THE UNCORPORATION AND CORPORATE INDETERMINACY

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

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Professors William Carney and George Shepherd pose a puzzle.[1] They note the "widely held view" that Delaware has won the corporate law race because it offers a better product, particularly an infrastructure of extensive and expert interpretation by high-quality judges and lawyers.[2] Yet a close look seems to reveal a body of law that sacrifices clarity by offering many mini-rules that invite firms to formalistically structure their transactions to reduce judicial review.[3] They say the system has increased litigation costs and compares unfavorably with the Model Business Corporation Act (MBCA), the model for most non-Delaware corporate law.[4] For Carney and Shepherd, the "mystery" of Delaware's success in corporate law is why Delaware continues to be so successful despite these flaws.[5]

Chancellor William Chandler of the Delaware Court of Chancery emphasizes the conundrum that Carney and Shepherd pose: despite Delaware's supposed flaws, "businessmen walk willingly into this slaughterhouse despite the easy availability of jurisdictions that have adopted the 'innovations' of the Model Business Corporations Act . . . (and that also have lower franchise fees)."[6] Chancellor Chandler challenges Carney and Shepherd's analysis by showing that they have essentially compared the apples of rich Delaware case law to the oranges of "the bare text of the Model Act."[7] This is a powerful rejoinder, but it is necessarily incomplete. Given Delaware's undoubted success, there is really no apple to compare it to—that is, there is relatively little reported non-Delaware case law dealing with large corporations. Moreover, even if Delaware corporate law is not clearly inferior to that of other states, it may not be superior enough to explain Delaware's dominance.

This Article offers an additional perspective that explains both Delaware's indeterminacy and why it nevertheless succeeds. I examine Delaware decisions on "uncorporations"—that is, limited partnerships (LPs) and limited liability companies (LLCs). As in the public corporation cases Carney and Shepherd focus on, the uncorporation cases require the same judges who decide the corporate cases to resolve complex disputes between managers and passive owners, and among owners under general statutory provisions.[8] The greater indeterminacy in corpo-

1. *See* William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 1–2.

2. *Id.* at 75.

3. *Id.*

4. *Id.*

5. *Id.* at 64.

6. William B. Chandler III & Anthony A. Rickey, *Manufacturing Mystery: A Response to Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success*,*"* 2009 U. ILL. L. REV. 95. (Chandler and Rickey included this quote in an earlier draft of their article, but it has subsequently been omitted.)

7. *Id.*

8. *Id.* at 98.

rate over uncorporate cases indicates that indeterminacy inheres in the nature of the cases rather than in how judges decide them.

Indeed, something within the corporation may be causing the problem. The corporation involves a particular approach to the governance of business associations that, at least for some types of firms, may involve costs in excess of benefits as compared with the rules for uncorporations.[9] Uncorporate business forms rely on specific contractual devices to provide incentives and managerial discipline, reducing their need to rely on monitoring devices such as owner voting, independent directors, fiduciary duties, and derivative litigation.[10] The parties, therefore, can tailor their contracts to their needs, and courts do not need to develop fiduciary rules to deal with a multitude of situations. It follows that indeterminacy is less likely to be a problem in uncorporate than in corporate cases. Indeed, I show that Delaware uncorporate cases involve fewer of the problems Carney and Shepherd find in corporate cases. This suggests that the problem lies at least partly in the corporate form rather than wholly with the courts.

This Article proceeds as follows. Part I briefly reviews the Carney-Shepherd critique of Delaware corporate law and Chancellor Chandler's criticism of this thesis. Part II compares the corporate and uncorporate approaches to governance and shows how uncorporations can address agency costs by avoiding heavy reliance on devices that produce much of the indeterminacy Carney and Shepherd criticize, such as owner voting and fiduciary duties. Part III develops the hypothesis by showing that Delaware uncorporate law does, in fact, exhibit fewer of the types of problems that Carney and Shepherd discuss although it is made by the same judges and legislators who produce Delaware corporate law. Part IV discusses implications of the analysis.

I. THE CARNEY-SHEPHERD CRITIQUE AND CHANCELLOR CHANDLER'S RESPONSE

Carney and Shepherd analyze several categories of Delaware cases that cast doubt on the hypothesis that Delaware attracts corporations because of the superiority of its law.[11] Much of the Carney and Shepherd analysis focuses on the many judicial rules regarding mergers.[12] As Carney and Shepherd note, what started with an effort to modernize valua-

9. *See* Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1435 (2006) [hereinafter Ribstein, *Accountability*]; Larry E. Ribstein, *Partnership Governance of Large Firms*, 75 U. CHI. L. REV. (forthcoming 2008) (on file with the University of Illinois Law Review) [hereinafter Ribstein, *Partnership Governance*]; Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 201 (2004) [hereinafter Ribstein, *Why Corporations?*].

10. *See* Ribstein, *Partnership Governance*, *supra* note 9.

11. *See* Carney & Shepherd, *supra* note 1, at 9–12 (casting doubt on the proposition that Delaware attracts corporations because of favorable law).

12. *See id.*

tion standards has evolved into a proliferation of tests for different types of transactions, relying on factors such as whether there is an independent board committee review, a majority-of-minority shareholder vote, or a tender offer for minority shares.[13] These tests produce a kind of formalism that to some extent allows parties to pick the applicable rule without regard to the transaction's substance.[14] At the same time, the tests have some of the uncertainty of standards. This includes the "murky" law on the sale of substantially all corporate assets,[15] board fiduciary duties to preferred shareholders,[16] the *Blasius* "compelling justification" test for infringements on the shareholder franchise,[17] and the vague independence and "business judgment" qualifications on special litigation committee review.[18]

Problems other than the proliferation of tests increase the indeterminacy of Delaware law. Carney and Shepherd take Delaware to task for disparities between concepts of market and legal value.[19] They observe that divorcing rules from market value sets up a "lottery" that enhances unpredictability.[20] Moreover, each new test surprises not only the parties to the case that formulates the test, but also the parties to contemporaneous transactions designed under the prior test.

This critique of Delaware begs for a comparison. Carney and Shepherd note that most other states have a simple unitary business judgment rule standard of reviewing takeover defenses and specific statutes authorizing ratification of poison pills.[21] Carney and Shepherd also show that the widely adopted MBCA offers many rules that contrast with Delaware's indeterminate standards: a bright-line safe harbor requiring a shareholder vote on major transactions,[22] a universal demand requirement in derivative suits that dispenses with the need for judicial standards as to demand futility,[23] mandatory dismissal after special litigation committee dismissal (again dispensing with vague judicial review standards),[24] a bright-line safe harbor for conflict transactions approved by disinterested shareholders or directors,[25] and an appraisal remedy for all fundamental changes that reduces the need for litigating fairness.[26]

13. *See id.* at 28–36.
14. *See id.* at 43.
15. *Id.* at 33 n.180.
16. *See id.* at 39–41.
17. Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988); *see also* Carney & Shepherd, *supra* note 1, at 41–43.
18. *See* Carney & Shepherd, *supra* note 1, at 47, 58.
19. *See id.* at 27.
20. *Id.* at 27–28.
21. *Id.* at 34–36.
22. *Id.* at 58.
23. *Id.*
24. *Id.*
25. *Id.* at 58–59.
26. *Id.* at 59–60.

Carney and Shepherd respond to prior defenses of Delaware indeterminacy, particularly those raised by Professor Jill Fisch.[27] Fisch argues that indeterminacy allows judges to adapt quickly to new circumstances and tailor rules to the wide range of possible behaviors.[28] Carney and Shepherd counter that indeterminacy comes at the significant cost of increasing the potential for litigation; that judges lack legislators' policy-making resources; and that even if judicial policymaking is efficient over the long run, it involves significant indeterminacy costs over the short run.[29] Fisch also argues that muddy rules facilitate bargaining.[30] However, even if this is true for default rules, it does not apply to the mandatory rules Carney and Shepherd focus on.[31]

Chancellor Chandler criticizes Carney and Shepherd's central premise that Delaware law compares unfavorably with the MBCA.[32] The problem, according to Chancellor Chandler, is that this unfairly contrasts the pristine terms of the MBCA with the messy world of real cases.[33] MBCA law can be as indeterminate and messy as Delaware law and, indeed, even relies on Delaware cases.[34] For example, MBCA cases often depart from strict market value, find open-ended terms in the supposedly bright-line conflict-of-interest rules, apply Delaware-type standards when applying the supposed safe harbor of the MBCA to asset sales, and review special litigation committee decisions in a way that is not clearly different from Delaware.[35] Also, Chancellor Chandler observes that courts in MBCA states face problems that Delaware courts do not, such as having to determine the effect of a modification of the MBCA that the relevant state has not yet adopted.[36] Finally, while Carney and Shepherd point to Delaware horror stories like *Technicolor* to illustrate their point about indeterminacy and high litigation costs, there is plenty of lengthy corporate litigation in other jurisdictions.[37] In the absence of a direct comparison between MBCA and Delaware case law, Carney and Shepherd have not proven their hypothesis that there is something distinctly wrong with Delaware law.

Carney and Shepherd have made a strong case that Delaware law is, in fact, vague, indeterminate, and unstable, and that these features can be costly. The question remains whether these are characteristics of corporate law generally, or of Delaware law in particular. The next Part at-

27. *Id.* at 64.
28. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1085 (2000).
29. *See*, *e.g.*, Carney & Shepherd, *supra* note 1, at 68.
30. Fisch, *supra* note 28, at 1083.
31. Carney & Shepherd, *supra* note 1, at 12.
32. *See* Chandler & Rickey, *supra* note 6, at 96.
33. *Id.* at 97.
34. *Id.* at 99.
35. *See id.* at 20–21, 27–37, 39–42.
36. *See id.* at 25.
37. *See* Carney & Shepherd, *supra* note 1, at 44–45.

tempts to answer these questions by making a different comparison than the one Carney and Shepherd focus on—that between corporations and uncorporations.

