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Publication Information

Repository Citation
http://open.mitchellhamline.edu/facsch/222
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Abstract
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Keywords
limited liability company, L.L.C., limited liability partnership, L.L.P., business organizations

Disciplines
Organizations Law

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ESSAYS

TWO DECADES OF "ALTERNATIVE ENTITIES": FROM TAX RATIONALIZATION THROUGH ALPHABET SOUP TO CONTRACT AS DEITY

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ABSTRACT

This essay: (i) puts into perspective the past 20 years of developments in the U.S. law of limited liability companies (LLCs), limited liability partnerships (LLPs), and limited liability limited partnerships (LLLPS); (ii) explains how a movement toward tax rationalization has been transformed into a palace coup aimed at fiduciary duty (a fundamental tenet of the U.S. law of closely held businesses); and (iii) criticizes both conceptually and pragmatically efforts to "kill Cardozo" and worship "freedom of contract."

A. INTRODUCTION

In 1988, unincorporated business organizations comprised a backwater in the U.S. law of business associations. Due to unlimited owner liability, general partnerships were the choice only of the ignorant, those constrained by regulations, or those who did not know they were making a choice. As for limited partnerships, the Tax Reform Act of 1986 had

1. Professor of Law and Director of the Mitchell Fellows Program, William Mitchell College of Law; A.B. 1972, Harvard University; J.D. 1979, Yale Law School. This essay is based on the keynote address delivered by the author at the 21st Century Commercial Law Forum, Seventh International Symposium, School of Law, Tsinghua University, Beijing, People's Republic of China (Oct. 21, 2007). As always, Professor Kleinberger's work depends on the insights and support of Carolyn Sachs, Esq.
crippled their use as tax shelters, and the Omnibus Budget Reconciliation Act of 1987 had eliminated "pass through" partnership tax status for almost all limited partnerships that were publicly traded. In U.S. law schools, introductory courses in "business associations" mentioned partnerships only in passing, if at all. Rather, the principal dividing line within such courses was between corporations that were publicly traded and those that were closely held.

Today, twenty years later, the law of unincorporated business organizations is the cutting edge of U.S. entity law. Almost everywhere in the United States, more limited liability companies are formed each year than are corporations. In addition, the limited liability partnership has resurrected the general partnership as a rational entity choice, and more than twenty states provide for limited liability limited partnerships.

As for the legal academy, law schools are slowly beginning to recognize that a single, one-semester course in "business organizations" is not possible. Many schools now offer a supplemental course in Agency, Partnerships and Limited Liability Companies, in addition to the traditional Corporations course. In 2002, in fact, the American Association amended in scattered sections of 26 U.S.C.).

6. Id.
of Law Schools granted permanent status to a section on Agency, Partnerships, Limited Liability Companies and Unincorporated Business Associations.\(^1\)

Twenty years ago, the "alphabet" of U.S. business organizations was principally about S Corporations and C Corporations. Today, we have "alphabet soup" — not only S Corporations and C Corporations, but also LLCs, LLPs, and LLLPs.

This essay will chart in summary form the developments in the U.S. law of unincorporated businesses with two goals in mind: first, to provide for fellow scholars a historical and conceptual context for understanding these developments; and second, to reveal a radical — and in my view disturbing — trend in U.S. law that has come to be seen as an integral part of the recrudescence of unincorporated business organizations in the United States.

**B. THE HISTORICAL AND CONCEPTUAL STARTING POINT — THE TAX SHIELD CONUNDRUM\(^1\)**

Although unincorporated business organizations involve much more than tax concerns, it is impossible to understand their development in the law without understanding key elements of the U.S. tax system as applied to the income of business organizations. That system distinguishes fundamentally between the taxation of organizations classified as partnerships, on the one hand, and the taxation of organizations classified as corporations, on the other. In most situations, partnership tax status is preferable because corporate shareholders face "double taxation" on any dividends they receive.\(^1\) An ordinary "C Corporation"\(^1\) is a taxable entity; it pays corporate income tax on any profits it earns.\(^1\) Dividends to shareholders are therefore made in "after-tax" dollars. Nonetheless, dividends are also taxable as received by the share-
holders.\textsuperscript{16} Thus, the profits comprising corporate dividends are taxed twice.

Partners do not suffer double taxation because a partnership is not a taxable entity. For income tax purposes, partnerships are "pass through" structures: the entities' profits (whether distributed or not) are allocated and taxable directly to the partners.\textsuperscript{17} Partnership losses also "pass through" and can serve as deductions on each partner's own tax return.\textsuperscript{18} In contrast, the losses of an ordinary corporation stay with the entity and are useful only if the entity later enjoys a profit.\textsuperscript{19} In 1988, the advantages of partnership tax status were diminished by "owner liability" — i.e., to be taxed as a partnership, an entity had to include at least one owner (almost always a "general partner") who was automatically liable for all debts of the entity.\textsuperscript{20} The driving force behind the development and spread of the limited liability company (and later the LLP and LLLP) has thus been the desire to solve this "tax-shield conundrum" — i.e., to create an entity that, as a matter of tax law, is classified as a partnership with each owner treated as a partner, but whose owners are shielded by state law from automatic personal liability.\textsuperscript{21}

Before the advent of the LLC, entrepreneurs could achieve partnership tax status and limit liability exposure by using an ordinary limited partnership with a corporate general partner.\textsuperscript{22} Alternatively, entrepreneurs could use an S corporation to obtain a full liability shield while achieving some of the advantages of partnership tax status\textsuperscript{23} or try to "zero out" the profits of a C corporation. None of these approaches, however, was fully satisfactory.

