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## The "New" Fiduciary Standards under the Revised Uniform Limited Liability Company Act: More Bottom Bumping from NCCUSL

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# THE “NEW” FIDUCIARY STANDARDS UNDER THE REVISED UNIFORM LIMITED LIABILITY COMPANY ACT: MORE BOTTOM BUMPING FROM NCCUSL

*Rutheford B. Campbell, Jr.*

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## THE “NEW” FIDUCIARY STANDARDS UNDER THE REVISED UNIFORM LIMITED LIABILITY COMPANY ACT: MORE BOTTOM BUMPING<sup>†</sup> FROM NCCUSL<sup>‡</sup>

*Rutheford B. Campbell, Jr.\**

### I. INTRODUCTION

Between 1995 and 2001, the influential National Conference of Commissioners on Uniform State Laws (NCCUSL)<sup>1</sup> promulgated iterations of uniform laws pertaining to partnerships, limited partnerships and limited liability companies. One or more of those acts have been widely adopted by state legislatures.<sup>2</sup>

Each of the three acts—the Uniform Partnership Act (1997) (hereinafter RUPA),<sup>3</sup> the Uniform Limited Partnership Act (2001) (hereinafter ULPA (2001)),<sup>4</sup> and the Uniform Limited Liability Company Act (1996) (hereinafter ULLCA)<sup>5</sup>—contains identical fiduciary duty provisions. The acts all adopt the same standards for the duty of care<sup>6</sup> and the duty of loyalty,<sup>7</sup> and offer parties the same limited rights to opt out of

<sup>†</sup> In the famous article, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974), the late Professor Cary used the “bottom” as a metaphor for corporate laws that include lax, pro-management fiduciary duties.

<sup>‡</sup> The National Conference of Commissioners on Uniform State Laws (NCCUSL) is a not-for-profit corporation that, since its beginning in 1892, has drafted and promulgated uniform state laws that are offered to states for adoption. For a description of NCCUSL, see 6A U. L. A. III (2003). See also NCCUSL, <http://www.nccusl.org> (last visited Dec. 21, 2008).

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1. See *supra* notes <sup>†</sup> and <sup>‡</sup>.

2. As of August 1, 2007, NCCUSL’s, [www.nccusl.org](http://www.nccusl.org), reported the following numbers of adoptions by states and territories in the United States. Thirty-five states and territories had adopted the Uniform Partnership Act (1997) [hereinafter RUPA]. NCCUSL, [http://www.nccusl.org/Update/uniformact\\_factsheets/uniformacts-fs-upa9497.asp](http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upa9497.asp) (last visited Aug. 1, 2007). Thirteen states and territories had adopted the Uniform Limited Partnership Act (2001) [hereinafter ULPA (2001)]. NCCUSL, [http://www.nccusl.org/Update/uniformact\\_factsheets/uniformacts-fs-ulpa.asp](http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ulpa.asp) (last visited Aug. 1, 2007). Nine states had adopted the Uniform Limited Liability Company Act (1996) [hereinafter ULLCA]. NCCUSL, [http://www.nccusl.org/Update/uniformact\\_factsheets/uniformacts-fs-ullca.asp](http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ullca.asp) (last visited Aug. 1, 2007).

3. RUPA (amended 1997), 6 U.L.A. 58-274 (2001).

4. ULPA (amended 2001), 6A U.L.A. 9-123 (2003).

5. ULLCA (amended 1996), 6A U.L.A. 560-650 (2003).

6. RUPA section 404(c), *supra* note 3, at 143, states that “a partner’s duty of care . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. ULPA (2001) section 408(c), *supra* note 4, at 62, states that “a general partner’s duty of care . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”

ULLCA section 409(c), *supra* note 5, at 600, states that a “member’s [or a manager’s] duty of care . . . is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”

7. RUPA states:

A partner’s duty of loyalty to the partnership and the other partners is limited to the following:

(1) to account to the partnership and hold as trustee for it any property, profit, or benefit

the statutory fiduciary standards.<sup>8</sup>

The fiduciary standards and the opt-out rights in RUPA, ULPA (2001), and ULLCA are badly flawed.<sup>9</sup> The fiduciary duty provisions in the three acts reflect a pro-management bias that facilitates managers' pecuniary interest in constructing inefficient transactions with the entity's investors. The default standards themselves, which are likely to govern most situations,<sup>10</sup> are inefficiently lax and limited, and the opt-out provisions, which permit the parties within broad limits to re-make the default standards of care and loyalty, fail to facilitate fully-informed bargaining between

derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;

(2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and

(3) to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.

