.⁶ And the Chief Justice’s article, although written in his unofficial capacity, shows that at least one member of the state’s five-member high court disagrees with the Chancery Court’s rulings.

Thus, Chief Justice Steele’s article has renewed the debate over fiduciary duties, albeit in a new context. Rather than debating whether fiduciary duties should be subject to contractual limitations,⁷ distinguished academics and practitioners now debate whether

Delaware LLC law “unless the LLC agreement . . . explicitly expands, restricts, or eliminates [such] duties); *Bay Center v. Emery Bay PKI*, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009) (“The Delaware LLC Act gives members of an LLC wide latitude to order their relationships, including the flexibility to limit or eliminate fiduciary duties. But, in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties . . .”).

³ DEL. CODE ANN. tit. 6, §§ 17-1101(d) (2011) (applying to LPs); *id.* 18-1101(c) (applying to LLCs).

⁴ See generally Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009).

⁵ See *supra* note 2.

⁶ For example, in the recent case *William Penn Partnership v. Saliba*, 13 A.3d 749, 256 (Del. 2011), the Delaware Supreme Court, per Chief Justice Steele, applied default fiduciary duties in an LLC dispute but only after noting the litigants had stipulated that such duties apply. In a subsequent interview, the Chief Justice confirmed that his ruling in *William Penn* did not address the question of whether fiduciary duties would apply in the absence of the parties’ agreement that such duties apply and that that “unresolved issue [has] never been squarely decided by the Delaware Supreme Court.” See Practical Law the Journal, *Q&A with Chief Justice Myron T. Steele of the Delaware Supreme Court*, Dec. 1, 2011, at <http://usld.practicallaw.com/3-515-1049>.

⁷ For a short summary of this debate, see Part I.B. of the forthcoming article Mohsen Manesh, *Contractual Freedom under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 36 J. CORP. L. (forthcoming 2012), available at

fiduciary duties should even apply as a legal default under unincorporated alternative entity law.⁸

On the surface, this new debate has significant implications for business planners and investors. In recent years, unincorporated alternative entities, and LLCs in particular, have become increasingly prominent in various aspects of the business world.⁹ And, much like its dominant position in the world of corporate law, Delaware has quickly gained preeminence in the alternative entity context, due in large part to its apparent success in attracting LLCs and LPs to organize under Delaware law.¹⁰

In this essay, however, I argue that this new debate, although interesting as a theoretical matter, has limited practical importance. Sophisticated parties can and will contract to avoid undesirable default rules. And LLCs and LPs with passive investors have contractually created an almost *de facto* rule eliminating fiduciary duties. Thus, even if one believes Chief Justice Steele's thesis is problematic, the problem it creates affects only a small portion of Delaware's alternative entity universe.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1939920.

⁸ For example, in December 2011, the Institute of Delaware Corporate & Business Law sponsored an online symposium on this subject entitled "Default Fiduciary Duties in LLCs and LPs," available at <http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/>.

⁹ See generally LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* (2010); Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465 (2009); Tom Lauricella & Carolyn Cui, *Frenzy in Energy Partnerships, Investors Stick Billions of Dollars Into a Stock-Market Niche Known as MLPs*, WALL ST. J. (Aug. 10, 2010).

¹⁰ See Bruce Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91, 116 (finding that among closely held LLCs with 50 or more employees that form outside of their home state, more than 61% are formed under Delaware law); Jens Dammann & Matthias Schundeln, *Where are Limited Liability Companies Formed? An Empirical Analysis* (June 28, 2010) p.3, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633472 (finding that among closely held LLCs with 5,000 or more employees that form outside of their home state, more than 95% are formed under Delaware law); see also Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 201-02 (2011) (finding that every LLC filing for or completing an initial public offering during a recent 6 year period was organized under Delaware law); Manesh, *Legal Asymmetry*, *supra* note 9, at 476 (finding that every LLC and LP filing for or completing an initial public offering during a recent three-plus year period was organized under Delaware law); Manesh, *Contractual Freedom under Delaware Alternative Entity Law*, *supra* note 7, at Appendix A (noting that every publicly traded LLC and LP organized under domestic law, save one, is organized in Delaware).

