# FIDUCIARY DUTY, CONTRACT, AND WAIVER IN PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

*by*
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*Among the controversies swirling around the promulgation of new uniform statutes governing partnerships and LLCs is the question whether and to what extent fiduciary duties should be made mandatory or waivable. Although courts and commentators have not traditionally focused on the costs of fiduciary duties, the costs are significant in that such duties may preclude agents from engaging in other legitimate ventures. Indeed, fiduciary duty may be used by those to whom it is owed to prevent competition or extort side benefits from participants. Mandatory duties effectively require participants who may identify multiple business opportunities to overinvest their human capital by forcing them to choose one and only one venture in a given market, and thus may preclude economic ventures from being undertaken by precisely those potential participants who have the most to offer. The thesis here is that the approach taken in RUPA and ULLCA, which allows for the broad waiver of fiduciary duties, but only to the extent specified in the partnership agreement or operating agreement, is eminently sound. The approach taken in the new uniform acts encourages disclosure and negotiation by effectively placing the burden on the agent who anticipates engaging in other ventures to negotiate for specific waivers of fiduciary duties. Because the partnership and LLC forms are likely to be used for a wide variety of ventures for which competition may be more or less worrisome, it is vitally important that a flexible approach to fiduciary duty be adopted. The new uniform acts do precisely that without sacrificing the protection of advance disclosure and negotiation to those who may have less bargaining power in connection with the formation of business ventures.*

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## I. INTRODUCTION

There has been an explosion of new forms of unincorporated business organizations in the last few years, ranging from the limited liability company (LLC) to the limited liability partnership (LLP) to arguably a whole new form of partnership under the Revised Uniform Partnership Act (RUPA).[1] A pattern that appears to be emerging in statutes allowing for these forms of organization is the idea that fiduciary duty can be limited by private agreement. In other words, most of the statutes allowing for the formation of unincorporated business organizations allow for the waiver, to some extent, of traditional fiduciary duties. Given that these new forms of organization tend to be used by smaller businesses, where the need for fiduciary duties have traditionally been viewed as strongest, the movement toward dilution of such duties is curious. Thus, it should come as no surprise that statutes allowing for the waiver of fiduciary duties have been quite controversial. The controversy is reminiscent of the tale of Goldie Locks and the Three Bears. The majority of commentators seem to view the new approach to fiduciary duty as too soft, while other commentators view it as too hard. The middle position, that the new statutory approach is just right, is the thesis of this Article.

## II. THE NEW STATUTORY APPROACH

Both RUPA and the Uniform Limited Liability Company Act (ULLCA) provide that fiduciary duties shall consist solely of a duty of care and a duty of loyalty.[2] Whether this limitation in itself constitutes a constriction of the fiduciary duties that have traditionally applied in the partnership setting is an open question. Some commentators suggest that traditionally fiduciary duty has included a duty of disclosure and a duty of good faith.[3] The real controversy, however, centers on the fact that both uniform acts provide that the duty of care and the duty of loyalty may be waived. As for the duty of care, both uniform acts provide that it may be waived so long as the waiver is not unreasonable.[4] As for the duty of loyalty, both acts provide that it may be waived with regard to "specific types or categories of activities . . . if not manifestly unreasonable."[5] In both

[1] UNIF. PARTNERSHIP ACT (RUPA) (1994), 6 U.L.A. 8-124 (1995).

[2] RUPA §§ 404, 603, 6 U.L.A. 58, 79; UNIF. LIMITED LIABILITY COMPANY ACT (ULLCA) §§ 409, 603(b)(2)-(3) (1995), 6A U.L.A. 464, 475 (1995).

[3] *See, e.g.*, J. William Callison, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1 J. SMALL & EMERGING BUS. L. 109, 114 (1997).

[4] RUPA § 103(b)(4), 6 U.L.A. 16; ULLCA § 103(b)(3), 6A U.L.A. 434.

[5] RUPA § 103(b)(3), 6 U.L.A. 16; ULLCA § 103(b)(2), 6A U.L.A. 434.

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cases, any waiver must be set forth in the partnership or operating agreement.[6] Several commentators have argued that the ability to waive virtually all fiduciary duties will lead to over-reaching by better informed partners or those with more bargaining power.[7] Other commentators have argued that the inability to waive all fiduciary duties is too restrictive: They favor a statutory formulation more like that of Delaware's LLC law which arguably allows for a complete waiver of fiduciary duties.[8]

### A. *The Duty of Care*

The extent of the duty of care under partnership law as it existed before RUPA is unclear.[9] Under the Uniform Partnership Act, partners are individually liable for the excess debts of the partnership.[10] In addition, partners have an equal say in the management of the partnership if there is no provision to the contrary in the partnership agreement.[11] Thus, some commentators have suggested that a duty of care never really evolved because partners have sufficient incentive to take care, given the prospect of individual liability and sufficient management authority to control risks that might be taken on by fellow partners.[12] While that argument largely holds true for partnerships under RUPA, it is not necessarily the case in an LLC, where limited liability for members is the rule and where many companies are managed by designated managers rather than all the members.[13] On the other hand, it is also arguable that the prospect of individual liability creates too much disincentive to take appropriate risks and that the duty of care that has developed in the context of corporation law may be closer to the appropriate standard for LLCs.[14] Moreover, it is arguable that statutes allowing for waiver of the duty of care were inspired by statutes allowing corporations to do away with director liability for negligence,[15] although it seems clear that such statutes

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[6] *See* RUPA § 103, 6 U.L.A. 16; ULLCA § 103, 6A U.L.A. 434.