RUPA § 404(b), *supra* note 3, at 143; ULPA (2001), § 408(b), *supra* note 4, at 62; ULLCA § 409(b), *supra* note 5, at 600.

8. RUPA § 103(b), *supra* note 3, at 73 ("The partnership agreement may not . . . eliminate the duty of loyalty under Section 404(b) . . . but . . . may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable" and that the agreement may not "unreasonably reduce the duty of care under Section 404(c)."); ULPA (2001) § 110(b), *supra* note 4, at 23 ("A partnership agreement may not . . . eliminate the duty of loyalty under Section 408 . . . but . . . may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable" and that the agreement may not "unreasonably reduce the duty of care under Section 408(c)."); ULLCA § 103(b), *supra* note 5, at 567 ("The operating agreement may not . . . eliminate the duty of loyalty under Section 409(b) . . . but . . . may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable" and that the agreement may not "unreasonably reduce the duty of care under Section 409(c).")

9. Not surprisingly, the fiduciary duties in the uniform acts have been widely criticized in the legal literature. See generally Rutheford B. Campbell, Jr., *Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes*, 96 KY. L.J. 163 (2007-08). What may be somewhat surprising, however, is that both sides of the debate over fiduciary duties—the so-called *contractarians*, who generally favor unfettered rights on the parts of parties to arrange their own fiduciary duty standards, and the so-called *fiduciarians*, who generally favor societally imposed fiduciary standards—have been critical of the fiduciary standards in the uniform acts. The contractarian view is well articulated in Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45, 52 (1993) (using contractarian arguments to criticize the fiduciary duty rules of RUPA as "seriously misguided"). The fiduciarian view is well articulated in Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 524 (1993). In discussing the contractarian error, Vestal concluded that it "is so basic to the Revised [Uniform Partnership] Act, and the deleterious effects of the error are so profound, that the Conference should withdraw the Revised Act, rework it to conform to the fiduciary world view, and only then repromulgate it and recommend its adoption by the states." *Id.*

10. Economic theory suggests that default rules may sometimes be "sticky," meaning that parties may sometimes fail to remake default rules, even when the default rules do not suit their preferences. This will always happen, for example, when the value created by remaking the default rule is less than the transaction costs associated with remaking the rule. Recent research supports this theoretical point. See, e.g., Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination* (Yale Law & Economics Research Paper No. 335, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=924578](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=924578) (examining the extent to which statutory default rules governing takeovers and contests for corporate control are accepted or remade by corporations and their shareholders).

managers and investors respecting the nature of fiduciary duties, making it likely that parties will misperceive and misprice their fiduciary duties.<sup>11</sup>

The recently promulgated Revised Uniform Limited Liability Company Act (hereinafter RULLCA) offered the NCCUSL the opportunity to begin to correct its past mistakes regarding the fiduciary duties applicable to managers of unincorporated business entities.<sup>12</sup> Unfortunately, the Commissioners squandered this opportunity and, once again in RULLCA, enacted duties that are poorly designed and bound to lead to inefficient and unfair outcomes.

RULLCA contains many of the same misdirected fiduciary duty notions that plague its predecessor uniform acts, although the Commissioners in RULLCA did make a sensible adjustment to managers' duty of loyalty standards<sup>13</sup> and, at least arguably, to managers' duty of oversight or monitoring, a part of their overall duty of care. Any modest progress in these regards, however, was more than offset by the adoption of the "business judgment rule" as a part of an awkward statutory framework for RULLCA's duty of care provision. This overlaying of the "business judgment rule" on RULLCA's negligence standard of care will be confusing to LLC parties and to courts, which in turn will increase transaction costs and the probability of unexpected and unintended outcomes. Even more importantly, the adoption of a business judgment standard will reduce managers' standard of care to a level that is even more lax and inefficient than the present gross negligence standard that one finds in RUPA, ULPA (2001), and ULLCA.

