

LLC Fiduciaries: Where Has All the Good Faith Gone?*

I. INTRODUCTION

Since its enactment in 1992, Delaware's limited liability company (LLC) act has given "maximum effect to the principle of freedom of contract" and allowed for the restriction of fiduciary duties.¹ A full decade later, when dealing with similar language in the limited partnership (LP) act, the Delaware Supreme Court acknowledged the ability of parties to restrict fiduciary duties but refused to go so far as to allow the complete waiver of those duties.² The state legislature quickly rebuffed the Delaware Supreme Court with an amendment in 2004 that explicitly provided the right to parties to eliminate fiduciary duties, further codifying the desire by the legislature to move toward a contract-based approach to LLC governance.³

Delaware's actions over the past decade are a microcosm of a larger debate. Since the early 1990s, three fundamental issues regarding the role of fiduciary duties in unincorporated entities have occupied considerable mind space: (1) the extent to which such entities allow fiduciary duties to be waived, (2) the default rules that apply in the absence of waiver, and (3) the requirements for effective waiver.⁴ The rapid succession of uniform acts for unincorporated entities has perpetuated this discussion, and those uniform acts further serve as a national track record of the trend away from the fiduciary-based

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1. *See* Delaware Limited Liability Company Act, 68 Del. Laws 1329, 1355 (1992) (current version at DEL. CODE ANN. tit. 6, § 18-1101(b)–(c) (West Supp. 2011)).

2. *See* *Gotham Partners v. Hallwood Realty Partners*, 817 A.2d 160, 167–68 (Del. 2002).

3. *See* Act effective Aug. 1, 2004, 74 Del. Laws 612, 613 (2004) (current version at DEL. CODE ANN. tit. 6, § 18-1101(c) (West Supp. 2011)).

4. *See infra* Part II.

approach—envisioned for much of the twentieth century—toward a contract-based approach.⁵

Despite the case law and legislative action of the last twenty years, questions still remain. The recent 2004 amendment closes the door on the question of whether fiduciary duties may be entirely eliminated in LLCs,⁶ but a string of recent Delaware Court of Chancery decisions has been inconsistent on Delaware's approach to default rules and the requirements for effective waiver.⁷ This uncertainty raises questions for states that follow Delaware's lead in business law and is nowhere more apparent than in Kansas, a state that uses a pre-2004 version of the Delaware statute.⁸ The question of the elimination of fiduciary duties may have been answered in Delaware, but it has not yet been addressed in Kansas.⁹

This Comment does not purport to evaluate the larger national trend. That debate continues to be vibrant and is carried out by far more experienced commentators.¹⁰ This Comment instead focuses narrowly on the approach of Delaware and Kansas by first addressing the statute and then examining how Delaware and Kansas courts can develop a cohesive approach within the framework those states' statutes envision.

This Comment begins with a brief observation of the history of fiduciary duties. It then examines the debate in Delaware and how it has played out in legislative acts, cases, and commentaries. But this Comment primarily builds upon the status of the law in Kansas. Alternative approaches will be examined and assessed according to their permissibility under the current Kansas statute. An analysis of the 1999 Kansas act reveals a mandate that requires the enforcement of complete

5. See generally Rutheford B. Campbell, Jr., *The "New" Fiduciary Standards Under the Revised Uniform Limited Liability Company Act: More Bottom Bumping From NCCUSL*, 61 ME. L. REV. 27 (2009) (discussing fiduciary duties in the Revised Uniform Limited Liability Company Act); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927 (2004) (discussing fiduciary duties in the Revised Uniform Limited Partnership Act); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523 (1993) (discussing fiduciary duties in the Revised Uniform Partnership Act).

6. See 74 Del. Laws at 613.

7. See *infra* Part II.B.

8. Compare KAN. STAT. ANN. § 17-76,134(c)(2) (2007) (allowing fiduciary duties to be "expanded or restricted"), with DEL. CODE ANN. tit. 6, § 18-1101(c) (West Supp. 2011) (allowing fiduciary duties to be "expanded or restricted or eliminated").

9. See *infra* Part II.C.

10. The debate surrounding the promulgation of RUPA is one such example of this. See, e.g., Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 57-61 (1993); Vestal, *supra* note 5, at 556-63.

waivers of fiduciary duties.¹¹ This conclusion places Kansas in roughly the same position as Delaware—faced with addressing the default rules and standards for effective waiver of those rules.¹² While aspects of this Comment will narrowly address the unique position of Kansas, the majority of its analysis is equally applicable to the law in Delaware or states using the Delaware LLC act as a model.

An analysis of both Kansas and Delaware statutes reveals that, despite the ability to waive, default fiduciary duties were intended to apply when deemed appropriate under common law.¹³ The Kansas and Delaware statutes are mute on the issue of the requirements for sufficient waiver,¹⁴ but significant policy objectives favor requiring explicit waiver.

II. BACKGROUND

The emergence of LLCs in the 1980s and 1990s¹⁵ coincided with the larger discussion of the role of fiduciary duties in unincorporated entities.¹⁶ Delaware's LLC act embraced a contract-based approach at its inception,¹⁷ but LLCs were still largely assumed to inherit the duties that historically governed like relationships.¹⁸ Recent Delaware cases obfuscate the issue of fiduciary duties in LLCs, leaving states that follow Delaware's lead in business law without a clear guide.¹⁹

11. See *infra* Part III.A.1.

12. See *infra* Parts II.B–C, III.A.

13. See *infra* Part III.B.1.

14. See DEL. CODE ANN. tit. 6, § 18-1101 (West Supp. 2011); KAN. STAT. ANN. § 17-76,134 (2007).

15. The first U.S. jurisdiction to adopt an LLC act was Wyoming in 1977. Larry E. Ribstein, *LLCs: Is the Future Here? A History & Prognosis*, BUS. L. TODAY, Nov.–Dec. 2003, at 10, 11. By 1996, every state had enacted an LLC act. *Id.* at 12.

16. See generally Ribstein, *supra* note 5 (discussing fiduciary duties in limited partnerships); Vestal, *supra* note 5 (discussing fiduciary duties in partnerships).

17. Delaware Limited Liability Company Act, 68 Del. Laws 1329, 1355 (1992) (current version at DEL. CODE ANN. tit. 6, § 18-1101(b)).

18. See Larry E. Ribstein, *Litigating in LLCs*, 64 BUS. LAW. 739, 739 (2009) (“The rapid development of limited liability companies (‘LLCs’) has caused numerous growing pains as courts and legislatures have searched for appropriate sources from which to draw the rules for this new business form. Not surprisingly, legislators and courts frequently apply rules from existing business entities.”); Allan Walker Vestal, “. . . Drawing Near the Fastness?”—*The Failed United States Experiment in Unincorporated Business Entity Reform*, 26 J. CORP. L. 1019, 1021 (2001) (“In brief, [the Uniform Limited Liability Company Act] provides nonmanaging members the comprehensive information rights of partners, with the narrow fiduciary obligations of noncontrolling shareholders.”).

19. See *infra* Part II.B.1.

A. *Fiduciary Duties Before the Emergence of LLCs*

Because LLCs borrowed characteristics from existing entity types, courts have understandably sought to adapt existing jurisprudence to the LLC context.²⁰ LLCs were often imbued with the same traditional fiduciary duties that permeated the law of partnerships and corporations,²¹ and thus a discussion of fiduciary duties in the LLC context requires an analysis of the jurisprudence from which courts drew inspiration.

Two aspects of fiduciary duties are specifically pertinent to the current analysis: (1) the status of fiduciary duties as default rules and (2) the waivability of those rules. Due to the enactment of Delaware's first LLC act in 1992, this discussion largely provides a snapshot of fiduciary duties—and the debate surrounding them—during that time.

1. Fiduciary Duties in Partnerships

Then-Chief Judge Cardozo's opinion in *Meinhard v. Salmon*²² is an early and oft-cited example of fiduciary duties in business organizations. The opinion is instructive regarding the twentieth century judiciary's approach to fiduciary duties.

Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.²³

Despite Cardozo's absolute declaration as to the “uncompromising rigidity” of the courts,²⁴ there is some debate over the extent to which fiduciary duties were in fact waivable in the partnership context throughout the twentieth century.²⁵ This historical debate was a feature of the discussion that surrounded the drafting and promulgation of the

20. See Ribstein, *supra* note 18, at 739; Vestal, *supra* note 18, at 1021.

21. See Ribstein, *supra* note 18, at 739; Vestal, *supra* note 18, at 1021.

22. 164 N.E. 545 (N.Y. 1928).

23. *Id.* at 546 (citations omitted).

24. *Id.*

25. See, e.g., Ribstein, *supra* note 10, at 60–61; Vestal, *supra* note 5, at 556–63.

Revised Uniform Partnership Act (RUPA) in 1992,²⁶ coinciding with the enactment of Delaware's first LLC act in the same year.²⁷

In 1993, Professor Allan Vestal argued that, before RUPA, common law placed significant limitations on the modification of fiduciary duties.²⁸ "Under existing common law, the general rule is that the duty of loyalty is not contractually modifiable, but it can be specifically waived. One party may release the obligation of another party whose actions would otherwise violate the duty of loyalty, but only after sufficiently specific disclosure"²⁹ This analysis conflicts with Professor Larry Ribstein's contention that the "[m]andatory fiduciary duties [embraced in RUPA] change decades of prior law under the [original Uniform Partnership Act]."³⁰ Ribstein did acknowledge, however, that "[a]lthough the UPA did not explicitly permit advance contracting around many of its default rules, it has been so interpreted."³¹

The debate surrounding the extent that fiduciary duties have historically been waivable is largely superseded by the express allowance of waivers in Delaware's LLC, LP, and partnership acts.³² It is important to note, however, there is broad consensus that fiduciary duties, absent waiver, apply by default in the partnership context.³³

2. Fiduciary Duties in Corporations

In a 1985 case, the Delaware Supreme Court affirmed the longstanding precedent that directors, when acting as managers, "are

26. See, e.g., Ribstein, *supra* note 10, at 57–61; Vestal, *supra* note 5, at 556–63.

27. 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 1:2 (2d ed. 2004).

