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The Limited Effect of "Maximum Effect"

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Recently, a learned professor of law described Delaware as "a mecca . . . for the organization of limited liability companies."[1],[2] Similarly, for more than 25 years a leading treatise has referred to "Delaware law['s] . . . almost gravitational pull on attorneys as well as some regulators." Carter G. Bishop & Daniel S. Kleinberger: Limited Liability Companies ¶ 14.01[2] (Bishop & Kleinberger).[3] Many factors explain this attractiveness:[4]

> Arguably . . . [Delaware law's] most attractive feature is the LLC members' contractual freedom to strike bargains that create relationships (with the LLC and its members) tailored to meet their personal business needs. This feature is grounded in the Delaware General Assembly's clear intent: the [Delaware LLC Act] affords maximum effect to the principle of *freedom of contract* . . . ."[5]

In full, the referenced statutory provision states: "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."[6] Essentially identical language appears in the Delaware limited partnership act.[7]

Numerous Delaware cases involving limited liability companies or limited partnerships have invoked this fundamental policy and quoted the statutory language.[8] Notably, however, no such language appears in any official version of the uniform limited liability company act or uniform limited partnership act. In fact, according to the official comments, both uniform acts "reject[] the ultra-contractarian notion that fiduciary duty within a business organization is merely a set of default rules and seeks instead to balance the virtues of 'freedom of contract'

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[1] This column is based on research conducted by Professors Kleinberger and Moll for a longer article provisionally titled *Oppression in the World of LLCs: In Comparison with the Law of Closely Held Corporations*.
[2] David G. Epstein & Jake Weiss, *The Fourth Circuit, "Suem" and Reverse Veil Piercing in Delaware*, 70 S.C. L. Rev. 1189, 1198 (2019). The lead author is the George E. Allen Professor of Law at the University of Richmond.
[3] Carter G. Bishop & Daniel S. Kleinberger: Limited Liability Companies ¶ 14.01[2] (Bishop & Kleinberger).
[4] *Id.; see also* Daniel S. Kleinberger, *Don't Dabble in Delaware,* Bus. L. Today, July 2017.
[5] Nicole M. Sciotto, *Opt-in vs. Opt-Out: Settling the Debate over Default Fiduciary Duties in Delaware LLCs*, 37 Del. J. Corp. L. 531, 567 (2012) (quoting Del. Code Ann. tit. 6, § 18-1101(b) (2005)) (emphasis in original).
[6] Del. Code Ann. tit. 6, § 18-1101(b) (2019).
[7] **Id.** § 17-1101(d). Cases arising from either statute are equally relevant here. *See infra* note 18.
[8] On May 5, 2020, the following search on Westlaw in Delaware cases yielded 86 cases: adv: *"maximum effect" /s "freedom #of contract"*.

against the dangers that inescapably exist when some persons have power over the interests of others."[9]

Nonetheless, on this point more than 20 jurisdictions have followed Delaware rather than the Uniform Law Commission (ULC),[10] including several jurisdictions the ULC lists as having adopted the uniform act.[11] It is therefore worthwhile to inquire into the practical import of the statutory pronouncement. Put another way, just how effective has the construct of "maximum effect" been?

For at least two reasons, the answer is "not very." First, courts deciding contract cases have long recognized the importance of freedom of contract and have done so without the need for any statutory pronouncement.[12] Second, courts quoting the statutory pronouncement use it as a point of emphasis, never as a *ratio decidendi* (rationale for decision).

Respect for freedom of contract is an essential part of the common law. In New Mexico, for example, it is "well settled that freedom of contract is a 'paramount' public policy 'not to be interfered with lightly,'"[13] and likewise, "Texas strongly favors parties' freedom of contract."[14] In New York, "agreements negotiated at arm's length by sophisticated, counseled parties are generally enforced according to their plain language pursuant to our strong public policy favoring freedom of contract."[15]

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[9] ULLCA § 105(d)(3) cmt. (2013); accord ULPA § 105(d)(2) cmt. (2013); *see also* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in Elgar Handbook on Alternative Entities (noting that "[a]s judges who have seen our fair share of alternative entity disputes, we do not immediately grasp why ["the establishment of a purely contractual relationship between entity managers and investors"] would be seen as a compelling advantage").