II. CORPORATE VS. UNCORPORATE GOVERNANCE

This Part considers whether the supposed problems of Delaware corporate law are associated with the corporate form itself rather than with the Delaware courts and legislature. It proceeds by comparing how corporate and uncorporate governance forms approach important aspects of firm governance.[38] Both types of firms incur potential agency costs by delegating power to strong managers.[39] In general, corporate governance attempts to constrain these costs by relying on monitoring devices, including the board of directors, owner voting, and fiduciary duties.[40] Uncorporations substitute higher-powered managerial incentives and obligations to distribute assets or liquidate for corporate-type monitoring.[41] Although firms organized as corporations under state law theoretically can adopt many of the uncorporate features discussed below, these features are more consistent with the norms of partnerships and other unincorporated firms.[42] Courts, therefore, are more likely to enforce these features when unincorporated firms adopt them.[43] In any event, the main point of the following discussion is that firms that adopt uncorporate features, whether or not they are formally organized as corporations, can avoid many of the problems Carney and Shepherd discuss.

A. Manager Power

Although the standard-form default partnership features coequal owners, many uncorporations, including limited partnerships and manager-managed LLCs, have powerful managers and passive owners. There are, however, two important distinctions between corporations and these centrally managed uncorporations. First, corporate managers and directors get most of their incentive compensation in the form of stock options, which may only roughly align pay with performance.[44] By

38. These features are discussed in more detail in Ribstein, *Partnership Governance*, *supra* note 9.

39. *See id.* (manuscript at 9) (noting that both uncorporations and corporations are centrally managed).

40. *See id.* (manuscript at 3) ("Monitoring is central in the standard corporate model.").

41. *See id.* (manuscript at 18).

42. *See id.* (manuscript at 38).

43. *See id.* (manuscript at 9).

44. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 121 (2004); Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 791–92 (2002).

contrast, uncorporate managers have full-fledged ownership interests that expose them to significant downside as well as upside risk.[45]

Second, corporate management includes both executives who manage the firm day-to-day and powerful directors who are supposed to oversee, and therefore be largely independent from, the executives.[46] While board oversight is supposed to constrain agency costs, it is important to bear in mind that directors are themselves agents.[47] Even if they do not act selfishly, they may lack strong incentives to maximize shareholder wealth.[48] Moreover, courts must supervise board conduct and independence on a case-by-case basis, which contributes to indeterminacy.

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

> As a public company, we intend to continue to employ our current management structure with strong central management by our founders and to maintain our focus on achieving successful growth over the long term. This desire to preserve our current management structure is one of the principal reasons why we have decided to organize The Blackstone Group L.P. as a limited partnership that is managed by our general partner and to avail ourselves of the limited partnership exception from certain of the New York Stock Exchange governance rules, which eliminates the requirements that we have a majority of independent directors on our board of directors and that we have a compensation committee and a nominating and corporate governance committee composed entirely of independent directors.[49]

Uncorporate directors are more like expert and involved colleagues than independent and powerful monitors. Their powers under the agreement normally are designed to address specific matters, such as conflicts, rather than to broadly supervise management.[50] Uncorporations' lack of reliance on a board means that courts have less need to develop rules to supervise the boards' election, qualifications, and operation.

B. Capital Lock-In

Managers' power is a function of what Hansmann and Kraakman have called "affirmative asset partitioning," which separates the owners'

45. *See* Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 9–10).
46. *See* Ribstein, *Accountability*, *supra* note 9, at 1439.
47. *See* Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 12).
48. *See* Ribstein, *Accountability*, *supra* note 9, at 1459–60.
49. Blackstone Group L.P., Securities Regulation Statement (Form S-1/A), at 195 (June 21, 2007), *available at* http://files.shareholder.com/downloads/BX/243990728x0xS1047469-07-5100/1393818/filing.pdf.
50. *See id.* at 195–96 (describing Blackstone board committees, including conflicts committee).

assets from the firm's.[51] While this feature inheres in firms generally, corporations have the unique characteristic of capital lock-in, or liquidation protection.[52] This insulates corporate assets and, more importantly, managers' power from the owners' ability to force liquidation. Some scholars argue that this feature has enabled the modern firm.[53]

Capital lock-in directly accounts for one form of indeterminacy in corporations noted by Carney and Shepherd: the interpretation of dividend provisions in preferred share contracts. Preferred shares can be used to ensure distributions to holders. However, despite these contracts' apparent assurances of distributions, they still leave the board with significant power. For example, the Delaware Court of Chancery held in *Baron v. Allied Artists Pictures Corp.* that preferred shareholders who had taken control of the board under a preferred share agreement that provided for transfer of control when dividends were skipped could decide when to resume dividends and thereby relinquish control.[54] The court rejected an alternative interpretation that would have forced the board to distribute cash and thereby avoided the need for judicial review of the board's exercise of discretion.[55] Venture capital financed firms have used preferred shares to empower venture capitalists to insist on refinancing, exit, or distributions of cash.[56] However, these powers may not fully protect the venture capitalists from abuse of power by entrepreneurs determined to hang on to control.[57]

Given the board's power over distributions, debt is the main way to ensure a continuing flow of distributions to investors.[58] The corporate tax structure and the firm's ability to deduct interest payments reduce owners' incentive to devise contractual mechanisms to compel distribu-

51. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 394–95 (2000).

52. *See id.* at 405.

53. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387 (2003); Margaret M. Blair, *The Neglected Benefits of the Corporate Form: Entity Status and the Separation of Asset Ownership from Control*, *in* CORPORATE GOVERNANCE AND FIRM ORGANIZATION: MICROFOUNDATIONS AND STRUCTURAL FORMS 45, 46 (Anna Grandori ed., 2004); Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 1 (2004).

54. 337 A.2d 653, 658–60 (Del. Ch. 1975), *appeal dismissed*, 365 A.2d 136, 136 (Del. 1976).

55. Carney & Shepherd, *supra* note 1, at 40, criticize this case for creating an indeterminate exception to the general rule of no fiduciary duties to preferred shareholders. In fact, the fiduciary duty would have been owed by a preferred-controlled board to the common shareholders. But in any case, the board's broad power necessitated the creation of an indeterminate board duty.

56. *See generally* William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891 (2002).

57. A prominent example of such a case is *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997). For an analysis of the case and a plea for broader judicial remedies to protect the preferred, see Bratton, *supra* note 56, at 926–39. Even apart from the risk of owner opportunism, venture capital preferred shares are mostly useful for end-game solutions rather than to assure continued distribution of cash. The main point to emphasize here is that, even if preferred shares are an optimal tool in the venture capital context, they cannot fully substitute for uncorporate governance forms outside this setting.

58. *See generally* Bratton, *supra* note 56.

tions.[59] Accordingly, corporations can constrain earnings retention only at the cost of an increased bankruptcy risk.[60]

Partners have long been able to provide for capital lock-in by contract,[61] and many LLC and LP statutes now provide by default that individual members can neither unilaterally compel the firm to dissolve nor demand cash for their interests upon dissociating from the firm.[62] But uncorporate standard forms are more conducive to contracts that loosen managers' control over the firm's cash.[63] Corporate statutes explicitly permit strong constraints on managerial discretion only in closely held corporations.[64] Even if the constraints are valid, courts strictly construe them as inconsistent with corporate norms of retaining earnings under managerial control.[65] By contrast, nothing prevents uncorporate firms from contracting regarding distributions, and uncorporation agreements, such as those in master LPs, often do include such provisions.[66]

Uncorporations also can loosen managers' hold over the firm's cash by compelling dissolution and termination after a set period of time.[67] Provisions requiring termination and liquidation are common in venture capital and private equity funds.[68] Indeed, LP statutes once commonly provided for a termination date by default.[69] By contrast, courts might hesitate to enforce mandatory termination for a corporation as inconsis-

59. Ribstein, *Why Corporations?*, *supra* note 9, at 227–28.

60. *See* Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 47).

61. *See* Larry E. Ribstein, *Should History Lock in Lock-in?*, 41 TULSA L. REV. 523, 531 (2006).

62. *See, e.g.*, REVISED UNIF. LTD. LIAB. CO. ACT §§ 404(b), 603, 701 (2006), 6B U.L.A. 480, 504–05, 506 (2008).

63. *See* Ribstein, *supra* note 61, at 538.

64. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 350–351 (2001). Although sections 350 and 351 of the Delaware General Corporation Law explicitly permit displacement of the board's power in firms that elect and qualify to be close corporations, this does not imply that only closely held corporations may limit their board's power. *See id.* § 356 (clarifying that the close corporation subchapter does not invalidate provisions governing corporations that are not closely held). Section 141 authorizes charter restrictions on board power for all corporations, but board power may not be diluted significantly for those that are publicly held. Ribstein, *Why Corporations?*, *supra* note 9, at 197 & n.63 (discussing limits on restricting board discretion).

65. *See* Steven A. Bank, *Tax, Corporate Governance, and Norms*, 61 WASH. & LEE L. REV. 1159, 1218–19, 1223–28 (2004).

66. *See* John Goodgame, *Master Limited Partnership Governance*, 60 BUS. LAW. 471, 476 (2005).

67. *See, e.g.*, Anthony v. Padmar, Inc., 415 S.E.2d 828, 833 (S.C. Ct. App. 1992) (dissolution on sale of all or substantially all of the assets), *aff'd in part*, *rev'd in part on other grounds*, 465 S.E.2d 745 (S.C. Ct. App. 1995).

68. *See* Philippe Aghion et al., *Exit Options in Corporate Finance: Liquidity Versus Incentives*, 8 REV. FIN. 327, 348–49 (2004); Douglas J. Cumming & Jeffrey G. MacIntosh, *Venture-Capital Exits in Canada and the United States*, 53 U. TORONTO L.J. 101, 106–08 (2003); Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 8); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 345–56 (2005); Brian Cheffins & John Armour, *The Eclipse of Private Equity* 10 (European Corp. Governance Inst., Working Paper No. 082/2007, 2007), *available at* http://ssrn.com/abstract=982114; Michael C. Jensen, *The Economic Case for Private Equity (and Some Concerns)* 7 (Harvard Bus. Sch. Negotiation, Orgs. & Mkts. Unit, Working Paper No. 07-02, 2007), *available at* http://papers.ssrn.com/abstract=963530.

69. *See* Tsakos Shipping & Trading, S.A. v. Juniper Garden Town Homes, Ltd., 15 Cal. Rptr. 2d 585, 595 (Cal. Ct. App. 1993); Levine v. Levine, 648 So. 2d 1228, 1230 (Fla. Dist. Ct. App. 1995); REVISED UNIF. LTD. P'SHIP ACT § 801(1) (amended 1985), 6B U.L.A. 321 (2008).