[7] *See, e.g.*, Callison, *supra* note 3, at 123; Allan W. Vestal, *Advancing the Search for Compromise: A Response to Professor Hynes*, 58 LAW & CONTEMP. PROBS. 55, 56 (Spring 1995).

[8] *See, e.g.*, J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 LAW & CONTEMP. PROBS. 29, 31 (Spring 1995); *cf.* Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 LAW & CONTEMP. PROBS. 81, 97 (Spring 1995) (arguing that the uniform approach is more or less correct, but for different reasons than those argued herein).

[9] *See* Callison, *supra* note 3, at 114.

[10] UNIF. PARTNERSHIP ACT (UPA) §§ 18, 40 (1914), 6 U.L.A. 526, 901 (1995).

[11] *See* UPA § 18, 6 U.L.A. 526.

[12] *See, e.g.*, Callison, *supra* note 3.

[13] *See* ULLCA §§ 303, 404, 6A U.L.A. 454, 457.

[14] For an authoritative statement of the duty of care in the context of a corporation, see AMERICAN LAW INSTITUTE, 1 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

[15] *See, e.g.*, CAL. CORP. CODE § 204 (West 1997).

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were enacted with publicly traded corporations in mind.[16] While it is arguable that diversified shareholders who own shares in a publicly traded corporation should be limited to recovery for intentional harm to the corporation, most partnerships and LLCs do not have diversified investors.[17] Rather, they tend to have undiversified investors who may be quite concerned about having some residual remedy against their managers for excessively risky behavior.[18] On the other hand, the duty of care has never really reached anything short of intentional harm to the corporation.[19] Thus, at a minimum, the new standard created by the advent of LLCs is a clearer statement of the law and, in those cases in which the parties do not opt out of the fiduciary duty, the standard arguably is higher. This is as it should be, given that in the case of LLCs there may well be a wide range of companies from the very small to those almost large enough to be publicly traded.

### B. *The Duty of Loyalty*

The duty of loyalty works a bit differently. Under both RUPA and the ULLCA, the acts or categories of acts as to which the duty of loyalty is waived must be specified.[20] Unlike the duty of care, which may not really exist in practice, the duty of loyalty is a serious issue in all business organizations. Generally speaking, duty of loyalty issues fall into three categories: self-dealing, diversion of business opportunities, and competition with the company.[21] The ability to waive the duty of loyalty will allow for participants to engage in these traditional breaches with impunity. The worry expressed by most commentators is that parties with bargaining power will use their position to eviscerate the duty of loyalty altogether by

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[16] *See* 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, pt. IV, introductory note b.

[17] Interests in partnerships and LLCs may not be publicly traded and still retain pass-through tax status. *See* IRC § 7704. *See generally* Richard A. Booth, *The Limited Liability Company and the Search for a Bright Line Between Corporations and Partnerships*, 32 WAKE FOREST L. REV. 79 (1997). Because such interests cannot be publicly traded, it is difficult for many investors to diversify. It is not, however, impossible or even unlikely that a venture capital firm might make investments in a number of unincorporated entities and thus achieve diversification. Indeed, there is no reason why a mutual fund could not offer publicly traded shares in a diversified portfolio of partnerships and LLCs. Nonetheless, it would seem reasonable to presume that most investors in such entities are undiversified.

[18] *See generally* Richard A. Booth, Stockholders, Stakeholders, and Bagholders (Or How Investor Diversification Affects Fiduciary Duty) (1997) (unpublished manuscript, on file with author and *The Journal of Small and Emerging Business Law*).

[19] *See id.* at 11.

[20] RUPA § 103(b)(3), 6 U.L.A. 16; ULLCA § 103(b)(2), 6A U.L.A. 435.

[21] *Compare* 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, §§ 5.02, .05-.06 (comparing the corporate fiduciary duty of loyalty with the duty of fair dealing), *with* RUPA § 404(b)(1)-(3), 6 U.L.A. 58 (explaining the duty of loyalty in a partnership agreement), *and* ULLCA § 409(b)(1)-(3), (h)(1)-(2), 6A U.L.A. 464 (explaining the duty of loyalty in an LLC agreement).

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specifying such broad categories of exemptions that there will be little left of the duty.[22] This practicality, among other considerations, leads some commentators to suggest that the duty of loyalty should be waivable in its entirety.[23]

## III. COSTS AND BENEFITS

What are the costs and benefits of diluting, or even waiving, fiduciary duty? On the cost side there is presumably some danger of over-reaching and advantage-taking. On the benefit side, the advantages are subtler. Although fiduciary duty may sound at first like one of those things of which more is always better, it is not. Fiduciary duty can easily be used by opportunistic partners to unduly confine the side activities of other partners. The casebooks are replete with cases in which principals have sought to prevent their agents from taking advantage of opportunities in which the principal had no genuine expectation, and cases in which principals have sought to prevent their agents or former agents from competing, sometimes only after waiting to see whether or not the competitive venture was successful.[24] For example, consider a variation on the facts of the classic case of *Meinhard v. Salmon*.[25] What if Meinhard had waited a year to see whether or not the new development being managed by Salmon was successful?[26] Would the court have been equally inclined to give Meinhard a share of it, recognizing that Meinhard perhaps would have declined to sue for his share if it turned out to be a losing venture? It was in precisely such a case that the Massachusetts Supreme Court adopted an "expectancy test" to deal with corporate opportunities and competition with the corporation.[27] Although most courts have applied a "line of business test" to distinguish between opportunities that may and may not be taken by a fiduciary, in *Lincoln Stores v. Grant*, the plaintiff firm attempted, after an apparent delay of about two years, to enjoin a group of former managers from acquiring and operating a competing department store. Clearly, the opportunity to acquire the new store was in the line of business of the existing store. Nevertheless, the court ruled that the existing store had no existing interest or expectancy in the acquisi-

[22] *See, e.g.*, Vestal, *supra* note 7, at 67 (noting that drafters of RUPA believed duty of loyalty could be eliminated by using categorical modifications).