\textsuperscript{16} Id.
\textsuperscript{17} See John E. Moye, The Law of Business Organizations 64 (5th ed. 1999).
\textsuperscript{18} Id.
\textsuperscript{20} See Choper et al., supra note 13, at 103.
\textsuperscript{21} See William T. Allen et al., Commentaries and Cases on the Law of Business Organizations 73, 77 (2d ed. 2007).
\textsuperscript{22} Id.
\textsuperscript{23} See Moye, supra note 17 at 221-24 (describing the tax implications of S corporations).
1. Ordinary Limited Partnerships with a Corporate General Partner

Under the traditional approach, typically a corporation would be formed for the sole purpose of serving as the general partner of the limited partnership. However, this approach had a number of disadvantages. The structure was complex and involved a significant risk of “piercing” for the corporate general partner (unless that corporation had assets of its own, thereby diverting capital from use in the limited partnership’s business). The structure also raised tax classification issues, unless the corporate general partner had assets of its own. Furthermore, difficult questions of fiduciary duty arose, pertaining to the officers of the corporate general partner. As a formal matter, those officers owed duties to the corporation, but as a practical matter they were managing and typically controlling the limited partnership. Lastly, before the modernization of the Uniform Limited Partnership Act, the “control rule” impeded power-sharing by limited partners, even when “the deal” could be made only on that basis.

2. S Corporations

An S corporation provides a full corporate liability shield with some of the benefits of pass-through tax status. Like a partnership, an S corporation generally pays no tax on its earnings; its profits and losses are passed through and taxed directly to its shareholders. S corporations, however, face significant constraints which do not apply to partnerships, including: (i) ownership restrictions, both in terms of the num-

27. Id. § 7; see Carter G. Bishop, The New Limited Partner Liability Shield: Has the Vanguished Control Rule Unwittingly Resurrected Limited Partner Estoppel Liability as Well as Full General Partner Liability, 37 SUFFOLK U. L. REV. 667, 669 (2004) (defining “control rule” as a rule making a “limited partner personally liable for the obligations of the partnership if, like a general partner, the limited partner took part in the management and control of the partnership’s affairs”).
29. See Moye, supra note 17, at 221-24.
ber and character of owners (i.e., excluding most institutional and foreign investors);\(^{30}\) (ii) the "one class of stock" requirement, which restricts the type of debt the corporation may issue, hampers efforts to gradually shift control of family-owned businesses, and generally makes passive investment very difficult to structure;\(^{31}\) and (iii) preclusions of a long list of business types and structures.\(^{32}\)

3. C Corporations and "Zeroing Out"

A corporation that cannot – or chooses not to – elect S status can try to avoid double taxation by "zeroing out." To "zero out," the C corporation makes ostensibly deductible payments to shareholder-employees, thereby reducing or eliminating corporate profits.\(^{33}\) Such payments can be made in a number of ways, the simplest being in salaries and bonuses.

This approach is not risk-free, however. The Internal Revenue Service may view the payments as disguised dividends, especially where: (i) the payments are excessive compared with the value of the services rendered to the corporation, (ii) the payments are proportional to the shareholders equity interests, or (iii) capital is a material income-producing factor for the business and the corporation is not paying reasonable dividends.\(^{34}\) Even when successful, zeroing out techniques provide none of the other advantages of pass-through tax status.

30. Id.
31. Id.
32. Id.
33. See HAMILTON & BOOTH, supra note 14 and accompanying text.
C. INVENTION AND DEVELOPMENT OF THE MODERN (U.S.) LLC

1. Wyoming Starts a Revolution

Wyoming started the LLC revolution by taking seriously the Internal Revenue Service's (IRS) "Kintner" Regulations on tax classification. Before January 1, 1997, the Kintner Regulations stated the rules for classifying unincorporated business organizations, and the rules were biased toward finding partnership status. The regulations identified six key corporate characteristics—among them limited liability, continuity of life, free transferability of ownership interests, and centralized management—and classified an unincorporated organization as a corporation only if the organization had more corporate characteristics than non-corporate characteristics. Thus, although limited liability may seem to be the hallmark corporate characteristic, the Kintner Regulations contained no "super" factor. Each characteristic was equally significant.

In 1977, the Wyoming legislature sought to exploit this "equal significance" aspect of the Kintner Regulations in order to resolve the "tax-shield conundrum." The Wyoming LLC Act provided for a new form of business organization with a full, corporate-like liability shield but partnership-like characteristics as to entity management, continuity of life, and transferability of ownership interests. Like a general partnership, a Wyoming LLC was managed by its owners. Like a limited partnership, it risked dissolution if one of its owners ceased to be an

35. The name "limited liability company" appears in the jurisprudence of other nations, but that fact is a mere linguistic coincidence. "[E]xcept perhaps as to name, foreign LLCs are not antecedents to U.S. LLCs." CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.01[4][a] (Warren Gorham & Lamont/RIA 1994 & Supp. 2007-2) [hereinafter BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES]. Also, it is possible to find scattered references to limited liability companies in 19th century U.S. jurisprudence, "but those companies have no connection to the modern U.S. phenomenon." Id. ¶ 1.01[4][b].


38. Id. § 301.7701-2.


40. Id. § 17-15-116.
owner. As with any partnership, Wyoming LLC ownership interests were not freely transferable; absent a contrary agreement, an LLC member had the right to transfer only the economic aspect of the ownership interest. If the Kintner Regulations meant what they said, then a Wyoming LLC would be accorded partnership tax status.