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

The power to compel distributions by or termination of an uncorporation is significant because it exposes managers to the discipline of the capital markets.[70] This gives managers a strong incentive to maintain the value of the firms they manage.[71] By contrast, corporate managers' power to retain earnings gives them permanent capital and thereby insulates them from the need to turn to capital markets for more funding.[72]

C. Owner Voting

Shareholders' powers to elect directors and vote on major corporate transactions are important mechanisms for constraining the agency costs inherent in the separation of ownership and control.[73] Corporations align voting power with ownership interests precisely to give shareholders the right incentives to perform this "error-correcting" role.[74] However, in several respects, the theory of corporate ownership breaks down in practice. Public corporation shareholders with small ownership interests have little incentive to invest in monitoring because other owners can free ride on their efforts.[75] Although shareholders could buy enough shares to mitigate this problem, regulatory and tax rules constrain this strategy, as Mark Roe has discussed.[76] Shareholders such as labor unions may have ample incentives to exercise control on behalf of their members, but their interests may differ from those of most corporate shareholders.[77] Other large, undiversified shareholders may have different incentives from shareholders who hold diversified portfolios. The managers of large institutional shareholders have the same sort of agency problems as the managers of their portfolio firms. And the technology of

70. Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 9).

71. Cheffins & Armour, *supra* note 68, at 9–10.

72. *See* Steven A. Bank, *Dividends and Tax Policy in the Long Run*, 2007 U. ILL. L. REV. 533, 569–70.

73. *See* Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. (forthcoming 2009) (manuscript at 7–15, 30–31), *available at* http://ssrn.com/abstract=1156901.

74. *See id.* at 7–15, 19–21.

75. *See*, *e.g.*, MARK J. ROE, STRONG MANAGERS, WEAK OWNERS 10–11 (1994); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 60 (1982).

76. *See* ROE, *supra* note 75, at 21.

77. *See* Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 634 n.88 (2006) (noting that "the most activist institutions—union and state and local employee pension funds—may have interests that diverge substantially from those of other investors"). For discussions of the incentives of activist shareholders, see Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 479–81 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 801–20 (1993); Stewart J. Schwab & Randall S. Thomas, *Realigning Corporate Governance: Shareholder Activism by Labor Unions*, 96 MICH. L. REV. 1018, 1033–34 (1998).

shareholder voting is subject to numerous pathologies that tend to make voting complex and opaque, and to misalign ownership and control.[78]

Perhaps the most important limit on the effectiveness of shareholder voting as a monitoring device is that it is ultimately subject to the control of the very managers the shareholders are trying to monitor. Managers can exercise their broad power in a number of ways to dilute owner voting power, like implementing poison pills or other devices that impede the market for control. Carney and Shepherd show that part of the complexity and indeterminacy of fiduciary duties comes from rules like the *Blasius* "compelling justification" standard that are intended to protect against interference with the shareholders' franchise.[79]

Although strong owner participation is a default rule in general partnerships, LP statutes provide for very limited voting rights.[80] Uncorporate firms may eliminate most owner voting rights,[81] substituting the alternative constraints on management discussed in this Part, including profit-based compensation, liquidation rights, and cash distributions.

D. The Market for Control

Despite the problems discussed in the previous Section, shareholder voting might work as a meaningful constraint on managerial power through the shareholders' ability to freely transfer both management and economic rights to owners who can aggregate the shares into control blocks.[82] Henry Manne explained how this market for control can answer Berle and Means's critique of corporate governance.[83]

In practice, however, the market for control is subject to significant limitations. Strong takeover defenses, state anti-takeover statutes, and the federal Williams Act[84] have increased the cost of hostile takeovers

78. *See* Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1248–67 (2008).

79. Carney & Shepherd, *supra* note 1, at 42 (discussing Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988)).

80. Neither the original Uniform Limited Partnership Act (1916) nor the 1985 Revised Uniform Limited Partnership Act—on which most current state statutes are based—provided for limited partner voting rights. The most recent version of the Uniform Limited Partnership Act gives limited partners a right to vote only on fundamental transactions and no default right to periodically elect the firm's managers. *See* UNIF. LTD. P'SHIP ACT § 406 (2001), 6A U.L.A. 434–35 (2008). Note, however, that partnerships are subject to many of the governance rules in the New York Stock Exchange Listed Company Manual. The main exception is the rule requiring owner approval of securities issuances in certain situations. NYSE Inc., Listed Company Manual § 312.03 (2007), *available at* http://www.nyse.com/Frameset.html?nyseref=http%3A//www.nyse.com/regulation/listed/1182508124422.html&displayPage=/lcm/lcm_section.html.

81. *See* Blackstone Group., *supra* note 49, at 18 (noting that "[u]nlike the holders of common stock in a corporation, our common unitholders will have only limited voting rights and will have no right to elect our general partner or its directors, which will be elected by our founders").

82. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965).

83. *See id.*

84. *See* Securities and Exchange Act of 1934 § 13(d)(1), 15 U.S.C. § 78m(d)(1) (2000) (requiring disclosure by any person or group that acquires 5% of a class of securities, thus limiting the initial

and, therefore, reduced their effectiveness as a check on inefficient management. Incumbent managers have strong powers and significant discretion to resist takeovers since courts are as reluctant to second-guess takeover defenses as they are other business decisions.[85] Shareholders may even lack legal power to initiate a vote to eliminate or prohibit poison pills or other takeover defenses,[86] and they face the usual free-rider problem in exercising any formal power they have.[87]

Uncorporate managers are generally insulated from the market for control. By default uncorporation owners cannot freely transfer management rights.[88] This means that rather than having to establish takeover defenses that are subject to court scrutiny and interpretation, uncorporate managers get the strongest protection possible from the statute itself: no owner power to transfer management rights. At the same time, uncorporate rules and policies provide an alternative to the market for control by forcing managers to return to the capital markets to fund their activities.[89]

E. Fiduciary Duties

A distinction between corporations and uncorporations that is critical to the indeterminacy criticism of Delaware corporate law concerns corporate fiduciary duties and remedies. The corporate reliance on fiduciary duties gives rise to most of the indeterminacy and other problems Carney and Shepherd discuss.[90] As long as courts, rather than the parties to firms, have to cope with the increasingly complex and dynamic corporate environment, such as new takeover and defensive technologies, significant indeterminacy is inevitable. Yet corporations need fiduciary du-

"stake" that a bidder can acquire before the market becomes aware of the increased likelihood of a premium bid); § 14(d)(1), (f) (requiring disclosure by bidders upon the making of a tender offer and upon the seriatim resignation of directors that often accompanies a transfer of control); § 14(d)(4) (regulating management recommendations to shareholders); § 14(d)(5)–(7) (regulating the substantive terms of a bidder's offer to shareholders); § 14(e) (general antifraud provision).

85. For a review of cases analyzing managers' fiduciary duties when defending against takeovers under Delaware Law, see Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769 (2006).

86. *See* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409, 414–15 (1998).

87. *See, e.g.*, Levmore, *supra* note 75.

88. *See, e.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 502 (2006), 6B U.L.A. 496–97 (2008) (permitting transfer of economic rights); UNIF. P'SHIP ACT § 502 (1997), 6 U.L.A. 156 (2001) (defining a partner's transferable interest as the partner's share of profits and losses and right to receive distributions); *id.* § 503, 6 U.L.A. 156–57 (permitting transfer of transferable interest).

89. Ironically, private equity firms, though insulated from the market for control, help drive the corporate-control market by providing an alternative management structure for target firms. For a discussion of the incentive structure of private equity, see Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 20–26). For a discussion of how the *ex ante* financial structure of the fund works in combination with *ex post* debt financing of the deal to provide the necessary incentives, see Ulf Axelson et al., *Why Are Buyouts Levered? The Financial Structure of Private Equity Funds*, J. FIN. (forthcoming 2009), *available at* http://ssrn.com/abstract=676546.

90. *See* Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 16–17).

ties, despite their indeterminacy, to address the misalignment of managers' incentives with those of their owners.

Fiduciary duties might seem to be even more important in uncorporations than in corporations. Justice Cardozo famously stated in *Meinhard v. Salmon*, a partnership case, that "[n]ot honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."[91] But it is questionable whether partners in standard-form partnerships even have fiduciary duties because their role as comanagers constrains their conduct without the need for such duties.[92] Even in large unincorporated firms, fiduciary duties may not be worth bearing because uncorporate managers' strong incentives and owners' liquidation and distribution rights can provide enough discipline.[93] Moreover, there is so much variation in management structure and owner and manager power that uncorporation rules must be provided by customized agreements rather than standard forms.[94] These considerations point to a need for greater flexibility of fiduciary duties in uncorporations than in corporations.

This contrast between the role of fiduciary duties in corporations and uncorporations helps explain why Delaware limits fiduciary duty waivers in corporations while, as discussed in the next Part, freely allowing waiver in unincorporated firms.[95] The Delaware corporation statute permits waiver only of the duty of care subject to a good faith qualifier.[96] The qualifier took on importance when the Delaware Supreme Court held in *Stone v. Ritter* that a board's conscious failure to adopt a compliance program in the face of a known duty to act may constitute a breach of good faith that survives a charter limitation on the board's duty of care.[97]

III. DELAWARE'S UNCORPORATE JURISPRUDENCE

The analysis in Part II has important implications for the Carney-Shepherd thesis. Because uncorporations rely less on fiduciary duties and monitoring by shareholders and independent directors, they require less judicial supervision than corporations.[98] Uncorporations can also

91. 164 N.E. 545, 546 (N.Y. 1928).

92. *See* Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 251.

93. *See* Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 3–4).

94. *Id.* (manuscript at 15).

95. Despite this explanation, it still might be argued that even corporate managers should be allowed to contract with corporate owners for fiduciary duty waivers. *See* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 71–72 (1990).

96. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2006). The statute also permits contractual qualification of liability for usurping corporate opportunities. *See id.* § 122(17).

97. 911 A.2d 362, 370 (Del. 2006).

98. *See* Robert H. Stikoff, *Trust as "Uncorporation": A Research Agenda*, 2005 U. ILL. L. REV. 31, 37.

rely on customized contractual powers, duties, and remedies. Courts adjudicating uncorporation cases, therefore, need not react to new business developments with retroactively applied rules as they do in corporate cases. Instead, they can simply enforce firms' contracts, which can be expected to evolve over time to meet firms' needs. Moreover, this enabling approach would allow contracts to fix problems in the judicial rules, in contrast to the mandatory corporate setting Carney and Shepherd describe.