28. See Vestal, *supra* note 5, at 557.

29. *Id.*

30. Ribstein, *supra* note 10, at 57.

31. Larry E. Ribstein, *Changing Statutory Forms*, 1 J. SMALL & EMERGING BUS. L. 11, 29 n.109 (1997).

32. See DEL. CODE ANN. tit. 6, §§ 15-103(f), 17-1101(c), 18-1101(c) (West Supp. 2011); see also *infra* Part III.B.1.

33. While Ribstein asserts that fiduciary duties were not mandatory under UPA, see Ribstein, *supra* note 10, at 57, he did acknowledge the existence of default, albeit narrowly defined, fiduciary duties. See Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 212. "[D]efault fiduciary duties should be confined to relationships that involve the contractual delegation of broad power over one's property." *Id.* at 212. The scope of this Comment does not allow for an in-depth analysis of what circumstances might trigger default fiduciary duties. For such a discussion, see generally *id.* Further, this Comment does not suggest a change to common law fiduciary duties but merely proposes that when default fiduciary duties are appropriate under common law, they should be applied unless explicitly waived. See *infra* Part III.B. This is the approach enunciated in the Kansas and Delaware statutes. See *infra* Part III.B.

charged with an unyielding fiduciary duty to the corporation and its shareholders.”³⁴ Delaware’s corporate statute now provides that an exculpation clause can be inserted into a corporation’s certificate of incorporation, limiting or eliminating the personal liability of a corporation’s director for a breach of fiduciary duty.³⁵ That exculpation clause, however, is subject to several broad exceptions; importantly, an exculpation clause would not limit or eliminate a director’s personal liability for breach of the duty of loyalty, intentional or knowingly unlawful misconduct, or a transaction from which the director derived a personal benefit.³⁶ These exceptions may be understood as maintaining a “mandatory core” of fiduciary duties, which may not be waived by agreement. Further, the statute does not propose to affect the default rules; traditional fiduciary duties apply if the certificate of incorporation includes no exculpation clause.³⁷ In a 2005 speech, Delaware Vice Chancellor Leo E. Strine reaffirmed the role of common law fiduciary duties, stating:

the continued importance of the common law of corporations is not the result of happenstance, but reflects a policy choice made by the Delaware General Assembly. That choice deliberately deploys Delaware’s judiciary to guarantee the integrity of our corporate law through the articulation of common law principles of equitable behavior for corporate fiduciaries.³⁸

34. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds by Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *see also Loft, Inc. v. Guth*, 2 A.2d 225 (Del. Ch. 1938) (enforcing a similar duty).

35. *See* DEL. CODE ANN. tit. 8, § 102(b)(7).

36. *See id.* That provision allows a corporation’s certificate of incorporation to include [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) [unlawful payment of dividend or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit.

Id.; *see also In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275 (Del. Ch. 2003) (involving a corporate director whose behavior fell outside the company’s exculpation clause).

37. *See* DEL. CODE ANN. tit. 8, § 102(b)(7).

38. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 6 (2007) (quoting Leo E. Strine, Vice Chancellor, Del. Court of Chancery, *If Corporate Action Is Lawful, Presumably There Are Circumstances in Which It’s Equitable to Take That Action: The Important Corollary to the Rule of Schnell v. Chris-Craft* 4, Regent’s Lecture at the UCLA School of Law (Mar. 31, 2005)).

B. The Debate in Delaware

“The two major paradigms of LLC governance are the fiduciary-based . . . approach borrowed from corporation and partnership law and the freedom of contract empowering elimination/full indemnification approach.”³⁹ The former, sometimes described as a status-based approach, contends that fiduciaries owe a duty to the company as a result of their status as a fiduciary.⁴⁰ The latter approach, often described as a contract-based approach, proposes that the duties owed are derived from the LLC agreement.⁴¹

Since its inception, Delaware’s LLC act has affirmed the policy goal of giving “maximum effect to the principle of freedom of contract.”⁴² As such, the statute embraces the contract-based approach. The statute also provides that “[t]he rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.”⁴³ Despite its clear policy objective and rules of interpretation, Delaware courts were not uniformly eager to give effect to waivers of fiduciary duties.

In *Gotham Partners v. Hallwood Realty Partners*, the Delaware Court of Chancery interpreted similar language in the state’s limited partnership statute as allowing for the elimination of fiduciary duties entirely.⁴⁴ The Delaware Supreme Court was not so bold.⁴⁵ On appeal, the court was reluctant to discard decades of fiduciary duty jurisprudence and chose to interpret the statute narrowly—in contravention of the clear rules of interpretation laid out in the statute.⁴⁶ The court acknowledged that the statute clearly allowed for the “expansion and restriction” of fiduciary duties, but it rejected the contention that the statute allowed such duties to be eliminated entirely.⁴⁷

39. Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 AM. BUS. L.J. 279, 280 (2009).

40. See *id.* at 281; Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More than a Decade of Experimentation?*, 32 J. CORP. L. 565, 581 (2007).

41. See DiMatteo, *supra* note 39, at 282–84; Miller, *supra* note 40, at 580–81.

42. DEL. CODE ANN. tit. 6, § 18-1101(b).

43. *Id.* § 18-1101(a).

44. 817 A.2d 160, 167 (Del. 2002) (quoting the lower court’s unpublished opinion which observed that the statute allowed for elimination of fiduciary duties).

45. See *id.* at 168 (“There is no mention in [the statute] . . . that a limited partnership agreement may eliminate the fiduciary duties or liabilities of a general partner.”).

46. See *id.* at 167–68; see also Steele, *supra* note 38, at 21.

47. *Gotham*, 817 A.2d at 167–68.

The Delaware legislature did not hesitate in rebuking the Supreme Court. In 2004, it amended the statute to expressly allow for the elimination of fiduciary duties.⁴⁸ The legislature went even further, emphasizing that the only unwaivable duties would be those arising under the implied covenant of good faith and fair dealing.⁴⁹ That covenant, commandeered from contract law, exists to protect the “reasonable expectations” of contracting parties.⁵⁰ Some have argued that the covenant’s incorporation into the statute further expresses the legislature’s intent to abandon the status-based fiduciary duties of common law and replace them with a solely contract-based set of duties.⁵¹ In fact, the pure contractarian approach—an approach that applies no fiduciary duties by default—would suggest that the sole default protection should be that provided for by the covenant.⁵² However, as discussed later, the 2004 amendment should be taken for what it is—an intent to allow for the elimination of fiduciary duties. Commentators who suggest that fiduciary duties should not apply by default do not find support for that assertion in the statute itself.⁵³

1. Current Questions and Recent Cases

Even with the large amount of business law litigation that Delaware sees each year, two important questions have yet to be answered since the 2004 amendment. First, what default rules apply when the LLC agreement is silent? And second, what is required to eliminate traditional fiduciary duties entirely?

48. See Act effective Aug. 1, 2004, 74 Del. Laws 589, 590–91 (2004) (current version at DEL. CODE ANN. tit. 6, § 17-1101(d)–(f)) (addressing limited partnerships); Act effective Aug. 1, 2004, 74 Del. Laws 612, 613–14 (2004) (current version at DEL. CODE ANN. tit. 6, § 18-1101(c)–(e)) (addressing limited liability companies); see also Steele, *supra* note 38, at 13.

49. 74 Del. Laws at 590–91, 613–14.

50. E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 442–44 (Del. 1996).

51. See, e.g., Steele, *supra* note 38, at 29 (advocating for a contractually based governance scheme).

52. See Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 233 (2009) (“Delaware courts should eschew their addiction to default fiduciary duties and instead adopt a policy of no default fiduciary duty.”).

53. See *infra* Part III.B.

a. Default Rules When the LLC Agreement Is Silent

One possible approach is to apply traditional fiduciary duties when the LLC agreement contains no waiver. In *Kelly v. Blum*, the Delaware Court of Chancery appeared to take this approach; the court analogized *Kelly*'s facts to the corporate context.⁵⁴

“[I]n the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty,” controlling members in a manager-managed LLC owe minority members “the traditional fiduciary duties” that controlling shareholders owe minority shareholders. . . .

. . . .

Because the [LLC agreement was] silent as to what duties controlling members owe minority members, [the court found] that [the defendant] owed [the plaintiff] traditional fiduciary duties⁵⁵

Kelly holds that fiduciary duties are applicable when the LLC agreement is silent,⁵⁶ but there is a supplementary point to be gleaned from the decision. The LLC agreement in *Kelly* was silent on the topic of fiduciary duties owed by members, but it *explicitly restricted* the fiduciary duties owed by managers.⁵⁷ This suggests that fiduciary duties not only serve as default rules when the LLC agreement is silent but remain in place as gap-fillers when the LLC agreement purports to edit the fiduciary duties of some parties but not others.

The approach of the court in *Kelly*, which assumes default fiduciary duties, has been met with some criticism.⁵⁸

[If the] reference to “restricted or eliminated by provisions in the partnership agreement,” was not clear enough, the quintessential contract reference, “provided that the partnership agreement may not eliminate the *implied contractual covenant of good faith and fair dealing*,” should make the legislature’s intent abundantly clear. This

54. No. 4516-VCP, 2010 WL 629850, at *11–12 (Del. Ch. Feb. 24, 2010).

55. *Id.* (citations omitted) (quoting *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. 3658-VCS, 2009 WL 1124451, at *8 n.33 (Del. Ch. Apr. 20, 2009)).

56. *See id.*

57. *See id.* at *12–13; *see also* Larry E. Ribstein, *The Persistent Fiduciary Duty Minefield in LLCs*, IDEOBLOG (Feb. 26, 2010, 8:28 AM), <http://busmovie.typepad.com/ideoblog/2010/02/the-persistent-fiduciary-duty-minefield-in-llcs.html>.