2. IRS Response to Wyoming: Common Characteristics of Early LLCs

The IRS took over ten years to acknowledge the consequences of its own tax classification regulations. Revenue Procedure 88-76 classified a Wyoming LLC as a partnership, causing legislatures around the country to consider seriously the LLC phenomenon. For the most part, Wyoming’s early emulators were faithful copiers, imposing through their LLC statutes the same basic structure as ordained in the Wyoming statute. The one major innovation was to establish an alternative governance template for manager-management (modeled on the limited partnership structure), while continuing to set the “default mode” as member-management.

Fidelity to the Wyoming model gave the earliest LLCs some common characteristics – at least to the extent that they followed the default blueprint of their respective LLC statutes. An LLC that left in place the statutory “default” rules was managed by its members in their capacity as members and was threatened with dissolution each time a member dissociated. Members had the right to freely transfer the economic rights associated with membership, but could transfer their membership interest (or any management rights associated with membership) without the consent of all the other members. These characteristics meant respectively that the LLC: lacked centralized management (like a general partnership); lacked continuity of life (like a limited partnership with

41. Id. § 17-15-123.
42. Id. § 17-15-122.
respect to the dissociation of any general partner); and lacked free transferability of interests (like both a general and limited partnership). In two senses, therefore, the LLC was a hybrid entity. First, it combined the liability shield of a corporation with the federal tax classification of a partnership. Second, it housed a partnership-like capital structure and governance rules within a corporate liability shield.

3. Increasing Flexibility of Form: IRS Bias Toward Manager-Managed LLCs

This characteristic picture began to lose focus in 1989 as the IRS began to loosen its approach to tax classification. In a series of public and private rulings, the IRS allowed for increasing flexibility of form, especially as to the continuity of life characteristic. This characteristic had done much to keep a "family resemblance" among LLCs because, until 1989, every LLC "blessed" by the IRS had lacked that characteristic. Beginning in 1989, however, the IRS began to accept both: (i) a shrinking of the categories of member dissociation that threatened dissolution, and (ii) a decrease in the quantum of member consent necessary to avoid dissolution following member dissociation. As a result, LLC organizers had a greater variety of structures from which to choose.

At the same time, however, the IRS's pronouncements on continuity of life and free transferability of interests were conducing toward a new characteristic LLC structure. Beginning with Private Letter Ruling 9210019, the IRS revealed a bias toward manager-managed LLCs. In contrast to a member-managed LLC, a manager-managed LLC could achieve partnership tax status while enjoying significant protection from business disruption and considerable control over member exit rights. Thus, in both official and unofficial ways, the IRS suggested that, for

47. Rodgers, supra note 46, at 359-60.
48. Id.
49. Id. at 360.
50. Id. at 357-58.
54. See id.
purposes of tax classification, LLCs were properly analogized to limited partnerships rather than to general partnerships.

In 1994, the IRS issued Revenue Procedure 95-10 and made its earlier suggestion a matter of policy. Revenue Procedure 95-10 purported to provide guidelines for LLCs seeking advance assurance of partnership tax status under the Kintner Regulations. In reality, however, these guidelines provided a series of safe harbors that rested heavily on the limited partnership analogy.

4. "Check-the-Box" and the End to Family Resemblance

Revenue Procedure 95-10 might well have pushed LLCs into the limited partnership mold if the IRS had not subsequently decided to do away with the Kintner Regulations entirely. Effective January 1, 1997, the Treasury Department adopted a "check-the-box" tax classification regime under which, in general, a business organization organized under a corporate or joint stock statute is taxed as a corporation. Any other business organization formed under the law of a U.S. jurisdiction – is taxed as a partnership if it has two or more owners, or is disregarded for income tax purposes if it has one owner – unless it elects to be taxed as a corporation by "checking the box".

"Check-the-box" severed the connection between tax classification and organizational structure, inviting entrepreneurs (and their attorneys) to specially tailor the structure of an LLC as each “deal” might require. "Check-the-box" also resulted in widespread changes to LLC statutes, as states moved quickly to take advantage of the newly permitted flexibility. These changes included: (i) eliminating the requirement that an LLC have at least two members (like a general or limited partnership) and authorizing one-member LLCs; (ii) authorizing operating agreements in one-member LLCs; (iii) allowing LLCs to have perpetual existence; (iv) changing the default rule on member dissociation to make dissociation more difficult, either by depriving members of the power to dissociate, or by freezing in the economic interest of dissociated members; and (v) changing the default rule on the relationship between member dissociation and entity dissolution, either by providing that

56. Simplification of Entity Classification Rules, 60 Fed. Reg. 66,584 (Dec. 18, 1996) (to be codified at 26 C.F.R. pt. 301); see also REVISED UNIF. LTD. LIAB. CO. ACT § 301(a) cmt. (2006) ("[F]lexibility of management structure is a hallmark of the limited liability company.").
member dissociation does not even threaten dissolution, or by changing the quantum of consent necessary to avoid dissolution following a member's dissociation. 57

D. THE COPYCATS—LIMITED LIABILITY PARTNERSHIPS AND LIMITED LIABILITY LIMITED PARTNERSHIPS

The advent of limited liability companies had a ripple effect on the law of general and limited partnerships. Put more simply: if a limited liability company could shield its owners from automatic, vicarious liability for the enterprise's debts and still be taxed as a partnership, why not provide a comparable liability shield for general partnerships? Once the IRS acknowledged that its Kintner Regulations meant what they said, there was nothing in tax law to deter state legislatures from providing for both limited liability general partnerships—LLPs—and limited liability limited partnerships—LLLPs.