Indeed, this Part shows that Delaware law accommodates uncorporations' distinct needs with an approach that enforces contracts and eschews mandatory fiduciary rules.[99] Section A describes the statutory backbone of the Delaware uncorporate approach. Section B analyzes the fundamentally contractual analysis in the Delaware LP and LLC cases decided since enactment of this statute.

A. Statutory Basis for the Contractual Approach

Delaware LLC and LP statutory provisions permit complete waiver of fiduciary duties.[100] The LP version (the LLC version is substantively the same) provides:

> (d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.
>
> (f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other

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

100. *See* tit. 6, § 17-1101 (applying to LPs); *id.* § 18-1101 (applying to LLCs). At least thirteen other state LLC statutes provide for waiver of fiduciary duties without specific restrictions. *See* LARRY E. RIBSTEIN & ROBERT KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES § 9 app. 9-6 (2004).

person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.[101]

These provisions sharply contrast with the more limited authorization of duty of care opt-outs in the corporate context.[102] Although both the corporate and partnership waiver provisions are subject to a "good faith" limitation,[103] the partnership provision explicitly refers to "the implied contractual covenant of good faith and fair dealing,"[104] thereby inviting a contractual rather than an open-ended fiduciary analysis. This language should prevent courts from importing a *Stone v. Ritter*-type qualification[105] into the partnership setting.

Carney and Shepherd's analysis suggests that judges might carry the indeterminacy of the corporate approach over to uncorporations despite these waiver provisions. Courts often have the leeway to do so even while purportedly enforcing the contract because the parties cannot contract explicitly for all contingencies, leaving room for interpretation and application of the implied good faith covenant.[106] The uncorporation cases, therefore, provide an opportunity to test whether indeterminacy is attributable to judges or to the corporate form.

In an important 2003 speech, published in 2007, Delaware Supreme Court Chief Justice Myron T. Steele recognized Delaware judges' temptation to corporatize uncorporate law and admonished them not to do it.[107] Chief Justice Steele wrote that "courts should look to the parties' agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance."[108] Rather than applying a "status" approach that applies default fiduciary duties regardless of the contract, the Chief Justice suggested that courts begin their analysis with the language and structure of the parties' contract.[109] This entails interpreting the statute consistently with its evident intent and applying a contractual rather than fiduciary approach to the "good faith" obligation. The Delaware contractual good faith qualification, specified in the Delaware uncorporate provisions,[110] applies only when it is clear from the

101. Tit. 6, § 17-1101.
102. *See supra* notes 96–97 and accompanying text.
103. RIBSTEIN & KEATINGE, *supra* note 100, § 9:7.
104. Tit. 6, § 17-1101.
105. *See supra* text accompanying note 97. Indeed, the Delaware Supreme Court has avoided applying this qualification in a case involving a publicly held LLC. *See infra* text accompanying note 166.
106. Ribstein, *supra* note 92, at 221–22.
107. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007).
108. *Id.* at 1.
109. *Id.* at 25.
110. *See supra* text accompanying note 102.

parties' contract that the parties "would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter."[111] This attention to the parties' contract can avoid the indeterminacy of corporate-type fiduciary duties. The next Section shows that the Delaware courts have, indeed, followed this approach.

B. The Contractual Approach in Uncorporate Cases

Consistent with the statutory provisions discussed in Section A and the approach recommended by Chief Justice Steele, most Delaware uncorporate cases have held that fiduciary duties apply only in the gaps left by the contract, interpreted in light of the general contractual principle of good faith.[112] The following sections deal with the important recurring fact patterns in the Delaware cases involving interpretation of waivers and other provisions in operating agreements, and the application of remedies.

1. Limited Partnership Fiduciary Duty Restrictions

Unlike the shifting and confusion in corporate cases, the Delaware uncorporation cases have been mostly clear and consistent. By focusing the court's attention on the contract, the statute has discouraged courts from substituting judicial default rules for clearly articulated contractual duties.[113] This clarity and consistency encourages the parties to Delaware LPs and their lawyers to craft careful partnership agreements that describe the partners' responsibilities and limit their duties. The following are some of the more important Delaware LP cases illustrating the Delaware courts' approach to applying the statutory freedom-of-contract provisions.

In *Kahn v. Icahn*, Chancellor Chandler dismissed a claim alleging that the general partner's owner breached duties to the LP by allocating some profits from partnership opportunities to his affiliates.[114] Chancellor Chandler reasoned that the Delaware statute made traditional fiduciary duties "defaults that may be modified by partnership agreements."[115] He added:

111. Steele, *supra* note 107, at 17 (quoting Chancellor Allen's opinion in Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986)).

112. *See* Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469, 1476 (2005); Andrew Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 127 (2006) (analyzing the good faith duty as a limitation on waiver); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 952–53 (2004).

113. Ribstein, *supra* note 112, at 953.

114. No. Civ. A. 15916, 1998 WL 832629, at *4 (Del. Ch. Nov. 12, 1998).

115. *Id.* at *2.

> Plaintiffs ask me to craft a new principle of law by recognizing that partners have separate and immutable duties of loyalty irrespective of clear and unambiguous modifications of fiduciary duties provided in a legally enforceable partnership agreement. Under the facts alleged I cannot so hold, for Defendants' actions are covered by the Agreement and as such are permissible as a matter of law.[116]

In *Sonet v. Timber Co.*, Chancellor Chandler dismissed a claim based on a general partner's receiving an unfairly large number of shares of a real estate investment trust (REIT) into which the LP was converted.[117] The LP agreement gave the general partner significant power to manage day-to-day affairs, subject to the requirement that its actions be fair and reasonable to the partnership.[118] The general partner had sole discretion to engage in mergers and certain other extraordinary acts or transactions, subject to approval by a supermajority unitholder vote.[119] In exchange for this approval right, the partner's discretion in these transactions was not subject to a fair and reasonable qualification.[120]

The resolution of this case contrasts sharply with the corporate cases that, as Carney and Shepherd discuss, have struggled with whether and to what extent to conduct an additional fairness review on transactions subject to owner vote. The chancellor held that the "careful framework established by the Agreement confirms that to the extent that unitholders are unhappy with the proposed terms of the merger (and in this case the resultant conversion), their remedy is the ballot box, not the courthouse."[121] The chancellor reasoned that "principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain."[122] Because of the Delaware freedom-of-contract provision, which had encouraged firms to make the "deliberate choice" to adopt the Delaware LP form,[123] courts should hesitate to draw from general principles of fairness in the corporate context. Rather, when faced with a clear opt-out, a court should analyze a limited partnership fiduciary duty claim "in terms of the operative governing instrument—the partnership agreement—and only where that document is silent or ambiguous, or when principles of equity are implicated, will a Court begin to look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence."[124]

116. *Id.* at *3.
117. 722 A.2d 319, 327 (Del. Ch. 1998).
118. *Id.* at 324.
119. *Id.*
120. *Id.*
121. *Id.* at 326.
122. *Id.* at 322.
123. *Id.*
124. *Id.* at 324.

Vice Chancellor Strine followed a similar approach in interpreting the scope of fiduciary duties under LP agreements.[125] Where there was no explicit waiver of default duties, the court resolved the disputes based on the duties provided for in the agreement, holding that these contractual duties in effect displaced default fiduciary duties.[126]

In *R.S.M. Inc. v. Alliance Capital Management Holdings L.P.*, a general partner reorganized a public LP into separate privately and publicly traded entities with the approval of a majority of the outside unitholders.[127] Plaintiff claimed the transaction provided special tax advantages to the general partner.[128] Vice Chancellor Strine held that the agreement's requirement of outside unitholder approval reduced the plaintiff's fiduciary claim to the single issue of inadequate disclosure, which the complaint sufficiently alleged.[129] The vice chancellor reasoned that *Sonet* required the application of default fiduciary duties in the absence of a clear waiver if such duties could be reconciled with the operation of the partnership agreement, as could a fiduciary duty of disclosure in the present case.[130] The court said that the agreement's voting provisions create "a safe harbor that, if effectively utilized, is outcome determinative. In the event that the safe harbor does not apply, the defendants would face liability under both contractual and fiduciary theories."[131] Again, this decision contrasts with the corporate cases Carney and Shepherd criticize for leaving unclear whether ratification or approval eliminates judicial scrutiny of a transaction's terms.[132]

In *Miller v. American Real Estate Partners*, Vice Chancellor Strine refused to hold that the agreement authorized the general partner to invest partnership funds to protect his own venture instead of pursuing investments that would be less risky and more profitable for the partnership.[133] The agreement gave the general partner

> full, exclusive and complete discretion to manage and control the business and affairs of the Partnership, to make all decisions affecting the business and affairs of the Partnership, and to take all such

125. *See, e.g.*, R.S.M., Inc. v. Alliance Capital Mgmt. Holdings L.P., 790 A.2d 478, 497 (Del. Ch. 2001) ("[O]ur courts have thus far adhered as a general matter to a close examination of whether the application of default fiduciary duties can be reconciled with the practical and efficient operation of the terms of the limited partnership agreement.").

126. *Id.* at 497 n.27.

127. *Id.* at 481.

128. *Id.* at 483–84.

129. *Id.* at 498, 502. The plaintiff alleged that the nondisclosure of the tax advantages of private partnership discouraged outside unitholders from converting their units into privately held shares, saving more of these shares for the general partner. *Id.* at 484.

130. *Id.* at 496–99.

131. *Id.* at 499 n.33.

132. *See* Carney & Shepherd, *supra* note 1, at 20–21.

133. No. Civ. A. 16788, 2001 WL 1045643, at *10–11 (Del. Ch. Sept. 6, 2001). This case involved the same partnership as in *Kahn v. Icahn*, discussed *supra* text accompanying notes 114–16, but dealt with different transactions and contract provisions.

> actions as it deems necessary or appropriate to accomplish the purposes of the Partnership as set forth herein.[134]

The agreement also provided:

> Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its "sole discretion" or "discretion", with "absolute discretion" or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its "good faith" or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.[135]

Vice Chancellor Strine held that the agreement not only failed explicitly to preclude the application of default fiduciary duties, but affirmatively revealed an intention to include such duties because the parties used a popular form but deleted language explicitly preempting default duties.[136] The court also noted references to default fiduciary duties in the registration statement used to sell the partnership interests.[137] Preemption of fiduciary duties therefore was not "plain" enough under *Sonet*, and so default substantive fairness and the duty of loyalty applied.[138]

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

> will not [be] tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.[139]

However, the court added:

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134. *Miller*, 2001 WL 1045643, at *7.

