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The Uncorporation and Corporate  
Indeterminacy

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# The Uncorporation and Corporate Indeterminacy

Larry E. Ribstein

## **Abstract**

William Carney and George Shepherd argue that Delaware's success in corporate law is a "mystery" when one considers the high transaction costs engendered by the indeterminacy and instability of Delaware law. This paper shows that the mystery is clarified by analyzing Delaware law on "uncorporate" cases – that is, limited partnerships and limited liability companies. In this setting, parties can rely on specific contractual incentive and disciplinary devices rather than on open-ended fiduciary duties. Delaware lawmakers provide substantial coherence by focusing on the parties' contracts. It follows that the problems of Delaware law seem to be mainly a function of the corporation rather than of Delaware lawmakers.

## THE UNCORPORATION AND CORPORATE INDETERMINACY

Larry E. Ribstein\*

Draft of April 1, 2008

### Abstract

William Carney and George Shepherd argue that Delaware's success in corporate law is a "mystery" when one considers the high transaction costs engendered by the indeterminacy and instability of Delaware law. This paper shows that the mystery is clarified by analyzing Delaware law on "unincorporate" cases – that is, limited partnerships and limited liability companies. In this setting, parties can rely on specific contractual incentive and disciplinary devices rather than on open-ended fiduciary duties. Delaware lawmakers provide substantial coherence by focusing on the parties' contracts. It follows that the problems of Delaware law seem to be mainly a function of the corporation rather than of Delaware lawmakers.

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\* Mildred van Voorhis Chair in Law, University of Illinois College of Law. Prepared for the University of Illinois College of Law Program in Business Law and Policy program, *The Mystery of Delaware Law's Success*, October 19, 2007, forthcoming Illinois Law Review. Thanks to Bob Thompson for comments.

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Professors William Carney and George Shepherd pose a puzzle.<sup>1</sup> They note the "widely held view" that Delaware has won the corporate law race because it offers a better product, particularly including an infrastructure of extensive and expert interpretation by high-quality judges and lawyers. Yet a close look seems to reveal a body of law that sacrifices clarity by offering many mini-rules that invite firms to formalistically structure their transactions in order to reduce judicial review. They say the system has increased litigation costs, and compares unfavorably with the Model Business Corporation Act, the model for most non-Delaware corporate law. For Carney and Shepherd, the "mystery" of their title is why Delaware continues to be so successful despite these flaws.

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<sup>1</sup> See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, <http://papers.ssrn.com/abstract=999477> (Sept. 11, 2007) (forthcoming 2008 Ill. L. Rev.).

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Chancellor Chandler emphasizes the conundrum that Carney & Shepherd pose: that despite Delaware's supposed flaws, "businessmen walk willingly into this slaughterhouse despite the easy availability of jurisdictions that have adopted the 'innovations' of the Model Business Corporations Act (and that also have lower franchise fees)."<sup>2</sup> The Chancellor challenges the Carney-Shepherd analysis by showing that they have essentially compared the apples of rich Delaware case law to the oranges of "the bare text of the Model Business Corporation Act." This is a powerful rejoinder, but it is necessarily incomplete because, given Delaware's undoubted success, there is really no apple to compare it to – that is, there is relatively little reported non-Delaware case law dealing with large corporations. Moreover, even if Delaware corporate law is not clearly inferior to that of other states, it may not be superior enough to explain Delaware's dominance.

This article offers an additional perspective that explains both Delaware's indeterminacy and why it nevertheless succeeds. I examine Delaware decisions on "uncorporations" – that is, limited partnerships and limited liability companies (LLCs). As in the public corporation cases Carney & Shepherd focus on, the uncorporation cases require precisely the same judges who are deciding the corporate cases to resolve complex disputes between managers and passive owners and among owners under general statutory provisions. Greater indeterminacy in corporate than in uncorporate cases indicates that indeterminacy inheres in the nature of the cases rather than in how judges decide them.

Indeed, something within the corporation may be causing the problem. The corporation involves a particular approach to the governance of business associations that, at least for some types of firms, may involve costs in excess of benefits as compared with rules for uncorporations.<sup>3</sup> Uncorporate business forms rely on specific contractual devices to provide incentives and managerial discipline, which reduces their need to rely on such monitoring devices as owner voting, independent directors, fiduciary duties and derivative litigation. The parties therefore can tailor their contracts to their needs and courts do not need to develop fiduciary rules to deal with a multitude of situations. It follows that indeterminacy less likely to be a problem in uncorporate than in corporate cases. Indeed, I show that Delaware uncorporate cases involve fewer of the problems Carney & Shepherd find in corporate cases. This suggests that the problem lies at least partly in the corporate form rather than wholly with the courts.

This paper proceeds as follows. Part I briefly reviews the Carney-Shepherd critique of Delaware corporate law and Chancellor Chandler's criticism of this thesis. Part II compares the corporate and uncorporate approaches to governance. It shows how uncorporations can address agency costs by avoiding heavy reliance on such devices as owner voting and fiduciary duties that produce much of the indeterminacy Carney and

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<sup>2</sup> See Chandler & Rickey, *Manufacturing Mystery: A Response to Professor Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success"*, forthcoming 2008 Ill. L. Rev).

<sup>3</sup> See Larry E. Ribstein, *Why Corporations?*, 1 Berk. Bus. L. J. 183 (2004); Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 Notre Dame Law Review 1431 (2006); Larry E. Ribstein, *Uncorporating the Large Firm (Uncorporating)*, ms. February 24, 2008.

Shepherd criticize. Part III develops the hypothesis by showing that Delaware unincorporate law does in fact exhibit fewer of the types of problems that Carney & Shepherd discuss though it is made by the same judges and legislators who produce Delaware corporate law. Part IV discusses implications of the analysis.

## I. THE CARNEY-SHEPHERD CRITIQUE AND CHANDLER RESPONSE

Carney & Shepherd analyze several categories of Delaware cases that cast doubt on the hypothesis that Delaware's attracts corporations because of the superiority of its law. Much of the Carney & Shepherd analysis focuses on the multitude of judicial rules regarding mergers. As Carney & Shepherd note, what started with an effort to modernize valuation standards has evolved into a proliferation of tests for many types of transactions, depending on such factors as whether there is independent board committee review, a majority-of-minority shareholder vote, or a tender offer for minority shares. These tests produce a kind of formalism that to some extent lets parties pick the applicable rule without regard to the substance of the transaction. At the same time, the tests have some of the uncertainty of standards. This includes the "murky" law on sale of substantially all of corporate assets; board fiduciary duties to preferred shareholders; the *Blasius* compelling justification test for infringements on the shareholder franchise; and the vague independence and court "business judgment" qualifications on special litigation committee review.

Problems other than the proliferation of tests increase the indeterminacy of Delaware law. Carney & Shepherd take Delaware to task for disparities between concepts of market and legal value. They observe that divorcing rules from market value sets up a "lottery" that enhances unpredictability. Moreover, each new test surprises not only the parties to the case that formulates the test and to contemporaneous transactions designed under the prior test.

This critique of Delaware begs for a comparison. Carney & Shepherd note that most other states have a simple unitary business judgment rule standard of reviewing takeover defenses and specific statutes authorizing ratification of poison pills. Carney & Shepherd also show that the widely adopted Model Business Corporation Act offers many rules that contrast with Delaware's indeterminate standards: a bright line safe harbor as to the requirement of a shareholder vote on major transactions; a universal demand requirement in derivative suits that dispenses with the need for judicial standards as to demand futility; mandatory dismissal after special litigation committee dismissal, again dispensing with vague judicial review standards; a bright line safe harbor for conflict transactions approved by disinterested shareholders or directors; and an appraisal remedy for all fundamental changes that reduces the need for litigating fairness.

Carney & Shepherd respond to defenses of Delaware indeterminacy, particularly by Professor Jill Fisch. Fisch argues that indeterminacy allows judges to adapt quickly to new circumstances and to tailor rules to the wide range of possible behaviors. However, Carney & Shepherd note that this comes at the significant cost of increasing the potential for litigation, that judges lack legislators' policymaking resources, and that even if judicial policymaking is efficient over the long run it involves significant indeterminacy

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costs over the short run. Fisch also argues that muddy rules facilitate bargaining. But even if this is true for default rules, it does not apply to the mandatory rules Carney & Shepherd focus on.

Chancellor Chandler criticizes Carney & Shepherd's central premise that Delaware compares unfavorably with the MBCA. The problem, according to Chancellor Chandler, is that this unfairly contrasts the pristine terms of the MBCA with the messy world of real cases. MBCA law can be as indeterminate and messy as Delaware law, and indeed even relies on Delaware cases. For example, MBCA cases often depart from strict market value; find open-ended terms in the supposedly bright line conflict of interest rules; apply Delaware-type standards in applying the supposed safe-harbor of MBCA as to asset sales; and review special litigation committee decisions in a way that is not clearly different from Delaware. Also, Chancellor Chandler observes that courts in MBCA states face problems that Delaware courts do not, such as having to determine the effect of a modification of the MBCA that the relevant state has not yet adopted. Finally, while Carney & Shepherd point to Delaware horror stories like *Technicolor* to illustrate their point about indeterminacy and high litigation costs, there is plenty of lengthy corporate litigation in other jurisdictions. In the absence of a direct comparison between MBCA and Delaware case law, Carney & Shepherd have not proven their hypothesis that there is something distinctly wrong with Delaware law.