58. *See Steele, supra* note 38, at 14.

language, carefully borrowed from contract law, as distinguished from corporate law, to set the parameters of action deemed to be in “good faith,” must be read as an affirmation that . . . [traditional fiduciary duties] is not the lens through which the action of parties to a limited partnership or limited liability company agreement will be viewed.⁵⁹

This language, written by Chief Justice Myron Steele in 2007, suggests that there is at least some support on the Delaware Supreme Court to abandon fiduciary duties as default rules when analyzing LLC agreements.⁶⁰

Support can also be found in a recent string of Court of Chancery cases. In these cases, the court has refused to impose default fiduciary duties.⁶¹ Such opinions are facially inconsistent with *Kelly*, but they could conceivably be explained by the nature of the relationship between the defendant and the LLC.⁶² Ribstein argues that “default fiduciary duties should be confined to relationships that involve the contractual delegation of broad power over one’s property.”⁶³ This theory suggests members do not, simply by virtue of being members, have fiduciary duties; it is when a member is delegated discretionary, managerial power that fiduciary duties exist.⁶⁴ “[A]lthough [such an understanding] may seem to differ radically from courts’ broad view of fiduciary duties, in fact a careful analysis of how courts have applied fiduciary duties shows that the law is largely consistent with [this] narrow view.”⁶⁵ It is possible that the Court of Chancery would have assumed default fiduciary duties

59. *Id.* (quoting DEL. CODE ANN. tit. 6, § 17-1101 (2004) (using similar language to the LLC statute)).

60. *See id.*; *see also* Francis G.X. Pileggi, *Fiduciary Duties in Delaware LPs and LLCs*, DEL. CORP. AND COM. LITIG. BLOG (Mar. 14, 2007), <http://www.delawarelitigation.com/2007/03/articles/commentary/fiduciary-duties-in-delaware-lps-and-llcs/>. A recent Delaware case did see Justice Steele apply fiduciary duties by default. *See William Penn P’ship v. Saliba*, No. 362, 2010, 2011 WL 440615, at *5 (Del. Feb. 9, 2011). However, *Saliba* was not an *en banc* review, and the existence of fiduciary duties was not challenged. *See id.* (“The parties here agree that managers of a Delaware limited liability company owe traditional fiduciary duties of loyalty and care to the members of the LLC . . .”).

61. *See, e.g.,* *Kuroda v. SPJS Holdings*, 971 A.2d 872 (Del. Ch. 2009); *Fisk Ventures v. Segal*, No. 3017-CC, 2008 WL 1961156 (Del. Ch. May 7, 2008).

62. *Cf.* Larry Ribstein, *More on Getting Rid of LLC Fiduciary Duties*, TRUTH ON THE MARKET (Aug. 12, 2010), <http://truthonthemarket.com/2010/08/12/more-on-getting-rid-of-llc-fiduciary-duties/> (reconciling two seemingly inconsistent cases by examining the difference in managerial power between the defendants).

63. Ribstein, *supra* note 33, at 212.

64. *Cf. id.* at 209 (“[P]artners, as such, are not fiduciaries because they do not delegate open-ended control to their co-partners.”).

65. *Id.* at 213.

had the defendants in these cases been a manager or member acting in a managerial capacity.⁶⁶

However, Ribstein's theory might not wholly account for the seemingly schizophrenic nature of Court of Chancery opinions. In *Fisk Ventures v. Segal*, the court stated: "In the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations *must be found in the LLC Agreement or some other contract.*"⁶⁷ It might be assumed that this decisive, far-reaching statement could not still be considered the approach of the court following the later *Kelly* decision, but this exact quote has been used to support post-*Kelly* Court of Chancery decisions.⁶⁸ As the Court of Chancery grapples with the question of what default rules apply, states that follow the Delaware model are left without a guide.

b. The Elimination of Fiduciary Duties

The Delaware Court of Chancery has also examined LLC fiduciary duties when the LLC agreement speaks to the duties. The Court of Chancery has stated that, consistent with Delaware's LLC act, fiduciary duties may be eliminated completely.⁶⁹ The requirements of waiver, however, have yet to be defined. The most recent and far-reaching case on the topic is the unpublished *Related Westpac LLC v. JER Snowmass LLC*.⁷⁰ In *Related Westpac*, the Court of Chancery refused to apply fiduciary duties because such duties were inconsistent with the terms of the LLC agreement.⁷¹ The plaintiff in *Related Westpac* claimed that the defendant had breached his fiduciary duties when he unreasonably refused a capital call.⁷² The LLC agreement stated that capital calls could not be "unreasonably withheld or delayed, *except with respect to*

66. *Id.*

67. 2008 WL 1961156, at *8 (emphasis added); *see also* Francis G.X. Pileggi, *Chancery Gives Victory to "Freedom of Contract" Regarding Fiduciary Duties in LLC Agreement*, DEL. CORP. & COM. LITIG. BLOG (May 9, 2008), <http://www.delawarelitigation.com/2008/05/articles/chancerycourt-updates/chancery-gives-victory-to-freedom-of-contract-regarding-fiduciary-duties-in-llc-agreement/>.

68. *See, e.g.*, *Related Westpac LLC v. JER Snowmass LLC*, No. 5001-VCS, 2010 WL 2929708, at *6 n.30 (Del. Ch. July 23, 2010).

69. *See, e.g.*, *Fisk*, 2008 WL 1961156, at *11.

70. 2010 WL 2929708; *see also* Francis G.X. Pileggi, *Chancery Refuses to Impose Fiduciary Duties on Parties to LLC Agreement*, DEL. CORP. AND COM. LITIG. BLOG (Aug. 9, 2010), <http://www.delawarelitigation.com/2010/08/articles/chancery-court-updates/chancery-refuses-to-impose-fiduciary-duties-on-parties-to-llc-agreement/>.

71. 2010 WL 2929708, at *8.

72. *Id.* at *1-3.

[the defendant].”⁷³ While this provision explicitly excludes the defendant from any reasonableness standard in refusing the capital call (implying that he may act *unreasonably*), the LLC agreement included no explicit waiver of fiduciary duties.⁷⁴

When a fiduciary duty claim is plainly inconsistent with the contractual bargain struck by parties to an LLC or other alternative entity agreement, the fiduciary duty claim must fall, otherwise “the primacy of contract law over fiduciary law in matters involving . . . contractual rights and obligations [would be undermined].”⁷⁵

This precedent is somewhat clouded by the fact that, other than a handful of rights to approve or veto a few “material actions,” the defendant was largely a nonmanaging, passive investor.⁷⁶ Under Ribstein’s managerial theory of fiduciary duties, it is questionable whether the defendant would have owed fiduciary duties absent the agreement provision relied upon by the court.⁷⁷ Had the defendant been a manager delegated with broad discretionary power, the court might not have been so cavalier in discarding fiduciary duties.⁷⁸ The Delaware Court of Chancery has not yet extended this precedent to a case where the defendant exercises managerial power; thus it is unclear whether terms merely inconsistent with traditional fiduciary duties can be used to exempt a manager or managing member. The standard required for an effective waiver of fiduciary duties remains an open question.

2. Implied Covenant of Good Faith and Fair Dealing

Still, even if the fiduciary duties can be waived, some unwaivable protection remains—the implied covenant of good faith and fair dealing. The covenant is not a new creation,⁷⁹ but its 2004 incorporation into Delaware’s LLC act adopted the covenant in a new context. The covenant’s new role in policing LLCs has yet to be sufficiently tested. However, as the one unwaivable principle established in the Delaware

73. *Id.* at *3.

74. *Id.* at *2 (outlining the LLC agreement’s terms).

75. *Id.* at *8 (quoting *Madison Realty Partners 7, LLC v. Ag ISA, LLC*, No. 18094, 2001 WL 406268, at *6 (Del. Ch. Apr. 17, 2001)).

76. *Id.* at *2 (outlining the defendant’s obligations in the LLC agreement).

77. *See supra* notes 63–66 and accompanying text.

78. *See supra* notes 63–66 and accompanying text.

79. *See Steele, supra* note 38, at 16–20 (discussing Delaware jurisprudence involving the covenant).

LLC act,⁸⁰ the covenant may stand as the sole source of protection in governing many LLC agreements.

The Second Restatement of Contracts informs us that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”⁸¹ The Restatement further discusses the concept of good faith in its comments.⁸²

Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.⁸³

The Restatement’s comments further describe good faith in the contractual contexts of purchasing, negotiation, and performance.⁸⁴ The illustrations provided in the Restatement, however, mostly describe contracts for the sale of goods and services, insurance contracts, and lease contracts.⁸⁵ This is unsurprising. When the Second Restatement was promulgated, LLCs had yet to be invented and existing forms of business organizations were not thought of in contractual terms.⁸⁶

Before the 2004 amendment, the covenant saw application in contractual disputes between employers and employees.⁸⁷ In these cases, the Delaware Supreme Court identified the purpose of the covenant as promoting “the spirit of the agreement and [protecting] against one side using underhanded tactics to deny the other side the fruits of the parties’ bargain.”⁸⁸ More tangibly, the covenant was described as protecting the “reasonable expectations” of the parties at the time the contract was formed.⁸⁹

80. DEL. CODE ANN. tit. 6, § 18-1101(c) (West Supp. 2011).

81. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

82. *Id.* § 205 cmt. a.

83. *Id.*

84. *Id.* § 205 cmts. b–d.

85. *See id.* § 205 ill. 1–7.

86. *See Vestal, supra* note 5, at 523–24 (discussing the fiduciary-based worldview that had existed in Uniform Partnership Act and the common law of partners prior to the 1990s).

87. *See, e.g., E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 442–44 (Del. 1996).

88. *Kelly v. McKesson HBOC, Inc.*, No. 99C-09-265WCC, 2002 WL 88939, at *10 (Del. Super. Ct. Jan. 17, 2002).

89. *Pressman*, 679 A.2d at 443.