[23] *See, e.g.*, Larry E. Ribstein, *Changing Statutory Forms*, 1 J. SMALL & EMERGING BUS. L. 11 (1997) (arguing that parties should be able to contractually opt out of fiduciary duties as a policy matter).

[24] *See generally* Saul Levmore, *Strategic Delays and Fiduciary Duty*, 74 VA. L. REV. 863 (1988).

[25] 164 N.E. 545 (N.Y. 1928).

[26] *See infra* Part VI.

[27] Lincoln Stores, Inc. v. Grant, 34 N.E.2d 704 (Mass. 1941). Although *Lincoln Stores* can be viewed as a competition with the corporation case, rather than as a corporate opportunity case, in the end, an insider's appropriation of an opportunity is itself a form of competition with the corporation. For another case applying the expectancy test, see *Lagarde v. Anniston Lime & Stone Co.*, 28 So. 199, 201 (Ala. 1899).

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tion of the new store. To be sure, the court could have ruled for the defendants on the ground of laches. But precluding the managers of the existing store from striking out on their own would eliminate an important potential source of competition and would constitute a windfall to the existing store in the sense that the existing store (if it was effectively awarded possession of the new store) would enjoy the benefits of its success without having taken the risk of failure. Most other courts have rejected the expectancy test as too narrow for most situations.[28] Still, the legitimate worry is that in some situations fiduciary duty may be used offensively by a supposedly cheated partner to exact a windfall gain in situations in which an allegedly faithless agent has taken all the risk.[29] Thus, some courts have opted for a simple "fairness test," holding that a fiduciary breach may be excused if the result is fair to the principal.[30] Although the test sounds mysterious and has been criticized by commentators as even more lax than the expectancy test because of its seeming lack of content,[31] it is certainly understandable how the fairness test evolved.

The fact that fiduciary duty can be abused indicates that it may be worthwhile for parties entering into business to negotiate its scope. Indeed, most commentators seem to agree with the notion that a court faced with a claim of breach should generally seek to determine what the parties would have bargained for if they had thought about the issue in advance, whatever the issue may be.[32] If the function of fiduciary duty is to supply missing contract terms, then it is difficult to argue that the parties should not be allowed to negotiate about predictable controversies if they think it is worthwhile to do so.[33]

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[28] *See generally* 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 5.05, reporter's note 2 (providing a list of cases that have rejected the expectancy test).

[29] *See generally* Levmore, *supra* note 24 (demonstrating that intentional delays can become a strategic advantage for the plaintiff).

[30] *See, e.g.*, Durfee v. Durfee & Canning, 80 N.E.2d 522, 529 (Mass. 1948); Lewis v. Fuqua, 502 A.2d 962, 970 (Del. Ch. 1985); *see also* Miller v. Miller, 222 N.W.2d 71, 81 (Minn. 1974) (adopting a two-step test including line of business analysis and fairness analysis).

[31] *See, e.g.*, Victor Brudney & Robert C. Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1020 (1981).

[32] *See, e.g.*, Callison, *supra* note 3, at 128-133.

[33] The criticism that RUPA and the ULLCA eliminate fiduciary duties that may exist during the formation stage of a business is also effectively answered by the fact that parties should be allowed to contract about such things. For an articulation of this criticism, see Callison, *supra* note 3, at 123-125, 162-164. Implying fiduciary duty at the formation stage would have the effect of precluding negotiation, because it would effectively bar arm's length bargaining. Thus the extension of fiduciary duties to the formation or preformation stage of a partnership would carry the danger of preventing any bargain that might be reached.

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## IV. WHY NOT TOTAL WAIVER?

The question that naturally arises is: If fiduciary duty is to be a matter purely of contract, then why should RUPA and the ULLCA preclude the total elimination of fiduciary duties? The answer is that these statutes are well designed to encourage and facilitate negotiation. A statute that allows for total waiver would likely undercut serious bargaining between the parties. Again, the primary concern is the duty of loyalty. A statute that requires specification of the types of conflicts to be exempted places the burden on the party who expects to be faced with such conflicts to raise the issue in advance and, in effect, to disclose the likely conflict to the other partners.[34] More importantly, a statute allowing for total waiver would give the more informed party an even bigger advantage. It would allow the more informed party simply to insist on a total waiver without specifying the nature of the conflict expected. If there is a disparity in bargaining power it is likely that one of the parties will insist on a total waiver. Resistance by the uninformed party to such demands could prevent a bargain from being struck. Thus, a statute allowing for total waiver is more likely to lead to deadlock in the negotiations. Similarly, without a statute allowing for waiver the parties may never reach a bargain at all because they cannot be sure of the extent to which they must give up other opportunities that they may wish to preserve.