Although Carney & Shepherd may not have proven their claim, they have made a strong case that Delaware law is, in fact, vague, indeterminate and unstable, and that these features can be costly. The question remains whether these are characteristics of corporate law generally, or only of Delaware law in particular. The next Part attempts to answer these questions by making a different comparison than the one Carney & Shepherd focus on – that between corporations and uncorporations.

### II. CORPORATE VS. UNCORPORATE GOVERNANCE

This Part considers whether the supposed problems of Delaware corporate law are associated with the corporate form itself rather than with the Delaware courts and legislature. It proceeds by comparing how corporate and uncorporate governance forms approach important aspects of firm governance.<sup>4</sup> Both types of firms incur potential agency costs by delegating power to strong managers. In general, corporate governance attempts to constrain these costs by relying on monitoring devices, including the board of directors, owner voting and fiduciary duties. Uncorporations substitute higher-powered managerial incentives and obligations to distribute assets or liquidate for corporate-type monitoring. Although firms organized as corporations under state law theoretically can adopt many of the uncorporate features discussed below, these features are more consistent with the norms of partnerships and other unincorporated firms. Courts therefore are more likely to enforce these features when firms adopt them. In any event, the main point of the following discussion is that firms that adopt uncorporate features, whether or not they are formally organized as corporations, can avoid many of the problems Carney & Shepherd discuss.

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<sup>4</sup> These features are discussed in more detail in Ribstein, *Uncorporating*, *supra* n. 3.

## A. MANAGER POWER

Although the standard form default partnership features co-equal owners, many unincorporations, including limited partnerships and manager-managed LLCs, have powerful managers and passive owners. There are, however, two important distinctions between corporations and these centrally managed unincorporations. First, corporate managers and directors get most of their incentive compensation in the form of stock options, which may only roughly align pay with performance.<sup>5</sup> By contrast, unincorporate managers have full-fledged ownership interests that expose them to significant downside as well as upside risk.

Second, corporate management includes both executives who manage the firm day-to-day and powerful directors who are supposed to oversee, and therefore be largely independent from, the executives. While board oversight is supposed to constrain agency costs, it is important to bear in mind that directors are themselves agents. Even if they do not act selfishly, they may lack strong incentives to maximize shareholder wealth. Moreover, courts must supervise board conduct and independence on a case by case basis, which contributes to indeterminacy.

While many unincorporations also have institutions that resemble corporate boards, they do not have important monitoring functions. For example, here is how Blackstone Group, L.P. describes its management structure:

As a public company, we intend to continue to employ our current management structure with strong central management by our founders and to maintain our focus on achieving successful growth over the long term. This desire to preserve our current management structure is one of the principal reasons why we have decided to organize The Blackstone Group L.P. as a limited partnership that is managed by our general partner and to avail ourselves of the limited partnership exception from certain of the New York Stock Exchange governance rules, which eliminates the requirements that we have a majority of independent directors on our board of directors and that we have a compensation committee and a nominating and corporate governance committee composed entirely of independent directors.<sup>6</sup>

Uncorporate directors are more like expert and involved colleagues than independent and powerful monitors. Uncorporate board powers under the agreement normally address specific matters such as conflicts rather than being a broad mandate to supervise management.<sup>7</sup> Uncorporations' lack of reliance on a board means that courts

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<sup>5</sup> See LUCIAN A. BEBCHUK & JESSE A. FRIED, *PAY WITHOUT PERFORMANCE* (2004); Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

<sup>6</sup> See Blackstone Group L.P., Form S-1A (filed June 21, 2007) ("Blackstone Agreement") at 188, available at <http://files.shareholder.com/downloads/BX/245990728x0xS1047469-07-5100/1393818/filing.pdf>, at 195.

<sup>7</sup> See *id.* at 161-62 (describing Blackstone board committees, including conflicts committee).

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have less need in this context than in corporations to develop rules to supervise boards' election, qualifications and operation.

### B. CAPITAL LOCK-IN

Managers' power is a function of what Hansmann & Kraakman have called “affirmative asset partitioning,” which separates the firm’s from the owners’ assets.<sup>8</sup> While this feature inheres in firms generally, corporations uniquely have the characteristic of capital lock-in, or liquidation protection. This insulates corporate assets, and more importantly managers' power, from the owners' ability to force liquidation. Some scholars argue that this feature has enabled the modern firm.<sup>9</sup>

Capital lock-in directly accounts for one form of indeterminacy in corporation noted by Carney and Shepherd – the interpretation of dividend provisions in preferred share contracts. Preferred shares can be used to ensure distributions to holders. However, despite these contracts’ apparent assurances of distributions, they still leave the board with significant power. For example, *Baron v. Allied Artists Pictures Corp.*<sup>10</sup> held that preferred shareholders who had taken control of the board under a preferred share agreement that provided for transfer of control when dividends were skipped could decide when to resume dividends and thereby relinquish control. The court rejected an alternative interpretation that would have forced the board to distribute cash and thereby avoided the need for judicial review of the board's exercise of discretion.<sup>11</sup> Venture capital-financed firms have used preferred shares to empower venture capitalists to insist on refinancing, exit or distributions of cash. However, these powers may not fully protect the venture capitalists from abuse of power by entrepreneurs determined to hang onto control.<sup>12</sup>

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<sup>8</sup> See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000).

<sup>9</sup> See Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, in CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS 45 (Anna Grandori ed., Oxford U. Press 2004); Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1 (2004); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

<sup>10</sup> 337 A.2d 653 (Del. Ch. 1975), *app. dismissed*, 365 A.2d 136 (Del. 1976).

<sup>11</sup> Carney & Shepherd, *supra* note 1 at 44, criticize this case for creating an indeterminate exception to the general rule of no fiduciary duties to preferred shareholders. In fact, the fiduciary duty would have been by a preferred-controlled board to the common shareholders. But in any case the board’s broad power necessitated the creation of an indeterminate board duty.

<sup>12</sup> A prominent example of such a case is *Equity-Linked Investors, L.P. v. Adams*, 705 A. 2d 1040 (Del. Ch. 1997). For an analysis of the case and a plea for broader judicial remedies to protect the preferred, see William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002). Even apart from the risk of owner opportunism, venture capital preferred shares are mostly useful for end-game solutions rather than to assure continued distribution of cash. The main point to emphasize here is that, even if preferred shares are an optimal tool in the venture capital context, they cannot fully substitute for unincorporate governance forms outside this setting.

Given the board's power over distributions, debt is the main way to ensure a continuing flow of distributions to investors. The corporate tax and the firm's ability to deduct interest payments reduce owners' incentive to devise contractual mechanisms to compel distributions. Accordingly, corporations can constraint earnings retention only at the cost of an increased bankruptcy risk.

Partners long have been able to provide for capital lock-in by contract,<sup>13</sup> and many LLC and limited partnership statutes now provide by default that individual members cannot unilaterally compel the firm to dissolve or demand cash for their interests upon dissociating from the firm.<sup>14</sup> But unincorporate standard forms are more conducive to contracts that loosen managers' control over the firm's cash. Corporate statutes permit strong constraints on managerial discretion only in closely held corporations.<sup>15</sup> Even if the constraints are valid, courts would strictly construe them as inconsistent with corporate norms of retaining earnings under managerial control.<sup>16</sup> By contrast, nothing prevents unincorporate firms from contracting regarding distributions, and unincorporation agreements such as those in master limited partnerships often do include such provisions.<sup>17</sup>

Uncorporations also can loosen managers' hold over the firm's cash by compelling dissolution and termination after a set period of time.<sup>18</sup> Provisions requiring termination and liquidation are common in venture capital and private equity funds.<sup>19</sup> Indeed, limited partnership statutes once commonly provided by default for a termination date.<sup>20</sup> By contrast, courts might hesitate to enforce mandatory termination as

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<sup>13</sup> See Larry E. Ribstein, *Should History Lock in Lock-in*, 41 *Tulsa Law Review* 525 (2006).

<sup>14</sup> See, e.g., Revised Uniform Limited Liability Act, §§404(b), 603; Revised Uniform Limited Liability Company Act, §§603, 701.

<sup>15</sup> See, e.g., Del. G. C.L. §§ 341-356. Although *id.* §141 provides for charter restrictions on board power, and *id.* §356 in the close corporation subchapter does not invalidate provisions authorized under other sections, an open-ended interpretation of this provision might conflict with the statute's explicitly permitting displacing the board only in firms that elect and qualify to be close corporations. See Ribstein, *supra* note at 197 (discussing limits on restricting board discretion).

<sup>16</sup> See Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 *WASH. & LEE L. REV.* 1159, 1218-19, 1223-28 (2004).

<sup>17</sup> See John Goodgame, *Master Limited Partnership Governance*, 60 *BUS. LAW.* 471 (2005).

<sup>18</sup> See, e.g., *Anthony v. Padmar, Inc.*, 307 S.C. 503, 415 S.E.2d 828 (1992), on other grounds *aff'd in part, rev'd in part*, 320 S.C. 436, 465 S.E.2d 745 (1996) (dissolution on sale of all or substantially oall of the assets).