Recent Delaware precedent indicates that the implied covenant of good faith and fair dealing offers far less protection than its unbecomingly ostentatious moniker would suggest. Delaware courts have recently applied—or, more accurately, refused to apply—the covenant in the context of LLCs. In *Kuroda v. SPJS Holdings*, the Court of Chancery rejected a claim based on the covenant, acknowledging that “[c]onsistent with its narrow purpose, the implied covenant is only rarely invoked successfully.”⁹⁰ In *Nemec v. Shrader*, the Delaware Supreme Court discussed the evidentiary standard of the covenant, citing earlier precedent in a footnote: “this Court has recognized the occasional necessity of implying such terms in an agreement so as to honor the parties’ reasonable expectations. But those cases should be rare and *fact-intensive*, turning on issues of compelling fairness.”⁹¹ These cases, while sparse and narrow to their individual facts, provide some insight into how the covenant might govern disputes in Delaware LLCs. The narrow purpose that Delaware courts have envisioned, along with the lofty standard that must be met for a claim based on the covenant to succeed, speak dramatically to the efficacy of invoking the covenant; in none of the cases has a claim based on the covenant succeeded.⁹²

C. *The Law in Kansas*

Kansas was ahead of the curve in the adoption of its LLC act. In 1990, Kansas was one of a mere four states to allow the formation of LLCs.⁹³ Despite this early adoption, however, Kansas has, for the last twenty years, consciously followed Delaware’s lead, adopting versions of Delaware statutes for its business organization acts.⁹⁴ The Kansas judiciary has also made explicit the persuasiveness of Delaware court decisions in interpreting those statutes.⁹⁵

90. 971 A.2d 872, 888 (Del. Ch. 2009).

91. 991 A.2d 1120, 1125 n.16 (Del. 2010) (quoting *Cincinnati SMSA Ltd. v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998)).

92. See *Nemec*, 991 A.2d at 1125; *Related Westpac LLC v. JER Snowmass LLC*, No. 5001-VCS, 2010 WL 2929708, at *6 (Del. Ch. July 23, 2010); *Kuroda*, 971 A.2d at 888; *Fisk Ventures v. Segal*, No. 3017-CC, 2008 WL 1961156, at *10–11 (Del. Ch. May 7, 2008).

93. See Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 384 (1992).

94. Edwin W. Hecker, Jr., *Fiduciary Duties in Business Entities*, 54 U. KAN. L. REV. 975, 975, 1006–07, 1015–18 (2006) (discussing Delaware’s legislation as a model and addressing Kansas’s business organization statutes in light of Delaware precedent).

95. See *id.* at 975.

But recent Delaware decisions do little to provide a consistent, comprehensive framework for the application of fiduciary duties in the LLC context.⁹⁶ This uncertainty is further compounded by a failure to update the Kansas LLC act since 1999.⁹⁷ As such, Kansas is working with a pre-2004 version of the Delaware statute that differs from Delaware's current statute.⁹⁸ The most important difference is that while the Kansas statute does allow for fiduciary duties to be "expanded or restricted," it does not explicitly allow for their elimination.⁹⁹ While Delaware's 2004 amendment clearly expresses an intent to allow complete waivers of fiduciary duties,¹⁰⁰ the same cannot be said of the Kansas legislature's inaction. This disparity may create some confusion for Kansas courts. However, as will be discussed, the pre-2004 version of the statute provides enough evidence to indicate approval of the elimination of fiduciary duties in LLCs.¹⁰¹

While Kansas courts have not settled the issue of whether LLCs can eliminate fiduciary duties, some insight can be gained from other fiduciary duty cases. A recent Kansas case involving fiduciary duties in unincorporated entities was *Welch v. Via Christi Health Partners*.¹⁰² In *Via Christi*, the defendant was a majority limited partner and sole general partner in a limited partnership.¹⁰³ The defendant unilaterally amended the entity's LP agreement to allow for merger without the approval of the minority limited partners.¹⁰⁴ Subsequently, the defendant approved a merger with an LLC in which the defendant had a majority stake.¹⁰⁵ The *Via Christi* opinion assumes that fiduciary duties did apply to the defendant as controlling limited partner.¹⁰⁶ However, the Kansas Supreme Court ruled that the self-dealing involved in the transaction was insufficient on its own to create any presumption that would have shifted

96. See *supra* Part II.B.

97. The current version of the Kansas LLC act was enacted in 1999 and entered into force in 2000. See Kansas Revised Limited Liability Company Act, 1999 Kan. Sess. Laws 701, 701-56 (current version at KAN. STAT. ANN. §§ 17-7662 to -76,142 (2007 & Supp. 2010)).

98. Compare DEL. CODE ANN. tit. 6, § 18-1101 (West 2006 & Supp. 2011), with KAN. STAT. ANN. § 17-76,134 (2007).

99. See KAN. STAT. ANN. § 17-76,134(c)(2). The Kansas statute also omits a reference to the implied covenant of good faith and fair dealing. See *id.* at § 17-76,134(c). However, its omission is unlikely to have a significant practical impact. See *infra* note 148.

100. See *supra* Part II.B.

101. See *infra* Part III.A.

102. 133 P.3d 122 (Kan. 2006).

103. *Id.* at 125.

104. *Id.* at 125-26.

105. *Id.* at 126.

106. See *id.* at 136.

the burden to the defendant.¹⁰⁷ This restrictive approach favors the enforcement of entity agreements and thus could serve as insight into how the court might treat an LLC agreement containing a fiduciary duty waiver.

D. Alternative Approaches

Still, Delaware's approach is not the only option available for Kansas. Three main alternatives to the Delaware approach have been proposed: (1) the approach envisioned in Revised Uniform Limited Liability Company Act (RULLCA), (2) the mandatory core approach, and (3) an approach that incorporates contract law-based protections.

Kansas's history of lockstep imitation of Delaware¹⁰⁸ makes it unlikely that the state will take affirmative action to enact any of these approaches. But the Kansas judiciary could still conceivably choose to incorporate aspects of these approaches into state common law or approximate their results by following a *Gotham*-like course of action¹⁰⁹ that allows for the restriction, but not elimination, of fiduciary duties.

1. The Revised Uniform Limited Liability Company Act

In contrast with the Delaware approach, which leaves it to courts to define fiduciary duties,¹¹⁰ RULLCA affirmatively establishes fiduciary duties.¹¹¹ RULLCA's listed fiduciary duties include both the duty of care and the duty of loyalty.¹¹² The act further identifies the discrete obligations those duties entail and the standards upon which such obligations are based.¹¹³ While examining how RULLCA defines its twin duties of loyalty and care is unnecessary, an examination of the law's limitations on waiver is informative.

RULLCA allows parties to opt out of . . . [the duty] of care, subject to only three substantive limitations. First, the duty of care may not be entirely eliminated. Second, the standard of care reconstituted by the

107. *Id.* at 140–43.

108. *See* Hecker, *supra* note 94, at 975.

109. *See supra* notes 44–47 and accompanying text.

110. *See supra* Part II.A (discussing the common law of fiduciary duties).

111. REVISED UNIF. LTD. LIAB. CO. ACT § 409 (2006); *see also* Campbell, *supra* note 5, at 35–36, 46–48 (discussing the uniform act's duty of care and duty of loyalty provisions).

112. *See* REVISED UNIF. LTD. LIAB. CO. ACT § 409.

113. *See id.*

parties may not be “manifestly unreasonable.” Finally, the reconstituted standard of care may not “authorize intentional misconduct or knowing violation of [the] law.”¹¹⁴

RULLCA’s duty of care provisions could be interpreted as maintaining a “mandatory core” of fiduciaries; however, any such “core” enunciated in RULLCA is generally narrower than most mandatory core proponents would prefer to maintain.¹¹⁵ RULLCA is generally more permissive with regard to waivers of the duty of loyalty.¹¹⁶ “[T]he only substantive limit that RULLCA imposes on the scope of an opt out of the duty of loyalty is that the opt out cannot be ‘manifestly unreasonable.’”¹¹⁷ RULLCA does allow for the elimination of the duty of loyalty, but it does not go as far as the Delaware act, which does not require a reasonableness test for a valid waiver.¹¹⁸

2. The Mandatory Core Approach

Another approach maintains that some “mandatory core” of fiduciary duties should remain unwaivable.¹¹⁹ The original Uniform Limited Liability Company Act (ULLCA) takes this approach.¹²⁰ While the revised version allows a broad waiver of the duty of loyalty subject to a reasonableness test,¹²¹ ULLCA embraces a more restrictive mechanism. ULLCA prevents the elimination of the duty of loyalty but allows parties to identify specific categories of activities that are exempted.¹²² As a practical matter, the inclusion of a long list of exemptions can effectively eliminate the duty of loyalty.¹²³ When engaging in activities unforeseen in the LLC agreement, however, a “mandatory core” of fiduciary duties would still remain.¹²⁴

114. Campbell, *supra* note 5, at 43 (citations omitted).

115. See *infra* Part II.D.2.

116. See REVISED UNIF. LTD. LIAB. CO. ACT § 110(c)(4); see also Campbell, *supra* note 5, at 50.

117. Campbell, *supra* note 5, at 50. An examination of what constitutes “manifestly unreasonable” restrictions is not necessary. Any reasonableness test is inconsistent with the Kansas and Delaware statutes. See *infra* Part III.A.2.

118. See *infra* Part III.A.2.

119. See, e.g., DiMatteo, *supra* note 39, at 302–04; Miller, *supra* note 40, at 600–04.

120. UNIF. LTD. LIAB. CO. ACT §§ 103(b)(2)–(3), 409(a)–(c) (1996).

121. See *supra* Part II.D.1.

122. UNIF. LTD. LIAB. CO. ACT § 103(b)(2).

123. Cf. Vestal, *supra* note 5, at 559 (discussing a similar feature in RUPA that allows parties to “craft[] a series of limitations that would, when taken together, effectively eliminate the duty of loyalty”).

124. See UNIF. LTD. LIAB. CO. ACT §§ 103(b)(2)–(3), 409(a)–(c).

Professor Sandra Miller proposes that a small amendment to RULLCA could achieve the same result:

The Mandatory Core approach to fiduciary duties . . . supports the approach taken in *earlier* [drafts of RULLCA] that prohibited the complete contractual elimination of duties. The paradigm suggested would permit considerable contractual modification of duties, but would do so against the backdrop of well-developed common law standards that presuppose a general duty of loyalty. . . .

