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## Seven Points to Explain Why the Law Ought Not Allow the Elimination of Fiduciary Duty Within Closely Held Businesses: Cardozo Is Dead; We Have Killed Him.

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## Seven Points to Explain Why the Law Ought Not Allow the Elimination of Fiduciary Duty Within Closely Held Businesses: Cardozo Is Dead; We Have Killed Him.

### Abstract

Prepared as part of the author's work as co-reporter for the Revised Uniform Limited Liability Company Act, this essay argues against legislation that empowers private agreements to eliminate fiduciary duty within a business organization. The essay considers: (i) the venerable role of fiduciary duty within business organizations and the limited predictive powers of those urging radical reform; (ii) the absence of prescience in contract drafters; (iii) the strict construction function of fiduciary law; (iv) the inevitable and inappropriate pressure that elimination would put on the obligation of good faith and fair dealing; (v) the differences in remedy available for fiduciary claims as distinguished from contract claims; (vi) the difference between drafting law for Delaware and drafting a uniform act; and (vii) reasons that public corporation law is different from LLC law and why Delaware law should not dominate the latter context.

### Keywords

Fiduciary duty, Delaware, Cardozo, Freedom of contract, Limited liability company, LLC, Re-ULLCA, NCCUSL, Uniform law

### Disciplines

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**Seven Points to Explain Why the Law Ought Not Allow the Elimination of Fiduciary Duty  
Within Closely Held Businesses**

*Cardozo Is Dead; We Have Killed Him.*

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My first point of explanation concerns history and my skepticism about making radical changes in the law. 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 or quickly reject such a long-standing position. It is perhaps arguable that fiduciary duty smacks of paternalism and 16th century English mercantilism, but 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.

I am a skeptic about the predictive powers of law reformers and therefore concerned with unintended consequences. The more fundamental a proposed change, the greater the risk of unintended consequences – in my avowedly conservative view, those proposing a sea change have a heavy burden of demonstrating why the current sea is so bad.

My second point of explanation has to do with what “elimination” means about the law’s view about human conduct and, more importantly, about human prescience. To break fundamentally with history and to annul fiduciary duty -- or to permit contracts to do so, which amounts to pretty much to the same thing whenever a controlling owner is involved in a business

-- involves more than just a fundamental break with long-standing rules; it also involves a sea change in: (i) how the law approaches the risks that inherently exist when people entrust their property and sometimes their livelihoods into management by, or co-management with, others, and (ii) what the law believes possible of contract drafters.

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).<sup>1</sup>

In short, promoting the elimination of fiduciary duty involves more than promoting freedom of contract; it also involves shifting the law's view of power relationships within closely held business from those of Cardozo to those of Pontius Pilate.

My third point of explanation concerns the "strict construction" aspect of fiduciary law. 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 the fiduciary.

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<sup>1</sup> Treatise, ¶ 14.05[4][a][ii].

In the latter respect, fiduciary law resembles a rule of baseball – “the tie goes to the runner.”

Where the relationship is fiduciary and the issue is waiver or consent, strict construction applies and the tie goes against the fiduciary.

The fourth point of explanation concerns the contractual obligation of good faith and its inability to substitute for fiduciary duty. History suggests that good faith and fiduciary duty are not functional equivalents; they developed independently to serve different values. The contractual duty of good faith serves principally to constrain behavior within arm’s length relationships<sup>2</sup> and to apply, in essence, “the morals of the marketplace.”<sup>3</sup> Fiduciary duty exists to police relationships that involve “the punctilio of an honor the most sensitive.”<sup>4</sup>

The scope of and power of the two duties are accordingly quite different. Although some authorities suggest that contractual good faith is a judge’s roving commission for determining fairness,<sup>5</sup> that approach is certainly foreign to Delaware law.<sup>6</sup> Properly understood, the

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<sup>2</sup> The obligation also inheres in contracts involving a fiduciary, but – given the applicable fiduciary rules – in that context the contractual obligation may be almost surplus.

<sup>3</sup> Meinhard v. Salmon, 164 N.E. 545 (N.Y. 1928) (Cardozo, J.)

<sup>4</sup> *Id.*

<sup>5</sup> See, e.g., RUPA § 404, comment 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.”).

contractual duty is ancillary and subservient to the contractual arrangements. Its function is to allow the contract to mean what it says;<sup>7</sup> it is therefore of no use to police misconduct that is outside the contract.<sup>8</sup> Moreover, at least under Delaware law, a person asserting a good faith

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<sup>6</sup> See e.g., *Continental Ins. Co. v. Rutledge & Co., Inc.*, 750 A2d 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 quotations omitted).

<sup>7</sup> See ULPA (2001), § 305, comment to subsection (b) (stating that “the 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 safeguarding it”).

<sup>8</sup> See e.g., *In re Wet Jet International, Inc.*, 235 B.R. 142, 151-152 (Bank. – 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

claim has the heavy burden of demonstrating an “issue[] of compelling fairness.”<sup>9</sup> This burden is in sharp contrast to the “strict construction” approach of fiduciary law described above. 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.<sup>10</sup>

The recent action of the Delaware legislature supports this assertion. After the Delaware Supreme Court’s decision in Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.,<sup>11</sup> the

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. . . intact by retaining a high level of scrutiny over dealings that fall outside the terms of the shareholder agreement.”).

<sup>9</sup> Continental Ins. Co. v. Rutledge & Co., Inc., 750 A2d at 1234.

<sup>10</sup> 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, 836 (Minn.Ct.App.1994) (affirming buy-out, without any discount, of a shareholder employee who had “pleaded guilty to assaulting someone in the scope of his employment”) and *Royals v. Piedmont Elec. Repair Co.*, 529 S.E.2d 515 (N.C.App. 2000) (ordering dissolution in connection with the claim of a shareholder whom “independent counsel . . . [had] concluded . . . had committed various acts of sexual harassment”).