135. *Id.* at *6 (emphasis omitted).

136. *Id.* at *9 (discussing forms 38 and 99 in MARTIN I. LUBAROFF & PAUL M. ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS (Aspen Supp. 2000) (1995)).

137. *Id.* at *9–10.

138. *Id.* at *8–9.

139. *Id.* at *8 (footnotes omitted).

> [J]ust as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.[140]

Miller clearly illustrates the Delaware courts' two-pronged approach to ensuring clear delineation of rights in uncorporation cases.[141] Under the first prong, an explicit agreement is enforced according to its terms.[142] However, under the second prong, to the extent that the agreement does not explicitly exclude default duties, the court will apply such duties unless they cannot be reconciled with the terms of the agreement.[143] The two prongs together give parties a strong incentive to clarify their rights and thereby eliminate the need for judicial intervention. By contrast, in corporate cases, the parties' rights are determined almost entirely by applying fiduciary principles, which the court must adapt to firms' changing needs.[144]

Later cases further explain when to interpret the agreement to preempt fiduciary duties. In *Continental Insurance Co. v. Rutledge & Co.*, the Delaware Court of Chancery held that a provision permitting a general partner to "engage in other business activities or possess interests in other business activities of every kind and description, independently or with others" did not permit self-dealing.[145] In *In re Marriott Hotel Properties II Limited Partnership*, the court held that the following provision preserved default fiduciary duties and thereby provided the basis for a claim based on a squeeze-out of the limited partners by manipulation of distributions:

> The General Partner shall be under a duty to conduct the affairs of the Partnership in good faith and in accordance with the terms of this Agreement. . . . Nothing contained in the Agreement is in-

140. *Id.* at *8 (footnote omitted).

141. *Id.* at *6–11.

142. *Id.* at *7–12. One caveat here is that the agreement may include open-ended terms that invite the application of fiduciary duties. Courts have held partners liable for careless conduct that was not protected under the agreement's exculpation clause. *See* Schuss v. Penfield Partners, L.P., No. 3132-VCP, 2008 WL 2433842, at *7–9 (Del. Ch. June 13, 2008) (refusing to dismiss a claim arising out of computation of distributions owed withdrawing limited partners where plaintiffs could prove that the defendants' interpretation of the amount owed resulted from bad faith, gross negligence, or willful misconduct excluded under the agreement's exoneration clause); Venhill Ltd. P'ship v. Hillman, C.A. No. 1866-VCS, 2008 WL 2270488, at *30 (Del. Ch., June 3, 2008) (holding that the general partner wantonly investing large amounts of money in a failed venture on grossly unreasonable terms constituted bad faith, willful misconduct, and gross negligence and therefore was outside scope of the exoneration clause).

143. *Miller*, 2001 WL 1045643, at *12–18.

144. *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

145. 750 A.2d 1219, 1236 (Del. Ch. 2000).

tended or shall be construed to contract away the fiduciary duty of the General Partner to the limited partners.[146]

So far the Supreme Court has issued only one important LP opinion, *Gotham Partners v. Hallwood Realty Partners.*[147] In this case, a publicly held hedge fund made a public offer for so-called "odd lot" units that significantly increased the ownership percentage of the general partner's parent.[148] This transaction involved a managerial conflict of interest that would have been subject to the mandatory fiduciary duty of loyalty in a corporation.[149] However, the partnership agreement required only audit committee review, and that the terms of self-dealing transactions involving the resale of units be "substantially equivalent to terms obtainable by the Partnership from a comparable unaffiliated third party."[150] The court applied the contractual standard to what it deemed to be a resale and held that the defendant had breached the standard by failing to comply with the contract's procedural safeguards.[151] It was clear under the court's reasoning that this self-dealing standard would not have applied had the transaction been an issuance rather than a resale.[152]

The most notable aspect of this case is not its holding or result, but its dictum. Chief Justice Veasey's opinion expressed "concern and caution relating to . . . dubious dictum" in the trial court's opinion, suggesting that an LP agreement may eliminate fiduciary duties and noting that the statute did not so provide.[153] The court noted, "[T]he historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly."[154] The court added that this issue could not be fully dealt with by the implied covenant of good faith and fair dealing as the trial court had suggested, stating that "[t]he issue of good faith and fair dealing is not before us, and we need not express any opinion on that issue in this case."[155]

The Delaware legislature swiftly reacted to the court's "caution" by amending the statute to explicitly permit elimination of fiduciary duties in LP and LLC agreements.[156] This exchange between the courts and the legislature confirmed the primacy of the agreement indicated by the earlier Chancery Court opinions.[157]

146. No. Civ. A. 14961, 2000 WL 128875, at *3 (Del. Ch. Jan. 24, 2000).
147. 817 A.2d 160 (Del. 2002).
148. *Id.* at 166.
149. *Id.* at 168 n.15.
150. *Id.* at 171.
151. *Id.* at 175.
152. *Id.* at 171–72.
153. *Id.* at 168.
154. *Id.*
155. *Id.* at 168 n.17.
156. *See* Act of June 24, 2004, ch. 275, sec. 14, § 18-1101, 74 Del. Laws 613 (codified as amended at DEL. CODE ANN. tit. 6, § 18-1101 (2005)).
157. *See, e.g.*, Sonet v. Timber Co., 722 A.2d 319, 323 (Del. Ch. 1998).

Chief Justice Steele later criticized his predecessor's opinion, consistent with his view that Delaware courts in uncorporate cases should adhere to the contract rather than presuming in favor of the fiduciary duties that normally attach to fiduciary status.[158] Chief Justice Steele said: "The supreme court apparently found it difficult to abandon the view that judicial oversight of disputes within the governance structure of limited liability unincorporated entities must invariably be from the perspective of a set of freestanding non-waivable equitable principles, drawn from the common law of corporate governance."[159] He added that the post-*Gotham* amendment "leaves little, if any, room for argument over whether the contract relationship has triumphed over the status relationship in Delaware limited partnership and limited liability company internal governance scrutiny."[160]

2. *LLC Fiduciary Duties and Operating Agreements*

Delaware LLC cases exhibit the same tendency as the LP opinions to enforce agreements when they clearly supersede default duties and, more generally, to apply a distinct contractual approach to uncorporate cases.[161] The most important LLC case is the Delaware Supreme Court's opinion in *Wood v. Baum*[162] refusing to excuse demand in a derivative suit based on allegations that the managers of a publicly held LLC had "breached their *Caremark* duties."[163] The court held that the allegations fell short in part because the operating agreement protected the managers from liability absent a showing of "fraudulent" or "illegal" conduct or a "bad faith" breach of the covenant of good faith and fair dealing. Absent such a showing, the managers had no incentive to protect themselves from liability in refusing a demand to sue. Thus, the court concluded that "[g]iven the broad exculpating provision contained in MME's Operating Agreement, the plaintiff's factual allegations are insufficient to establish demand futility."[164]

Perhaps most interestingly, the court dismissed the complaint despite its allegation that defendants had breached their duties by "'fail[ing] properly to institute, administer and maintain adequate accounting and reporting controls, practices and procedures,' which resulted in a 'massive restatement process, an SEC investigation, and loss

158. Steele, *supra* note 107, at 12 (citing *Gotham*, 817 A.2d at 175–76).
159. *Id.* (citing *Gotham*, 817 A.2d at 175–76).
160. *Id.* at 14.
161. *See, e.g.*, Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs. Inc., 854 A.2d 121, 158 (Del. Ch. 2004).
162. 953 A.2d 136 (Del. 2008). For an analysis of this case, see Posting of Larry E. Ribstein to The Harvard Law School Corporate Governance Blog, http://blogs.law.harvard.edu/corpgov/2008/08/05/delaware-enforces-a-fiduciary-opt-out-in-a-publicly-held-firm/ (Aug. 5, 2008, 14:58 CST).
163. *Wood*, 953 A.2d at 139.
164. *Id.* at 144.

of substantial access to financial markets.'"[165] Although these allegations may have raised a good faith issue under *Stone*, the court said:

> the Complaint does not purport to allege a "bad faith violation of the implied contractual covenant of good faith and fair dealing." The implied covenant of good faith and fair dealing is a creature of contract, distinct from the fiduciary duties that the plaintiff asserts here. The implied covenant functions to protect stockholders' expectations that the company and its board will properly perform the *contractual* obligations they have under the operative organizational agreements. Here, the Complaint does not allege any contractual claims, let alone a "bad faith" breach of the implied contractual covenant of good faith and fair dealing. Nor, as discussed above, does the Complaint contain any particularized allegations that the defendants acted with the requisite scienter (in "bad faith").[166]

This reasoning is interesting because the allegations the court deemed insufficient in *Wood* were enough to excuse demand in a suit against corporate directors in *Stone v. Ritter*.[167]

Chancery court LLC cases have emphasized the controlling effect of the operating agreement, consistent with the LP cases discussed above. For example, *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies Inc.* declined to impose

> a judicially encrusted requirement that the LLC managers provide proxy-statement-like disclosures each time they make a capital call. This would be inefficient and would threaten to convert the duty to disclose all material facts in connection with a discretionary vote or tender into a pervasive, across-the-board rule governing all entity disclosures, because entity owners can usually connect any disclosure to a decision they might make (e.g., the decision whether to hold or sell their ownership interests).[168]

Also, in *Walker v. Resource Development Co.*, the court held that members could not remove a misbehaving comember without operating agreement authorization, stating that the statute merely fills gaps in the agreement and that "LLC members' rights begin with and typically end with the Operating Agreement."[169] Thus, the members were not protected by good faith reliance on the agreement pursuant to the LLC equivalent of the LP freedom-of-contract provision quoted above.[170] In *Minnesota Invco of RSA # 7, Inc. v. Midwest Wireless Holdings LLC*, the court interpreted the operating agreement as permitting sale of the ma-

165. *Id.* at 139 (footnotes omitted).
166. *Id.* at 143 (footnotes omitted).
167. *See supra* text accompanying note 97.
168. 854 A.2d 121, 158 (Del. Ch. 2004). However, the court applied the corporate rule in *Malone v. Brincat*, 722 A.2d 5, 12 (Del. 1998), limiting liability to statements made in the context of shareholder voting or tendering.
169. 791 A.2d 799, 813 (Del. Ch. 2000).
170. *Id.*

jority interest over the objection of the minority owners and permitting the controlling member to exercise his voting power to amend the agreement to clarify the absence of first refusal rights.[171] And in *Eureka VIII LLC v. Niagara Falls Holdings LLC*, the court rigorously enforced an LLC operating agreement permitting a 50% owner to become the sole member when the other member breached the LLC agreement by granting a security interest to another entity and upon the death of the person who was required under the agreement to retain control of the other member.[172] The court effectuated the nonbreaching member's clear intent to bar membership of anyone it disapproved of,[173] odd as it might seem for death to be a contract breach.