Insignificance of Default Rules for Sophisticated Investors

Chief Justice Steele carefully limits his thesis to only those LLCs and LPs that are created from a “bargained for exchange” among “sophisticated” parties.¹¹ The Chief Justice argues that among sophisticated parties the application of default fiduciary duties makes little sense:

[I]t 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.¹²

But it is among this very group—sophisticated parties who bargain for their rights and obligations—that the debate as to default rules is likely to have the least relevance. Regardless of the default rules that apply to LLCs and LPs, as long as Delaware law affords the maximum freedom of contract to deviate from such rules,¹³ sophisticated parties can and will contract for their desired result. By hypothesis, sophisticated parties

¹¹ See Steele, *supra* note 4, at 225, 241 n.71.

¹² Likewise, elsewhere in the article, the Chief Justice argues that

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 risk. . . . To help answer this question, it is important to note that sophisticated parties bargain for the obligations and duties provided in an LLC agreement. The choice of the LLC form was an intentional form, chosen by sophisticated parties because that form provides the contracting parties with the maximum ability to customize their relationship. 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. . . .

Id. at 237.

¹³ See DEL. CODE ANN. tit. 6, § 17-1101(c) (governing LPs) (2011); *id.* § 18-1101(b) (governing LLCs).

are aware of the default rules, understand they are not inescapably bound to such rules and will bargain for different rules if the default rules are undesirable. If fiduciary duties apply as the default, sophisticated parties that want to eliminate or modify such duties can and will easily do so.¹⁴ If, on the other hand, no fiduciary duties apply as the default, as Chief Justice Steele advocates, sophisticated parties can just as easily impose corporate-like fiduciary duties (or some subset of such duties) by simple reference to such duties in the terms of the LLC or LP governing agreement.¹⁵

To be sure, the Chief Justice would disagree with this analysis. He argues that it is easier (or, to use his jargon, it would reduce “contracting costs”) to contractually recreate fiduciary duties in a world where no fiduciary duties is the default (i.e., Chief Justice Steele’s preferred world) than to selectively eliminate limited aspects of fiduciary duties in a world where fiduciary duties are the default (i.e., the world in which we currently live).¹⁶ But it is not clear that this is true.¹⁷ In a world where fiduciary duties apply as the

¹⁴ For examples of LLC agreement provisions eliminating all fiduciary duties see *Fisk Ventures, LLC*, 2008 WL 1961156, *11 (Del. Ch. May 7, 2008), *aff’d*, 984 A.2d 124 (Del. 2009) (interpreting the following provision to eliminate all fiduciary duties of LLC members: “No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements.”); *In re Atlas Energy Resources LLC*, 2010 WL 4273122, *12 (Del. Ch. Oct. 28, 2010) (interpreting the following provision to eliminate all fiduciary duties of officers and directors in a manager-managed LLC: “Except as expressly set forth in this Agreement or required by law, none of the Directors, nor any other Indemnitee shall have any duties or liabilities, including fiduciary duties, to the Company or any Member.”).

¹⁵ See Steele, *supra* note 4, at 240 (“[I]f we proceed from a 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.”). For an example of a LLC agreement provision that creates corporate-like fiduciary duties by reference, see OCH-ZIFF CAPITAL MANAGEMENT GROUP LLC, SECOND AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT, in Annual Report (Form 10K), exhibit 3.2, § 5.23 (Nov. 13, 2007), available at <http://www.sec.gov/Archives/edgar/data/1403256/000119312508064885/dex32.htm> (“Except as otherwise expressly set forth in this Agreement or required by the Delaware Act, (i) the duties and obligations owed to the Company by the Officers and Directors shall be the same as the duties and obligations owed to a corporation organized under DGCL by its officers and directors, respectively, and (ii) the duties and obligations owed to the Members by the Officers and Directors shall be the same as the duties and obligations owed to the shareholders of a corporation under the DGCL by its officers and directors, respectively.”).

¹⁶ See Steele, *supra* note 4, at 240-41.

¹⁷ Attorney Callison and Dean Vestal make a similar claim to support their view that fiduciary duties should apply as a default. See J. William Callison & Allan W. Vestal, “Triple Error: Chief Justice Steele and Default,” The Institute of Delaware Corporate & Business Law Blog, On-Line Symposium: Default Fiduciary Duties in LLCs and LPs, available at <http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/j-william-callison-and-allan-w-vestal-triple-error-chief-justice-steele-and-default/> (“[B]ased on our experience, we do not think it is apparent that starting with a panoply

default, parties wishing to retain only a discrete aspect of the fiduciary duties (for example, a restriction on self-dealing transactions) may simply contractually eliminate all fiduciary duties (which Chief Justice Steele agrees may be achieved “at little cost”¹⁸) and then draft an explicit contractual provision prescribing the specific conduct that default fiduciary principles would otherwise normally prescribe (which Chief Justice Steele also suggests would be simple to draft¹⁹). Although the Chief Justice raises the concern that such provisions will “necessarily appear contradictory,”²⁰ LLC and LP agreements eliminating all fiduciary duties but also restricting self-dealing transactions are quite common, and there is little reason to believe the Delaware courts would have trouble interpreting such agreements.²¹ Thus, it seems that regardless of the default rule, if the default rule is undesirable, sophisticated parties can and will readily contract to avoid it.