[10] *See* Ala. Code § 10A-5A-1.06(a); Ark. Stat. Ann. § 4-32-1304; Cal. Corp. Code § 17701.07(a); Colo. Rev. Stat. Ann. § 7-80-108(4); Conn. Gen. Stat. Ann. § 34-283d(a); D.C. Code § 29-1201.06; Fla. Stat. Ann. § 605.0111(1); 805 Ill. Comp. Stat. Ann. 180/55-1(b); Ind. Code Ann. § 23-18-4-13; La. Rev. Stat. Ann. § 12:1367(B); Kan. Stat. Ann. § 17-76,134(b); Ky. Rev. Stat. § 275.003(1); Md. Code Ann. Corps. & Ass'ns § 4A-102(a); Me. Stat. tit. 31 § 1507(1); Miss. Code Ann. § 79-29-1201(2); Nev. Rev. Stat. § 86.286(b); N.H. Rev. Stat. Ann. § 304-C:2; N.J. Stat. Ann. § 42:2C-11(i); N.M. Stat. Ann. § 53-19-65(A); N.C. Gen. Stat. Ann. § 57D-10-01(c); O.S. tit. 18, § 2058(D); S.D.C.L. § 47-34A-114; Va. Code Ann. § 13.1-1282; Wash. Rev. Code § 25.15.801(2); Wis. Stat. Ann. § 183.1302(1). Delaware and several of these jurisdictions have similar language in one or both of their respective limited partnership and general partnerships acts. For simplicity's sake, this column refers only to limited liability companies and operating agreements, but this column's analysis and the cases cited should be equally relevant in the partnership realm.

[11] *See* the ULC's list of "uniform" enactments (last visited July 14, 2020).

[12] During the *Lochner* era, courts regularly invoked freedom of contract as a limitation on the police powers of the government, citing the 14th Amendment of the U.S. Constitution. *See, e.g.,* Lochner v. New York, 198 U.S. 45, 53 (1905) ("The general right to make a contract in relation to his business is part of the liberty of the individual protected by the 14th Amendment of the Federal Constitution."), *overruled in part by* Day-Brite Lighting Inc. v. State of Mo., 342 U.S. 421 (1952), *and overruled in part by* Ferguson v. Skrupa, 372 U.S. 726 (1963), *and abrogated by* W. Coast Hotel Co. v. Parrish, 300 U.S. 379 (1937). When the *Lochner* era ended, so did routine citation of a person's liberty interest in contracting.

[13] United Rentals Nw., Inc. v. Federated Mut. Ins. Co., No. CIV 08-0443 RB/DJS, 2009 WL 10665768, at *4 (D.N.M. Mar. 9, 2009) (quoting Tharp v. Allis-Chalmers Mfg. Co., 81 P.2d 703, 706 (N.M. 1938)).

[14] Gym-N-I Playgrounds, Inc. v. Snider, 220 S.W.3d 905, 912 (Tex. 2007).

[15] 159 MP Corp. v. Redbridge Bedford, LLC, 128 N.E.3d 128, 130 (N.Y. 2019).

Yet despite its strength, the public policy's principal function is rhetorical, i.e., as a device invoked for emphasis when a court holds parties to the plain meanings of their deal documents. Courts apply the device over a wide range of specific types of agreements—from restrictive covenants to insurance policies. Thus, in Texas for example, "when construing a restrictive covenant [which the court considers a type of contract], the court's primary duty is to ascertain the drafter's intent as expressed within the four corners of the instrument" in order to be "[c]onsistent with the freedom of contract."[16] With respect to insurance policies, the North Carolina Supreme Court has stated:

> This Court has long recognized its duty to construe and enforce insurance policies as written, without rewriting the contract or disregarding the express language used. The duty is a solemn one, for it seeks to preserve the fundamental right of freedom of contract.[17]

This same rhetoric appears in many cases invoking the statutory pronouncement of maximum effect. Most of these cases come from Delaware, some involving limited liability companies and some involving limited partnerships.[18] For example, *Continental Insurance Co. v. Rutledge & Co.* links plain meaning and "maximum effect" as follows:

> We have . . . held that Delaware courts should give the terms of contracts their plain meaning. This preference rings particularly true in a limited partnership context where "[i]t is the policy of [the Delaware Revised Uniform Limited Partnership Act] to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."[19]

The court in *Brinckerhoff v. Enbridge Energy Co.* makes the same connection, which the court uses on its way to the "plain meaning" conclusion, i.e., cases interpreting limited partnership agreements must be understood in terms of the specific language at issue in the particular agreement at issue:

> [W]hen trying to square existing precedent with the language of different LPAs [limited partnership agreements], we have observed that: "Although the limited partnership agreements in all of these cases contain troublesome language, each decision was based upon significant nuanced substantive differences among each of the specific limited partnership agreements at issue. That is not surprising, because the Delaware Revised Uniform Limited

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[16] Vance v. Popkowski, 534 S.W.3d 474, 478 (Tex. App. 2017).