<sup>19</sup> See Brian R. Cheffins & John Armour, *The Eclipse of Private Equity*, ECGI - Law Working Paper No. 082/2007 at 10, available at <http://ssrn.com/abstract=982114>; Phillippe Aghion et al., *Exit Options in Corporate Finance: Liquidity Versus Incentives*, 8 *REV. FIN.* 327 (2004); Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 *U. TORONTO L.J.* 101 (2003); Michael C. Jensen, *The Economic Case For Private Equity*, available at <http://papers.ssrn.com/abstract=963530> (February 15, 2007); Ribstein, *Uncorporating*, *supra* note 3, Part II.B.; D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 *UCLA L. Rev.* 315 at 345-56 (2005).

<sup>20</sup> See RULPA §801(1); *Tsakos Shipping & Trading, S.A. v. Juniper Garden Town Homes, Ltd.*, 12 Cal. App. 4th 74, 92, 15 Cal. Rptr. 2d 585, 595 (1993); *Levine v Levine*, 648 So. 2d 1228, 20 Fla. L.

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inconsistent with the board's fundamental power to initiate dissolution and other fundamental transactions.

The power to compel distributions or termination of uncorporations is significant because it exposes managers to the discipline of the capital markets. This gives managers a strong incentive to maintain the value of the firms they manage. By contrast, corporate managers' power to retain earnings gives them permanent capital and thereby insulates them from the need to beg capital markets for more funding.

### C. OWNER VOTING

Shareholders' powers to elect directors and vote on major corporate transactions are important mechanisms for constraining the agency costs inherent in the separation of ownership and control. Corporations align voting power with ownership interests precisely in order to give shareholders the right incentives to perform this role.<sup>21</sup> However, in several respects the theory of corporate ownership breaks down in practice. Public corporation shareholders with small ownership interests have little incentive to invest in monitoring because other owners can free-ride on their efforts. Although shareholders could buy enough shares to mitigate this problem, regulatory and tax rules constrain this strategy, as Mark Roe has discussed.<sup>22</sup> Shareholders such as labor unions may have ample incentives to exercise control on behalf of their members whose interests may differ from those of most corporate shareholders.<sup>23</sup> Other large undiversified shareholders may have different incentives from shareholders who hold diversified portfolios. Large institutional shareholders' managers have the same sort of agency problems as the managers of their portfolio firms. And the technology of shareholder voting is subject to numerous pathologies that tend to make voting complex and opaque and to misalign ownership and control.<sup>24</sup>

Perhaps the most important limit on the effectiveness of shareholder voting as a monitoring device is that it is ultimately subject to the control of the very managers the

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Weekly D201 (Fla. App. 1995).

<sup>21</sup> See Robert B. Thompson & Paul H. Edelman, *Corporate Voting in a World of Financial Engineering* (ms. February 11, 2008) (arguing that shareholder voting performs an "error-correcting" function that explains why only shareholders and not other corporate constituencies may vote, and analyzing one-share-one-vote rules and restrictions on separating ownership and voting in light of that function).

<sup>22</sup> See Mark J. Roe, *STRONG MANAGERS, WEAK OWNERS* (1996).

<sup>23</sup> See Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 *UCLA L. REV.* 601, 634 n.88 (2006) (noting that "the most activist institutions—union and state and local employee pension funds—may have interests that diverge substantially from those of other investors"). For discussions of the incentives of activist shareholders see Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *GEO. L.J.* 445, 479–81 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 *COLUM. L. REV.* 795, 801–19 (1993); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 *MICH. L. REV.* 1018, 1033–34 (1998).

<sup>24</sup> See Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, available at <http://ssrn.com/abstract=1007065>, forthcoming Georgetown L.J.

shareholders are trying to monitor. Managers can exercise their broad power in a number of ways to dilute owner voting power, as through poison pills and other devices that impede the market for control. Carney & Shepherd show that part of the complexity and indeterminacy of fiduciary duties owes to rules like the *Blasius* "compelling justification" standard which are intended to protect against interference with the shareholders' franchise.<sup>25</sup>

Although strong owner participation is a default rule in general partnerships, many unincorporate firms dispense with the costly pretense of shareholder voting rights. For example, limited partnership statutes provide for no or very limited voting rights.<sup>26</sup> Unincorporate firms may eliminate most owner voting rights,<sup>27</sup> substituting the alternative constraints on management discussed in this part, including profit-based compensation, liquidation rights and cash distributions.

#### **D. THE MARKET FOR CONTROL**

Despite the problems discussed in the previous subpart, shareholder voting might work as a meaningful constraint on managerial power through shareholders' ability to freely transfer both management and economic rights to owners who can aggregate the shares into control blocks. Henry Manne explained how this market for control can answer Berle & Means' critique of corporate governance.<sup>28</sup>

In practice, however, the market for control is subject to significant limitations. Strong takeover defenses, state anti-takeover statutes and the federal Williams Act<sup>29</sup> have increased the cost of hostile takeovers and therefore reduced their effectiveness as a check on inefficient management. Incumbent managers have strong powers and

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<sup>25</sup> See *Blasius Industries, Inc. v Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), discussed in Carney & Shepherd, *supra* note 1 at \_\_\_.

<sup>26</sup> Neither the original Uniform Limited Partnership Act (1916), nor the 1985 Revised Uniform Limited Partnership Act on which most current state statutes are based, provided for limited partner voting rights. The most recent version of the Uniform Limited Partnership Act gives limited partners only a right to vote on fundamental transactions, and no default right to periodically elect the firm's managers. See ULPA (2001) §406. Note, however, that partnerships are subject to many of the governance rules in the New York Stock Exchange Listed Company Manual. The main exception is the rules for owner approval of securities issuances (§312.03).

<sup>27</sup> See Blackstone Agreement, *supra* note 6 at 12 (noting that "[u]nlike the holders of common stock in a corporation, our common unitholders will have only limited voting rights and will have no right to elect our general partner or its directors, which will be elected by our founders").

<sup>28</sup> See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

<sup>29</sup> See Securities and Exchange Act of 1934 § 13(d)(1) (requiring disclosure by any person or group that acquires 5% of a class of securities, thus limiting the initial "stake" that a bidder can acquire before the market becomes aware of the increased likelihood of a premium bid); 14(d)(1), (f) (requiring disclosure by bidders upon the making of a tender offer and upon the seriatim resignation of directors that often accompanies a transfer of control; §14(d)(5)-(7) (regulating the substantive terms of a bidder's offer to shareholders; § 14(e) (general antifraud provision); §14(d)(4) (regulating management recommendations to shareholders).

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significant discretion to resist takeovers. Shareholders may even lack legal power to take the initiative to vote down or prohibit poison pills or other takeover defenses,<sup>30</sup> and face the usual free-rider problem in exercising any formal power they have. And courts are as reluctant to second-guess takeover defenses as they are other business decisions.<sup>31</sup>

Uncorporation managers generally are insulated from the market for control. Uncorporation owners cannot by default freely transfer management rights.<sup>32</sup> This means that rather than having to provide for takeover defensive moves which are subject to court scrutiny and interpretation, uncorporation managers get the strongest protection of all – no owner power to transfer management rights – from the statute itself. At the same time, uncorporations have incentive and other devices that make the control market less necessary. These devices provide an alternative to the market for control by forcing managers to return to the capital markets to fund their activities.<sup>33</sup>

### E. FIDUCIARY DUTIES

A distinction between corporations and uncorporations that is critical to the indeterminacy criticism of Delaware corporate law concerns corporate fiduciary duties and remedies. The corporate reliance on fiduciary duties gives rise to most of the indeterminacy and other problems Carney & Shepherd discuss. As long as courts rather than the parties to firms have to cope with the increasingly complex and dynamic corporate environment, such as new takeover and defensive technologies, significant indeterminacy is inevitable. Yet corporations need fiduciary duties, despite their indeterminacy, to address the misalignment of managers' incentives with those of members.

Fiduciary duties might seem to be even more important in uncorporations than in corporations. Justice Cardozo famously stated in *Meinhard v. Salmon*<sup>34</sup> that “[n]ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” But it is questionable that partners in standard form partnerships even have fiduciary duties because their role as co-managers constrains their conduct without the

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<sup>30</sup> See Lawrence A. Hamermesh, *Corporate Democracy and Shareholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998).

<sup>31</sup> For a review of cases under the Delaware test for managers' fiduciary duties in defending against takeovers, see Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769 (2006).

<sup>32</sup> See, e.g., RUPA §502 (1997) (defining a partner's transferable interest as the partner's share of profits and losses and right to receive distributions); 503 (permitting transfer of transferable interest); Revised ULLCA §502 (permitting transfer of economic rights).

<sup>33</sup> Ironically, private equity firms, though insulated from the market for control, help drive the corporate control market by providing an alternative management structure for target firms. For a discussion of the incentive structure of private equity, see Ribstein, *Uncorporating*, *supra* note 3, Section II.B.1. For a discussion of how the ex ante financial structure of the fund works in combination with ex post debt financing of the deal to provide the necessary incentives, see Ulf Axelson, Per Stromberg & Michael S. Weisbach, *Why are Buyouts Leveraged? The Financial Structure of Private Equity Funds* (January 4, 2007), available at <http://ssrn.com/abstract=676546>.

<sup>34</sup> 164 N.E. 545, 546 (N.Y. 1928)

need for such duties.<sup>35</sup> Even in large unincorporated firms fiduciary duties may not be worth bearing because unincorporate managers' strong incentives and owners' liquidation and distribution rights can provide enough discipline. Moreover, there is so much variation among unincorporations regarding management structure and the powers of owners and managers that the rules have to be provided by customized agreements rather than standard forms. These considerations point to a need for greater flexibility of fiduciary duties in unincorporations as compared with corporations.