<sup>11</sup> 817 A.2d 160, 167 – 168 (Del. 2002).

Delaware legislature moved promptly to empower partnership and LLC agreements to “eliminate” as well “restrict” fiduciary duties. However, the legislation carefully preserved from elimination “the contractual covenant of good faith and fair dealing.”<sup>12</sup>

Although “the official legislative synopsis to the [parallel] amendments to the limited partnership act describes them as mere clarification[, it] . . . is an interesting conceptual question . . . whether repudiating forceful dicta from the state's highest court is a mere clarification.”<sup>13</sup> In any event, the legislature clearly thought it was doing something important and just as clearly thought it was drawing an important line when permitting elimination of fiduciary duty but not good faith. 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.

The fifth point of explanation pertains to the difference in remedies available for contract claims and breach of fiduciary duty claims. 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. Suppose a breach of the stated duties. Does that breach give rise to a fiduciary duty claim or a contract claim?

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<sup>12</sup> 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 in 2004 Del. Laws, ch. 265 (S.B. 273), § 15 and ch. 266 (S.B. 274), § 3, respectively.

<sup>13</sup> [cite treatise]



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. But disgorgement is not typically a contractual remedy.<sup>14</sup> In contract, parties are limited to damages (reliance or expectation) or in some cases restitution for benefit conferred (which is not the same of disgorgement of benefits wrongfully taken).

If the claim is “merely” for breach of the operating agreement, from where would a court get the power to order disgorgement?<sup>15</sup> 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, with the ability *vel non* to prove damages irrelevant.

Suppose further that the drafters of the operating agreement, foreseeing this problem, cause the operating agreement to provide contractually for a disgorgement remedy. Will the law

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<sup>14</sup> The proposed Restatement (Third) of Restitution, § 39 might change this part of the legal landscape. The black letter is detailed and the comments lengthy, but the former begins as follows:

§ 39. Profit Derived from Opportunistic Breach

(1) 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.

<sup>15</sup> The situation is entirely different if the agreement purports only to delimit or “sculpt” the fiduciary duties and states which fiduciary remains post-sculpting.

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 (e.g., contractual provisions stating that the parties agree that breach of the non-compete agreement will cause the obligee irreparable injury). The Delaware LLC Act purports to answer this question by expressly authorizing an LLC agreement to provide for “specified penalties or specified consequences,”<sup>16</sup> but such authority is at odds when hundreds of years of contract law.

The sixth point of explanation concerns the difference between drafting law for Delaware and drafting a uniform act. In the realm of business entity law, Delaware has always excelled at exercising state’s rights within our federalist system. Decades ago, Delaware’s focus was corporate law, and academics exercised themselves by discoursing on the “race to the bottom.”<sup>17</sup>

Today, Delaware’s focus is at least equally on the realm of unincorporated business entities, but here the race is quite different. Publicly traded entities have every incentive to consider “moving” to Delaware to incorporate, but most limited liability companies are closely held and the costs and benefits of organizing “away from home” are quite different. With large publicly traded corporations, if a state’s domestic law does not take account of “Delaware genius” , the state’s corporations may do so by incorporating in Delaware. Practically speaking, the same option is not open for most LLCs. If they are going to partake of the Delaware worldview, it will be because their respective legislatures have adopted that view.

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<sup>16</sup> Del. Code. Ann. tit. 6, §§ 18-305 (for member’s breach) and 18-405 (for manager’s breach).

<sup>17</sup> It is possible to argue that the consequences of that race now include the federal overregulation that is Sarbanes-Oxley.

A NCCUSL drafting committee working to inform those legislatures should respect Delaware for its intelligence and innovation but should remember that a uniform act is designed principally for the mass of entrepreneurs. Those entrepreneurs will never need or be able to afford the exceedingly sophisticated conceptualization that drives those responsible for shaping the Delaware LLC statute.<sup>18</sup> For example, whenever the drafting committee's discussion focuses on the ability of counsel to draft opinion letters on some abstruse point, for the moment – and perhaps for good reason – the discussion has left behind at least 95 percent of all the LLCs that have been or ever will be formed under anything other than the Delaware Act.

The seventh point of explanation concern the profusion and variability of Delaware case law and the moving target that is Delaware statutory law. Anyone with even a passing familiarity with Delaware case law understands that the judges of the Court of Chancery are very intelligent and knowledgeable jurists, as are the justices who sit on the Delaware Supreme Court.<sup>19</sup> However, it is open to wonder why, if Delaware law is so excellent as to be our lodestar, it is so often necessary for the Delaware Chancery Court to write at such length about so many different aspects of Delaware law.

Perhaps the answer is that, when big bucks are on the line, parties will litigate until it's over or at least until some judicial handwriting is on the wall. Even if this is the only explanation, the explanation should give us pause; we are not drafting primarily for people who have the kind of money displayed and at issue in most Delaware Chancery cases. Moreover, it is

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<sup>18</sup> For example, dual citizenship. For further example, series LLCs.

<sup>19</sup> And if we didn't know that ourselves, the Delaware legislature has told us so. [cite]

open to suggest, especially since a former chancellor from Delaware has said so, that sometimes Delaware law gets too complicated even for the good of the sophisticates and experts who practice with it. Further, although the late Chairman Mao advocated continuing revolution, there seems to be some value in a statute that stays constant for at least several years at a time. The Delaware LLC Act is a work constantly in progress, having been amended every year since its enactment. This statutory instability may be appropriate when the most important users of the statute are at the very cutting edge of transactional work. But a uniform entity act should not court that type of users if the cost is an unjustified sea change in the way the law looks at fiduciary duty.

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