De Facto Rules for Passive Investors

In contrast to LLCs and LPs bargained for by sophisticated parties, Chief Justice Steele excludes from his analysis LLCs and LPs that involve passive (possibly unsophisticated) investors, who purchased or otherwise acquired their units and were not involved in the formation or negotiation of the firm’s governing agreement.²² Perhaps because such firms bear closer resemblance to public corporations,²³ Chief Justice Steele would retain fiduciary duties as a default for such firms.

But even if default rules continue to apply fiduciary duties to LLCs and LPs that

of default duties and then contracting for modification or elimination of those duties is more difficult th[a]n starting with a blank slate and drafting a full set of duties.”)

¹⁸ See Steele, *supra* note 4, at 240 (“I agree that a wholesale elimination of duties in an LLC agreement comes at little cost. . .”).

¹⁹ *Id.* (“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. . .”).

²⁰ *Id.*

²¹ For example, in *In re Atlas Energy Resources LLC*, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010), Vice Chancellor Noble held that the LLC agreement at issue eliminated all common law fiduciary duties of the LLC’s officers and directors, but replaced such duties with a contractually defined fiduciary duty of good faith. *Id.* at *12. In dismissing the complaint against the defendant officers and directors, the Vice Chancellor noted that “[a]lthough Plaintiffs accuse certain defendants of conduct that might constitute breach of traditional fiduciary duties, they do not allege that the Individual Defendants engaged in conduct [violating the contractually defined duty of good faith].” *Id.* at *15.

²² See Steele, *supra* note 4, at 241 n. 71.

²³ See Manesh, *Legal Asymmetry*, *supra* note 9, at 483-488 (describing the ways in which publicly traded LLCs and LPs are indistinguishable from their corporate counterparts).

involve passive investors, such rules will be largely irrelevant. This is because LLCs and LPs with passive investors still retain the statutory freedom to contract out of the default rules,²⁴ and evidence suggests that almost all such entities actually do.²⁵ In a study forthcoming in the *Journal of Corporation Law*, I find that 88% of all publicly traded Delaware LLCs and LPs—firms that have sold units to disaggregated, largely passive public investors—have either entirely waived all fiduciary duties owed to investors or eliminated any liability arising from the breach of such duties.²⁶ This finding is perhaps unsurprising given that for publicly traded LLCs and LPs, the firm’s governing agreement is not the product of a give-and-take bargaining process between the firm and sophisticated investors sitting around a negotiating table, but rather drafted exclusively by the firm’s promoters and offered to public investors on a take-it-or-leave-it basis. And although my results are limited to the relatively few extant publicly traded Delaware LLCs and LPs, it is not unreasonable to believe that private LLCs and LPs with passive investors eliminate fiduciary duties with similar frequency.

Thus, even putting aside the problems of bifurcating default rules for sophisticated and unsophisticated parties that attorney Callison and Dean Vestal have noted,²⁷ the ultimate default rules in this context prove largely irrelevant. Given the statutory freedom of contract to deviate from default rules, LLCs and LPs with passive investors regularly eliminate fiduciary duties. In this sense, debating whether fiduciary duties should apply as a default in the context of LLCs and LPs with passive investors is like debating whether the fiduciary duty of care should apply as a default in the context of public corporations. The debate is largely academic: in practice, the *de jure* default rule applying such duties has been all but replaced with a *de facto* practice eliminating the same.²⁸

²⁴ See DEL. CODE ANN. tit. 6, § 17-1101(c) (governing LPs) (2011); *id.* § 18-1101(b) (governing LLCs).

²⁵ See generally Manesh, *Contractual Freedom under Delaware Alternative Entity Law*, *supra* note 7.

²⁶ *Id.* at Part III.A.

²⁷ See Callison & Vestal, *supra* note 17; see also Lyman Johnson, Untitled Comment, The Institute of Delaware Corporate & Business Law Blog, On-Line Symposium: Default Fiduciary Duties in LLCs and LPs, available at <http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/lyman-johnson/>.