If a statute allows for waiver to any extent—even total—it is entirely possible, if both sides are sophisticated, that they will reach a mutually acceptable bargain. It is doubtful that the requirement of specifying foreseeable conflicts will entail significant costs for two sophisticated parties such that they would not be able to reach a bargain. Where there are more than two parties, the negotiating dynamic obviously becomes much more complicated as the chances of deadlock, as well as windfall benefits, are enhanced. Thus it does not appear that there are any particular costs in a statute allowing for specific waiver, though it is at least conceivable that a court would interpret failure to waive as evidence of a duty that might not be implied in the absence of an opportunity to waive. Nevertheless, it is hard to fault the uniform statutes in that they succeed in placing the burden precisely on the party best able to carry it, namely, the party who is in a position to predict his or her own conflicts.[35]

The argument here in favor of the uniform approach to waiver of fiduciary duty is similar to an argument that I have made in connection with limited liability.[36] To summarize that argument briefly, limited liability for corporations and other entities is a mysterious convention. The

[34] Such a statute would have the effect of creating a duty of disclosure early in the formation process and thus answers the criticism that the limitation of fiduciary duties to duties of care and loyalty may have eliminated any duty of disclosure recognized by the courts, if indeed any such duty is recognized.

[35] *See* RUPA § 404, 6 U.L.A. 58-59; ULLCA § 409, 6A U.L.A. 464-65.

[36] Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Nw. U. L. Rev. 140 (1994).

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trend in the law has been in the opposite direction from limited liability, with courts holding a broader array of parties liable for a broader array of harms to third parties.[37] Witness the explosion in theories of product liability over the last several decades.[38] On reflection, however, it becomes apparent that limited liability does not in fact offer much protection in the context of a very small business. Voluntary creditors will typically insist on personal guarantees. In tort claims against the corporation, the sole shareholder will typically be personally liable because he or she was presumably involved in the tortious conduct. If the corporation is a bit larger—large enough to have employees such that a shareholder may not in fact be involved in torts of the corporation—limited liability creates no particular incentive to behave recklessly because the shareholders are likely to have most of their wealth tied up in the business. Thus, they have adequate incentives to take care. In the very largest corporations limited liability matters in only the most extreme and unexpected situations. Indeed, even in those situations, it matters little to diversified shareholders.

If limited liability does not matter, why do we have it? The answer is that it does matter, but not because it allows investors to walk away from their obligations. Rather, without limited liability creditors would not need to negotiate for personal guarantees.[39] Anyone who goes into business would be potentially liable to the extent of his or her entire personal wealth. With limited liability investors are able to decide how much they are willing to put at risk in connection with any given venture. It may be that creditors will insist on an unlimited personal guarantee (although in practice they often do not do so), but at least investors will know what is at stake.[40] Thus, limited liability may also be seen as serving an informational or educational function. Finally, if creditors did not need to negotiate for personal guarantees, they would not have as much incentive to compete with each other in offering the best possible terms.[41] Because creditors deal with many different debtors, they are effectively diversified and can easily build into the price of the goods, services, or money they furnish the possibility that a few debtors may not pay. By charging a bit more to each debtor, the creditor can offer what might be thought of as insolvency insurance in lieu of a personal guarantee, although a debtor who fails to pay may nonetheless be pursued if the creditor thinks the debtor is solvent or has otherwise abused its limited liability. In the absence of limited liability, however, the creditor would presumably keep the benefits of diversification and enforce whatever rights the creditor

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[37] *See id.* at 140.

[38] *See id.*

[39] *See id.* at 157.

[40] *See id.*

[41] *See id.* at 158.

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has against the personal wealth of the shareholders.[42] In short, in the absence of limited liability, bargaining between debtors and creditors would be less likely to arise.[43]

The same analysis can be applied to fiduciary duty. Why should a potential partner be required to forgo all transactions that can be characterized as in conflict of interest with the contemplated partnership? Suppose that the potential partner is engaged in another business that might be a supplier or customer of the contemplated partnership. Should the potential partner be required to choose between the two businesses and engage in only one? Is there some good reason that if the potential partner can deal with the partnership, on terms equal to or even better than those offered by other contractees, that the potential partner, if he or she becomes a partner, should be precluded from doing business with the partnership? While it is apparent that these types of transactions raise the possibility of abuse, it is also apparent that a *per se* ban will discourage entrepreneurial activity and preclude numerous economically viable deals. Although such a rule might make sense in a large market in which competition is intense, it may do more harm than good in small markets in which the potential for additional competitors is limited.

The essential point is the same as it was in connection with limited liability. Why should potential partners not be allowed to decide how much they want to invest in a contemplated business venture in terms of devotion to the endeavor? If fiduciary duty is non-negotiable, then one must, in effect, promise absolute loyalty to any venture undertaken, and all other ventures must either be forgone, or the fiduciary must take the risk that all returns resulting from any conflicting venture must be disgorged. Either outcome provides a disincentive to economic activity. In other words, negotiable fiduciary duty allows potential partners to decide in advance how much of their human capital to invest in a contemplated venture.[44]

The line-item waiver approach to fiduciary duty, under which each act or category of potential breach must be specified, is consistent with the logic of many well reasoned fiduciary duty cases. As one quickly discovers from a sampling of judicial opinions, it is often more difficult to

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[42] Incidentally, this function of limited liability also argues against the extension of the benefits of fiduciary duty to creditors. If creditors are diversified, their availing themselves of protections designed for owners constitutes double dipping. *See id.* at 157-61.

[43] Similar arguments have been made in connection with vicarious liability. *See generally* Alan O. Sykes, *The Economics of Vicarious Liability*, 93 YALE L.J. 1231 (1984). The ultimate point is one that flows from the Coase Theorem, namely, one of the more important functions of legal rules is to eliminate barriers to contracting. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 43-45 (3d ed. 1986).