An uncorporate agreement may implicitly authorize judicial application of corporate-type fiduciary duties by using fiduciary language, as Chief Justice Steele recognized.[174] For example, the court in *Solar Cells, Inc. v. True North Partners, LLC* preliminarily enjoined a merger based on evidence of lack of fair dealing and fair price, where the agreement waived liability for conflict of interest "provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar]."[175] Also, in *In re Regional Diagnostics, LLC*, a federal bankruptcy court applying Delaware law applied the Delaware corporate rule from *Stone v. Ritter* in holding that the conduct at issue in the case was not within a clause of the operating agreement exculpating liability for acts in good faith.[176]

One of the strongest applications of Delaware's freedom-of-contract approach in LLCs is *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, which enforced an operating agreement provision waiving the right to bring an action for judicial dissolution.[177] Chancellor Chandler emphasized Delaware's strong public policy favoring freedom of contract, observing that this freedom is important to "[t]he allure of the limited liability company."[178] The chancellor reasoned that a provision in the Delaware statute is mandatory only if the statute explicitly so provides, which was not the case here.[179] He also stressed that "there are legitimate business reasons why members of a limited liability company may wish to waive their right to seek dissolution or the appointment of a

171. 903 A.2d 786, 796–98 (Del. Ch. 2006).
172. 899 A.2d 95, 115–16 (Del. Ch. 2006).
173. *See id.* at 112–13.
174. *See* Steele, *supra* note 107, at 25–26.
175. No. Civ. A. 19477, 2002 WL 749163, at *4 (Del. Ch. 2002).
176. *In re* Reg'l Diagnostics, LLC, 372 B.R. 3, 28 (Bankr. N.D. Ohio 2007) (applying Delaware law).
177. No. 3803-CC, 2008 WL 3846318, at *8 (Del. Ch. Aug. 19, 2008). For a discussion of this case, see Ideoblog, Waiving Judicial Dissolution: Our Remedies Oft in Ourselves Do Lie, http://busmovie.typepad.com/ideoblog/2008/08/waiving-judicia.html (Aug. 23, 2008, 17:45 CST).
178. *R & R Capital*, 2008 WL 3846318, at *8.
179. *Id.* at *6.

receiver."[180] For example, the chancellor noted that the members may want to ensure against judicial dissolution to avoid default in loan agreements.[181] *R & R Capital* is a particularly interesting case because judicial dissolution might be considered a kind of fallback or escape valve to backstop the operating agreement. Allowing the parties to opt-out of even this remedy illustrates the extent to which Delaware courts will go in respecting the parties' agreement.

At least one case, however, provides a troubling indication that corporate-type analysis has not been expunged from the Delaware uncorporate cases. In *VGS, Inc. v. Castiel*, the Delaware Court of Chancery held that a manager who secretly schemed to take power away from the controlling member by persuading a director appointed by the controlling member to switch sides "breached their duty of loyalty to the original member and their fellow manager by failing to act in good faith."[182] The court reached the right result because the case arguably involved an abuse of agreed governance powers contrary to the implied covenant of good faith and fair dealing.[183] But the court was wrong to ground its result on a breach of the duty of loyalty since the managers were acting as owners under the contract rather than as fiduciaries.[184] Chief Justice Steele singled out *VGS* as an example of how "Delaware courts have continued to focus on the status relationships of the parties, rather than upon their contractual relationship when resolving governance disputes."[185] *VGS* might not be decided the same way today in the wake of *Wood v. Baum* and the Chief Justice's instructions to Delaware courts.

3. Limited Partnership Agreements

LPs should present the same issues as LLCs since both types of firms are uncorporations operating under similar statutory provisions giving primacy to the parties' agreement.[186] If there is any distinction, LP fiduciary provisions should present fewer problems since their agreements often will be more heavily lawyered than those in more informal LLCs.[187] However, because of the traditionally subordinate role of limited partners, LPs tend to involve greater delegation of power to the managing general partners, increasing the importance of agency cost-control mechanisms. Although this control can be provided by uncorporate-type disciplinary mechanisms rather than fiduciary duties, courts that are not sufficiently sensitive to the different transactional back-

180. *Id.* at *7.
181. *Id.*
182. No. C.A. 17995, 2000 WL 1277372, at *1 (Del. Ch. 2000).
183. For an analysis rationalizing the result along these lines, see Ribstein, *supra* note 92, at 250 n.12.
184. *VGS*, 2000 WL 1277372, at *1–2.
185. Steele, *supra* note 107, at 28.
186. *See supra* note 100 and accompanying text.
187. *See supra* Part III.B.1.

ground may erroneously carry corporate-type fiduciary duties over to uncorporations.[188] Two significant post-*Gotham* LP opinions indicate that the Delaware Chancery Court continues to struggle with the contractual approach in uncorporate cases.[189]

In *Twin Bridges Ltd. Partnership v. Draper*, two general partners of a family LP had deadlocked under a partnership agreement requiring both general partners to agree to "all major decisions" affecting the partnership.[190] The agreement allowed amendment by two-thirds of the capital interests of all general and limited partners.[191] One of the general partners formed a coalition with most of the limited partners to circumvent the other partner.[192] The coalition first amended the agreement to add a provision enabling merger by two-thirds of the partnership interests executed by either general partner and then authorized a merger that had the effect of amending the partnership agreement by adding a third general partner—namely, one of the former limited partners.[193] Vice Chancellor Parsons reasoned that:

> Under Delaware limited partnership law, a limited partnership is a creature of both statute and contract. The Delaware Revised Uniform Limited Partnership Act "embodies the policy of freedom of contract and maximum flexibility." [quoting *Gotham*] As the Delaware Supreme Court has recognized, parties to a Delaware limited partnership have the discretion to create a limited partnership "in an environment of private ordering" and operate that entity according to the provisions in the limited partnership agreement. The provisions of the partnership agreement define the contractually bargained rights and responsibilities of those who are parties to the agreement and are afforded significant deference by the courts. Limited partnerships, therefore, offer contractual flexibility with few statutory constraints.[194]

The court added:

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

188. Ribstein, *Partnership Governance*, *supra* note 9, (manuscript at 17).

189. Forsythe v. ESC Fund Mgmt. Co., No. 1091-VCL, 2007 WL 2982247 (Del. Ch. Oct. 9, 2007); Twin Bridges Ltd. P'ship v. Draper, No. Civ. A. 2351-VCP, 2007 WL 2744609 (Del. Ch. Sept. 14, 2007).

190. *Twin Bridges*, 2007 WL 2744609, at *2.

191. *Id.* at *3.

192. *Id.* at *1.

193. *Id.*

194. *Id.* at *8 (footnotes omitted).

> sions, . . . will [a court] look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence." In other words, unless the partnership agreement is silent or ambiguous, a court will not look for extrinsic guidance elsewhere, so as to "give maximum effect to the principle of freedom of contract" and maintain the preeminence of the intent of the parties to the contract. Based on these overarching principles of limited partnership law, I now turn to the interpretation of Paragraph 31(b).[195]

Consistent with the Chief Justice's recommendation, the court carefully construed the operating agreement and held that it permitted the integrated merger and amendment.[196] The court also held that since the transaction was authorized by the operating agreement and was not "clearly against the intent of the parties as expressed in the [partnership agreement]," it did not violate the implied duty of good faith and fair dealing.[197]

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

> As the Delaware Supreme Court in *Gotham Partners* instructs, the Legislature's basic approach in limited partnerships is to maintain the policy of freedom of contract and maximum flexibility. A court will superimpose statutory default rules onto a written agreement "only in situations where the partners have not expressly made provisions in their partnership agreement," or where the agreement is inconsistent with mandatory statutory provisions. Hence, a court must tread lightly when determining whether to apply default statutory provisions to an agreement of limited partnership.[198]

The court also appropriately refused to import a corporate statutory provision requiring a unanimous vote to amend the partnership agreement to allow approval of a merger by a lesser vote.[199] The court said:

> Because the conceptual underpinnings of the corporation law and Delaware's limited partnership law are different, courts should be wary of uncritically importing requirements from the DGCL into the limited partnership context. Further, Section 242(b)(4) differs significantly from Section 17-211(b) of DRULPA. The latter constitutes a default rule meant to be applied only if the partnership

195. *Id.* at *13 (other footnotes omitted) (citing Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 291 (Del. 1999) ("The basic approach of the Delaware Act is to provide members with broad discretion in drafting the Agreement and to furnish default provisions when the members' agreement is silent."); Steele, *supra* note 107).

196. *See id.* at *16. Specifically, the court held that the step transaction did not have the effect of permitting limited partners to participate in control, which would have required unanimous consent under the operating agreement. *See id.* at *15.

197. *Id.* at *17.

198. *Id.* at *18 (footnotes omitted).

199. *See id.* at *19.