²⁸ Compare Manesh, *Contractual Freedom under Delaware Alternative Entity Law*, *supra* note 7 (finding that 88% of all publicly traded Delaware LPs and LLCs have either eliminated all fiduciary duties or eliminated any liability arising from the breach of any fiduciary duties) with J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waver of Liability Provision, and the Race to the Bottom*, 42 IND. L. REV. 285 (2009) (finding that all but one corporation in the Fortune 100 have provisions eliminating liability for breaches of the fiduciary duty of care).

Limited Practical Relevance for Delaware

So, for whom are Delaware's default rules regarding fiduciary duties relevant? Perhaps it is those Delaware residents—those “mom and pop” businesses, as Professor Kleinberger describes them²⁹—who may be legally unsophisticated but desire to use the LLC form to obtain limited liability and pass-through partnership tax treatment for their small business. Such “users” of Delaware LLC law may be unaware of Delaware's default rules or lack the resources to competently tailor a governing agreement to contractually alter any undesirable aspects of the default rules. And, to the extent one believes that most of these unsophisticated business owners would prefer a regime in which fiduciary duties apply, adopting Chief Justice Steele's interpretation of Delaware law could create undesired consequences.

But even if the Chief Justice's preferred default rules would harm unsophisticated “mom and pop” businesses, as various practitioners and academics have suggested,³⁰ note that in Delaware, a state that is largely a haven for attracting out-of-state alternative entity charters,³¹ where the ratio of LLCs to actual residents will soon approach one-to-one,³² it

²⁹ Daniel S. Kleinberger, “Why Justice Cardozo Was Right, and Chief Justice Steele Is Wrong,” The Institute of Delaware Corporate & Business Law Blog, On-Line Symposium: Default Fiduciary Duties in LLCs and LPs, *available at* http://blogs.law.widener.edu/delcorp/?page_id=335&preview=true. Note, it is unlikely that unsophisticated out-of-state mom-and-pop business would reach to Delaware LLC law—rather than the law of their home state—to organize a small business.

³⁰ See Callison & Vestal, *supra* note 17 (“In our view, it is unlikely that 112,000 new [Delaware] LLCs involved sophisticated parties with the resources to enter customized governance structures, just as it is unlikely that the LLC form was chosen because it provides parties with the maximum ability to customize their relationship.”); Kleinberger, *supra* note 29 (“Presumably, Delaware LLCs are the vehicle of choice not only for the sophisticated venturers from throughout the world but also myriad local (Delaware-based) ‘mom and pop’ entrepreneurs ... many of [whom] are outside the Chief Justice's assumptions.”); John Cunningham, Untitled Comment, The Institute of Delaware Corporate & Business Law Blog, On-Line Symposium: Default Fiduciary Duties in LLCs and LPs, *available at* <http://blogs.law.widener.edu/delcorp/on-line-symposium-default-fiduciary-duties-in-llcs-and-lps/john-cunningham-dec-9-2011/> (“It seems clear that the Chief Justice meant the article to apply to what, in practice, is only a minute percentage of actual Delaware LLCs.”).

³¹ See *supra* note 10.

³² As of 2010, the population of natural persons in Delaware was 897,934, up from 783,600 in 2000, See U.S. CENSUS BUREAU, DELAWARE QUICKFACTS (2010), *available at* <http://quickfacts.census.gov/qfd/states/10000.html>. At the same time, at the end of 2010, Delaware was home to 550,238 LLCs, with 82,027 new LLCs formed during 2010 alone. See A. Gilchrist Sparks, “Legislative Developments in Delaware's “Alternative Entities”, Harvard Law School Forum on Corporate Governance and Financial Regulation, at <http://blogs.law.harvard.edu/corpgov/2011/09/08/legislative-developments-in-delaware%E2%80%99s-%E2%80%9Calternative-entities%E2%80%9D/>.

is unlikely that a significant percentage of Delaware's 550,238 LLCs fall into the unsophisticated "mom and pop" category.³³ Thus, if Chief Justice Steele's interpretation of Delaware LLC and LP law is in fact problematic, the problem it creates affects only a narrow slice of the Delaware alternative entity universe. And it is this small population that the new debate as to fiduciary defaults is all about.

³³ See Robert B. Thompson, *Allocating the Roles for Contracts and Judges in the Closely Held Firm*, 33 W. NEW ENG. L. REV. 369, 401 (2011) (pointing to anecdotal data that suggests Delaware law attracts a specific subset of the LLC marketplace, namely sophisticated parties who are willing and able to contract around statutory defaults).