[44] One cannot help but suspect that allowing waiver of the duty of loyalty is somehow connected to the increasing fluidity of the workforce and the fact that it is now rare for an individual at any level of responsibility or power not to hold many jobs in the course of his or her worklife.

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articulate reasons why a fiduciary duty should exist than it is to articulate reasons why a duty should not exist.[45] In other words, it is easier to identify areas of activity that are not covered by fiduciary duty than it is to define with precision what constitutes a breach. Why is that? The simple answer would seem to be that it is easier to identify those situations in which the potential costs of fiduciary duty become important. How can one know, after all, when the benefit of fiduciary duty is important? How can one identify a situation in which fiduciary duty has caused an agent to refrain from engaging in conflict?

Again, the question arises: Why not allow total waiver? The answer is that total waiver is too easy. The fact that fiduciary duty may be negotiable does not mean it is useless. It is important to keep sight of the fact that fiduciary duty seeks (almost in the spirit of arbitration) to determine how a controversy would have been settled if it had been known in advance that it was likely to arise. If total waiver is allowed, it is unlikely that genuine bargaining will arise. Partial waiver, no matter how closely it approaches total waiver, requires the person with information as to likely conflicts to disclose those conflicts and to seek advance approval from the other partners. Total waiver in the absence of specification allows a partner who expects a conflict simply to demand a total waiver.[46]

The line-item waiver may frequently give rise to situations in which a partner neglects to predict a colorable conflict and as a result may be charged with a breach of fiduciary duty. There is, of course, nothing to keep the courts from dealing with such unexpected conflicts as they come up in the same fashion in which they currently deal with fiduciary duty cases in a world with statutes that do not authorize waiver. Although it is possible, as suggested earlier, that the courts may construe remaining fiduciary duties more strictly, or even rule that other duties have been created as a result of waiver of some duties, it would probably be wise in recording any waivers to specify that no such presumption is created.

## V. PARALLELS

The idea that fiduciary duty is to some extent waivable is hardly new with RUPA and the ULLCA. While the traditional rule was that a breach of the duty of loyalty rendered the subject transaction void or voidable,[47] Delaware corporation law long ago provided for a safe harbor from such

[45] *See, e.g.*, Moss v. Vadman, 463 P.2d 159, 160-61 (Wash. 1969) (if agency limited to conveying offer, agent not precluded from entering own bid for property when original bidders were unable to finance purchase).

[46] In addition to bargaining considerations, it seems unlikely that a total waiver would ever be enforced. A total waiver, if enforced, could be likened to an illusory contract in which one side promises nothing at all. *Cf.* Stanley J. How & Assocs., Inc. v. Boss, 222 F. Supp. 936, 943 (S.D. Iowa 1963) (promoter held liable for contract on behalf of corporation to be formed); RKO-Stanley Warner Theatres, Inc. v. Graziano, 355 A.2d 830, 834 (Pa. 1975) (same).

[47] *See* 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 5.02 cmt. a.

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consequences, both before and after the fact, through shareholder ratification.[48] The Model Business Corporation Act[49] and the American Law Institute's Principles of Corporate Governance (PCG)[50] followed suit with minor variations. Indeed the PCG allows for the possibility that a standard of the corporation may trump off-the-rack fiduciary duties.[51] As for the duty of care, Delaware law allows for waiver of negligence claims against officers and directors.[52] To be sure, the Delaware waiver statute was passed in reaction to the seemingly extraordinary decision in *Smith v. Van Gorkom*[53] and may thus be seen as an effort to return the law of fiduciary duty in Delaware to its former status. Nevertheless, other states have followed suit.[54] Moreover, if the waiver statute is construed as insulating management from claims such as that made in *Smith v. Van Gorkom*, then it arguably may constitute an expansion of waivability in that most commentators have seen *Smith v. Van Gorkom* as either a case of negligence in connection with gathering information (and thus making a decision based on what is known to be inadequate information) or as a determination by the company in connection with a decision to sell in the context of a takeover (as to which the Delaware courts have imposed a heightened duty).[55] If the Delaware waiver statute is viewed as including such breaches, then it may in fact be a contraction of fiduciary duty.[56]

The possibility of waiver extends well beyond standard form business organizations and into classical one-on-one fiduciary relationships. For example, the Maryland Court of Appeals recently ruled that a standard form brokerage contract absolving a broker from liability for negligence in handling an investor's account is enforceable.[57] While most would agree that the duty to use reasonable care cannot be waived with regard to physical accidents,[58] the Maryland Court of Appeals had no difficulty

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[48] *See* DEL. CODE ANN. tit. 8, § 144 (1974).

[49] MODEL BUS. CORP. ACT §§ 8.60-.63 (1984).

[50] 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 5.02(a).

[51] *Id.*

[52] DEL. CODE ANN. tit. 8, § 102(b)(7) (Michie Supp. 1996).

[53] 488 A.2d 858 (Del. 1985).

[54] *See, e.g.*, 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, pt. IV, introductory note b (providing a list of states that have enacted such statutes).

[55] On the other hand, failure to seek top dollar in a takeover situation could be classified as doing intentional harm to the corporation. Moreover, intentional harm may be a surrogate for an unidentified duty of loyalty problem. *See, e.g.*, Booth, *supra* note 18, at 11.

[56] It does not appear that there are any decided cases involving waiver under Delaware's section 102(b)(7) in such circumstances. DEL. CODE ANN. tit. 8, § 102(b)(7) (Michie Supp. 1996). Moreover, there was no reporter's note in connection with the statement in the PCG regarding a standard of the corporation, suggesting that such a form of waiver was altogether new and therefore constitutes another example of expanded opportunities for waiver. 1 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 14, § 5.09.