> agreement is silent on the vote needed to approve a merger. In contrast, Section 242(b)(4) positively requires that any alteration, amendment, or repeal of a supermajority vote requirement in a certificate of incorporation be accomplished with the approval of the same supermajority. No comparable, affirmative requirement appears in DRULPA, and I do not perceive any basis for implying such a requirement.[200]

Although the opinion generally adhered to the agreement and to partnership principles, in one respect the vice chancellor allowed the corporate nose under the uncorporate tent. The partner opposing the transaction claimed that the other general partner's involvement in the amendment and merger was a breach of the duty of loyalty.[201] While nodding to the partnership's ability to eliminate fiduciary duties,[202] the court said that unless these duties are preempted, general partners have a loyalty duty comparable to that of corporate directors.[203] The proponent of the transaction stressed that no self-dealing transactions had taken place.[204] But the court noted that the new partnership agreement entered into in connection with the merger eliminated all fiduciary duties in connection with development and implementation of a Development Plan.[205] This could result in shielding a future self-dealing transaction without the objecting partner's approval. The court cited the corporate case of *Schnell v. Chris-Craft Industries, Inc.*[206] for the proposition that a transaction complying with law may nevertheless be inequitable.[207] Because allowing this transaction would eliminate any future right to self-dealing review and permit only the lower level of good faith review, the court denied dismissal of these claims.[208]

The court's decision on this last point is questionable because it is not clear why the parties could not amend the agreement to eliminate fiduciary duties. The specific question should be whether such an amendment was permitted by the express terms of the original contract construed in light of the parties' contractual obligation of good faith. Instead of applying a narrow contractual analysis, the court nodded to the *Schnell* rule, thereby introducing corporate-style indeterminacy.[209]

Forsythe v. ESC Fund Management Co. excused partner demand in an LP derivative suit and then held on similar grounds that the complaint's allegations of mismanagement withstood dismissal on the mer-

200. *Id.* (citing Steele, *supra* note 107, at 10–13, 19).
201. *See id.* at *20.
202. *Id.* at *20 n.123.
203. *Id.* at *20.
204. *Id.* at *21.
205. *Id.*
206. 285 A.2d 437 (Del. 1971).
207. *Twin Bridges*, 2007 WL 2744609, at *21.
208. *Id.* at *22.
209. *See id.* at *21.

its.[210] Although the case does not involve a fiduciary opt-out, it is instructive both on interpretation of the agreement and application of general corporate standards. The LP was a fund set up by a bank to offer some of its employees an opportunity to coinvest with the bank.[211] The plaintiff alleged that the bank had actually schemed to free its capital from underperforming investments, and mismanagement had cost the fund 75% of its value.[212] The court held that the relevant standard of excuse involved breach not of the general corporate duty of care, but of a higher oversight duty that the partnership agreement imposed on the general partner.[213] Because the agreement provided for the general partner to delegate most of its functions to affiliates of the bank that established the fund, the general partner's only remaining duty was that of oversight, which was important because of the affiliates' conflicts of interest.[214] The court held that the complaint adequately alleged breach of this duty by failure to take any steps to inquire into investment decisions.[215]

The court's decision is questionable. The agreement in *Forsythe* provided that the general partner and the advisors were liable only for actions or omissions resulting from their bad faith, willful misconduct, gross negligence, or a material breach of the partnership agreement,[216] which is similar to the general gross negligence or recklessness standard applied by default in partnership statutes.[217] The court noted that the Delaware Supreme Court held in *Stone* that directors "are liable for breach of their oversight duty only if they ignore 'red flags' that actually come to their attention, warning of compliance problems."[218] But the *Forsythe* complaint apparently did not adequately allege breach of a "red flags" duty.[219] Nevertheless, the court held that delegation of power to the partner alone is enough under these circumstances to justify imposing an even stricter duty of supervision on the general partner than would apply to a corporate board.[220] The court reasoned that the standard "red flags" duty assumes the existence of "an effective compliance system" that entitles the corporate directors to assume corporate executives were exercising their responsibilities in the absence of red flags.[221] By contrast, in this case,

210. *See* Forsythe v. ESC Fund Mgmt. Co., No. 1091-VCL, 2007 WL 2982247, at *6–11 (Del. Ch. Oct. 9, 2007).
211. *Id.* at *1–2.
212. *Id.* at *3.
213. *Id.* at *1, 6, 10.
214. *Id.* at *1, 3, 7.
215. *Id.* at *8–9.
216. *Id.* at *3.
217. *See* UNIF. P'SHIP ACT § 404(c) (1997), 6 U.L.A. 143 (2001); UNIF. LTD. P'SHIP ACT § 408(c) (2001), 6A U.L.A. 439 (2008); ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON PARTNERSHIP § 16.07(f) nn.110–15 (2008).
218. *Forsythe*, 2007 WL 2982247, at *7 (citing Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)).
219. *Id.* at *8.
220. *Id.* at *7.
221. *Id.*

> [i]nstead of a board of directors sitting atop a command-style management structure of persons legally required to act loyally to the corporation, there is a nominally independent general partner that has delegated nearly all of its managerial responsibilities to conflicted entities who act through persons employed by and loyal to a third party. There is no command-style system of management reporting up to the General Partner, and the General Partner had no reason to believe that the Special Limited Partner or the Investment Advisor, entities made up of persons whose primary loyalty was and is to [the bank], would likely exercise their delegated duties in a manner that was loyal to the partnership. In the circumstances, the duty of oversight created by the Partnership Agreement is better understood as imposing on the General Partner an active obligation, at a minimum, to take steps to satisfy itself that the Special Limited Partner and the Investment Advisor actually discharge their delegated duties in compliance with the Partnership Agreement and in a manner loyal to the partnership.[222]

This reasoning is not persuasive in light of this Article's analysis.[223] Although the court noted the particular circumstances that may have justified imposing a strict duty,[224] it did not adequately take into account either the nature of the duty specified in the agreement or other circumstances relating to the uncorporate nature of the firm that may have justified imposing the usual version of the gross negligence standard. In particular, the opinion indicates that managers breached specific contract limitations on the fund's investments, including a provision restricting transfers to the fund only of investments made between 2000 and 2006, a limitation on coinvestment with the bank's merchant capital division,[225] and the requirement of codivestment with the bank.[226] The timing restriction limited the extent to which the bank could dump existing bad investments on the fund, while the other restrictions constrained conflicts of interest by ensuring that the fund was not taking greater risks than the sponsoring bank. The agreement, therefore, arguably anticipated many of the situations in which conflicts of interest would be a problem. These specific restrictions serve the usual uncorporate function of replacing general monitoring with specific constraints on managers' power. It follows that any remedy should have been limited to one for breach of specific investment restrictions or other contract provisions, rather than potential mismanagement liability for all of the fund's losses.

222. *Id.*

223. The court's reasoning also may not hold up under the Delaware Supreme Court's analysis in *Wood v. Baum*, discussed *supra* text accompanying notes 162–66. *Wood* refused to impose a duty of oversight under a partnership agreement that referred specifically to the implied covenant of good faith and fair dealing. It is not clear whether the court would apply the same approach to an agreement that referred only to "bad faith" and not to the implied covenant.

224. *Forsythe*, 2007 WL 2982247, at *1

225. *Id.* at *4.

226. *Id.* at *10 n.55.

Twin Bridges and *Forsythe*, therefore, suggest that the Delaware courts do not yet fully recognize the fundamental differences between the corporate and uncorporate cases. The court in *Twin Bridges* was not ready to embrace the full implications of enforcing private ordering in this context.[227] More seriously, the *Forsythe* court failed to take account of the uncorporate-type provisions that constrained the fund managers and instead treated the firm like a corporation by focusing on the amount of discretion delegated to the managers.[228] But it is notable, and perhaps an indication of future results, that the court in *Twin Bridges* generally embraced Chief Justice Steele's admonition about enforcing contracts in uncorporations.[229]

4. Remedies

Cases broadly enforcing arbitration provisions clearly acknowledge the role of the contract in uncorporation cases, particularly those involving LLCs.[230] This contrasts with corporate cases, where arbitration of fiduciary duties is controversial.[231] The leading uncorporate case is *Elf Atochem North America, Inc. v. Jaffari*, which held that LLC members contracted away a derivative remedy under a clause providing for "'[n]o action at law or in equity based upon *any* claim arising out of or related to this Agreement' except an action to compel arbitration or to enforce an arbitration award."[232] The court applied the following description of LP agreements to LLCs:

> Truly, the partnership agreement is the cornerstone of a Delaware limited partnership, and effectively constitutes the entire agreement among the partners with respect to the admission of partners to, and the creation, operation and termination of, the limited partnership. Once partners exercise their contractual freedom in their partnership agreement, the partners have a great deal of certainty that their partnership agreement will be enforced in accordance with its terms.[233]

The Supreme Court's forceful approval of arbitration in *Elf* has encouraged the Chancery Court to broadly interpret the scope of arbitration provisions to preclude default remedies in LLCs.[234]

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227. *See supra* text accompanying notes 190–209.
228. *See supra* text accompanying notes 210–26.
229. Twin Bridges Ltd. P'ship v. Draper, No. Civ. A. 2351-VCP, 2007 WL 2744609, at *1 (Del. Ch. Sept. 14, 2007).
230. *See, e.g.*, Elf Atochem N. Am., Inc. v. Jaffari, 727 A.2d 286, 287 (Del. 1999).
231. For an analysis of the issues and legal rules, see John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 925–26 (1988).
232. 727 A.2d at 294.
233. *Id.* at 291 (quoting MARTIN I. LUBAROFF & PAUL ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS § 1.2 (1999)).
234. *See* Douzinas v. Am. Bureau of Shipping, Inc., 888 A.2d 1146, 1150, 1152 (Del. Ch. 2006) (broadly applying an arbitration provision in a case involving an alleged breach of fiduciary duties by a

The enforcement of arbitration is significant not only as a contractual approach to fiduciary duties, but also as a basis for broader judicial enforcement of contracts. Uncorporation owners' ability to escape corporate indeterminacy through arbitration gives Delaware courts an extra incentive to minimize the problems discussed by Carney and Shepherd, or else they risk losing business to arbitrators.[235] In other words, arbitration potentially adds a dimension to the market for business association law.[236]