[17] Fid. Bankers Life Ins. Co. v. Dortch, 348 S.E.2d 794, 796 (N.C. 1986) (citing Muncie v. Insurance Co., 116 S.E.2d 474 (N.C. 1960)).

[18] The limited partnership cases are as relevant here as LLC cases because "Delaware courts consider LLC and limited partnership jurisprudence to be reciprocally precedential." Bishop & Kleinberger, *supra* note 3, ¶ 14.01 n.3 (citing Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999) as "emphasizing the fundamental importance of the LLC agreement by quoting a passage from a treatise on Delaware limited partnerships").

[19] Cont'l Ins. Co. v. Rutledge & Co., 750 A.2d 1219, 1228 (Del. Ch. 2000) (citing Hallowell v. State Farm Mut. Auto. Ins. Co., 443 A.2d 925, 926 (Del. 1982) and quoting Del. Code. Ann. tit. 6, § 17–1101(c)).

> Partnership Act is intended to give "maximum effect to the principle of freedom of contract." Accordingly, our analysis here must focus on, and examine, the precise language of the LPA that is at issue in this case.[20]

Occasionally, a Delaware court will go beyond just using the "plain meaning" rule to decide an issue and will lecture litigants and lawyers on the dangers of "maximum effect." For example:

- "freedom [of contract] allows parties to adopt contractual arrangements that do not work, particularly when the principals do not trust each other and do not get along."[21]
- "[w]ith the contractual freedom granted by the LLC Act comes the duty to scriven with precision."[22]

"Maximum effect" can also play a different role in the Delaware cases. The Delaware LLC Act expressly provides that an LLC "member's or manager's or other person's duties [including fiduciary duties] may be . . . restricted or eliminated by provisions in the limited liability company agreement,"23 and Delaware courts sometimes invoke "maximum effect" as a preface to applying the "restrict or eliminate" provision. *Kelly v. Blum* provides a good example of how Delaware courts pair the provisions:

> The LLC Act expressly provides that it is the policy of the Act "to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." Thus, the LLC Act grants LLC members significant discretion and wide latitude in the ordering of their relationships, "including the flexibility to limit or eliminate fiduciary duties."[24]

CSH Theatres, LLC v. Nederlander of San Francisco Assocs. provides another example:

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[20] Brinckerhoff v. Enbridge Energy Co., Inc., 159 A.3d 242, 253 (Del. 2017) (quoting DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chicago, 75 A.3d 101, 106–07 (Del. 2013)) (citations and footnotes omitted in original).

[21] Acela Investments LLC v. DiFalco, No. CV 2018-0558-AGB, 2019 WL 2158063, at *24 (Del. Ch. May 17, 2019).

[22] Willie Gary LLC v. James & Jackson LLC, No. CIV.A. 1781, 2006 WL 75309, at *2 (Del. Ch. Jan. 10, 2006), *aff'd*, 906 A.2d 76 (Del. 2006). *See generally* Daniel S. Kleinberger, *Careful What You Wish For—Freedom of Contract and the Necessity of Careful Scrivening*, XXIV PUBOGRAM 19 (Oct. 2006) (Committee on Partnerships and Unincorporated Business Organizations of the ABA Business Law Section).

[23] Del. Code Ann. tit. 6, § 18-1101(c).

[24] Kelly v. Blum, No. CIV.A. 4516-VCP, 2010 WL 629850, at *10 n.67 (Del. Ch. Feb. 24, 2010) (quoting Del. Code Ann. tit. 6, § 18-1101(b) and Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at *8 n.33 (Del. Ch. Apr. 20, 2009)). Some cases invoke "maximum effect" when enforcing other provisions of a jurisdiction's LLC act. *See, e.g.*, Condo v. Conners, 266 P.3d 1110, 1119 (Colo. 2011) (stating that "'maximum effect' . . .{Note to editor – this quotation is [double quote][single quote]maximum effect[single quote] – Thank you. indicate[s] a legislative preference for the freedom of contract over the free alienability of membership rights"). However, the pairing described in the text accounts for the lion's share both in Delaware and elsewhere.