This contrast between the role of fiduciary duties in corporations and unincorporations helps explain why Delaware limits fiduciary duty waivers in corporations while, as discussed in the next Part, freely allowing waiver in unincorporated firms.<sup>36</sup> The Delaware corporation statute permits waiver only of the duty of care subject to a good faith qualifier.<sup>37</sup> The qualifier took on importance when the Delaware Supreme Court held in *Stone v. Ritter*<sup>38</sup> that a board's conscious failure to adopt a compliance program in the face of a known duty to act may constitute a breach of good faith that survives a charter limitation on the board's duty of care.

### III. DELAWARE'S UNINCORPORATE JURISPRUDENCE

Part II's analysis has important implications for the Carney-Shepherd thesis. Because unincorporations rely less on fiduciary duties and monitoring by shareholders and independent directors they require less judicial supervision than corporations. Unincorporations also can rely on customized contractual powers, duties and remedies. Courts adjudicating unincorporation cases therefore need not react to new business developments with retroactively applied rules as they do in corporate cases. Instead, they can simply enforce firms' contracts, which could be expected to evolve over time to meet firms' needs. Moreover, this enabling approach would make contracts available to fix problems in the judicial rules, in contrast to the mandatory corporate setting Carney & Shepherd describe.

Indeed, this Part shows that Delaware law accommodates unincorporations' distinct needs with an approach that enforces contracts and eschews mandatory fiduciary rules.<sup>39</sup>

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<sup>35</sup> See Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 ILL. L. REV. 209.

<sup>36</sup> Despite this explanation, it still might be argued that even corporate owners should be allowed to contract for the extent of fiduciary duties. See Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1 (1990). Perhaps there is an argument for bundling the power to waive fiduciary duties with choice of form. The question remains whether waiver should be subject to the extra costs of bundling.

<sup>37</sup> See Del. Gen. Corp. L. §102(b)(7). The statute also permits contractual qualification of liability for usurping corporate opportunities. See *id.* §122(17).

<sup>38</sup> 911 A.2d 362, 365 (Del. 2006).

<sup>39</sup> A possible caveat to this analysis is that the Delaware cases discussed below generally do not explicitly or even implicitly connect the distinct needs or governance approaches of unincorporations to the contractual analysis. Thus, the courts do not identify the unincorporate governance devices present in the specific situations that make fiduciary duties and other corporate devices less necessary, and may even stress the presence of corporate devices such as voting rights. This point is discussed further in *infra*

## The Uncorporation and Corporate Indeterminacy

Subpart A describes the statutory backbone of the Delaware unincorporate approach. Subpart B analyzes the fundamentally contractual analysis in the Delaware limited partnership and LLC cases decided since enactment of this statute.

### A. STATUTORY BASIS FOR THE CONTRACTUAL APPROACH

Delaware LLC and limited partnership statutory provisions permit complete waiver of fiduciary duties.<sup>40</sup> The limited partnership version (the LLC version is substantively the same) provides:

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.

(f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

These provisions sharply contrast with the more limited authorization of duty of care opt-outs in the corporate context.<sup>41</sup> Although both the corporate and partnership waiver provisions are subject to a "good faith" limitation, the partnership provision explicitly refers to "the implied contractual covenant of good faith and fair dealing," thereby inviting a contractual rather than an open-ended fiduciary analysis. This language should prevent courts from importing a *Stone v. Ritter*-type qualification<sup>42</sup> into the partnership setting.

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subpart IV.

<sup>40</sup> See Del. Code, tit. 6, §17-1101 (applying to limited partnerships); *id.* §18-1101 (applying to LLCs). At least 13 other state LLC state statutes provide for waiver of fiduciary duties without specific restrictions. See Larry E. Ribstein & Robert Keatinge, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, Ch. 9, app. 1.

<sup>41</sup> See *supra* notes 37-38 and accompanying text.

<sup>42</sup> See *supra* text accompanying note 38.

Carney & Shepherd's analysis suggests that judges might carry the indeterminacy of the corporate approach over to unincorporations despite these waiver provisions. Courts often have the leeway to do so even while purportedly enforcing the contract because the parties cannot contract explicitly for all contingencies, leaving room for interpretation and application of the implied good faith covenant. The unincorporation cases therefore provide an opportunity to test whether indeterminacy is attributable to judges or to the corporate form.

In an important 2004 speech, published in 2007,<sup>43</sup> Delaware Chief Justice Steele recognized Delaware judges' temptation to corporatize unincorporate law and admonished them not to do it. Chief Justice Steele wrote that "courts should look to the parties' agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance."<sup>44</sup> Rather than applying a "status" approach that applies default fiduciary duties regardless of the contract, the Chief Justice suggested that courts begin their analysis with the language and structure of the parties' contract. This entails interpreting the statute consistent with its evident intent and applying a contractual rather than fiduciary approach to the "good faith" obligation. The Delaware *contractual* good faith qualification specified in the Delaware unincorporate provisions<sup>45</sup> applies only when it is clear from the parties' contract that the parties "would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter" may a party invoke the covenant's protections."<sup>46</sup> This attention to the parties' contract can avoid the indeterminacy of corporate-type fiduciary duties. The next subpart shows that the Delaware courts have, indeed, followed this approach.

## **B. THE CONTRACTUAL APPROACH IN UNINCORPORATE CASES**

Consistent with the statutory provisions discussed in Subpart A and the approach recommended by Chief Justice Steele, most Delaware unincorporate cases have held that fiduciary duties apply only in the gaps left by the contract, interpreted in light of the general contractual principle of good faith.<sup>47</sup> The following sections deal with the important recurring fact patterns in the Delaware cases involving interpretation of waivers and other provisions in operating agreements and the application of remedies.

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<sup>43</sup> Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. C. L. 1, 1 (2007).

<sup>44</sup> *Id.* at \_\_\_.

<sup>45</sup> See *supra* text accompanying note 41.

<sup>46</sup> *Id.* at 17 (quoting Chancellor Allen's opinion in *Katz v. Oak Indus., Inc.*, 508 A. 2d 873, 880 (Del. Ch. 1986).

<sup>47</sup> See Raju & Altman, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469 (2005); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004); Andrew Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 Wake Forest L. Rev. 123 (2006) (analyzing the good faith duty as a limitation on waiver).

# The Uncorporation and Corporate Indeterminacy

## 1. Limited partnership fiduciary duty restrictions

Unlike the shifting and confusion in corporate cases, the Delaware unincorporation cases have been mostly clear and consistent. By focusing the court's attention on the contract, the statute has discouraged courts from substituting judicial default rules for clearly articulated contractual duties. This clarity and consistency encourages the parties to Delaware limited partnerships and their lawyers to craft careful partnership agreements that describe the partners' responsibilities and limit their duties. The following are some of the more important Delaware limited partnership cases illustrating the Delaware courts' approach to applying the statutory freedom-of-contract provisions.

In *Kahn v. Icahn*<sup>48</sup> Chancellor Chandler dismissed a claim alleging that the general partner's owner breached duties to the limited partnership by allocating some profits from partnership opportunities to his affiliates. Chancellor Chandler reasoned that the Delaware statute made traditional fiduciary duties "defaults that may be modified by partnership agreements."<sup>49</sup> He added:

Plaintiffs ask me to craft a new principle of law by recognizing that partners have separate and immutable duties of loyalty irrespective of clear and unambiguous modifications of fiduciary duties provided in a legally enforceable partnership agreement. Under the facts alleged I cannot so hold, for Defendants' actions are covered by the Agreement and as such are permissible as a matter of law.

In *Sonet v. Timber Co. L.P.*,<sup>50</sup> Chancellor Chandler dismissed a claim based on a general partner's receiving an unfairly large amount of shares of a REIT into which the limited partnership was converted. The limited partnership agreement gave the general partner significant power to manage day-to-day affairs, subject to the requirement that its actions be fair and reasonable to the partnership. The general partner had sole discretion to engage in mergers and certain other extraordinary acts or transactions, subject to approval by a supermajority unitholder vote. In exchange for this approval right, the partner's discretion in these transactions was not subject to a fair and reasonable qualification.

The resolution of this case contrasts sharply with the corporate cases that, as Carney & Shepherd discuss, have struggled with whether and to what extent to subject transactions subject to owner vote to an additional fairness review. The Chancellor held that the "careful framework established by the Agreement confirms that to the extent that unitholders are unhappy with the proposed terms of the merger (and in this case the resultant conversion) their remedy is the ballot box, not the courthouse."<sup>51</sup> The Chancellor reasoned that "principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain." Because of the

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<sup>48</sup> 1998 WL 832629 (Del. Ch. Nov. 12, 1998).

<sup>49</sup> *Id.* at 2-3.

<sup>50</sup> 722 A. 2d 319 (Del. Ch. 1998).

<sup>51</sup> *Id.* at 326.

Delaware freedom-of-contract provision, which had attracted firms to make the "deliberate choice" to adopt the Delaware limited partnership form,<sup>52</sup>

courts should hesitate to draw from general principles of fairness in the corporate context. Rather, when faced with a clear opt out, a court should analyze a limited partnership fiduciary duty claim in terms of the operative governing instrument--the partnership agreement--and only when that document is silent or ambiguous, or when principles of equity are implicated, will a court begin to look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence.<sup>53</sup>

Vice Chancellor Strine has followed a similar approach in interpreting the scope of fiduciary duties under limited partnership agreements. Even in cases where there was no explicit waiver of default duties, the court resolved the disputes based on the duties provided for in the agreement, holding that these contractual duties in effect displaced default fiduciary duties.