There remained non-tax forces of inertia, however. Most importantly, from a non-tax and historical perspective, a general partner's liability seemed inherently and inescapably the hallmark of partnership law. It took five years after the IRS's seminal ruling on LLCs for any state legislature to authorize limited liability partnerships. Moreover, the first LLP shield was decidedly inferior to an LLC or corporate shield; it protected against owner liability only if the underlying entity debt arose in tort, not in contract. 58

Today, however, the limited liability partnership is firmly established and widespread, and the limited liability limited partnership is only a few steps behind. All states authorize limited liability partnerships, and a plurality of LLP statutes now provide liability shields that are essentially indistinguishable from an LLC or corporate shield. Under the Uniform Limited Partnership Act (2001)—now the law in seventeen states 59—a limited partnership can originate as or become an

57. States did not, however, change the default rules on transferability of ownership interests. See BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES, supra note 35, ¶¶ 1.08, 8.06[1][a].

58. WILLIAM T. ALLEN, ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION, § 3.6.2.1, at 76 (2d ed. 2007).

LLLP simply by including a one-line statement in the certificate of limited partnership.\textsuperscript{60}

A limited liability partnership is a general partnership that has invoked the LLP provisions of its governing general partnership statute by filing with a specified public official a specified document (typically called "a statement of qualification" or a "registration"). The entity thereby becomes a limited liability [general] partnership and eliminates partially or completely the automatic personal liability of each partner for each partnership obligation.\textsuperscript{61} A limited liability limited partnership, on the other hand, is a limited partnership that has invoked the limited liability limited partnership provisions of its state partnership law by filing with a specified public official a specified document, and thereby becoming a limited liability limited partnership and eliminating completely the automatic personal liability of each general partner for each partnership obligation and, under most statutes, also eliminating the "control rule" liability exposure for all limited partners.\textsuperscript{62}

**E. THE CURRENT LANDSCAPE**

### 1. Dominance of LLCs

As of 2007, in the U.S. world of non-publicly traded entities, unincorporated business organizations predominate over corporations, and limited liability companies dominate the world of unincorporated business organizations.

For example, an annual report from the International Association of Corporate Administrators reported the following data on entities formed in 2006:

\begin{footnotesize}
\begin{itemize}
\item[60.] Uniform Limited Partnership Act, iii (2001) ("Instead, the Act makes LLLP status available through a simple statement in the certificate of limited partnership."). Section 102(9) states that a limited liability limited partnership's certificate "states that the limited partnership is a limited liability partnership." \textit{Id.} § 102(9).
\item[61.] CHOPER, ET AL., supra note 13, at 844; Daniel S. Kleinberger, Agency, Partnerships, and LLCs, § 7.3, at 227 (3d ed. 2008).
\item[62.] CHOPER, ET AL., supra note 13, at 845.
\end{itemize}
\end{footnotesize}
Even in states in which new corporate formations still outnumber LLC formations, the trend is toward LLCs:

Ironically, as the limited liability company has increased in prominence, LLC law has become increasingly subject to corporate concepts and legal doctrines. Some have criticized this influence as "conceptual miscegenation" – a "corpufuscation" foreign to "the practice, philosophy and law of partnerships" that engendered the LLC.


64. Id.

65. See, e.g., In re Mooney, Bankruptcy No. 05-13392-JMD, Adversary No. 05-1205-JMD, 2007 WL 2403774, at *2 (Bankr. D.N.H. Aug. 17, 2007) (assuming that Massachusetts courts would apply to LLCs the same rules as for corporations with regard to managers’ duties to creditors and the doctrine of piercing the veil).

At least in some respects, however, the extrapolation from corporate to LLC law is proper and even inevitable. For example, the doctrine of piercing the veil originated in the corporate sphere but depends on two more general concepts: limited liability for an organization's owner and a legal identity for the organization separate from the legal identities of its owners. 67 These twin concepts apply as much to limited liability companies as they do to corporations; it would be neither efficient nor logical to re-invent the wheel.

Another major area of overlap concerns the rights of minority owners. Over the past fifty years, the U.S. law of close corporations has evolved to recognize that dangers of "oppression" or "unfairly prejudicial" conduct exist when: (i) a minority shareholder is subject to the will of the majority shareholder, and (ii) market limitations or stock transfer restrictions combine to effect a "lock in" preventing the minority shareholder from "voting with his feet." 68 Comparable dangers exist within limited liability companies, where transfer restrictions are built into LLC statutes and most LLCs, like corporations, have perpetual existence. Predictably, courts have begun to analogize LLCs to close corporations and provide remedies for oppression. 69


The parallel has begun to appear in statutes as well. For example, while the newest Uniform Limited Partnership Act allows a court to decree dissolution only when "it is not reasonably practicable to carry on the activities of the limited partnership in conformity with the partnership agreement," the new Revised Uniform Limited Liability Company Act also permits judicial dissolution "on application by a member . . . on the grounds that the managers or those members in control of the company . . . have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant."  

2. The Question of "Corpufuscation" and the Influence of Delaware

The "corpufuscation" issue has roiled the water around the question of a "shelf" LLC — "i.e., an LLC formed without having at least one member upon formation." When the Uniform Laws Conference was working on the Revised Uniform Limited Liability Company Act ("Re-ULLCA"), "[n]o topic received more attention or generated more debate in the drafting process . . . . Reasonable minds differed (occasionally intensely) as to whether the "shelf" approach (i) is necessary to accommodate current business practices; and (ii) somehow does conceptual violence to the partnership antecedents of the limited liability company."  