Ultimately, this thesis would support the widespread enactment of [RULLCA], but recommend that states modify the wording of [its fiduciary duty provisions] to comply with [earlier versions].¹²⁵

Kansas courts could conceivably adopt such an approach by interpreting the current legislative language in the same way the Delaware Supreme Court did in *Gotham*, the approximate result of which would be a preservation of a mandatory core of fiduciary duties.¹²⁶

3. Incorporation of Contract Law Principles

Yet another approach merely incorporates the protections offered under contract law principles. Professor Larry DiMatteo argues that Delaware's contract-based approach necessitates the incorporation of contract law principles found in common law:

Freedom of contract in modern contract law is restricted by immutable rules, such as reasonableness, unconscionability, good faith, and fair dealing. Furthermore, specific clauses are highly regulated, including limitations of liability, liquidated damages, limitation of remedy, and exculpatory clauses. Because the Delaware Act fails to define freedom of contract or provide standards of conduct, the jurisprudence of the entire common law of contracts should be used in the interpretation of operating agreements.¹²⁷

Commentators who suggest this course of action, however, often offer only a milquetoast endorsement.¹²⁸ Both DiMatteo and Miller propose that states allowing elimination of fiduciary duties should

125. Miller, *supra* note 40, at 603.

126. See *supra* notes 44–48 and accompanying text.

127. DiMatteo, *supra* note 39, at 283.

128. See *id.* at 302; Miller, *supra* note 40, at 589.

establish an overlay of contract law-based protections, but both ultimately argue that a mandatory core approach is superior.¹²⁹

III. ANALYSIS

Despite the lack of an express invitation for parties to eliminate fiduciary duties in the Kansas LLC act, an examination of the act reveals an intent by the legislature to allow elimination.¹³⁰ This revelation closes off the alternative approaches envisioned by commentators and in other model codes.¹³¹ Kansas and Delaware, then, are similarly positioned—both must decide on default rules and standards for effective waiver.¹³² Delaware precedent is inconsistent on this issue, leaving those issues insufficiently answered in that state and providing little persuasive authority to guide states that follow the Delaware model.¹³³ Regardless of how these questions are ultimately answered in Delaware, an examination of both Delaware and Kansas statutes reveals that fiduciary duties should apply by default.¹³⁴ When deciding what constitutes sufficient waiver, policy considerations should lead Kansas courts to require explicit waiver.¹³⁵

A. *The Kansas Statute Mandates Enforcement of Fiduciary Duty Waivers*

The three main alternatives to Delaware's approach—the approach advanced in RULLCA, the mandatory core approach, and an approach that incorporates contract law principles—are unavailable to the Kansas judiciary. The three approaches fail due to their inconsistency with the Kansas statute, and their adoption would thus require action by the Kansas legislature.

129. For example, Professor Miller argues: "It is hoped that the jurisdictions permitting the broad elimination of fiduciary duties will develop meaningful limitations to curb abusive conduct using contractually based concepts. However, . . . the better approach is to statutorily prohibit the complete elimination of fiduciary duties." Miller, *supra* note 40, at 589; *see also* DiMatteo, *supra* note 39, at 302–03.

130. *See* KAN. STAT. ANN. § 17-76,134 (2007).

131. *See infra* Part III.A.1–3.

132. *See* KAN. STAT. ANN. § 17-76,134; *see also infra* Part III.B–C.

133. *See supra* Part II.B.1–2.

134. *See infra* Part III.B.

135. *See infra* Part III.B–C.

1. The Kansas Statute Allows the Complete Elimination of Fiduciary Duties

The Delaware Supreme Court's approach in *Gotham*, at least nominally, is not an adoption of the mandatory core approach, but it achieves a similar end: the preservation of an immutable core of fiduciary duties.¹³⁶

Advocates for this approach might argue that the Kansas statute has yet to be amended, as Delaware's statute has, to expressly allow for the elimination of fiduciary duties.¹³⁷ This argument makes an accurate point that the Kansas legislature might choose to outsource the labor of statute-writing, but it does not outsource its intent. Put more simply, while we might infer from Delaware's quick legislative response to *Gotham* a consistent intent to allow for the elimination of fiduciary duties,¹³⁸ no similar inference can be made regarding the Kansas legislature's inaction.

Such an argument is logical, but wholly pedantic. There is no evidence that the esoteric issue of fiduciary duties in alternative entities would be the issue that convinced Kansas to break with Delaware—that Kansas was willing to follow Delaware's constant march toward unfettered laissez-faire economics but once it stared into the dilated pupils of the beast of no fiduciary duties, dared to go no further. No, by consistently outsourcing legislative prerogative to Delaware, the Kansas legislature has indicated an approval of Delaware's trend toward liberalization. Regardless, the intent of the legislature is sufficiently evidenced in the pre-2004 version of the law that Kansas uses.

In fact, *Gotham* was probably an incorrect decision at the time it was made, regardless of any reactive legislative action.¹³⁹ In *Gotham*, the Delaware Supreme Court focused narrowly on the statute provision that allowed only for the “expans[ion] or restrict[ion]” of fiduciary duties.¹⁴⁰ Reading the provision in a vacuum, it is not unreasonable that one would conclude it falls short of expressly allowing complete waiver. A more comprehensive approach, which observes and upholds the statute's clear

136. See *supra* Part II.B.

137. See KAN. STAT. ANN. § 17-76,134.

138. See Steele, *supra* note 38, at 11–12 (“It is fair to say that the Delaware Supreme Court [in *Gotham*] . . . failed to recognize a clear legislative intent to enable parties to negotiate contractual relationships . . .”).

139. See *id.*

140. See *Gotham Partners v. Hallwood Realty Partners*, 817 A.2d 160, 160 (Del. 2002) (quoting DEL. CODE ANN. tit. 6, § 18-1101(b) (2002)).

policy goals and rules of interpretation,¹⁴¹ reveals the conclusion in *Gotham* was unfounded.

The Kansas and Delaware statutes both give “maximum effect to the principle of freedom of contract and to the enforceability” of the terms of LLC agreements.¹⁴² Observing a fiduciary duty waiver and choosing not to enforce it, as the court did in *Gotham*, is in contravention of the stated policy goal of enforceability. Furthermore, the statutes’ rules of interpretation preclude *Gotham*’s excessively narrow reading.

The Kansas Supreme Court arguably shares the desire to maintain the enforceability of parties’ agreements.¹⁴³ While *Via Christi* did not involve the waiver of fiduciary duties, it did evidence a restrictive approach to fiduciary duties that favors the enforcement of entity agreements.¹⁴⁴ As final arbiter, the Kansas Supreme Court may choose to extend these enforcement considerations to fiduciary duty waivers. Kansas courts, despite dealing with identical statutory language, should come to a different conclusion than that reached in *Gotham* and allow the complete waiver of fiduciary duties.

2. RULLCA-esque Limitations Hamper the Statute’s Policy Goals

Kansas courts could, however, conceivably choose to impose a reasonableness condition on the statute’s allowance of fiduciary duty waivers. This is the approach adopted in most parts of RULLCA, which allows fiduciary duties to be completely eliminated so long as their elimination is not “manifestly unreasonable.”¹⁴⁵ The Kansas statute currently allows the elimination of fiduciary duties, but it does not expressly propose what parties must do to effectively eliminate fiduciary duties. Therefore, the argument goes, the judiciary is free to imply a reasonableness condition on their elimination. But despite acknowledging that fiduciary duties may be eliminated under the statute, this approach still runs afoul of the statute’s policy goals.¹⁴⁶ In the instance that a fiduciary duty waiver is limited by a court as a result of

141. See DEL. CODE ANN. tit. 6, § 18-1101(c) (2002), amended by Act effective Aug. 1, 2004, 74 Del. Laws 612, 613 (2004).

142. See *id.* § 18-1101(b); KAN. STAT. ANN. § 17-76,134(b).

143. See *Welch v. Via Christi Health Partners*, 133 P.3d 122, 141–42 (Kan. 2006).

144. *Id.* at 142 (“Under the terms of their agreement and Kansas law, Via Christi had the authority to orchestrate the merger.”).

145. See *supra* Part II.D.1.

146. See DEL. CODE ANN. tit. 6, § 18-1101(b) (West Supp. 2011); KAN. STAT. ANN. § 17-76,134(b).

being unreasonable, the enforceability of that waiver is compromised. As such, this RULLCA-esque approach does not sufficiently fulfill the goal of enforceability. The Kansas statute allows complete waivers of fiduciary duties—yes, even unreasonable ones.

Of course, unreasonable waivers that frustrate a party's reasonable expectations might still be set aside under the implied covenant of good faith and fair dealing.¹⁴⁷ Any limitation on waivers, however, must not be broader than the statutorily approved covenant.¹⁴⁸

Because fiduciary duties are fully waivable under the Delaware model, the model may subject Kansas and Delaware courts to significant pressure to adopt some sort of limitation to parties' broad power to waive fiduciary duties, especially when such a waiver results in inequity. It is necessary under the Delaware model that courts exercise restraint and tolerate a modicum of inequity to further the goals of enforceability and freedom of contract. While such an approach might seem antithetical to the role of modern courts of equity, it is worthwhile to keep in mind that at least some of the benefits of a contract-based approach occur outside the courtroom—by avoiding a judicial standard of oversight that promotes opportunistic lawsuits and post hoc rewriting of agreements.¹⁴⁹ Whether the benefits of this approach outweigh the potential benefits of a more interventionist judiciary is ultimately a quantitative question, and such a question is difficult to answer. A proposed benefit of the contract-based model is the *avoidance* of litigation, which, because disputes fail to arise, is difficult to quantify.¹⁵⁰ Ultimately though, this policy

147. See DEL. CODE ANN. tit. 6, § 18-1101(c).

148. While the Delaware act does embrace the implied covenant of good faith and fair dealing as an unwaivable principle, the Kansas statute does not. DEL. CODE ANN. tit. 6, § 18-1101(c); KAN. STAT. ANN. § 17-76,134(c). The import of the covenant's omission might at first appear consequential. However, Professor Edwin Hecker observes that while

the [Kansas act] does not codify an obligation of good faith and fair dealing[,] . . . limited liability companies are highly contractual in nature, and Kansas case law implies a covenant of good faith and fair dealing in all contracts other than those relating to employment at will. Therefore, members and managers of Kansas limited liability companies are subject to the obligation of good faith and fair dealing, and it will be applied in a manner analogous to partnership law.

Hecker, *supra* note 94, at 1003 (footnotes omitted).

149. In the context of arguing for narrowly defined fiduciary duties, Ribstein acknowledged the moral hazard that broad fiduciary duties may create in some circumstances. See Ribstein, *supra* note 33, at 235–36. “Where the costs and benefits of ex post litigation are asymmetrical a broad remedy gives a party the power to use litigation to extract more from the deal than the parties bargained for. In other words, the power to litigate creates a moral hazard.” *Id.* at 235.