In *R.S.M. Inc. v. Alliance Capital Management Holdings, L.P.*,<sup>54</sup> a general partner reorganized a public limited partnership into separate privately and publicly traded entities with the approval of a majority of the outside unitholders. Plaintiff claimed the transaction provided special tax advantages to the general partner. Vice Chancellor Strine held that the agreement's requirement of outside unitholder approval reduced the plaintiff's fiduciary claim to the single issue of inadequate disclosure, which the complaint sufficiently alleged.<sup>55</sup> The Vice Chancellor reasoned that *Sonet* required the application of default fiduciary duties in the absence of a clear waiver *if* such duties could be reconciled with the operation of the partnership agreement, as could a fiduciary duty of disclosure in the present case.<sup>56</sup> The court said that the agreement's voting provisions create "a safe harbor that, if effectively utilized, is outcome determinative. In the event that the safe harbor does not apply, the defendants would face liability under both contractual and fiduciary theories."<sup>57</sup> Again, the decision contrasts with corporate cases *Carney & Shepherd* criticize that leave unclear whether ratification or approval eliminates judicial scrutiny of transaction terms.

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<sup>52</sup> *Id.* at 321.

<sup>53</sup> *Id.* at 324.

<sup>54</sup> 790 A. 2d 478 (Del. Ch. 2001).

<sup>55</sup> The plaintiff alleged that the nondisclosure of the tax advantages of private partnership discouraged outside unitholders from converting into privately held shares, saving more of these shares for the general partner.

<sup>56</sup> *Id.* at 496-99.

<sup>57</sup> *Id.* at 499, n. 33.

## The Uncorporation and Corporate Indeterminacy

In *Miller v. American Real Estate Partners, L.P.*<sup>58</sup> Vice Chancellor Strine refused to hold that the agreement authorized the general partner to invest partnership funds to protect his own venture instead of pursuing investments that would be less risky and more profitable for the partnership. The agreement gave the general partner "full, exclusive and complete discretion to manage and control the business and affairs of the Partnership, to make all decisions affecting the business and affairs of the Partnership, and to take all such actions as it deems necessary or appropriate to accomplish the purposes of the Partnership as set forth herein."<sup>59</sup> The agreement also provided:

Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its "sole discretion" or "discretion", [sic] with "absolute discretion" or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its "good faith" or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.<sup>60</sup>

Vice Chancellor Strine held that the agreement not only failed explicitly to preclude the application of default fiduciary duties, but affirmatively revealed an intention to include such duties because the parties used a popular form but deleted language explicitly preempting default duties.<sup>61</sup> The court also noted references to default fiduciary duties in the registration statement used to sell the partnership interests. Preemption of fiduciary duties therefore was not "plain" enough under *Sonet* and default substantive fairness and bad faith duties applied.<sup>62</sup>

Although the court applied default fiduciary duties, it again emphasized the importance of the agreement. Vice Chancellor Strine said that the court

will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the

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<sup>58</sup> 2001 WL 1045643 (Del. Ch. Sept. 6, 2001). This case involved the same partnership as in *Kahn v. Icahn*, discussed *supra* text accompanying note 48, but dealt with different transactions and contract provisions.

<sup>59</sup> *Id.* at 7.

<sup>60</sup> *Id.* at 6.

<sup>61</sup> *Id.* at 9 (discussing Martin I. Lubaroff & Paul Altman, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS F-38, F-99 (2000 Supp.)).

<sup>62</sup> *Id.* at \*8, n. 25 (quoting *Sonet*, 722 A. 2d at 322).

DRULPA reflects the doctrine of caveat emptor, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.<sup>63</sup>

However, the court added:

[J]ust as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.<sup>64</sup>

*Miller* clearly illustrates the Delaware courts' two-pronged approach to ensuring clear delineation of rights in unincorporation cases. Under the first prong, an explicit agreement is enforced according to its terms. However, under the second prong, to the extent that the agreement does not explicitly exclude default duties, the court will apply such duties unless they cannot be reconciled with terms of the agreement. The two prongs together give parties a strong incentive to clarify their rights and thereby eliminate the need for judicial intervention. By contrast, in corporate cases, the parties' rights are determined almost entirely by applying fiduciary principles, which the court must adapt to firms' changing needs.

Later cases further explain when to interpret the agreement to preempt fiduciary duties. *Continental Insurance Co. v. Rutledge & Co.*<sup>65</sup> held that a provision permitting a general partner to "engage in other business activities or possess interests in other business activities of every kind and description, independently or with others" did not permit self-dealing. *Marriott Hotel Properties II Limited Partnership*,<sup>66</sup> held that the following provision preserved default fiduciary duties and thereby provided the basis for a claim based on a squeeze-out of the limited partners by manipulation of distributions:

The General Partner shall be under a duty to conduct the affairs of the Partnership in good faith and in accordance with the terms of this Agreement. . . . Nothing contained in the Agreement is intended or shall be construed to contract away the fiduciary duty of the General Partner to the limited partners.

The above cases were decided by the Delaware Chancery Court. So far the Supreme Court has issued only one important limited partnership opinion, *Gotham*

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<sup>63</sup> *Id.* at \*8 (internal footnote by court omitted).

<sup>64</sup> *Id.* at \*8 (internal citation omitted).

<sup>65</sup> 2000 WL 268297 (Del. Ch. Feb. 15, 2000).

<sup>66</sup> 2000 WL 128875 (Del. Ch. Jan. 24, 2000).

## The Uncorporation and Corporate Indeterminacy

*Partners, L.P. v. Hallwood Realty Partners, L.P.*<sup>67</sup> In this case a publicly held hedge fund made a public offer for so-called "odd lot" units that significantly increased the ownership percentage of the general partner's parent. This transaction involved a managerial conflict of interest that would have been subject to the mandatory fiduciary duty of loyalty in a corporation. However, the partnership agreement required only that the terms of self-dealing transactions involving resale of units be "substantially equivalent to terms obtainable by the Partnership from a comparable unaffiliated third party," and for audit committee review. The court applied the contractual standard to what it deemed to be a resale, and held that defendant had breached the standard by failing to comply with the contract's procedural safeguards. It was clear under the court's reasoning that this self-dealing standard would not have applied had the transaction been an issuance rather than a resale.

The most notable aspect of this case is not its holding or result but its dictum. Chief Justice Veasey's opinion expressed "concern and caution relating to . . . dubious dictum" in the trial court's opinion suggesting that a limited partnership agreement may eliminate fiduciary duties, noting that the statute did not so provide.<sup>68</sup> The court noted "the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly."<sup>69</sup> The court added that this issue could not be fully dealt with by the implied covenant of good faith and fair dealing as the trial court had suggested, stating that "[t]he issue of good faith and fair dealing is not before us, and we need not express any opinion on that issue in this case."<sup>70</sup>

The Delaware legislature swiftly reacted to the court's "caution" by amending the statute to explicitly permit elimination of fiduciary duties in limited partnership and LLC agreements.<sup>71</sup> This exchange between the courts and the legislature confirmed the primacy of the agreement indicated by the earlier Chancery Court opinions.

Chief Justice Steele later criticized his predecessor's opinion, consistent with his view that Delaware courts in unincorporate cases should adhere to the contract rather than presuming in favor of the fiduciary duties that normally attach to fiduciary status. Chief Justice Steele said:

The supreme court apparently found it difficult to abandon the view that judicial oversight of disputes within the governance structure of limited liability unincorporated entities must invariably be from the perspective of a set of

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<sup>67</sup> 817 A. 2d 160 (Del. 2002).

<sup>68</sup> *Id.* at 167-68.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 168, n. 17.

<sup>71</sup> Del. Code, tit. 6, §§17-1101, 18-1101 [cite to amending statute].

freestanding non-waivable equitable principles, drawn from the common law of corporate governance.<sup>72</sup>

He added that the post-*Gotham* amendment "leaves little, if any, room for argument over whether the contract relationship has triumphed over the status relationship in Delaware limited partnership and limited liability company internal governance scrutiny."

## 2. LLC operating agreements

Delaware LLC cases exhibit the same tendency as the limited partnership opinions to enforce agreements when they clearly supersede default duties, and more generally to apply a distinct contractual approach to unincorporate cases. For example, *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies Inc.*<sup>73</sup> declined to impose

a judicially encrusted requirement that the LLC managers provide proxy-statement-like disclosures each time they make a capital call. This would be inefficient and would threaten to convert the duty to disclose all material facts in connection with a discretionary vote or tender into a pervasive, across-the-board rule governing all entity disclosures, because entity owners can usually connect any disclosure to a decision they might make (e.g., the decision whether to hold or sell their ownership interests).