Re-ULLCA solved the problem (perhaps temporarily) with a compromise, but a recent federal court decision concerning the Delaware LLC Act may have mooted the debate. In deciding an important point

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71. Revised Uniform Limited Liability Company Act §§ 701(a)(5)(B), 701(b) (2006) (permitting a court to decree a less or different remedy, e.g., a buy-out of the applicant); see also, Michigan Limited Liability Company Act § 515(1) (2008) (codified at MICH. COMP. LAWS ANN. § 450.4515(1) (West 2008)) (providing a judicial remedy for a member when, inter alia, the "acts of the managers or members in control of the limited liability company . . . constitute willfully unfair and oppressive conduct toward the limited liability company or the member").
73. Id.
74. Id. (describing a two-filing mechanism that provides some of the benefits of a shelf LLC without actually authorizing that approach).
of federal jurisdiction, the court noted that "no one became a member at the formation of the LLC" and held that "[t]his is perfectly acceptable under Delaware law and does not in any manner implicate the validity of the LLC." 76

An opinion on the Delaware LLC Act has magnified importance because "the Delaware law seems to exert an almost gravitational pull" on LLC practice and jurisprudence. 77 Delaware preeminence in the world of publicly traded corporations is well known, 78 and ever since the IRS accepted the LLC phenomenon, Delaware practitioners, legislators and judges have striven to achieve the same preeminence with LLCs.

The core advantage for Delaware is its vaunted Court of Chancery, a business court without peer in the United States, and its state Supreme Court, many of whose justices first served in the Court of Chancery. 79 Another part of Delaware's pull has been its approach to the overlap of contract and fiduciary duty. That approach is part of a larger debate and, in my view, the developments discussed above in LLC law in general, and Delaware LLC law in particular, have provided a "sleight of hand" with disturbing consequences.

F. CONTRACT AS DEITY AND THE DEATH OF CARDozo

It has been hornbook law for centuries that a partnership inherently and inescapably involves fiduciary duties among the partners. 80 Until

76.  Id. at 20-21.

77.  BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES, supra note 35, ¶ 14.01[2].


80.  JOSEPH STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP §§ 172, 174-81 (William S. Hein & Co., Inc. 1980) (1841) ("The necessity of entire good faith, and of the absence of fraud on the part of partners towards each other, is inculcated by Cicero in terms of deep import and sound morality.") [hereinafter STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP]. Sections 174 through 181 catalogue various aspects of what Story terms "good faith" and what in modern parlance is called "the duty of loyalty." See also Nathaniel Lindley, LAW OF PARTNERSHIP, INCLUDING ITS APPLICATION TO JOINT-STOCK AND OTHER COMPANIES 412 (T. & J. W. JOHNSON & CO.) (1860) ("The utmost good faith is due from every member of a partnership towards
quite recently, fiduciary duty has been the unquestioned lodestar of partnership law in the United States. Justice Cardozo's pronouncement in *Meinhard v. Salmon* was once unquestionably emblematic:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.81

Cardozo's seminal view was questioned in the early 1990s during a Uniform Laws82 project to revise the then 80-year-old general Uniform Partnership Act ("UPA").83 The revision process fueled a debate over whether the partnership agreement should have the power to annul fiduciary duties. So-called "contractarians" argued that fiduciary duties were merely default rules, completely subject to revision - or even elimination - by agreement.84 Traditionalists defended fiduciary duty as a core value not only for society generally but also within business enterprises.85 Eventually, in 2007, the Revised Uniform Partnership Act

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("Re-UPA") sided with tradition, while nonetheless making clear that the partnership agreement had great powers to regulate the partners' relation *inter se*. 86

The advent of limited liability companies created a forum to renew the contractarian-fiduciary duty debate. From its very inception, the Delaware LLC Act has proclaimed: "It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." 87 More specifically, as originally enacted the Delaware LLC Act also provided that:

To the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager . . . the member's or manager's duties and liabilities may be expanded or restricted by provisions in a limited liability company agreement. 88

By itself this language was interesting but not radical. 89 However, *dicta* in some decisions of the Delaware Chancery Court suggested that the power to restrict might encompass the power to eliminate fiduciary duties entirely. 90 In 2002, in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, the Delaware Supreme Court engaged in some "counter-*dicta*" and announced that the power to restrict did not include the power to eliminate. 91

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87. DEL. CODE ANN. tit. 6 § 18-1101(c) (1992).
88. Id.
89. Id. § 18-1101(c) (2000) (expanding this language to include "an other person that is a party to or is otherwise bound by a limited liability company agreement").
91. See *Gotham Partners*, 817 A.2d at 167-68.; Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 290 (Del. 1999) (concerning a Delaware limited partnership, where "[t]he Delaware Act has been modeled on the popular Delaware LP Act. In fact, its architecture and much of its wording is almost identical to that of the Delaware LP
But the Delaware legislature soon overruled the Delaware Supreme Court. Statutory amendments enacted in 2004 expressly provided that an LLC agreement may eliminate fiduciary duties. Now, the American Bar Association's Committee on Limited Liability Companies, Partnerships and Unincorporated Business Entities is considering whether a "model" LLC act should follow the Delaware approach.