This situation will be made substantially worse if—as seems highly likely—courts defining the application and meaning of RULLCA's business judgment standard turn for guidance to the common law that has developed in Delaware regarding corporate fiduciary duties. Delaware jurisprudence on the matter of corporate fiduciary duties generally<sup>14</sup> and the duty of care specifically is not only

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11. The problems in the opt out provisions of RUPA, ULPA (2001), and ULLCA are due to the statutes' failure to encourage full information among the parties and to the statutory mandatory floor on fiduciary duties, which is set too low. These same problems are found in RULLCA's opt-out provisions as well. See *infra* notes 75-80 and accompanying text.

12. Revised Unif. Ltd. Liab. Co. Act (2006), 6A U.L.A. 213-94 (Supp. 2007) [hereinafter RULLCA]. See *infra* Appendices A and B for RULLCA's fiduciary duty and opt-out provisions.

13. See *infra* notes 81-99 and accompanying text.

14. An example of the confusion wrought by Delaware courts can be found in the chaotic state of fiduciary duties applied to managers of corporations that are in financial distress. Delaware courts apparently shifted the beneficiaries of corporate managers' fiduciary duties from the corporate shareholders, who are beneficiaries of fiduciary duties during normal, solvent periods, to the corporation, when the corporation is in the "vicinity" of insolvency, and then to creditors, when the corporation becomes insolvent. See Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. CORP. L. 491, 495-506 (2007) (describing shifting fiduciary duties as corporations move from solvency to the vicinity of insolvency to actual insolvency). Obviously, this is extremely confusing for corporate fiduciaries to implement. More importantly, it becomes nearly impossible for corporate constituencies—shareholders, creditors, and managers, for example—to price the terms of their arrangements. The Delaware Supreme Court recently tried to resolve some of this confusion, stating:

When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

exceedingly confusing<sup>15</sup> and unnecessarily complex<sup>16</sup> but also overly lax, unduly pro-management and inefficient.<sup>17</sup> In such an environment, managers of LLCs operating under the RULLCA may enjoy default rules that essentially free them from any duty of care and opt out privileges that will further enable them to extract an even more inefficient and unfair “bargain” with those investing in their LLC.<sup>18</sup>

This is a matter of some economic importance. History suggests that the fiduciary duty provisions of RULLCA will define the terms of relationships between many thousands of investors and their agents. It seems certain that a material portion of the small businesses in this country will in time operate as limited liability companies under the provisions of RULLCA. While the first version of the Uniform Liability Company Act has had some difficulty in getting traction,<sup>19</sup> a broader look at the NCCUSL's various uniform unincorporated business statutes demonstrates the popularity these statutes have enjoyed with state legislatures.<sup>20</sup> Data also demonstrate the increasing importance and popularity of limited liability companies,<sup>21</sup> especially

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N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007). Even that language, of course, does not resolve the uncertainty regarding the beneficiaries of corporate fiduciaries' duties. For example, it is still unclear the extent to which, if any, directors may take an action that benefits non-shareholder constituencies—creditors, for example—at the expense of shareholders.

15. See *infra* notes 54-62 and accompanying text.

16. See *supra* note 14. An example of the unnecessary complexity of the Delaware common law regarding fiduciary duties is the way Delaware handles a case in which the fiduciary fails to meet one of the predicates of business judgment standard. The most common predicate that is violated is the obligation to make a reasonable investigation, which was the case, for example, in both *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) and in *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993) [hereinafter *Technicolor II*]. In *Technicolor II*, the Supreme Court of Delaware held that when making a business judgment, if the board fails to make a reasonable investigation, then the case must be considered (or more likely—as was the case in *Technicolor II*—reconsidered) under an intrinsic fairness standard. *Id.* at 370 (failure to use reasonable care at the investigation stage “required the directors to prove that the transaction was entirely fair”). One is at a loss regarding the logic of such an approach. The duty to make a reasonable investigation is a *duty* owed, and if the failure to meet that duty causes harm, the violator of the duty should be liable in damages to the injured party. In short, once the duty is violated, the better approach is to consider the case at that point only a matter of causation and damages. Certainly, one should not go back and re-litigate the standard, as is done in Delaware.