[57] *See* Wolf v. Ford, 644 A.2d 522, 528-29 (Md. 1993).

[58] *See* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 68, at 482-84 (5th ed. 1984).

holding that a cause of action for negligence could be waived in the case of a broker's handling of an account.[59] The difference is that the very idea of negligence breaks down in connection with the performance of forward-looking tasks or managerial skills. The possibility of loss is always present in connection with any voluntarily undertaken risk. Thus mere foreseeability will not suffice. Part of the reason for allowing waiver of the duty of care may be that the courts are confused by these two very different ideas of negligence.

Some forms of fiduciary waiver are so familiar that they may not even be recognized as such. For example, no one now seriously doubts that a leveraged buyout is legal. Yet, the transaction is by its very nature a form of self-dealing. Why then is it tolerated? The simple answer is that management is often the party most likely to offer the most for the target company because it knows more about the business than anyone else. Shareholders simply would not want a *per se* rule against management buyouts because it would eliminate a large category of potential purchasers. Thus, this particular form of self-dealing should not necessarily be seen as a breach of fiduciary duty, although, of course, such transactions are subject to significant procedural protections designed to insure the equivalent of arm's length dealing.[60]

On the other hand, there are some types of fiduciary duty that seem unlikely to be waivable. For example, the federal law of insider trading is ultimately based on a fiduciary duty to the shareholders or, to the extent that the misappropriation theory applies, a fiduciary duty to the owner of the information.[61] Would the federal courts enforce a waiver of fiduciary duty by a company or by a company on behalf of its shareholders, allowing employees of the company to engage in insider trading? Probably not. On the other hand, few companies are likely to agree to such a waiver in the first place. In many cases, service companies, such as investment banks, law firms, and accounting firms will want to assure their clients and customers of confidentiality.[62] In the case of publicly traded companies, it is unclear that shareholders would or could validly waive the duty owed to them by management.[63] Thus, it may be that one obsta-

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[59] *See Wolf*, 644 A.2d at 528.

[60] *See generally* Richard A. Booth, *Management Buyouts: Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630 (1985) (discussing and defending management buyouts without further imposition of barriers on the grounds that management may legitimately value the stock at a higher price than the market).

[61] *See* Chiarella v. United States, 445 U.S. 222, 228 (1980).

[62] *See generally* Richard A. Booth, *Vicarious Liability and Securities Fraud*, 22 SEC. REG. L.J. 347 (1995) (explaining that employers are harmed when employees use or leak sensitive information).

[63] *See, e.g.*, Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945, 997 (1991).

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cle to waiver of fiduciary duty is the practical problem of gaining approval from numerous investors.[64]

In addition to transactional waivers, there are whole industries in which traditional notions of fiduciary duty are effectively waived as a matter of course. Consider for example, the real estate brokerage business. A real estate broker is generally considered to be the agent of the seller on the theory that the seller agrees to pay the commission out of the proceeds of sale.[65] Most successful real estate brokers have numerous houses listed for sale and, indeed, many of the houses listed with any given broker are quite comparable to each other. Suppose the market is tight and the broker is only able to sell one of the houses. Do the remainder of the sellers have a claim for breach of fiduciary duty? Clearly there is no self-dealing involved, but arguably the broker took on competing duties to several principals, and each seller was in some sense in competition with each other seller. It could also be argued that the opportunity to sell to one available buyer was appropriated by the broker for the benefit of one of the sellers (and for the benefit of the broker to the extent of the commission) and to the exclusion of the other sellers. It seems highly unlikely, however, that any court would view the accomplished sale for the benefit of one of the sellers as somehow constituting a breach of fiduciary duty to any of the others.[66]

Why is it that such claims for breach of fiduciary duty seem so lacking in merit? The simple answer is that buyers and sellers of real estate happily waive the benefit of any such duty in order to gain the services of real estate agents more cheaply then they otherwise could. Consider the position of the seller if the seller insists on total loyalty from the real estate agent and desires to preclude that agent from representing any competing properties. Presumably the agent would need to charge a higher com-

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[64] It is not altogether clear, even in the context of a closely held firm, whether waiver must be unanimous or may be achieved by a majority vote when it is added after the fact and is not part of the charter or operating agreement from the outset.

[65] *See, e.g.*, Moore & Co. v. TALL, Inc., 792 P.2d 794, 798 (Colo. 1990).

[66] Similarly, if the broker manages to sell the house to a customer who called that broker as a result of seeing the broker's sign, it could hardly be argued by either the seller or the buyer that the broker breached a fiduciary duty by representing both sides of the transaction. Indeed, the courts have dealt with this question by holding that no duty is owed to the buyer because the commission is paid by the seller out of the proceeds, even though an independent broker representing the buyer would have shared in half of the commission under the generally prevailing practice among real estate brokers. There are some older cases that seem to hold that when a single broker acts as agent for both the buyer and the seller (i.e., in situations constituting a dual agency), the broker must disgorge the commission from both. *See, e.g.*, Glenn v. Rice, 162 P. 1020, 1021 (Cal. 1917). A few modern courts would even recognize that a claim for breach of fiduciary duty had been stated in such circumstances. *See, e.g.*, Foley v. Mathias, 233 N.W. 106, 106-07 (Iowa 1930). *See generally* J. Clark Pendergrass, *The Real Estate Consumer's Agency and Disclosure Act: The Case Against Dual Agency*, 48 ALA. L. REV. 277 (1996); Note, *A Reexamination of the Real Estate Broker-Buyer-Seller Relationship*, 18 WAYNE L. REV. 1343 (1972).