The ABA model act is in its early phases and the more or less ad hoc group of attorneys who make up the drafting subcommittee includes both individuals strongly opposed to the "eliminate" approach and individuals who favor the approach. Meanwhile, the chief justice of the Delaware Supreme Court has embraced the "eliminate" approach as being the proper course for the law of unincorporated business organizations. In a law review article published in 2007, Chief Justice Myron Steele stated that "Delaware courts need to be mindful of the distinction between status relationships and contractual relationships." In addition, he urged that we:

92.  DEL. CODE ANN. tit. 6 § 18-1101(c) (2004). To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's, manager's or other person's duties may be expanded, restricted or eliminated by provisions in the limited liability company agreement, provided that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

93.  Formerly called the Committee on Partnerships and Unincorporated Business Organizations, the Committee is part of the ABA Business Law Section. The older ABA Prototype Act empowered the operating agreement to exculpatory provisions.

94.  Prototype Limited Liability Co. Act § 402 (1992) (defining duties as avoiding "gross negligence or willful misconduct").


Come to grips with the reality that the contractual relationship between parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes—not the status relationship of the parties. When the parties specify duties and liabilities in their agreement, the courts should resist the temptation to superimpose upon those contractual duties common law fiduciary duty principles...

Chief Justice Steele criticized the Gotham Partners decision for its “singular focus on status relationships” and for “treating the parties to all limited partnership or limited liability company agreements as having a dependency relationship (e.g., a trustee to beneficiary or agent to principal), rather than a contractual relationship. . . .”98 Moreover, Chief Justice Steele disparaged the Gotham Partners court for “its nostalgia for the familiar, and inability to escape the lure of the common law”99 and for importing into the pristine world of contractual relationships status-related fiduciary duties “analogized from the law of corporate governance.”100

Chief Justice Steele’s remarks illustrate the contractarian’s “sleight of hand” with regard to fiduciary duty. While for some purposes the limited liability company is seen as a form of partnership,101 that connection (and the historical antecedents) disappear when fiduciary duty is at issue. In that context, the LLC is characterized as purely a creature of contract. Moreover, to further “re-frame” the debate, the lodestar role for fiduciary duty is linked to corporate, rather than partnership law.

But Meinhard v. Salmon was not a corporate case. Rather, it involved joint adventurers (essentially partners for a particular undertaking) arguing over a lacuna in their agreement. Moreover, “status relationship” and “contract” are not dichotomous concepts. Status relationships often arise by or in connection with a contract, and the creative tension between agreement and fiduciary duty within closely held businesses dates back at least to the formation of the United States and most likely before.102 In the twentieth century, the law of corporations approached close corporations as “incorporated partnerships” in order to

97. Id. at 25.
98. Id. at 13.
99. Id. at 22.
100. Id. at 25.
101. BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES, supra note 35, ¶¶ 5.04[2][d][i], 8.06[1].

G. A Warning Against the Notion of Contract as Deity

It is wrong to treat limited liability companies as involving a unique relationship between contract and fiduciary duty. To do so both ignores the place of limited liability companies in the history of unincorporated business organizations and misunderstands the general relationship between contract and fiduciary duty. Fiduciary duty attaches to particular contractual relationships for the same basic reason applicable in other contexts — to proscribe and constrain abuses of power.\footnote{Carter G. Bishop, Discussions on Fiduciary Duty and Capital Lock-In: A Good Faith Revival of Duty of Care Liability in Business Organization Law, 41 TULSA L. REV. 477, 510-11 (2006).} Abuse of power is no less a threat under operating agreements than under partnership agreements. Indeed, the “lock in” problem is substantially greater under a modern LLC statute than in a general partnership organized under the original Uniform Partnership Act.\footnote{See Kleinberger, Why Not Good Faith, supra note 68 and accompanying text.}

The problem is not merely historical and conceptual. The following five points explain the substantial practical risks involved in killing off Cardozo and turning contract into deity:

1. The Permissible Will Become Standard

In the long run, permitting contracts to annul fiduciary duty will be tantamount to annulling fiduciary duty essentially whenever a controlling owner is involved in a business. Fiduciary duty burdens those with power; controlling owners will naturally seek to avoid those burdens
when they have both the legal mandate and the negotiating power to do so.

2. Radical Change Brings Unintended Consequences

Law reformers, being human, have imperfect predictive powers. The more fundamental a proposed change, the greater the risk of unintended consequences. As both a practical and ethical matter, those proposing a sea change in norms have a heavy burden of demonstrating why the current sea is so bad. 106

For centuries, the Anglo-American system of law and equity has held that a special relationship inevitably arises, and should arise, when people join their property and their efforts in a common business enterprise. We should not lightly, nor quickly, reject such a long-standing position.

Consider, for example, the “pick your partner” principle that is at the core of the law of limited liability companies. 107 That principle rests on the notion that each co-owner relates to each other in a position of trust and confidence – i.e., as a fiduciary. If the law begins to see fiduciary duty as merely a set of contractual default rules, what happens

106. Most advocates for the death of fiduciary duty approach the subject from a “law and economics” perspective. E.g. Andrew S. Gold, On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms, 41 WAKE FOREST L. REV. 123, 140-45 (2006); Larry E. Ribstein, Are Partners Fiduciaries?, 2005 U. ILL. L. REV. 209, 232-38 (2005). This highly theoretical approach is impossible to prove or disprove. However, the development of the law of close corporations suggests that, at least for the overwhelming majority of closely held businesses, fiduciary duty has great practical importance and appeal. Kleinberger, Why Not Good Faith?, supra note 68, at 1165 (explaining how courts developed fiduciary norms for close corporations to deal with abuse of power by majority owners); S. Mark Curwin, Comment, Fiduciary Duty and the Minnesota Limited Liability Company: Sufficient Protection of Member Interest?, 19 WM. MITCHELL L. REV. 989, 1016-18 (1993); Sandra K. Miller, The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC, 152 U. PA. L. REV. 1609, 1654 (2004) (arguing that “a broad approach to fiduciary duties is arguably preferable . . . because it better reflects society’s norms of ethical conduct, may be more effective in combating subtle freeze-out schemes, and does not rest on the assumption that the parties’ relationship is governed by a highly negotiated . . . contract”).