Other chancery court LLC cases emphasized the controlling effect of the operating agreement, consistent with the limited partnership cases discussed above. *Walker v. Resource Development Co. Ltd., L.L.C. (DE)*,<sup>74</sup> held that members could not remove a misbehaving co-member operating agreement authorization, stating that the statute merely fills gaps in the agreement, and that "LLC members' rights begin with and typically end with the Operating Agreement." Thus, the members were not protected by good faith reliance on the agreement pursuant to the LLC equivalent of the limited partnership freedom-of-contract provision quoted above. *Minnesota Invco of RSA #£7, Inc. v. Midwest Wireless Holdings LLC*<sup>75</sup> interpreted the operating agreement as permitting sale of the majority interest over the objection of the minority owners, and permitting the controlling member to exercise his voting power to amend the agreement to clarify the absence of first refusal rights. And *Eureka VIII LLC v. Niagara Falls Holdings LLC*<sup>76</sup> rigorously enforced an LLC operating agreement permitting a 50% owner to become the sole member because the other member's granting of a security interest and the death of the person who controlled the other member breached the LLC

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<sup>72</sup> Steele, *supra* note 43 at 12.

<sup>73</sup> 854 A.2d 121, 158 (Del. Ch. 2004). However, the court applied the corporate rule in *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) limiting liability to statements made in the context of shareholder voting or tendering.

<sup>74</sup> 791 A.2d 799 (Del. Ch. 2000).

<sup>75</sup> 903 A.2d 786 (Del. Ch. 2006).

<sup>76</sup> 899 A.2d 95 (Del. Ch. 2006).

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agreement. The court effectuated the non-breaching member's clear intent to bar membership of anyone it disapproved of, odd as it might seem for death to be a contract breach.

An unincorporate agreement may implicitly authorize judicial application of corporate-type fiduciary duties by using fiduciary language, as Chief Justice Steele recognized.<sup>77</sup> For example the court in *Solar Cells, Inc. v. True North Partners, LLC*<sup>78</sup> preliminarily enjoined a merger based on evidence of lack of fair dealing and fair price, where the agreement waived liability for conflict of interest "provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar]." Also, *In re Regional Diagnostics, LLC*,<sup>79</sup> a federal bankruptcy court applying Delaware law applied the Delaware corporate rule in *Stone v. Ritter* in holding that the conduct at issue in the case was not with a clause of the operating agreement exculpating liability for acts in good faith.

At least one case, however, provides a troubling indication that corporate-type analysis has not been expunged from the Delaware unincorporate cases. *VGS, Inc. v. Castiel*<sup>80</sup> held that managers who secretly schemed to take power away from the manager by persuading a director appointed by controlling member to switch sides "breached their duty of loyalty to the original member and their fellow manager by failing to act in good faith." The court reached the right result because the case arguably involved an abuse of agreed governance powers contrary to the implied covenant of good faith and fair dealing.<sup>81</sup> But the court was wrong to ground its result on a breach of the duty of loyalty, since the managers were acting as owners under the contract rather than as fiduciaries. Chief Justice Steele singled out *VGS* as an example of how "Delaware courts have continued to focus on the status relationships of the parties, rather than upon their contractual relationship when resolving governance disputes."<sup>82</sup> *VGS* might not be decided the same way today in the wake of the Chief Justice's instructions to Delaware courts.

### 3. Limited partnership agreements

Limited partnerships theoretically should present the same issues as LLCs since both types of firms are unincorporations operating under similar statutory provisions giving primacy to the parties' agreement.<sup>83</sup> If there is any distinction, limited partnership fiduciary provisions should present fewer problems since their agreements often will be

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<sup>77</sup> See Steele, *supra* note 43 at \_\_\_.

<sup>78</sup> 2002 WL 749163 (Del. Ch. 2002).

<sup>79</sup> 2007 WL 1587256 (Bkrcty.N.D. Ohio, June 01, 2007) (Del. law).

<sup>80</sup> 2000 WL 1277372 (Del. Ch. 2000).

<sup>81</sup> For an analysis rationalizing the result along these lines, see Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 Ill. L. Rev. 209, 250, n. 12.

<sup>82</sup> Steele, *supra* note 43 at 28.

<sup>83</sup> See *supra* note 40 and accompanying text.

more heavily lawyered than those in more informal LLCs.<sup>84</sup> However, because of the traditionally subordinate role of limited partners, limited partnerships also may tend to involve greater delegation of power to the managing general partners, which increases the importance of agency-cost control mechanisms. Although this control can be provided by unincorporate-type disciplinary mechanisms rather than fiduciary duties, courts that are not sufficiently sensitive to the different transactional background may erroneously carry corporate-type fiduciary duties over to unincorporations. Two significant post-*Gotham* limited partnership opinions indicate that the Delaware chancery court continues to struggle with the contractual approach in unincorporate cases.

In *Twin Bridges Ltd Partnership v. Draper*,<sup>85</sup> two general partners of a family limited partnership had deadlocked under a partnership agreement requiring both general partners to agree to "all major decisions" affecting the partnership. The agreement allowed amendment by two thirds of the capital interests of all general and limited partners. One of the general partners formed a coalition with most of the limited partners to circumvent the other partner. The coalition first amended the agreement to add a provision enabling merger by two thirds of the partnership interests executed by either general partner, and then authorized a merger that had the effect of amending the partnership agreement by adding a third general partner – namely, one of the former limited partners. Vice Chancellor Parsons reasoned that

Under Delaware limited partnership law, a limited partnership is a creature of both statute and contract. The Delaware Revised Uniform Limited Partnership Act “embodies the policy of freedom of contract and maximum flexibility.” [citing *Gotham Partners*] As the Delaware Supreme Court has recognized, parties to a Delaware limited partnership have the discretion to create a limited partnership “in an environment of private ordering” and operate that entity according to the provisions in the limited partnership agreement. The provisions of the partnership agreement define the contractually bargained rights and responsibilities of those who are parties to the agreement and are afforded significant deference by the courts. Limited partnerships, therefore, offer contractual flexibility with few statutory constraints.<sup>86</sup>

The court added:<sup>87</sup>

Consistent with the underlying policy of freedom of contract espoused by the Delaware Legislature, limited partnership agreements are to be construed in accordance with their literal terms. “The operative document is the limited partnership agreement and the statute merely provides the ‘fall-back’ or default provisions where the partnership agreement is silent.” Only “if the partners have not expressly made provisions in their partnership agreement or if the agreement

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<sup>84</sup> See *supra* text accompanying note **Error! Bookmark not defined.**

<sup>85</sup> 2007 WEL 2744609 (Del. Ch. Sept. 14, 2007).

<sup>86</sup> *Id.* at 8 [footnotes omitted].

<sup>87</sup> *Id.* at 13 [most footnotes omitted].

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is inconsistent with mandatory statutory provisions, ... will [a court] look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence.” In other words, unless the partnership agreement is silent or ambiguous, a court will not look for extrinsic guidance elsewhere, so as to “give maximum effect to the principle of freedom of contract” and maintain the preeminence of the intent of the parties to the contract.<sup>73</sup> Based on these overarching principles of limited partnership law, I now turn to the interpretation of Paragraph 31(b).

**73.** See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. of Corp. L. 1 (2007); see also *Elf Atochem N. Am., Inc. v. Jaffari*, 727 A.2d 286, 291 (Del.1999) (“The basic approach of the Delaware Act is to provide members with broad discretion in drafting the Agreement and to furnish default provisions when the members' agreement is silent”).

Consistent with the Chief Justice's recommendation, the court carefully construed the operating agreement and held that it permitted the integrated merger and amendment.<sup>88</sup> The court also held that since the transaction was authorized by the operating agreement and was not "clearly against the intent of the parties as expressed in the [partnership agreement]" it did not violate the implied duty of good faith and fair dealing.<sup>89</sup>

The court was careful not to let default rules intrude on the enforcement of the specific provisions of the parties' agreement. The court said:

As the Delaware Supreme Court in *Gotham Partners* instructs, the Legislature's basic approach in limited partnerships is to maintain the policy of freedom of contract and maximum flexibility. A court will superimpose statutory default rules onto a written agreement “only in situations where the partners have not expressly made provisions in their partnership agreement,” or where the agreement is inconsistent with mandatory statutory provisions. Hence, a court must tread lightly when determining whether to apply default statutory provisions to an agreement of limited partnership.<sup>90</sup>

The court also appropriately refused to import a corporate statutory provision requiring a unanimous vote to amend the partnership agreement to allow approval of a merger by a lesser vote. The court said:

Because the conceptual underpinnings of the corporation law and Delaware's limited partnership law are different, courts should be wary of uncritically importing requirements from the DGCL into the limited partnership

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<sup>88</sup> Specifically, the court held that the step transaction did not have the effect of permitting limited partners to participate in control, which would have required unanimous consent under the operating agreement.

<sup>89</sup> *Id.* at 17.

<sup>90</sup> *Id.* at 18 [footnotes omitted].

context.<sup>113</sup> Further, Section 242(b)(4) differs significantly from Section 17-211(b) of DRULPA. The latter constitutes a default rule meant to be applied only if the partnership agreement is silent on the vote needed to approve a merger. In contrast, Section 242(b)(4) positively requires that any alteration, amendment, or repeal of a supermajority vote requirement in a certificate of incorporation be accomplished with the approval of the same supermajority. No comparable, affirmative requirement appears in DRULPA, and I do not perceive any basis for implying such a requirement.

**113.** See Steele, *supra* note 73, at 10-13, 19 (describing the evolution of DRULPA § 17-1101(d), which allows a limited partnership to contract away partners' fiduciary duties, and how the Legislature enacted it in response to the Delaware Supreme Court's willingness in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del.2002) to incorporate fiduciary duties from the common law of Delaware corporations into the partnership context).