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mission. By representing additional properties, the agent can spread his or her cost over several properties and charge sellers a smaller commission. In addition, the broker minimizes risk by having a diversified portfolio of houses for sale. Finally, and perhaps most important of all, the seller maximizes the possibility of selling the house by listing it with a broker who has numerous listings, thereby attracting more traffic among buyers.[67]

A similar phenomenon occurs in connection with talent and sports agents. One might think that actors, writers, and athletes would be reluctant to hire an agent who represents other similarly situated principals because of the possibility that the agent would favor others. But an agent with numerous principals is more likely to attract the attention of those who ultimately do the hiring—movie producers, directors, publishers, and sports teams. Moreover, customers will be more inclined to deal with an agent who has a stake in his or her reputation as a result of handling more clients and who therefore is more knowledgeable about the market. (Indeed, the idea of an agent with only one principal is so odd that it inspired the movie *Jerry Maguire.*) Similar arguments can be made about investment banks, which are sometimes called upon to take conflicting positions in rendering fairness opinions.[68] The point is that many industries build conflict into the structure of the business. Indeed, one reason for forming a firm rather than relying on ad hoc contracts is to internalize such conflicts of interest.[69]

In the end, it is unclear whether the broad availability of waiver in connection with fiduciary duty in fact differs much from the law as it stands. To be sure, the uniform statutory approach allows for near total waiver, banning only waiver of intentional harms to the firm and allowing for very broad waiver of the duty of loyalty, which, if artfully worded in very general terms, can eliminate most claims of conflict. Assuming that a firm opts for the maximum allowable waiver under one of the uniform statutes, all that would seem to be prohibited is intentional harm to the firm and outright stealing of existing business. Arguably, however, that is

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[67] Although the phenomenon of a multiple listings service arose as a convenience to brokers, it complicates the analysis somewhat, because buyers have access to all sellers through any one broker.

[68] *See, e.g.*, Arthur H. Rosenblum, *Investment Banker Liability: A Panel Discussion*, 16 DEL. J. CORP. L. 557, 600 (1991).

[69] In some lines of business, it seems not to matter much whether one is dealing with an agent with attendant fiduciary duties. For example, in buying stock on an exchange one buys through a broker (an agent), whereas in buying stock in the over-the-counter market one typically buys from a dealer that is trading for its own account. Indeed, for the most part the securities laws make little distinction between the two types of professionals, lumping both into the generic notion of the broker-dealer. *See* VI LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 2976-77 (3d ed. 1990). Presumably, it is competition between the two types of markets that makes investors more or less indifferent to the supposed benefits of fiduciary duty that go with brokers but not with dealers.

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all that fiduciary duty prohibits in practice as it currently stands. Viewed in terms of damages, the distinction is one between out-of-pocket damages and benefit of the bargain damages. Generally speaking, damages in duty of care cases are out-of-pocket damages to compensate for the harm done to the business. Damages in duty of loyalty cases are usually thought of as benefit of the bargain damages in the sense that they are designed to take the profit out of any breach and to encourage the offering of opportunities to the firm.[70] The line between benefit of the bargain damages and out-of-pocket damages is, however, difficult to draw. In duty of loyalty cases in which the business has an existing expectation or interest, or is already engaged in the exploitation of a similar opportunity, it could be argued that benefit of the bargain damages are the same as out-of-pocket damages. Indeed there are relatively few cases in which a pure benefit of the bargain measure is applied. Perhaps it is more accurate to say that there are relatively few cases in which a duty of loyalty breach has been found in which it could not be argued that the benefit appropriated by the agent was one already identified by the firm or one that carried so little risk as to amount to a sure thing and was therefore the kind of opportunity that any rational business person would have taken.

If in fact damages other than out-of-pocket damages are rarely assessed, the question is: What is left of fiduciary duty? How, if at all, does it differ from a mere contractual duty of good faith? After all, every contract carries with it the obligation to act in good faith.[71] If there is nothing more to fiduciary duty, who needs it? The answer is that the law of fiduciary duty in effect allows the courts to supply missing terms of the contract between the parties, whereas the obligation to act in good faith merely prohibits subversion of the contract. To be sure, a breach of good faith will ordinarily also be a breach of fiduciary duty. But not all breaches of fiduciary duty are also breaches of good faith. Fiduciary duty is a gap-filler. It is more akin to arbitration than it is to contract interpretation. In a sense, fiduciary duty amounts to an agreement to agree later. It may be used either if it is too expensive or burdensome to specify every detail of a business relationship, or if the negotiation over certain details might tend to create such a level of hostility or ill-will that a valuable business venture might never be undertaken. In this sense, too, fiduciary duty differs from the contractual duty of good faith which only extends as far as the bargain that the parties have made. An agreement to agree, after all, has never been enforceable as a matter of contract.

## VI. AN EXAMPLE

To see how waiver would work, it may be useful to consider how it might have been used or abused in a classic case such as *Meinhard v.*

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[70] *See, e.g.*, Lynch v. Vickers Energy Corp., 429 A.2d 497, 501 (Del. 1981).

[71] *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1989).

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*Salmon.*[72] Meinhard and Salmon were equal partners in a very profitable hotel venture. The lease on the hotel was about to expire and the owner, Elbridge T. Gerry, approached Salmon, the active manager of the venture, with a proposal to renew the lease and eventually tear down the hotel and expand the operation to adjacent properties. It is unclear whether Gerry knew about the silent partner, Meinhard. It does appear, however, that the venture was so likely to be profitable that Meinhard quickly sued to claim half of Salmon's share of the venture.