107. Revised Uniform Limited Liability Company Act § 502 cmt.; see also BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES, supra note 35, ¶ 8.06[1][b] n.452 (noting that the dramatic changes in LLC statutes following “check-the-box” did not affect this aspect of LLC statutes).
to the conceptual (and historically venerated) notion of *delectus personae*?\(^{108}\)

Consider also, that for at least a century, fiduciary duty has co-existed with a marketplace economy and a marketplace ideology. Indeed, "co-exist" may be an understatement. Within closely held businesses, fiduciary duty may have helped firms function coherently and thereby compete more effectively. Eliminating fiduciary duty may thus increase costs and decrease efficiency.\(^{109}\)

### 3. Uprooting Fiduciary Duty Will Have Direct and Substantial Doctrinal Fallout

Eliminating fiduciary duty will produce serious and direct doctrinal consequences, particularly with regard to the "strict construction" aspect of fiduciary law and the remedies available for breach.

When a fiduciary invokes waiver or consent to justify otherwise objectionable conduct, the law not only requires antecedent full disclosure but also resolves doubtful cases against that fiduciary.\(^{110}\) Also, when a fiduciary attempts to operate within a lacuna in an agreement, the law strictly scrutinizes that conduct.\(^{111}\) If a contract can eliminate fiduciary duty, the weaker participant is left with the far less protective device of *contra proferentem*.\(^{112}\)

As for remedies, the difference between contract claims and breach of fiduciary duty claims is substantial. Suppose that an operating agreement in a Delaware limited liability company purports to eliminate all fiduciary duties of the owners and to replace those duties with a contractual restatement. Does a breach of those stated duties give rise to a fiduciary duty claim or a contract claim?

The answer might be quite significant with regard to remedies. With a fiduciary duty claim, the plaintiff can seek disgorgement (constructive trust) without having to prove damages.\(^{113}\) But disgorgement

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110. *Id.* at 590.
111. *Id.* at 598.
112. This canon of contract interpretation suggests that contractual ambiguities be construed against the party that controlled the contract drafting process. 11 WILLISTON ON CONTRACTS § 32:12 (4th ed. 2008).
is not typically a contractual remedy. In contract, parties are limited to damages on theories of reliance or expectation, while in some cases parties are limited to restitution for benefit conferred.

If the claim is “merely” for breach of the operating agreement, from where would a court get the power to order disgorgement? Perhaps if the plaintiff could demonstrate that it could not prove damages, the court might reach into its equity power to find a remedy because there is no adequate remedy at law. But that situation is a far cry from a plaintiff having the disgorgement remedy as a matter of right, where the ability to prove damages is irrelevant.

Suppose the drafters of the operating agreement, foreseeing this problem, cause the operating agreement to provide contractually for a disgorgement remedy. Will the law permit this novel type of “agreed damage” provision? The remedy is equitable in nature, and generally courts have resisted contractual attempts to mandate equitable relief. The Delaware LLC Act purports to answer this question by expressly authorizing an LLC agreement to provide for “specified penalties or specified consequences,” but such authority is at odds with hundreds of years of contract law.

114. The proposed Restatement (Third) of Restitution (Profit Derived from Opportunistic Breach) § 39 (Tentative Draft No. 4 2005) might change this part of the legal landscape. The black letter law is detailed and the comments lengthy, but the former begins as follows: “If a breach of contract is both material and opportunistic, the injured promisee has a claim in restitution to the profit realized by the defaulting promisor as a result of the breach.” Id. at § 39(1). However, this proposal is quite controversial.

115. The situation is different if the agreement purports only to delimit or “sculpt” the fiduciary duties and either implicitly or explicitly preserves some fiduciary duty. For a discussion of the complexity of this approach, see Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 166-67 (Del. 2002) (“[T]he Partnership Agreement supplanted traditional fiduciary duties and provided for contractual fiduciary duties by which the defendants’ conduct would be measured.”).

116. See, e.g., Kanan, Corbin, Schupak & Aronow, Inc. v. FD Int'l, Ltd., 797 N.Y.S.2d 883, 889 (N.Y. Sup. Ct. 2005) (reasoning that because the factors for determining compensatory damages were known, injuries were not irreparable).

4. The Limited Power of Contractual Good Faith

Although some authorities suggest that contractual good faith is a judge’s roving commission for determining fairness, contractual good faith is simply no substitute for fiduciary duty.

History suggests that contractual good faith and fiduciary duty are not functional equivalents; they developed independently to serve different values. The contractual duty serves principally to constrain behavior within arm’s length relationships and to apply, in essence, “the morals of the market place [sic].” Fiduciary duty exists to police relationships that involve, in Cardozo’s eternal words, “the punctilio of an honor the most sensitive.”