Apart from arbitration, the choice between direct and derivative remedies may matter to the courts' application of a contract-based or fiduciary approach. In a direct suit the courts are likely to focus on the owners' specific contractual rights, while in a derivative suit the general rights of the legal entity against its managers are likely to control. For example, the court in *Anglo American Security Fund, L.P. v. S.R. Global International Fund, L.P.* held that hedge fund limited partners could sue a general partner directly for diminution of the value of their interests.[237] The court observed that "the limited partners have absolutely no control over the governance and management of the Fund," but instead are protected only by the managers' disclosure duty and by their ability to withdraw from the fund.[238] The court thus referred directly to a key distinction between corporations and uncorporations: the contractual substitution of specific disciplinary devices for judicial monitoring via fiduciary duties.[239]

manager to minority members because that arbitration provision was in the LLC operating agreement, applied to claims "related to" rather than merely "arising under" the agreement, and plaintiff's claims clearly implicated the agreement's governance provisions, including its exculpatory clause); Terex Corp. v. STV USA, Inc., No. Civ. A. 1614-N, 2005 WL 2810717, at *1 (Del. Ch. Oct. 20, 2005) (interpreting an arbitration provision as precluding judicial action for dissolution); CAPROC Manager, Inc. v. Policemen's & Firemen's Ret. Sys. of City of Pontiac, No. Civ. A. 1059-N, 2005 WL 937613, at *1, 6 (Del. Ch. Apr. 18, 2005) (holding that an operating agreement provision for arbitration of "any 'dispute or controversy arising under' the Agreement" required arbitration of a dispute concerning removal of a manager). *But see* Willie Gary LLC v. James & Jackson LLC, No. Civ. A. 1781, 2006 WL 75309, at *1, 10 & n.32 (Del. Ch. Jan. 10, 2006) (interpreting an arbitration provision as not precluding a party from seeking judicial dissolution where the agreement provided for "judicial determination" of dissolution grounds and for court action for injunctive relief and specific performance, distinguishing *Terex*, but observing that parties could "contract to have an arbitrator hear claims for dissolution"), *aff'd*, 906 A.2d 76 (Del. 2006). The generally broad interpretation of arbitration in Delaware contrasts with the narrow approach used in *Mission Residential, LLC v. Triple Net Properties, LLC*, 654 S.E.2d 888, 891 (Va. 2008), which held that an arbitration agreement between LLC members did not require arbitration of a member's derivative claim against another member because the derivative claim belonged to the LLC as a separate entity. For criticism of this case, see Ideoblog, LLC Derivative Suits and Arbitration Clauses: Thoughts on Drafting and the Nature of LLCs, http://busmovie.typepad.com/ideoblog/2008/03/llc-derivative.html (Mar. 22, 2008 11:49 CST).

235. Erin Ann O'Hara & Larry E. Ribstein, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 673.

236. For a general analysis of arbitration's role in the market for law, see chapter five in ERIN A. O'HARA & LARRY E. RIBSTEIN, THE LAW MARKET (forthcoming 2008).

237. 829 A.2d 143, 151–52 (Del. Ch. 2003).

238. *Id.* at 154.

239. The court in *Anglo American Security Fund* also emphasized the aggregate nature of the fund: that the losses were passed directly to the partners through their capital accounts, and that the

IV. IMPLICATIONS AND CAVEATS

Part III indicates that the indeterminacy problems that Carney and Shepherd discuss may be a function of *corporate* law rather than of *Delaware* law. In uncorporate cases, the Delaware courts generally stay close to the parties' agreement, thereby enabling the parties to avoid the instability and indeterminacy of corporate fiduciary jurisprudence through careful drafting.[240] This provides an additional basis for Chancellor Chandler's skepticism that there really is any difference between Delaware's corporate law and that under the MBCA.

There are, however, some important caveats to this conclusion. First, it may be significant that the distinct uncorporate treatment in Delaware has been primarily instigated and promoted by the legislature rather than by the courts. The cases, of course, began with the Delaware waiver provisions.[241] Then the legislature had to make its edict more explicit after *Gotham*,[242] and Chief Justice Steele felt it necessary to admonish his colleagues to pay attention to the legislature.[243] This suggests that any Delaware-specific indeterminacy problem may lie in the courts rather than the legislature. This seems plausible based on the legislature's strong incentive to respond to its business constituency. Thus, while commentators have emphasized Delaware's incentives to create indeterminacy,[244] perhaps they should be looking at the different incentives of courts and legislatures.

Second, it is of possible interest that the courts have not explicitly connected any distinct treatment of uncorporation cases with the differences between corporations and uncorporations discussed in Part II. For

Fund "operates more like a bank" in the sense that partners have individual accounts and the fund has no going concern value. *Id.* at 154. But these facts do not clearly differentiate the partnership from a corporation, since in both cases the value of the partners' interests, which the partners would realize on sale either on the open market or back to the firm, would depend on the firm's overall value. For a general analysis of members' remedies in LLCs and a criticism of applying the derivative remedy in this context, see Larry E. Ribstein, *Litigating in LLCs*, BUS. LAW. (forthcoming Apr. 2009).

240. Notably, Delaware's uncorporate law is more determinate not only than its corporate law, but also than other states' uncorporate law. While Delaware allows complete waiver of fiduciary duties, most other states restrict fiduciary duty opt-outs in uncorporate firms, thus rejecting Delaware's contractarian approach. *See* RIBSTEIN & KEATINGE, *supra* note 100, § 9 app. 9-6 (tabulating state LLC provisions on opting out of fiduciary duties). The complex and indeterminate fiduciary duty provisions in the Revised Uniform Limited Liability Company Act indicate the general direction of state law in this regard. *See* REVISED UNIF. LTD. LIAB. CO. ACT §§ 110, 409 (2006), 6B U.L.A. 442–44, 488–89 (2008); Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 36 (2008). This is further support for the idea that any Delaware indeterminacy is a function of corporate law rather than of its courts generally.

241. *See supra* Part III.A.

242. *See supra* text accompanying note 156.

243. *See* Steele, *supra* note 107.

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

example, *Sonet* and *R.S.M.* merely emphasized the availability of the corporate protection of shareholder voting rights rather than uncorporate elements,[245] while *Forsythe* mentioned but did not emphasize uncorporate protections.[246] Does this mean that there is no particular reason to distinguish corporate and uncorporate cases? That would depend on whether uncorporate-type constraints controlled the conduct involved in the cases. This seems likely given this Article's analysis, particularly in the *Forsythe* case.[247] An alternative explanation is that the courts simply did not see the corporate versus uncorporate distinction and, therefore, did not emphasize the facts that related to this distinction. Thus, the lesson of these cases may be that the courts should be more careful in discerning the agreement's tradeoffs between corporate and uncorporate protections in considering the extent to which the parties intended to waive fiduciary protections.

A third caveat to this Article's analysis is that cases like *Gotham*, *VGS*, *Twin Bridges*, and *Forsythe* show that the judicial tendency to apply corporate rules is always lurking and that courts have not yet completely severed the uncorporate cases from corporate indeterminacy.[248] In particular, it is important to keep in mind that the uncorporate cases have arisen mainly in closely held firms, and uncorporate law has not been fully tested under the conditions that corporate law has had to face.[249] Courts may be particularly tempted to apply corporate rules to uncorporate firms that resemble large-scale corporations. Among other things, the courts may be concerned about the rigorous accountability to shareholder interests that uncorporate governance devices entail.[250] Delaware may also face federal pressure to hold large partnerships to corporate-type scrutiny.[251] On the other hand, it is worth noting that, in *Wood v. Baum*, the Delaware Supreme Court applied the uncorporate freedom-of-contract analysis to an LLC with 2,500 record holders listed on the New York Stock Exchange, without suggesting that these facts should lead to a different analysis than in cases involving closely held uncorporations.[252]

Fourth, even if the corporate versus uncorporate distinction generally holds, it may affect only a limited set of firms. The uncorporate at-

245. R.S.M., Inc. v. Alliance Capital Mgmt. Holdings L.P., 790 A.2d 478, 498 (Del. Ch. 2001); Sonet v. Timber Co., 722 A.2d 319, 326 (Del. Ch. 1998).

246. Forsythe v. ESC Fund Mgmt. Co., No. 1091-VCL, 2007 WL 2982247 (Del. Ch. Oct. 9, 2007).

247. *See supra* text accompanying notes 213–29.

248. Gotham Partners v. Hallwood Realty Partners, 817 A.2d 160 (Del. 2002); *Forsythe*, 2007 WL 2982247; Twin Bridges Ltd. P'ship v. Draper, No. Civ. A. 2351-VCP, 2007 WL 2744609 (Del. Ch. Sept. 14, 2007); VGS, Inc. v. Castiel, No. C.A. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000).

249. *See, e.g.*, Miller v. Am. Real Estate Partners, No. Civ. A. 16788, 2001 WL 1045643, at *1 (Del. Ch. Sept. 6, 2001).

250. *See* Ribstein, *Accountability*, *supra* note 9, at 1439–41.

251. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 591–93 (2003) (arguing that Delaware responds to the threat of potential federalization of corporate law).

252. *See supra* text accompanying notes 162–67.

tributes discussed in Part II, including customizing or eliminating fiduciary duties, may be best suited only to those firms that can use uncorporate-type discipline instead of corporate-type monitoring. This discipline may not work in firms that, for example, have unstable earnings and, therefore, cannot commit to making distributions to owners or to liquidating at a specific future date.

Fifth, it is not yet clear as a policy matter how far the uncorporate approach of strict reliance on contract terms *should* be applied. This approach involves its own transaction costs, which must be balanced against any savings in indeterminacy costs. In the Delaware cases, fiduciary duties loom in the background, ready to flow into any gap left by the contract.[253] Vice Chancellor Strine's admonition to lawyers not to address fiduciary duties "coyly"[254] could require such careful and costly drafting that it makes fiduciary duties in effect mandatory. Even a moderate insistence on careful drafting could put fiduciary duty waivers out of the reach of smaller firms. In other words, by making very skilled drafting the price of avoiding indeterminacy, Delaware's uncorporate law may be trading lower litigation costs for higher fees to transactional lawyers. This may reserve the benefits of the uncorporate approach only for the largest and most sophisticated uncorporations.

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

V. CONCLUSION

This Article shows that the problem with Delaware corporate law may be a feature of the corporation rather than of adjudicating business association cases. Corporate governance calls for courts to exercise broad supervisory powers over managers. Given the complex and constantly changing corporate environment, it is not surprising that courts charged with this task cannot provide perfect stability and clarity. In the uncorporate setting, the parties themselves do the work by fashioning contracts that provide the discipline and incentives that corporations expect from fiduciary duties. The Delaware courts and legislature have responded with rules that enforce these contracts. The uncorporation,

253. *See, e.g.*, *Miller*, 2001 WL 1045643, at *6–11.
254. *Id.* at *8.

therefore, may provide an escape route from corporate indeterminacy, at least for some firms. More importantly for present purposes, this analysis helps solve the mystery of Delaware's success: Corporate law is inherently a messy business.