150. See *id.* at 234–35 (discussing the role of “extralegal incentives” in LLC governance and the difficulty of assessing the benefits of fiduciary duties because such benefits “cannot be measured by observing conduct in reported cases because extralegal incentives *help most in reducing disputes*” (emphasis added)).

question is beyond the reach of the courts because the Kansas and Delaware legislatures have provided for complete fiduciary waivers and, importantly, their enforcement.

3. The Incorporation of Contract Law Principles Is Similarly Disallowed

An approach that adopts contract law principles as a proxy for fiduciary duties is similarly disallowed. Professor Larry DiMatteo offers a strong rebuttal to the contract-based approach that Delaware has adopted:

The major problem of the contract model of LLCs is that it begins and ends at a point that reflects out-of-date contract law theory. Its premise is that the enforcement of [LLC] agreements should begin and end with the express terms. This is the realm of legal formalism and classical legal theory.¹⁵¹

DiMatteo's observation is incisive. The Delaware legislature purported to adopt a contract-based approach but then refused to adopt an application of contract law jurisprudence.¹⁵² This atavistic approach embraces a form of contract law that no longer exists.¹⁵³ The incorporation of contract law principles offers an attractive, logical consistency and may even represent sound policy; however, it fails due to a single, but significant, flaw—such an approach is decidedly contradictory to the statute.

If the Delaware act had simply stated a mandate to incorporate contract law into LLC governance, we might infer an intent to employ all aspects of contract law. The Delaware act does not do this. The Delaware act not only embraces the freedom of contract but also cites the act's policy goal of giving "maximum effect" to the enforceability of LLC agreements.¹⁵⁴ The contract law principles that DiMatteo cites, such as unconscionability and reasonableness,¹⁵⁵ are equitable principles that *impede* enforceability rather than promote it. It would follow from

151. DiMatteo, *supra* note 39, at 308.

152. See DEL. CODE ANN. tit. 6, § 18-1101.

153. See DiMatteo, *supra* note 39, at 308 (explaining that the modern contract-interpretation approach is more contextual).

154. DEL. CODE ANN. tit. 6, § 18-1101(b).

155. DiMatteo, *supra* note 39, at 283.

the act's clear policy objective that contract law principles standing as obstacles to enforceability were intended to be superseded.

Supporters might point to the statute's inclusion of the implied covenant of good faith and fair dealing¹⁵⁶ as recognition of the applicability of contract law principles,¹⁵⁷ but such an assertion assumes too much. Recognizing that some contract law is applicable and useful to LLC governance and thus incorporating it does not result in a broader adoption of contract law principles. This is the case in the Delaware statute, which includes one contract law principle but not others. Had the Delaware legislature intended to incorporate other contract law principles into the law, those principles may have been similarly enunciated.¹⁵⁸

It might be interesting, or possibly painful, to view how courts reconcile the rift between common-law contract law—with its overlay of duties and protections—with the bare-bones contractual relationship envisioned in Kansas and Delaware LLC statutes.¹⁵⁹ Courts may be expected to enforce bargains under the LLC statute that they would, under any other contractual relationship, generally set aside.¹⁶⁰ However, regardless of the potential difficulties of early application, this bare-bones contractual approach is the one adopted by the Kansas legislature.

It is conceivable that Kansas courts might still be seduced into incorporating contract law principles in an effort to end-run the statute, or a genuine attempt to address new and novel questions with existing jurisprudence. But as such an approach does not effect the intent of the legislature, Kansas courts would be ill-advised to adopt it.

B. Fiduciary Duties Should Serve as Default, but Fully Waivable, Rules

Concluding that the Kansas statute allows complete waivers of fiduciary duties and is unrestricted by a reasonableness test or an incorporation of contract law is but one step in the analysis. The second

156. DEL. CODE ANN. tit. 6, § 18-1101(c).

157. DiMatteo, *supra* note 39, at 295 (“[T]he statute at least implicitly recognizes the applicability of the common law of contracts.”).

158. *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (“[T]he limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”).

159. *See id.* § 18-1101; KAN. STAT. ANN. § 17-76,134 (2007).

160. One might imagine a situation where an LLC provision might be unconscionable or, as a result of changed circumstances, lead to a frustration of purpose. How courts will deal with such an issue has yet to be seen. Such circumstances could be rare because such provisions may also run afoul of the implied covenant of good faith and fair dealing. *See supra* note 147–48 and accompanying text. While the Kansas statute lacks an explicit reference to the covenant, it is unlikely that its absence will have much of an effect in practice. *See supra* note 148.

step requires an answer to an ancillary question: What default rules apply when the LLC agreement is silent? There are two main approaches Kansas courts could adopt in answering this question: (1) the pure contractarian approach that assumes no default duties except those arising out of the implied covenant of good faith and fair dealing or (2) a contract-based approach that uses fiduciary duties as default, but fully waivable, rules. Further examination of the statute and a consideration of important policy objectives suggest that the second option is the only tenable option under the Kansas statute.

1. The Kansas Statute Embraces Fiduciary Duties as Default Rules

Under the pure contractarian approach, no fiduciary duties would be assumed unless expressly adopted by the LLC agreement.¹⁶¹ Under this regime, the only protection that would apply by default would be the implied covenant of good faith and fair dealing.¹⁶²

There are ample and significant reasons for Delaware courts to retreat from resolving governance disputes within unincorporated entities based upon a focus on status relationships that entails a common law scrutiny potentially at odds with statutory policy and the contracting parties' intent. That potential disconnect is reason enough for Delaware courts to refocus on contractual relationships and the potential for gap filling through the implied covenant of good faith and fair dealing.¹⁶³

This may very well be the approach that Delaware will take in the future.¹⁶⁴

Language in the statute, however, does not indicate that fiduciary duties were intended to be eliminated by default. The Delaware statute states: "To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) . . . [those] duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement."¹⁶⁵ The import of the statute's language is obvious. Not only does the statute acknowledge that duties "at law or in equity" are applicable to the LLC context, it references fiduciary duties explicitly. In addition to identifying such common-law duties, the statute

161. See Steele, *supra* note 38, at 29.

162. See *id.*

163. *Id.*

164. See *id.*; Pileggi, *supra* note 60.

165. DEL. CODE ANN. tit. 6, § 18-1101(c) (West Supp. 2011).

makes no effort to alter them, instead leaving any alteration to those party to the LLC agreement. The equivalent clause in the Kansas statute includes the same prefatory language, so it similarly implies the applicability of fiduciary duties as default rules.¹⁶⁶

One possible rebuttal to this interpretation is that the stated policy goal of “enforceability” is abridged.¹⁶⁷ In truth, this approach embraces the freedom of contract by allowing parties to fully waive fiduciary duties. Furthermore, explicit inclusion of fiduciary duties, much like the explicit reference to the implied covenant of good faith and fair dealing, implies their consistency with the statute’s policy goals. Regardless, any obstacle to enforceability presented by a *fully amendable* default rule is negligible at best.

It is important to take a moment to further note the extent to which the statute cedes to common law. The statute includes fiduciary duties “[t]o the extent” that they exist “at law or in equity.”¹⁶⁸ The statute therefore is not creating an implication of broad fiduciary duties applied to every member—it is suggesting that those that have such a duty under the common law will continue to do so under the statute. Therefore, if we assume Ribstein’s managerial theory of fiduciary duties is correct, a nonmanaging, noncontrolling member would still not owe default fiduciary duties under the statute.¹⁶⁹ It is unnecessary to examine the exact types of situations that give rise to fiduciary duties, suffice to say that the statute does not purport to edit those common law rules and thus implies courts should continue to apply fiduciary duties when appropriate under common law.¹⁷⁰

2. Protections in the Pure Contractarian Approach Are Illusory

A significant shortcoming of the pure contractarian approach is the illusory promise that the implied covenant of good faith and fair dealing can serve as a gap-filler in LLC agreements.¹⁷¹ The truth is that while the Delaware LLC act purports to establish the covenant as an immutable

166. See KAN. STAT. ANN. § 17-76,134(c) (2007).

167. See *id.* § 17-76,134(b).

168. DEL. CODE ANN. tit. 6, § 18-1101(c).

169. See *supra* notes 62–66 and accompanying text.

170. See DEL. CODE ANN. tit. 6, § 18-1101(c).

171. See Steele, *supra* note 38, at 29 (arguing that the good faith and fair dealing concept is “freewheeling”).

concept in LLC agreements, in practice, the covenant has been rendered almost entirely feckless, at least as applied by Delaware courts.¹⁷²

[I]t is clear that “a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter.” Only rarely invoked successfully, the implied covenant . . . protects the spirit of what was *actually bargained and negotiated for* in the contract.¹⁷³

The instances where a missing term is firmly ensconced in the bargained-for terms of the agreement, yet still somehow omitted from its express terms, are irreducibly narrow.¹⁷⁴

The covenant’s purported scope further shrinks when a party engages in conduct authorized by the LLC agreement.¹⁷⁵ “[O]ne generally cannot base a claim for breach of the implied covenant on conduct authorized by the agreement.”¹⁷⁶ The implicit effect of this standard is that conduct authorized in the terms of an LLC agreement is presumed to be fair and in good faith. This presumption is not overcome by a preponderance of the evidence but only overcome when sufficient facts are presented as to create a compelling case that the conduct was in fact unfair.¹⁷⁷ When exercising an option provided for by the LLC agreement, even a grossly negligent and unreasonable party will be considerably inoculated from judicial oversight.¹⁷⁸ One might argue that a party conceivably should be allowed to *bargain for* such a protection, but it is quite another thing to argue that such behavior should be tolerated *by default*.

Pure contractarians might consider the narrow applicability of the covenant to be an advantage as it serves the further goal of limiting potentially costly judicial oversight. It is true that the inefficacy of the covenant alone is not in itself grounds to dismiss the pure contractarian approach. However, the pure contractarian’s envisioned role of the

172. See *supra* Part II.B.2 (discussing the low level of protection offered by Delaware courts).

173. *Fisk Ventures v. Segal*, No. 3017-CC, 2008 WL 1961156, at *10 (Del. Ch. May 7, 2008) (internal footnotes omitted).