Although the opinion generally adhered to the agreement and to partnership principles, in one respect the vice chancellor allowed the corporate nose under the unincorporate tent. The partner opposing the transaction claimed that the other general partner's involvement in the amendment and merger was a breach of the duty of loyalty. While nodding to the partnership's ability to eliminate fiduciary duties,<sup>91</sup> the court said that unless these duties are preempted, general partners have a loyalty duty comparable to that of corporate directors.<sup>92</sup> The proponent of the transaction stressed that no self-dealing transactions had taken place. But the court noted that the new partnership agreement entered into in connection with the merger eliminated all fiduciary duties in connection with development and implementation of a Development Plan. This could result in shielding a future self-dealing transaction without the objecting partner's approval. The court cited the corporate case of *Schnell v. Chris-Craft Industries, Inc.*<sup>93</sup> for the proposition that a transaction complying with law may nevertheless be inequitable. Because allowing this transaction would eliminate any future right to self-dealing review and permit the lower level of good faith review, the court denied dismissal of these claims.

The court's decision on this last point is arguable because it is not clear why the parties could not amend the agreement to eliminate fiduciary duties. The specific question should be whether such an amendment was permitted by the express terms of the original contract construed in light of the parties' contractual obligation of good faith. Instead of applying a narrow contractual analysis, the court nodded to the *Schnell* rule, thereby introducing corporate-style indeterminacy.

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<sup>91</sup> *Id.* at 20, n. 123.

<sup>92</sup> *Id.* at 20.

<sup>93</sup> 285 A. 2d 437 (Del. 1971).

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*Forsythe v. ESC Fund Management Co.*<sup>94</sup> excused partner demand in a limited partnership derivative suit and then held on similar grounds that the complaint's allegations of mismanagement withstood dismissal on the merits. Although the case does not involve a fiduciary opt-out, it is instructive both on interpretation of the agreement and application of general corporate standards. The limited partnership was a fund set up by a bank to offer some of its employees an opportunity to co-invest with the bank. The plaintiff alleged that the bank had actually schemed to free its capital from underperforming investments, and mismanagement had cost the fund 75% of its value. The court held that the relevant standard of excuse involved breach not of the general corporate duty of care, but of a higher oversight duty that the partnership agreement imposed on the general partner. Because the agreement provided for the general partner to delegate most of its functions to affiliates of the bank that established the fund, the general partner's only remaining duty was that of oversight, which was important because of the affiliates' conflicts of interest. The court held that the complaint adequately alleged breach of this duty by failure to take any steps to inquire into investment decisions.

The court's decision is questionable. The agreement in *Forsythe* provided that the general partner and the advisors were liable only for actions or omissions resulting from their bad faith, willful misconduct, gross negligence, or a material breach of the Partnership Agreement,<sup>95</sup> which is similar to the general gross negligence or recklessness standard applied in partnerships.<sup>96</sup> The court noted that the Delaware Supreme Court held in *Stone* that directors "are liable for breach of their oversight duty only if they ignore 'red flags' that actually come to their attention, warning of compliance problems."<sup>97</sup> But the *Forsythe* complaint apparently did not adequately allege breach of a "red flags" duty. Nevertheless, the court held that delegation of power to the partner alone is enough under these circumstances to justify imposing an even stricter duty of supervision on the general partner than would apply to a corporate board. The court reasoned that the standard "red flags" duty assumes the existence of "an effective compliance system" that entitled the corporate directors to assume corporate executives were exercising their responsibilities in the absence of red flags. By contrast, in this case

[i]nstead of a board of directors sitting atop a command-style management structure of persons legally required to act loyally to the corporation, there is a nominally independent general partner that has delegated nearly all of its managerial responsibilities to conflicted entities who act through persons employed by and loyal to a third party. There is no command-style system of management reporting up to the General Partner, and the General Partner had no reason to believe that the Special Limited Partner or the Investment Advisor, entities made up of persons whose primary loyalty was and is to [the bank] would

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<sup>94</sup> 2007 WL 2982247 (Del. Ch., Oct. 9, 2007).

<sup>95</sup> *Forsythe*, 2007 WL 2982247 at 3.

<sup>96</sup> See R.U.P.A. §404(c) and U.L.P.A. §408(c) (2001); Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP, §16.07(f), notes 110-115.

<sup>97</sup> *Id.* at 7, citing *Stone*, 911 A. 2d at 370.

likely exercise their delegated duties in a manner that was loyal to the partnership. In the circumstances, the duty of oversight created by the Partnership Agreement is better understood as imposing on the General Partner an active obligation, at a minimum, to take steps to satisfy itself that the Special Limited Partner and the Investment Advisor actually discharge their delegated duties in compliance with the Partnership Agreement and in a manner loyal to the partnership.<sup>98</sup>

This reasoning is not persuasive in light of this article's analysis. Although the court noted the particular circumstances of the fund that may have justified imposing a strict duty, it did not adequately take account either of the nature of the duty specified in the agreement or other circumstances relating to the unincorporate nature of the firm that may have justified imposing the usual version of the gross negligence standard. In particular, the opinion indicates that managers breached specific contract limitations on the fund's investments, including a provision restricting transfers to the fund only of investments made between 2000 and 2006, a limitation on co-investment with the bank's merchant capital division,<sup>99</sup> and requirement of co-divestment with the bank.<sup>100</sup> The timing restriction limits the extent to which the bank can dump existing bad investments on the fund, while the other restrictions constrain conflicts of interest by ensuring that the fund is not taking greater risks than the sponsoring bank. The agreement therefore arguably anticipated many of the situations in which conflicts of interest would be a problem. These specific restrictions serve the usual unincorporate function of replacing general monitoring with specific constraints on managers' power. It follows that any remedy should have been limited to one for breach of specific investment restrictions or other contract provisions, rather than potential mismanagement liability for all of the fund's losses.

*Twin Bridges* and *Forsythe* therefore suggest that the Delaware courts do not yet fully recognize the fundamental differences between the corporate and unincorporate cases. *Twin Bridges* was not ready to embrace the full implications of enforcing private ordering in this context. More seriously, *Forsythe* failed to take account of the unincorporate-type provisions that constrain the fund managers rather than treating the firm like a corporation and focusing on the amount of discretion delegated to the managers. But it is notable and perhaps an indication of future results that the court in *Twin Bridges* generally embraced Chief Justice Veasey's admonition about enforcing contracts in incorporations.

#### 4. Remedies

Cases broadly enforcing arbitration provisions clearly acknowledge the role of the contract in unincorporation cases, particularly those involving LLCs. This contrasts with corporate cases, where arbitration of fiduciary duties is controversial.<sup>101</sup> The leading

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<sup>98</sup> *Id.*

<sup>99</sup> *Id.* at 4.

<sup>100</sup> *Id.* at 10, and n. 55.

<sup>101</sup> For an analysis of the issues and legal rules, see John Coffee, Jr., *No Exit?: Opting Out, The*

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uncorporate case is *Elf Atochem North America, Inc. v. Jaffari*,<sup>102</sup> which held that LLC members contracted away a derivative remedy under clause providing for "[n]o action at law or in equity based upon any claim arising out of or related to this Agreement" except an action to compel arbitration or to enforce an arbitration award). The court applied the following description of limited partnership agreements to LLCs:

Truly, the partnership agreement is the cornerstone of a Delaware limited partnership, and effectively constitutes the entire agreement among the partners with respect to the admission of partners to, and the creation, operation and termination of, the limited partnership. Once partners exercise their contractual freedom in their partnership agreement, the partners have a great deal of certainty that their partnership agreement will be enforced in accordance with its terms.<sup>103</sup>

The Supreme Court's forceful approval of arbitration in *Elf* has encouraged the Chancery Court to broadly interpret the scope of arbitration provisions to preclude default remedies in LLCs.<sup>104</sup>

The enforcement of arbitration is significant not just as a contractual approach to fiduciary duties, but also as a basis for broader judicial enforcement of contracts. Uncorporation owners' ability to escape corporate indeterminacy through arbitration gives Delaware courts an extra incentive to minimize the problems discussed by Carney

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*Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOKLYN L. REV. 919 (1988).

<sup>102</sup> 727 A.2d 286, 288 (Del. 1999).

<sup>103</sup> *Id.* at 291 (quoting Lubaroff & Altman, DELAWARE LIMITED PARTNERSHIPS § 1.2 (1999)).

<sup>104</sup> *See* *Terex Corp. v. STV USA, Inc.*, 2005 WL 2810717 (Del.Ch., Oct 20, 2005) (interpreting arbitration provision as precluding judicial action for dissolution); *CAPROC Manager, Inc. v. Policemen's & Firemen's Retirement System of City of Pontiac*, 2005 WL 937613 (Del. Ch. 2005) (holding that an operating agreement provision for arbitration of "any dispute or controversy arising under this Agreement" required arbitration of dispute concerning removal of a manager); *Douzinis v. American Bureau of Shipping, Inc.*, 888 A.2d 1146 (Del.Ch., 2006) (broadly applying arbitration provision in case involving alleged breach of fiduciary duties by manager to minority members emphasizing that arbitration provision was in LLC operating agreement, applied to claims "related to" rather than merely "arising under" agreement, and that plaintiff's claims clearly implicated the agreement's governance provisions, including its exculpatory clause). *But see* *Willie Gary LLC v. James & Jackson LLC*, 2006 WL 75309 (Del.Ch., Jan 10, 2006), *aff'd* *James & Jackson LLC v. Willie Gary LLC*, 906 A.2d 76 (Del., 2006) (interpreting arbitration provision as not precluding party from seeking judicial dissolution where the agreement provided for "judicial determination" of dissolution grounds and for court action for injunctive relief and specific performance, distinguishing *Terex* above this note; but observing that parties could "contract to have an arbitrator hear claims for dissolution" [slip p. 10, n. 32]). The generally broad interpretation of arbitration in Delaware contrasts with the narrow approach *Mission Residential, LLC v. Triple Net Properties, LLC*, 654 S.E.2d 888 (Va., 2008), which held that an arbitration agreement between LLC members did not require arbitration of member's derivative claim against other member because derivative claim belongs to LLC as a separate entity. For criticism of this case, see Larry E. Ribstein, *LLC Derivative Suits and Arbitration Clauses: Thoughts on Drafting and the Nature of LLCs*, <http://busmovie.typepad.com/ideoblog/2008/03/llc-derivative.html> (March 22, 2008).