17. See *infra* notes 65-69 and accompanying text.

18. See *infra* notes 57-62 and accompanying text.

19. See *supra* note 2, regarding state adoptions of ULLCA. In Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager after More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 567-68 (2007), the author offers a history of state adoptions of limited liability company acts and speculates about the low adoption rate of ULLCA. The author notes that at the time ULLCA was promulgated, “most states had just completed . . . adopting their own . . . statutes, and few states wanted to quickly return to their legislative chambers to adopt a different LLC statute.” *Id.* at 568.

20. See *supra* note 2 for adoptions of RUPA, ULPA (2001), and ULLCA. In addition to those acts, prior uniform acts governing partnerships and limited partnerships were widely adopted. For example, the NCCUSL website reports that the Uniform Partnership Act, which was the predecessor to RUPA, “was adopted in every state except Louisiana.” NCCUSL, <http://www.nccusl.org> (follow “Final Acts & Legislation” hyperlink; then follow “Partnership Act” hyperlink) (last visited Sept. 11, 2008). By 2005, fifty-one states and territories had adopted the Revised Uniform Limited Partnerships Act. REVISED UNIF. LTD. P'SHIP ACT [hereinafter RULPA ], 6A U.L.A. 154 (Supp. 2007). That Act was the predecessor to ULPA (2001).

21. Professor Eisenberg reports that in “2002, there were 946,000 LLCs in the United States . . . . During the period 1996-2002, the number of LLCs increased more than 400%.” MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 499 (9th ed. 2005). For 2005, there were 1,456,125

with small businesses. The combination of single taxation and limited liability for owners, will certainly continue to make LLCs an attractive, and perhaps even a dominant, choice for small businesses.

Finally, it is difficult to overstate the importance of small businesses to our economy. There are, for example, approximately 5.2 million businesses in the United States with less than twenty employees.<sup>22</sup> Those small businesses employ a total of 20.8 million workers, or approximately 18.4% of all workers in the United States economy.<sup>23</sup> The products of small businesses are vital to our everyday life,<sup>24</sup> and the firms themselves are an important source of entrepreneurial energy and initiatives.<sup>25</sup>

It is unfortunate, therefore, that NCCUSL's most recent iteration of fiduciary duty provisions in RULLCA will once again facilitate outcomes that are unfair, inefficient and not priced by LLC parties.

States, of course, do not face an all-or-nothing requirement regarding the adoption of RULLCA. They are, instead, able to adopt all, most, some or none of the Act.<sup>26</sup>

This, then, becomes the prescriptive center of my piece. States adopting RULLCA should reject RULLCA's flawed fiduciary duty provisions. States should re-make the fiduciary duty provisions, including the opt-out provisions, in a way that facilitates fair and efficient outcomes. This, in turn, requires states to adopt duty of care and duty of loyalty provisions that fully-informed parties—the LLC owners and their agents or managers—would agree upon in most cases. States should also adjust RULLCA's opt-out provisions in a way that promotes full information at the time the parties “agree” to re-make the statutory fiduciary duties.

In Part II of this article, I offer an analytical and critical framework within which to evaluate RULLCA's fiduciary duty provisions. The framework is based on simple, uncontroversial principles, which, unfortunately, seem to have been overlooked by the Committee that considered and promulgated RULLCA. In Part III, I use this framework to demonstrate the significant flaws in RULLCA's fiduciary duty provisions and to support the prescription that is suggested.

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limited liability companies in the United States, which amounted to a 91.5% increase over the number of LLCs in 2002. BizStats website, <http://www.bizstats.com/reports/industry-sales-firm-summary.asp> (last visited Sept. 10, 2008).