174. *But see* *O’Tool v. Genmar Holdings*, 387 F.3d 1188, 1195–98 (10th Cir. 2004) (discussing a plaintiff that was denied fair opportunity to benefit from bargained-for provisions in the contract).

175. See *Nemec v. Shrader*, 991 A.2d 1120, 1125–26 (Del. 2010).

176. *Id.* (quoting *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 441 (Del. 2005)).

177. *Id.* at 1126 n.16.

178. See *id.* at 1126.

covenant as a gap-filler is a bit optimistic for a covenant that has yet to actually succeed in filling any gaps in LLC agreements.¹⁷⁹

The covenant also fails for a more fundamental reason. The purported value of the covenant is its protection of parties' reasonable expectations,¹⁸⁰ but the nature of LLCs makes this an ineffective tool for doing so. Unlike most contracts, the formation of an LLC envisions joint and sustained enterprise.¹⁸¹ When people form an LLC, they agree "to advance the collective interest and not [their] short term individual interest."¹⁸² This ongoing nature of an LLC necessitates a view that allows for adaptability to changed circumstances.¹⁸³ Despite the covenant's protection of reasonable expectations,¹⁸⁴ it is impossible that parties would have any expectations at all with regard to unforeseen circumstances, which, by their nature, were unexpected. Of course, experienced agreement drafters can succeed in protecting themselves against unforeseen circumstances by crafting adaptable or broadly applicable safeguards, such as exit provisions, managerial audits and oversight, and buy-out provisions. The contract-based approach of Delaware and Kansas allows parties to do this, but the approach should not impute this level of sophistication on all aspiring LLC members. The adaptability of fiduciary duties to changing circumstances promotes their use as default, but fully waivable, rules.¹⁸⁵

3. Default Fiduciary Duties Better Protect Parties' Expectations

Historical context should play a limited role in deciding the best policy going forward. It is, however, still relevant, inasmuch as it affects the expectations of the parties. That fiduciary duties have historically applied by default¹⁸⁶ is important in that it affects parties' expectations with regard to the existence of such duties. Humorously, while the pure contractarian approach would prefer no default assumption of the applicability of fiduciary duties,¹⁸⁷ the adoption of the implied covenant

179. See *supra* notes 90–92 and accompanying text.

180. See *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996).

181. Cf. *Vestal*, *supra* note 5, at 527 (discussing formation in the context of partnerships).

182. *Id.* (discussing the nature of partnerships).

183. Cf. *id.* at 540 ("The only way to accommodate successfully the unforeseen variations either in a given partnership or in partnerships generally is to allow for accommodation after the fact.").

184. See *Pressman*, 679 A.2d at 443.

185. See *Vestal*, *supra* note 5, at 540–41 (discussing the "flexibility and adaptability" of fiduciary duties).

186. See *supra* Part II.A.

187. See *supra* notes 161–73 and accompanying text.

of good faith and fair dealing could conceivably serve to incorporate traditional fiduciary duties. The covenant protects the “reasonable expectations” of the parties;¹⁸⁸ however, it is conceivable that the parties to an LLC agreement might *reasonably expect* that their fellow members are bound by the most fundamental duties that have governed like parties for decades: traditional fiduciary duties.¹⁸⁹ Such a line of reasoning appears facetious, but it does augur an important issue to consider in crafting the best policy—that fiduciary duties are expected.

The formation of a business envisions an ongoing relationship.¹⁹⁰ Parties are rarely successful at hammering out all the necessary provisions to govern such a relationship in advance, so parties generally provide their colleagues some level of discretion by which to respond to changing circumstances.¹⁹¹ It is the nature of this discretion that promotes the use of fiduciary duties.¹⁹² While Ribstein argues for the right of parties to waive fiduciary duties, he also recognizes the efficiency-enhancing aspects of accompanying fiduciary duties with the delegation of broad discretionary power.¹⁹³ When one affords a fellow member a certain amount of managerial discretion, it should be expected that she exercise that discretion within long-established norms. The presumption that such a member’s actions are bound by considerations of reasonableness and fairness is one that has existed throughout the twentieth century.¹⁹⁴ This presumption should be maintained in LLC governance.

4. Forcing Waiver Preserves LLCs’ Accessibility

A major benefit of the contract-based approach is the flexibility it provides.¹⁹⁵ LLCs can be customized to fit the unique requirements of each individual venture by allowing LLC members a boundless environment in which to innovate.¹⁹⁶ However, it is important to acknowledge that flexibility can damage another attractive attribute of

188. *Pressman*, 679 A.2d at 443.

189. *See supra* Part II.A.

190. Vestal, *supra* note 5, at 527.

191. *See Ribstein*, *supra* note 33, at 212.

192. *See id.*

193. *See id.*

194. *See supra* Part II.A.

195. 1 RIBSTEIN & KEATINGE, *supra* note 27, § 3:3 (“[T]he LLC form offers enhanced flexibility that . . . is an appropriate alternative to incorporation or limited partnership for some firms.”).

196. *See id.*

LLCs—accessibility. LLCs are created with relative ease and without the formality that generally accompanies forming and operating corporations.¹⁹⁷ But accessibility is abridged when the landscape of LLCs is littered with potential legal pitfalls. That is not to say that accessibility and flexibility are dueling objectives. Measures that preserve the accessibility of LLCs without damaging their flexibility are no-brainers. The adoption of fiduciary duties as default, fully waivable rules is one such measure.

An analogy to bumper bowling is apt. Inexperienced bowlers may decide that bumper bowling, rather than conventional bowling, is the most suitable game for them. Those inexperienced bowlers can play to their heart's content without the risk of a gutter ball ruining their fun. The existence of bumper bowling, however, does not prevent more experienced bowlers from engaging in the sport sans bumpers. A simple flick of the wrist converts a bumpered lane into a conventional bowling lane. Furthermore, any trip to a bowling alley, even on Disco Thursdays, will reveal bumper bowlers and conventional bowlers cohabitating without issue.

In case the analogy was not clear enough, fiduciary duties as default, fully waivable rules provide experienced parties with the means to craft the agreement they wish without imperiling less experienced parties with the “gutter balls” that discourage their participation. This approach maintains flexibility by allowing parties that wish to fully eliminate fiduciary duties to do so, while maintaining an accessible, hazard-free environment for LLC virgins.

The legally inexperienced should be a consideration in policy decisions for both Kansas and Delaware, but this consideration is especially important in Kansas. Delaware has created an industry in the state by attracting businesspeople from around the country to incorporate under its unrestrained business laws.¹⁹⁸ There is a question, however, whether Kansas should choose to emulate such an approach. In contrast to the state-hopping, legally sophisticated Delaware investor, Kansas should be mindful of an equally important constituent—the middle-income entrepreneur. While a small business's capitalization may be smaller, the stakes can be larger when that owner relies on the business for her livelihood. Kansas courts should be aware that not every

197. See Ribstein, *supra* note 15, 11–12 (noting the combination of corporate-type limited liability with more simple partnership-type management and taxation).

198. “More than 50% of all publicly-traded companies in the United States including 63% of the Fortune 500 have chosen Delaware as their legal home.” *About Agency*, DEL. DIV. OF CORPS., <http://corp.delaware.gov/aboutagency.shtml> (last visited Jan. 6, 2011).

investor–manager relationship is one envisioned by the attorneys of venture capitalists. Kansas courts should, within the framework adopted by the legislature, consider how their decisions may affect less-sophisticated, but no less important, small business owners. The equitable principles that govern traditional fiduciary duties best protect this important constituent.

LegalZoom, an online service offering legal documents, provides LLC formation services.¹⁹⁹ After filling out a “simple online questionnaire,” LegalZoom creates your LLC documents and files them with the appropriate secretary of state.²⁰⁰ This is a positive development. If a person decides to turn her affinity for crafts into a part-time business enterprise, she should not be forced to retain counsel to do so. Joining with a sister-in-law to sell aromatic candles at the renaissance fair is not the sort of endeavor that requires vociferous bargaining across a conference table. The unnecessary abridgment of LLCs’ accessibility discourages this kind of participation. Even if this aspiring candle-maker is in the minority, it is a minority that deserves protection.

That is not to say that Kansas should not seek to attract investors from outside the state; establishing fiduciary duties as default rules does not discourage the legally sophisticated. Experienced parties, in line with the Kansas statute,²⁰¹ are fully free to waive fiduciary duties. Requiring waiver of fiduciary duties enables first-time entrepreneurs to form an LLC without the additional risk of falling prey to legal chicanery by their more experienced counterparts. This necessary protection, however, in no way impedes those that prefer to opt out.

C. Fiduciary Duty Waivers Must Be Explicit

The applicability of fiduciary duties as waivable, default rules raises an additional question: What is required to waive fiduciary duties? Recent Delaware cases suggest that fiduciary duties can be waived by incorporating LLC terms that are inconsistent with traditional fiduciary duties.²⁰² Such an approach creates an unclear standard, subjects parties to perilous trap-door agreements, and fails to provide sufficient notice to

199. *LLC Formation & Business Incorporation Services*, LEGALZOOM, <http://www.legalzoom.com/limited-liability-company/limited-liability-company-overview.html> (last visited Jan. 24, 2011).

200. *Id.*

201. *See supra* Part III.A.

202. *See, e.g.*, *Related Westpac LLC v. JER Snowmass LLC*, No. 5001-VCS, 2010 WL 2929708, at *8 (Del. Ch. July 23, 2010).

parties to the LLC agreement. The superior policy approach is to require an explicit waiver of fiduciary duties. This clear standard aids in the process of contract drafting by forcing parties to negotiate their business relationship in a manner that places all parties on notice.

1. Mere Inconsistency Is Not Enough

In its recent *Related Westpac* decision, the Delaware Court of Chancery established that fiduciary duties can be waived when the terms of the LLC agreement are inconsistent with the application of fiduciary duties.²⁰³ The case is unpublished, and it is unclear whether its approach will be applied more broadly. What is clear is that such a standard produces uncertain results and serves as a questionable guide for attorneys.