If RUPA or the ULLCA had been on the books at the time, would Salmon have exacted a waiver for such a situation or would the possibility of such a waiver have affected the outcome of the case? The answer is completely unclear. On the one hand, Salmon, as the active manager of the venture, might well have sought a waiver of any duty to share other projects that might come his way. Clearly it would make sense for the managing partner of a real estate development business to make such a reservation. Indeed, part of the return that Salmon may have anticipated from the original venture was enhanced reputation and experience in the industry. Thus it is entirely possible that in some sense Salmon paid for the waiver either by negotiation for less return for himself or by working harder during the course of the venture than he might otherwise have been inclined to work. Moreover, it is far from clear that the waiver by the firm allowing Salmon to engage in other ventures (and conceivably even ventures that might be thought of as competing with the original venture, such as another hotel development) would actually do any harm to the original venture. Although Meinhard as a silent partner might want a share of the profits from other ventures that might come Salmon's way, it is not at all clear that even closely related ventures would have the effect of reducing the return that Meinhard would otherwise enjoy. It is also not clear that Salmon would agree. Thus, it is not clear that any of the traditional purposes served by fiduciary duty are disserved by allowing waiver. The question boils down to one of whether the opportunity to participate in the renewal of the lease belonged to the partnership. If it did belong to the partnership then one does not need fiduciary duty to conclude that the partnership was harmed by Salmon taking the opportunity. By the same token, if the opportunity did not belong to the partnership, not even fiduciary duty would require that Salmon share it.

## VII. WHY HERE? WHY NOW? WHO CARES?

It is no coincidence that the issue of waiver of fiduciary duty has arisen in connection with the proliferation of unincorporated limited liability entities. The duty of care is not much of an issue in the traditional partnership because the risk of individual liability is more than enough to make partners cautious. Moreover, shared managerial authority, which itself is necessitated by individual liability, means that duty of loyalty ques-

[72] 164 N.E. 545 (N.Y. 1928).

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tions will often be preempted by equal partners looking out for their own interests.[73] Limited liability in the context of LLCs and LLPs subverts these natural incentives and is likely to lead to an increased number of controversies.

Some of the pressure to rethink fiduciary duty may simply be a result of the opportunity to do so. Close corporation law, after all, grew out of general corporation law which was primarily focused on publicly held corporations. In other words, the principles of fiduciary duty that apply in the context of the closely held corporation have been based on modifications of more general principles of corporation law. Thus, there may well have been pent up demand for a reconsideration of fiduciary duty from the ground up.

Finally, limited liability in the context of the LLC will in all likelihood lead to numerous efforts to pierce the veil of limited liability. Many LLCs are likely to suffer bankruptcy. This is not to say that there is something inherently risky about doing business in the form of an LLC. Rather it is only to state the obvious, that many small businesses are likely to choose to do business in the form of an LLC and that many small businesses become bankrupt. In the event of bankruptcy, creditors acting through a trustee or receiver will often be able to step into the shoes of the firm and assert whatever claims may be made on behalf of the firm, including claims that may be made for breaches of fiduciary duty. It may be argued that profits from conflicting transactions or investments in conflicting projects should be regarded as property of the firm in question and should be available to satisfy its obligations.

To be sure, creditors are not supposed to be able to assert breaches of fiduciary duty. Nevertheless, courts frequently seem to miss the distinction between shareholders and creditors in the bankruptcy context in that claims made for breaches of fiduciary duty during the life of the corporation or firm will ordinarily result in a recovery by the corporation or firm.[74] Because creditors can slip into the shoes of the corporation through their trustee or receiver and assert claims that may be asserted on behalf of the corporation, creditors can assert claims that supposedly can only be asserted by shareholders.[75]

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[73] *See generally* UPA § 18, 6 U.L.A. 526 (setting out rules determining rights and duties of partners).

[74] *See, e.g.*, Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1510-11 (1993) (under current law several courts hold that when the firm is solvent, directors owe a duty of loyalty and care to shareholders, however, upon insolvency those duties shift to creditors).

[75] *See, e.g.*, Pepper v. Litton, 308 U.S. 295, 310-11 (1939) (bankruptcy trustee allowed to vacate prior judgment when that judgment was the result of a breach of fiduciary duty); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *1-*2 (action by creditor under section 255 of the Delaware General Corporation Law seeking judicial determination of who constituted the lawfully elected board of directors of a Delaware corporation).

It is unlikely that the emerging law of the LLC will make this distinction any more obvious than it has been in the past. Thus, it is likely that courts will continue to allow creditors to make claims that arguably they should not be able to make. One way of protecting against such claims, however, is through waiver of fiduciary duty. In other words, members of LLCs and other unincorporated entities that are covered by statutes allowing for waiver should at least be able to specify a narrower concept of fiduciary duty so as to protect themselves against overreaching creditors in the event of bankruptcy.

## VIII. CONCLUSION

While at first blush it may seem quite curious that a concerted movement toward more flexible fiduciary duties has arisen in the context of closely held businesses, on further reflection it is not all that surprising. Owners of small businesses are in fact likely to need more freedom, rather than less, and are likely to encounter more, rather than fewer, conflicts of interest. RUPA and the ULLCA have taken a sensible approach toward allowing businesspeople to plan their own affairs. It is now up to the courts to interpret both the statutes and the contractual provisions adopted thereunder accordingly.

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