> Limited liability companies are creatures of contract, and the Delaware Limited Liability Company Act states that "[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract." The drafters of an LLC agreement can modify the traditional duties of care and loyalty or displace them altogether.[25]

Non-Delaware cases follow the same pattern. The "plain meaning" function is well illustrated in *Condo v. Connors*, a decision from the Colorado Supreme Court, and the case is especially instructive because it shows how the statutory pronouncement duplicates the common law. The case dealt with the effect of an LLC member's assignment of economic rights and turned on the meaning of an anti-assignment clause. In rejecting one party's asserted interpretation, the court grounded its decision on contract law principles and cases having nothing to do with limited liability companies. The court then invoked the statutory pronouncement as if to say *afortiori*:

> In the present context . . . this interpretation is too narrow given the plain meaning of the [operating agreement's] anti-assignment clause. Thompson, 84 P.3d at 501 ("[T]erms in a [contract] should be assigned their plain and ordinary meaning.") [insurance case]. Although contract rights are generally assignable, this presumption may nevertheless be overcome by an express prohibition on such a transfer. Parrish v. Rocky Mountain Hosp. & Med. Servs. Co., 754 P.2d 1180, 1182 (Colo.App.1988); see Restatement (Second) of Contracts § 322 cmt. c (noting that this rule "depends on all the circumstances"). Further, in the context of an LLC operating agreement, Colorado law compels us to give "maximum effect" to the terms of the operating agreement. [Colo. Stat.] § 7–80–108(4).[26]

As for the link between "maximum effect" and limiting or eliminating fiduciary duties, *Stoker v. Bellemeade* provides a succinct example. This Georgia case intertwines the two statutory principles as follows:

> Although OCGA § 14–11–305 [of the Georgia LLC statute] describes various duties and liabilities, including fiduciary duties, it also makes clear that the duties and liabilities "may be expanded, restricted, or eliminated by provisions in the articles of organization or a written operating agreement" subject to the restrictions set forth. The contractual flexibility provided in this section is consistent with OCGA § 14–11–1107(b) of the LLC Act which provides that: "It is the policy of this state with respect to limited liability

[25] CSH Theatres, LLC v. Nederlander of San Francisco Assocs., No. CV 9380-VCP, 2015 WL 1839684, at *11 (Del. Ch. Apr. 21, 2015) (citing Del. Code. Ann. tit. 6, § 18–1101(b)) (footnotes omitted).
[26] Condo v. Conners, 266 P.3d 1110, 1116 (Colo. 2011).

> companies to give maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."[27]

We could cite many other cases, from both Delaware and elsewhere, reflecting the pattern this column describes.[28] By way of a conclusion, we offer an analogy to the law of lawyering, in particular to lawyer ethics. In the days before the Model Rules of Professional Conduct, the American Bar Association promulgated a Model Code of Professional Responsibility, which comprised two types of provisions: Ethical Canons (ECs) and Disciplinary Rules (DRs). The ECs contained important principles and other rhetoric, but only the DR determined outcomes. As this column has shown, "maximum effect" functions much more like an EC than a DR. That is to say, the "maximum effect" pronouncement is of little practical effect.[29]

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[27] Stoker v. Bellemeade, LLC, 615 S.E.2d 1, 9 (Ga. Ct. App. 2005), *rev'd in part on other grounds sub nom.* Bellemead, LLC v. Stoker, 631 S.E.2d 693 (Ga. 2006).

[28] Maryland case law might become an exception to this pattern with regard to elimination of fiduciary duties. The Maryland LLC act does not address the fiduciary duties of those who manage a Maryland limited liability company, does contain a "maximum effect" pronouncement, Md. Code Ann., Corps. & Ass'ns § 4A-102(a), and does not expressly authorize an operating agreement to restrict or eliminate fiduciary duties. In July 2020, the Maryland Court of Appeals held that "[d]espite the statutory silence concerning fiduciary duties in the LLC Act . . . managing members of an LLC owe fiduciary duties to the LLC and the minority members arising under traditional common law agency principles." Plank v. Cherneski, No. 3, Sept. Term, 2019, 2020 WL 3967980, at *8 (Md. July 14, 2020). If Maryland courts eventually consider the enforceability of an operating agreement provision that purports to entirely eliminate fiduciary duties, might the courts take the act's "maximum effect" pronouncement as sufficient to determine the issue? For an analysis of this question, see the forthcoming article, *supra* note 1.

[29] For the analog to the DRs, we of course look to the operating agreement. *See* ULLCA (2013) § 105 cmt. (referring to "the primacy of the operating agreement in establishing relations *inter se* the limited liability company, its member or members, and any manager"); Bishop & Kleinberger, *supra* note 3, ¶ 5.06[1][a] ("One court has referred to the operating agreement as the "heart and soul of an LLC" and another has used the word "cornerstone." (footnotes omitted)).