22. See U.S. SMALL BUSINESS ADMINISTRATION, SMALL BUSINESS ECONOMY FOR DATA YEAR 2005: A REPORT TO THE PRESIDENT 229-31 (2006) [hereinafter SMALL BUSINESS ECONOMY 2005] (reporting a total of 5,767,127 businesses with 5,150,316 employing less than 20).

23. *Id.* (reporting total employment of 113,398,043 with 20,830,352 employed by firms with less than twenty employees).

24. See Rutheford B. Campbell, Jr., *The Impact of NSMIA on Small Issuers*, 53 BUS. LAW. 575 n.1 (1998).

25. For example, the Small Business Administration reports that the “estimated number of small business starts in 2005 . . . [was] 671,800 . . .” SMALL BUSINESS ECONOMY 2005, *supra* note 22, at 1. See also Campbell, *supra* note 24, at 576 (“[S]tudies commissioned by the SBA estimate that small businesses are responsible for 55% of all manufacturing product innovations and that small firms account for twice as many innovations per employees as do larger firms.”).

26. State legislatures often revise uniform acts in the adoption process. For example, when the Kentucky Legislature adopted RUPA, it adopted a duty of loyalty provision different from that of the Uniform Act. Compare RUPA § 404(b), 6 U.L.A. 143 (amended 1997) (duty of loyalty “is limited to”) with KY. REV. STAT. § 362.1-404(2) (2007) (duty of loyalty “includes but is not limited to”).

## II. ANALYTICAL AND CRITICAL FRAMEWORK FOR EVALUATING RULLCA'S FIDUCIARY DUTIES

The nature and scope of the fiduciary duties running between the owners of a LLC and their agents are fundamentally private matters, and the terms of their arrangements generate no apparent material externalities.<sup>27</sup> Assuming that both parties—the owners of the LLC and their agents—are fully informed and that there are no other impediments to their bargaining with each other, it is difficult to identify any adverse material economic impact caused, for example, by the level of care that the agents are obliged to observe in acting on behalf of the LLC owners.<sup>28</sup>

Economic and moral theories support the rights of parties in such circumstances to construct the terms of their private arrangements. In economic theory, allowing parties freely to bargain and trade is essential to the creation of economic value and wealth.<sup>29</sup> In moral theory, permitting or encouraging such trades enhances utility and autonomy, values that underlie, respectively, utilitarianism<sup>30</sup> and Kantian moral theory.<sup>31</sup>

27. For a description of the economic concept of externalities, see STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 77 (2004) (“One party’s action is said to create an *externality* if it influences the well-being of another person.”). Professor Shavell goes on to provide examples of externalities, or third-party effects, as they are sometimes called, in the areas of nuisance, pollution, etc. *Id.* at 77-79. Generally, the externalities that are important to this discussion are negative or adverse externalities—externalities that adversely affect the well being of another person.

28. See, e.g., Mark J. Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the “Manifestly Unreasonable” Standard* 3 (Univ. of Colo. Sch. Of Law, Working Paper No. 06-06, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=893213](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=893213) (“[W]hy should parties dealing at arm’s length not be free to craft any sort of arrangement that they desire, inasmuch as no third parties are adversely affected by their deal?”) (citing J. Dennis Hynes, *Freedom of Contract, Fiduciary Duties and Partnerships: The Bargain Principle and the Law of Agency*, 54 WASH. & LEE L. REV. 439, 443 (1997)). Non-owner constituencies—creditors, for example—may argue that they suffer a negative externality if investors and managers agree to a very low standard of care, because the low standard of managerial care may subject creditors to increased default risk. Creditors, however, are able to secure full compensation for any such increased risk by increasing the price they charge for their credit or, alternatively, contracting for their own, higher, standard of care.