& Shepherd or risk losing business to arbitrators. In other words, arbitration potentially adds a dimension to the market for business association law.<sup>105</sup>

Apart from arbitration, the choice between direct and derivative remedies may matter to the courts' application of contract-based or fiduciary approach. In a direct suit the courts are likely to focus on the owners' specific contract rights, while in a derivative suit the general rights of the legal entity against managers are likely to control. For example, *Anglo American Security Fund, L.P. v. S.R. Global International Fund, L.P.*<sup>106</sup> held that hedge fund limited partners could sue a general partner directly for diminution of the value of their interests. The court observed that “the limited partners have absolutely no control over the governance and management of the Fund,” but instead are protected only by the managers’ disclosure duty and by their ability to withdraw from the fund.<sup>107</sup> The court thus refers to directly to a key distinction between corporations and unincorporations – the contractual substitution of specific disciplinary devices for judicial monitoring via fiduciary duties.<sup>108</sup>

#### IV. IMPLICATIONS AND CAVEATS

Part III indicates that the indeterminacy problems that Carney & Shepherd discuss may be a function of *corporate* law rather than of *Delaware* law. In unincorporate cases the Delaware courts generally stay close to the parties’ agreement, thereby enabling the parties to avoid the instability and indeterminacy of corporate fiduciary jurisprudence through careful drafting.<sup>109</sup> This provides an additional basis for Chancellor Chandler’s skepticism that there really is any difference between Delaware’s corporate law and that under the MBCA.

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<sup>105</sup> For a general analysis of arbitration's role in the market for law, see Erin A. O'Hara & Larry E. Ribstein, *The Law Market*, ch. 5 (forthcoming 2008).

<sup>106</sup> 829 A. 2d 143 (Del. Ch. 2003).

<sup>107</sup> *Id.* at \_\_\_.

<sup>108</sup> The court also emphasized the aggregate nature of the fund – that the losses were passed directly to the partners through their capital accounts, and that the Fund “operates more like a bank” in the sense that partners have individual accounts and the fund has no going concern value. But these facts do not clearly differentiate the partnership from a corporation, since in both cases the value of the partners’ interests, which the partners would realize on sale either on the open market or back to the firm, would depend on the firm's overall value.

<sup>109</sup> Notably, Delaware’s unincorporate law is generally more determinate not only than its corporate law, but also than other states’ unincorporate law. While Delaware allows complete waiver of fiduciary duties, most other states restrict fiduciary duty opt-outs in unincorporate firms, thus rejecting Delaware's contractarian approach. See Ribstein & Keatinge, *supra* note 40, App. 9-6 (tabulating state LLC provisions on opting out of fiduciary duties). The complex and indeterminate fiduciary duty provisions in the Revised Uniform Limited Liability Company Act indicate the general direction of state law in this regard. See Revised Uniform Limited Liability Company Act, §§110 & 409 (2006), available at [http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act\\_final.htm](http://www.law.upenn.edu/bll/archives/ulc/ullca/2006act_final.htm); Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, Part VI, forthcoming 2008 VA. L. & BUS REV. Thus, a comparison between Delaware unincorporate law and that of the rest of the country in this respect works to Delaware's advantage.

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There are, however, some important caveats to this conclusion. First, it may be significant that the distinct unincorporate treatment in Delaware has been primarily instigated and promoted by the legislature rather than by the courts. The cases, of course, began with the Delaware waiver provisions.<sup>110</sup> Then the legislature had to make its edict more explicit after *Gotham*,<sup>111</sup> and Chief Justice Steele felt it necessary to admonish his colleagues to pay attention to the legislature.<sup>112</sup> This suggests that any Delaware-specific indeterminacy problem may lie in the courts rather than the legislature. This seems plausible based on the incentives of the two institutions: The legislature has every incentive to respond to its business constituency, while the courts may have their own incentives to create indeterminacy. Thus, while commentators have emphasized *Delaware's* incentives to create indeterminacy,<sup>113</sup> perhaps they should be looking at the different incentives of courts and legislatures.

Second, it is of possible interest that the courts have not explicitly connected any distinct treatment of unincorporation cases with the differences between corporations and unincorporations discussed in Part II. For example, *Sonet* and *RSM* merely emphasized the availability of the corporate protection of shareholder voting rights rather than unincorporate elements, while *Forsythe* mentioned but did not emphasize unincorporate protections. Does this mean that there is no particular reason to distinguish corporate and unincorporate cases? That would depend on whether unincorporate-type constraints constrained the conduct involved in the cases. This seems likely given this article's analysis, particularly in the *Forsythe* case. An alternative explanation is that the courts simply did not see the corporate/unincorporate distinction, and therefore did not emphasize the facts that related to this distinction. Thus, the lesson of these cases may be that the courts should be more careful in discerning the agreement's tradeoffs between corporate and unincorporate protections in considering the extent to which the parties intended to waive fiduciary protections.

A third caveat to this article's analysis is that cases like *Gotham*, *VGS*, *Twin Bridges* and *Forsythe* show that the judicial tendency to apply corporate rules is always lurking and that courts have not yet completely severed the unincorporate cases from corporate indeterminacy. In particular, it is important to keep in mind that the unincorporate cases have arisen mainly in closely held firms and has not been fully tested under the conditions that corporate law has had to face. Courts may be particularly tempted to apply corporate rules to unincorporate firms that resemble large-scale corporations. Among other things, the courts may be concerned about the rigorous

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<sup>110</sup> See *supra* subpart III.A.

<sup>111</sup> See *supra* text accompanying note 71.

<sup>112</sup> See Steele, *supra* note 43.

<sup>113</sup> See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998) (arguing that indeterminacy enhances Delaware's competitive position); Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (arguing that rules that Delaware law serves lawyers' interests by increasing litigation).

accountability to shareholder interests that unincorporate governance devices entail.<sup>114</sup> Delaware also may face federal pressure not to let large partnerships escape corporate-type scrutiny.<sup>115</sup>

Fourth, even if the corporate/unincorporate distinction generally holds, it may affect only a limited set of firms. The unincorporate attributes discussed in Part II, including customizing or eliminating fiduciary duties, may be best suited only to those widely held firms that can use unincorporate-type discipline instead of corporate-type monitoring. This discipline may be antithetical to firms that, for example, have unstable earnings and therefore cannot commit to making distributions to owners or to liquidating at a specific future date.

Fifth, it is not yet clear as a policy matter how far the unincorporate approach of strict reliance on contract terms *should* be applied. This approach involves its own transaction costs, which must be balanced against any savings in indeterminacy costs. In the Delaware cases fiduciary duties loom in the background, ready to flow into any gap left by the contract. Vice Chancellor Strine's admonition to lawyers not to address fiduciary duties "coily" could require such careful and costly drafting that it makes fiduciary duties in effect mandatory. Even a moderate insistence on careful drafting could put fiduciary duty waivers out of the reach of smaller firms. In other words, by making very skilled drafting the price of avoiding indeterminacy, Delaware's unincorporate law may be trading lower litigation costs for higher fees to transactional lawyers. This may reserve the benefits of the unincorporate approach only for the largest and most sophisticated incorporations.

Despite these caveats, the unincorporate perspective is important in analyzing the problems that Carney & Shepherd raise. Even if indeterminacy and instability is an inherent problem of Delaware law that cannot be solved by the unincorporation, courts and commentators should take the unincorporate perspective into account in fully analyzing these problems. Moreover, apart from why the problem exists, the availability of unincorporate forms of governance at least shows that the corporation is to some extent on the margin. The problems Carney & Shepherd highlight may be instrumental in driving firms increasingly toward unincorporate forms of governance.

## V. CONCLUSION

This paper shows that the problem with Delaware corporate law may be a feature of the corporation rather than of adjudicating business association cases. Corporate governance calls for courts to exercise broad supervisory powers over managers. Given the complex and constantly changing corporate environment, it is not surprising that courts charged with this task cannot provide perfect stability and clarity. In the unincorporate setting the parties themselves do the work by fashioning contracts that

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<sup>114</sup> See Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 N. D. L. REV. 1431 (2006)

<sup>115</sup> See Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (arguing that Delaware responds to the threat of potential federalization of corporate law).

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provide the discipline and incentives that corporations expect from fiduciary duties. The Delaware courts and legislature have responded with rules that enforce these contracts. The uncorporation therefore may provide an escape route from corporate indeterminacy, at least for some firms. More importantly for present purposes, this analysis helps solve mystery of Delaware's success: Corporate law is inherently a messy business.