The scope and power of the two duties are accordingly quite different. Properly understood, the contractual duty is ancillary and subservient to the contractual arrangements. Its function is to allow the contract to mean what it says; it is therefore of no use to police mis-

118. See, e.g., Revised Uniform Partnership Act § 404 cmt. 4 (“The meaning of ‘good faith and fair dealing’ is not firmly fixed under present law. ‘Good faith’ clearly suggests a subjective element, while ‘fair dealing’ implies an objective component. It was decided to leave the terms undefined in the Act and allow the courts to develop their meaning based on the experience of real cases.”).

119. Nomenclature in this area can be confusing, because modern U.S. decisions involving close corporations sometimes use the phrase “utmost good faith” to encompass fiduciary duties among shareholders. See, e.g., Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505, 515-16 (Mass. 1975).

120. The obligation also inheres in contracts involving a fiduciary, but – given the applicable fiduciary rules – in that context the contractual obligation may be surplus.


122. Id.

123. See, e.g., Cont'l Ins. Co. v. Rutledge & Co., Inc., 750 A.2d 1219, 1234 (Del. Ch. 2000) (“The implied covenant of good faith requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the contract. This doctrine emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party. The parties’ reasonable expectations at the time of contract formation determine the reasonableness of the challenged conduct . . . . [C]ases invoking the implied covenant of good faith and fair dealing should be rare and fact- intensive. Only where issues of compelling fairness arise will this Court embrace good faith and fair dealing and imply terms in an agreement.”) (footnotes and internal quotation marks omitted).

124. See Uniform Limited Partnership Act (2001) § 305(b) cmt. (“[T]he purpose of the obligation of good faith and fair dealing is to protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of
conduct that is outside the contract. Moreover, at least under Delaware law, a person asserting a good faith claim has the heavy burden of demonstrating an "issue of compelling fairness." This burden is in sharp contrast to the "strict construction" approach of fiduciary law described above.

Delaware's reaction to *Gotham Partners* supports the assertion that contractual good faith is less powerful than fiduciary duty. When the legislature empowered operating agreements to "eliminate" fiduciary duty, the legislature also carefully preserved from elimination "the contractual covenant of good faith and fair dealing." Therefore, since the legislation's evident intent was to empower agreements and "cabin in" judicial scrutiny, the legislature must have considered the contractual covenant to be less powerful than fiduciary duty.

In short, to rely on the contractual duty of good faith as a substitute for fiduciary duty is akin to replacing heavy cream with skim milk.

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safeguarding it.

125. *See, e.g.*, *In re Wet-Jet Int'l, Inc.*, 235 B.R. 142, 151 (Bankr. D. Mass. 1999) ("A distinction ought . . . to be drawn between actions taken by stockholders with respect to one another, which are explicitly covered by their unfettered agreement to be bound, and actions taken outside of such an agreement. Such a distinction . . . gives effect to the intention of the parties with regard to the specific terms of their agreement, and yet leaves the [fiduciary] policies . . . intact by retaining a high level of scrutiny over dealings that fall outside the terms of the shareholder agreement.").


127. DEL. CODE ANN. tit. 6 § 18-1101(e), enacted by 2004 Del. Laws, ch. 275 (H.B. 411) § 13. Parallel amendments to the limited and general partnership acts are found in 2004 Del. Laws, ch. 265 (S.B. 273) § 15 and ch. 266 (S.B. 274) § 3, respectively.

128. To the extent the courts try to churn contractual good faith into heavy cream, the result may be a contractarian's nightmare. Fiduciary duty derives from equity, and equity jurisprudence contains some useful limitations on plaintiffs (e.g., the "clean hands" doctrine). If the elimination of fiduciary duty causes courts to distort the duty of good faith into, for example, a doctrine that protects extra-contractual "reasonable expectations," we may see the elimination of fiduciary duty produce results like *Pooley v. Mankato Iron & Metal, Inc.*, 513 N.W.2d 834, 837-38 (Minn. Ct. App. 1994) (affirming buy-out, without any discount, of a shareholder employee who had "pledged guilty to assaulting someone in the scope of his employment") and *Royals v. Piedmont Elec. Repair Co.*, 529 S.E.2d 515, 515, 517 (N.C. Ct. App. 2000) (ordering dissolution in connection with the claim of a shareholder whom "independent counsel . . . [had] concluded . . . had committed various acts of sexual harassment").
5. The Lack of Human Prescience

To break fundamentally with history and uproot fiduciary duty involves more than just a fundamental break with long-standing rules. The break also involves a sea of change in: (i) how the law approaches the risks that inherently exist in people entrusting their property and sometimes their livelihoods into management by, or co-management with, others, and (ii) what the law believes possible of contract drafters. As the author has observed elsewhere:

The open-ended nature of fiduciary duty reflects the law's long-standing recognition that devious people can smell a loophole a mile away. For centuries, the law has assumed that (1) power creates opportunities for abuse and (2) the devious creativity of those in power may outstrip the prescience of those trying, through ex ante contract drafting, to constrain that combination of power and creativity. For an attorney to advise a client that the attorney's drafting skills are adequate to take the place of centuries of fiduciary doctrine may be an example of chutzpah or hubris (or both).129

CONCLUSION

The limited liability company has revitalized the law of unincorporated business organizations and has become the principal vehicle in the U.S. for housing closely held businesses. The LLC should not, however, be the vehicle for transforming fiduciary duty into a mere set of default rules. That transformation would rewrite the brief, modern history of LLCs and ignore the centuries-long history of U.S. closely held businesses.

129. BISHOP & KLEINBERGER, LIMITED LIABILITY COMPANIES, supra note 35, ¶ 14.05[4][a][ii].
Notes & Observations