29. Economists often speak of “economic efficiency” or “wealth maximization,” which may be defined as a state in which property or rights are in the hands of those that are willing and able to pay the most for the property or rights. See, e.g., the discussion in RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 10-16 (6th ed. 2003). Judge Posner has offered a moral defense of the pursuit of economic efficiency as leading to “an ethically attractive combination of happiness, of rights (to liberty and property), and of sharing with less fortunate members of society.” Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 487 (1980) (citation omitted). See also Guido Calabresi, *An Exchange About Law and Economics: A Letter to Ronald Dworkin*, 8 HOFSTRA L. REV. 553, 556 (1980); Ronald M. Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191, 191 (1980) (both observing that wealth maximization should be considered only an instrumental goal); Christopher D. Stone, *Corporate Social Responsibility: What It Might Mean if It Were Really to Matter*, 71 IOWA L. REV. 557, 570 (1986) (characterizing the pursuit of economic efficiency or wealth maximization as a “crude sort of utilitarianism”).

30. For a description of utilitarianism, see JEFFRIE G. MURPHY & JULES L. COLEMAN, PHILOSOPHY OF LAW: AN INTRODUCTION TO JURISPRUDENCE 72-75 (1990). Murphy and Coleman state, “Bentham summed up the essence of the [utilitarian] theory in the slogan ‘The greatest happiness for the greatest number.’” *Id.* at 72. Utilitarianism is based largely on the writings of Jeremy Bentham and John Stuart Mill. See generally JEREMY BENTHAM, THE PRINCIPLES OF MORALS AND LEGISLATION (1789); JOHN STUART MILL, UTILITARIANISM (1863). More recent works on utilitarianism include J.J.C. SMART & BERNARD WILLIAMS, UTILITARIANISM: FOR AND AGAINST (1973), and H.L.A. Hart, *Between Utility and Rights*, 79 COLUM. L.



This may suggest no need for societal rules respecting fiduciary duties of LLC agents or managers, as parties in each case should bargain for particularized fiduciary duties that suit their preference. Such is not the case, however. Well-crafted, societal fiduciary duty provisions can promote efficiency and fair outcomes in a number of ways.

Economists have long recognized that default fiduciary duty rules can promote efficiency by lowering transaction costs.<sup>32</sup> Majoritarian default rules—the rules that most LLC owners and their agents would select in most cases—can promote efficiency by saving most parties the necessity and thus the expense of negotiating, constructing, and memorializing the terms of their particular arrangement. The default rules simply become off-the-shelf contracts that the parties adopt without any action on their parts. Some parties—those whose preferences are not captured by the majoritarian default rules—will have the costs of re-making or opting out of the default rules, but significant efficiencies may be generated by reducing transactional cost in most cases.<sup>33</sup>

Majoritarian fiduciary rules do not lead to an efficient outcome in every case, however.<sup>34</sup> Both economic theory and empirical research<sup>35</sup> suggest that default rules tend to be “sticky.” The term “stickiness” is used to describe default rules that parties do not remake or opt out of, even when the default rules do not suit their preferences.

Stickiness often may be explained by reference to the transaction costs associated with opting out, since rational parties will not opt out of a default rule if the value created by opting out is less than the costs of opting out. To use a simple example, if the value created by opting out of default provisions is ten, but it costs the parties twenty to opt out, the parties will not exercise their opt-out rights but, instead, will operate under the assumedly inefficient default provision.

REV. 828 (1979). Utilitarianism has drawn extensive and thoughtful criticism. *See, e.g.*, Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 511 (1980) (“[U]tilitarianism is an impoverished moral theory, incapable of accounting for the full range of moral obligation and right action.”); Dworkin, *supra* note 29, at 216 (“[U]tilitarianism as a general theory of either value or justice is false, and . . . its present unpopularity is well-deserved.”).

31. *See* MURPHY & COLEMAN, *supra* note 30, at 75-82. For a more extensive scholarly discussion of the moral theory of Immanuel Kant, *see generally* JEFFRIE G. MURPHY, *KANT: THE PHILOSOPHY OF RIGHT* (1970).

32. While generally default rules promote efficient outcomes, in certain cases, mandatory rules may better promote efficiency. *See infra* note 80 and accompanying text.

33. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1444-45 (1989) (arguing in favor of corporate law that “fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance”); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982) (“[O]ptimal fiduciary duties should approximate the bargain that investors and managers would reach if transactions costs were zero.”); Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, *supra* note 29, at 494 (inferring consent “by trying to answer the hypothetical question whether, if transaction costs were zero, the affected parties would have agreed . . .”).

34. In addition to the points made here, non-majoritarian default rules may in some cases promote efficiency by enhancing the information available to the bargaining parties. *See infra* notes 66-68 and accompanying text.

35. *See, e.g.*, Listokin, *supra* note 10 (examining the extent to which statutory default rules governing takeovers and contests for corporate control are accepted or remade by corporations and their shareholders); Miller, *supra* note 19, at 586 (reporting that with regard to parties in an LLC bargaining for contractual rights, “The empirical research paints a picture of an imperfect and diverse contractual playing field.”).

This stickiness demonstrates the need for society in most situations to enact majoritarian default rules.<sup>36</sup> Non-majoritarian default rules increase the number of parties that will be required to opt out of the default rule in order to achieve an efficient outcome in their particular case. Stickiness makes matters even worse because parties whose preferences differ from the default rules may be captured by the stickiness and thus fail to achieve efficient arrangements between or among themselves.

For default rules to work at their best, the parties must be fully informed. Full information, of course, is always an important prerequisite for an efficient trade. Without full information on the part of both parties, we cannot be sure that the trade enhances allocative efficiency. When operating under default rules, full information on the part of parties is necessary in order for the parties to make value-maximizing decisions regarding whether to accept the default rule or opt out.

Default rules defining the fiduciary duties of LLC managers, therefore, should be fashioned in a way that promotes full information on the parts of all parties to the LLC. Society should avoid rules that encourage or enable informationally-privileged LLC parties to exploit their superior position through inefficient "bargains."

In summary, for rules respecting LLC fiduciary duties to work in a pleasing way, the rules generally should be majoritarian default rules and should be designed in a manner that promotes fully informed bargaining. Measured against these simple, widely accepted concepts, one finds that NCCUSL, once again in RULLCA, promulgated fiduciary duty standards that are materially deficient.

### III. FIDUCIARY DUTIES UNDER RULLCA

RULLCA's fiduciary duty provisions<sup>37</sup> continue the general construct found in the fiduciary duty provisions of RUPA, RULPA (2001), and ULLCA by dividing fiduciary duties into a duty of loyalty and a duty of care, and then overlaying a good faith obligation on the regime.<sup>38</sup> While this overall approach is sound, RULLCA's specific fiduciary duty rules will generate, or at least facilitate, outcomes that are inefficient and unfair.

#### A. Duty of Care

##### 1. The RULLCA Standard

RULLCA's basic standard of care is negligence. It requires LLC fiduciaries to act with a level of "care that a person in like position would reasonably exercise under similar circumstances and in a manner the . . . [fiduciary] . . . reasonably believes to be in the best interests of . . . [the LLC]." RULLCA's obligation to act reasonably or non-negligently, however, is expressly made "[s]ubject to the business judgment rule."<sup>39</sup>

The business judgment rule is a fiduciary duty concept that developed in corporate law.<sup>40</sup> To understand fully the pernicious impact of RULLCA's overlaying a business judgment rule on its negligence duty of care provision, it is helpful to consider briefly

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36. *But see supra* note 34.

37. RULLCA § 409(a)-(d). *See infra* Appendix A.

38. *See supra* notes 6-7 for the duty of care and loyalty provisions of RUPA, RULPA, and ULLCA.

39. RULLCA § 409(c). *See infra* Appendix A for the full text of this section.

40. *See* S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

portions of the corporate jurisprudence that have developed in regard to the duty of care. Much of the jurisprudence is found in the common law of Delaware.