In *Related Westpac*, an express exclusion of one LLC member from a reasonableness limitation was treated as a broad waiver of fiduciary duties.²⁰⁴ The court correctly identified an LLC agreement provision allowing a member to *unreasonably* refuse capital calls as inconsistent with traditional fiduciary duties.²⁰⁵ However, an exemption from a fiduciary duty standard fails to provide any standard at all. The capital-call provision in *Related Westpac* would reasonably be interpreted to allow a member to act unreasonably, but it does not necessarily follow that he may also act in bad faith or otherwise breach the duty of loyalty. Furthermore, an exception for unreasonable behavior fails to completely eliminate the duty of care. Would, for example, an exception for unreasonable behavior allow a member to act recklessly? *Related Westpac* shows that even minor provisions narrowly abridging fiduciary duties might have the effect of waiving fiduciary duties more broadly.²⁰⁶ The plaintiff in the case was on notice that his fellow member was unbound by a reasonableness restriction in refusing capital calls, but it is unlikely that he could have foreseen that his colleague might be inoculated against judicial oversight on broader grounds.

As support for the contract-based approach to unincorporated entities, proponents often cite the decreased likelihood of judicial intervention in the terms of the LLC agreement.²⁰⁷ This argument is

203. *Id.* at *8; *see also supra* Part II.B.1.b.

204. *See Related Westpac*, 2010 WL 2929708, at *8; *see also* Pileggi, *supra* note 70.

205. *See id.*

206. *See id.*

207. *See* Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 550 (1997) (discussing the inefficiency and costs of enforcing fiduciary duties).

valid; members of the judiciary should not seek to solve the controversy in front of them without adequate consideration as to how their decision might affect the behavior of parties outside their courtroom. The *Related Westpac* approach squanders the potential efficiency-enhancing aspects of the contract-based approach by establishing a nebulous standard of review that creates uncertainty in judicial oversight. The smarter approach is to adopt a clear standard that requires explicit waiver of fiduciary duties. Not only does explicit waiver limit the uncertainty of judicial oversight, it also provides a clear standard by which parties can craft LLC agreements.

Such an approach does not impair the statute's goals of enforceability.²⁰⁸ To the contrary, express terms in an LLC agreement that are inconsistent with fiduciary duties would be fully enforceable. However, such express terms should only amend fiduciary duties to the extent that the term is inconsistent with them and not purport to waive fiduciary duties broadly. In *Related Westpac*, this approach would still respect the defendant's bargained-for right to unreasonably refuse capital calls, but it would not assume that a broad waiver was intended when there was no expression of such.

2. Reducing Uncertainty in the Business Relationship

Inherent in the contract-based approach is the assumption that the terms of an LLC agreement are negotiated for, and thus judges should be reluctant to intervene and set aside contractual rights and duties.²⁰⁹ The reality of LLC agreement negotiations does not bear out this presumption.²¹⁰ Surveys suggest that LLC agreements are generally negotiated unilaterally by one party as opposed to multiple equally powerful parties.²¹¹ The Kansas and Delaware statutes do little to address this inequity.

However, when faced with a decision of whether to impose the requirement of an express waiver upon the more sophisticated parties to an agreement, the answer is obvious. In the very least, the risks are disclosed to each party and an additional datum is presented by which

through litigation).

208. See DEL. CODE ANN. tit. 6, § 18-1101(b) (West Supp. 2011).

209. See Miller, *supra* note 40, at 614 ("A purely contractarian paradigm presupposes the existence of a fair and level contractual playing field, a well-negotiated LLC agreement, and a legal community of practitioners and courts that are well-trained in fiduciary duties.")

210. See *id.* at 583-86 (discussing the results of a survey of attorneys representing both majority and minority LLC investors).

211. See *id.*; see also DiMatteo, *supra* note 39, at 283 (discussing Miller's survey).

parties may conclude whether to form an LLC. This reduces uncertainty over the long run because it forces the parties to hammer out their relationship before its formation, rather than in post hoc disputes. It might be exceedingly optimistic to expect such a process to head off litigation early, but in some circumstances, it certainly has the potential to do so. Regardless of whether such a standard results in decreased litigation, there is no downside to forcing parties to engage in the conversation during the formation of the business, thereby negotiating their respective duties and amending their expectations. Explicit waiver accomplishes just this.

3. Explicit Waivers Best Provide Notice

The pure contractarian assertion that viewing LLC members through the lens of a contractual relationship is the best way to uphold the contracting parties' intent is not universally correct.²¹² Such an argument is based on the assumption that the parties' intent is most accurately evidenced in the express terms of the LLC agreement. But because disputes are generally the result of unintended results, the parties' intent is hardly provided for by express terms of the contract.²¹³ The fact that parties to an agreement are, by default, bound by some basic duties helps decrease the risk that a seemingly innocuous agreement provision may become a tool by which a member acting in bad faith might inflict harm upon fellow members.

Of course, the beauty of fiduciary duties serving as default, but waivable, rules is that parties that disagree with this contention are free to expressly waive these default rules, but they must be so waived. Legally sophisticated members should be encouraged to protect their interests and avoid litigation by carefully crafting their own set of rules contrary to these default gap-fillers, but they may not do so at the expense of less-sophisticated counterparts.

The problem with the *Related Westpac* approach is that such a standard provides no indication on the LLC agreement's face that basic concepts of fairness and equity are inapplicable.²¹⁴ While the end result in an agreement that explicitly waives traditional fiduciary duties might

212. *Cf.* Vestal, *supra* note 5, at 540 (discussing parties' ability to predict "unforeseen variations" in the partnership context).

213. *Cf. id.* ("The only way to accommodate successfully the unforeseen variations either in a given partnership or in partnerships generally is to allow for accommodation after the fact. This is precisely the virtue of the present, fiduciary-based regime.").

214. *See supra* notes 204–06 and accompanying text.

still be the abandonment of those duties, the important difference is that this approach puts all parties on notice. Such an approach is justifiable in that it places the legal burden on the party most capable of bearing it. The alternative—forcing action upon the less-sophisticated members that may be insufficiently aware of their exposure to risk—is an approach that is far more likely to lead to inequity.

It is of course possible that inexperienced players might observe the waiver but be unaware of its import. This is a reasonable criticism. Because the statute is silent on the question of how to waive fiduciary duties,²¹⁵ the judiciary might be free to implement standards of disclosure. Following the promulgation of RULLCA, Professor Rutheford Campbell suggested effective waiver should require “a prominent, concise statement in plain English on the outside front cover page of the operating agreement describing and explaining the essential terms of the opt-out and the reformulat[ion]” of the applicable duty.²¹⁶ Such a strong disclosure requirement is good policy, but there is a question of whether such a policy is available under the Kansas and Delaware statutes.²¹⁷ In the instance that fiduciary duties are waived but this lofty standard is not met, such a waiver would be unenforceable; this might run afoul of the statute’s goal of enforceability.²¹⁸ However, given the limited leeway afforded by the Kansas statute, requiring an explicit waiver is still superior to a standard that forces parties, especially unsophisticated ones, to decode a series of provisions that may or may not be deemed by a court as inconsistent with fiduciary duties. Kansas should adopt a policy that rewards adequate disclosure instead of promoting the use of carefully crafted trap-door agreements.

IV. CONCLUSION

Much has been made of Delaware’s move to a contract-based approach to unincorporated entities.²¹⁹ The trend in Delaware, however, is but a more pronounced case of the same national trend, evidenced partially in the promulgation of uniform codes. From UPA to RUPA, ULLCA to RULLCA, the country has seen a move toward a more

215. See DEL. CODE ANN. tit. 6, § 18-1101 (West Supp. 2011); KAN. STAT. ANN. § 17-76,134 (2007).

216. Campbell, *supra* note 5, at 44 (making the proposal in reference to standard of care waivers); see also *id.* at 52 (making a similar proposal for the duty of loyalty).

217. See DEL. CODE ANN. tit. 6, § 18-1101; KAN. STAT. ANN. § 17-76,134.

218. See DEL. CODE ANN. tit. 6, § 18-1101(b); KAN. STAT. ANN. § 17-76,134(b).

219. See *supra* Part II.B.

liberalized view of fiduciary duties and parties' ability to contractually modify them.²²⁰ The task at hand for Kansas and Delaware courts, however, is ultimately far narrower in scope because both Kansas and Delaware statutes require that fiduciary duty waivers be enforced.²²¹

There will likely be significant growing pains associated with the reorientation around this contractarian right, but courts should observe the statute's mandate to cede the terms of fiduciary relationships to private parties. The benefits advanced by proponents of the contract-based approach are often seen outside of the courtroom; such benefits require the restraint of the judiciary. Thus, courts should focus their efforts on creating a coherent approach within the framework of the statute. The default nature of fiduciary duties is not superseded by the statute,²²² and so courts should, absent waiver, continue to employ fiduciary duties when they are deemed appropriate under the common law. In addition to the statutory language approving the use of fiduciary duties as default, but waivable, rules, are the policy objectives advanced by such an approach. These default rules serve to protect the expectations of the parties and maintain the accessible quality of LLCs. Delaware may serve as a comfortable haven for business interests.²²³ However, courts in that state and Kansas should recognize that waivable defaults do not abridge those interests and further serve the goal of protecting the expectations of less-experienced, less-represented parties.

The standard for effective waiver is one instance where the courts are left with more leeway to innovate. Delaware's recent cases indicate a tolerance for the elimination of fiduciary duties even in cases where full waiver is not expressly adopted. Such a standard of judicial oversight creates uncertainty and thereby wastes the potential efficiency-enhancing benefits of the contract-based approach. Requiring explicit waiver, in contrast, serves to clarify the business relationship and provides important notice.

As in *Gotham*, some courts might be reluctant to embrace the contract-based approach;²²⁴ however, because such an approach is mandated by Delaware law, courts should work to develop cohesive and consistent jurisprudence within that framework. Such jurisprudence should give effect to the legislation's intent and observe important policy

220. See sources cited *supra* note 5.

221. See *supra* Part III.A.1.

222. See *supra* Part III.B.1.

223. See *About Agency*, *supra* note 198.

224. See *supra* Part II.B.

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considerations by maintaining fiduciary duties as default, fully waivable rules.