Corporate directors' duty of care is divided along functional lines into monitoring responsibilities and decision-making responsibilities.<sup>41</sup> The monitoring function involves the duty of corporate directors to exercise oversight over the affairs of the corporation and, importantly, over the officers and agents who run the corporation. Corporate boards of directors are required to monitor the officers and agents of the corporation to make sure, for example, that they are not expropriating corporate value or otherwise mismanaging the corporation. The propriety of a corporate board's monitoring is generally evaluated under a negligence standard. Therefore, boards are charged in their oversight function to act reasonably.<sup>42</sup>

Corporate directors' discrete decisions—as contrasted to their monitoring functions—may be evaluated under the business judgment rule,<sup>43</sup> and in that case their duty of care obligations are more complicated. Under what I shall refer to as the traditional business judgment rule,<sup>44</sup> directors must meet the predicates for the applicability of the business judgment rule, including good faith<sup>45</sup> and the absence of a conflict.<sup>46</sup> The other predicate for the applicability of the business judgment rule is that the directors must be fully informed when they make their discrete decision or

41. See, e.g., JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 187-96 (2d ed. 2003) (contrasting the duty to be attentive with the duties to make rational decisions based on reasonable investigations). The *Principles of Corporate Governance* also make the distinction between monitoring and decision-making. See *infra* note 42 for discussion.

42. See, e.g., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(a) (1994) (applying a negligence standard to directors' monitoring duties). The Comments specifically explain why the Principles do not apply the more lax business judgment standard to monitoring:

Section 4.01(c) [the business judgment rule] affords protection only to a “business judgment.” This means that to be afforded protection a decision must have been consciously made and judgment must, in fact, have been exercised.

There is, however, no reason to provide special protection where no business decision-making is to be found. If, for example, directors have failed to oversee the conduct of the corporation's business . . . , business judgment rule protection would be manifestly undesirable.

*Id.* § 4.01(c) cmt. c. An instructive example here is *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981), a case in which a director who was old, infirm, and seemingly unsophisticated was held to have violated her monitoring duty as a result of the theft of corporate assets by her sons, who were the senior officers of the corporation. The court applied a negligence standard to the director's monitoring obligation and concluded that the director had, in that case, acted unreasonably or negligently. The obligation of corporate boards to monitor came under intense scrutiny in the wake of the debacle of Enron and other large companies. It seems unlikely that society, operating in the wake of Enron, is inclined to reduce the rigor of the standard applied to this function.

43. Section 4.01(c) of the *Principles of Corporate Governance* offers a clear articulation of a widely held view of the business judgment rule. The comments to the section also offer a wealth of background, citations, and analyses regarding the business judgment rule. See generally PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) cmts.

44. What I refer to as the “traditional business judgment rule” is explicated by section 4.01(c) of the *Principles of Corporate Governance*. See *infra* notes 45-47, 50.

45. See, e.g., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c) (stating that to get the business judgment standard, a corporate manager must make “a business judgment in good faith”).

46. See, e.g., *id.* § 4.01(c)(1) (stating that a corporate manager is entitled to the business judgment standard only if she “is not interested in the subject of the business judgment”).

business judgment. This obligation to be fully informed is measured against a negligence standard and thus requires the directors to inform themselves “with respect to the subject of the business judgment to the extent the director . . . *reasonably* believes to be appropriate under the circumstances [emphasis added].”<sup>47</sup> It is this obligation, of course, that boards in some of the highest profile Delaware cases—such as *Smith v. Van Gorkom*<sup>48</sup> and *Cede & Co. v. Technicolor, Inc.*<sup>49</sup>—failed to meet.

The traditional business judgment rule cuts boards some slack at the point where the board members actually make their decision. If a board in making a discrete decision is unconflicted and acting in good faith and has made a reasonable investigation into the decision, then the propriety of their actual decision is no longer evaluated under a rigorous negligence standard. Instead, the actual judgment of the board is evaluated under a less rigorous standard of care, such as gross negligence.<sup>50</sup>

RULLCA’s duty of care provision is apparently intended to follow this corporate model. Accordingly, RULLCA’s business judgment carve-out from the general care standard of negligence would seemingly not apply to monitoring responsibilities. As in the traditional corporate model,<sup>51</sup> managers of LLCs operating under RULLCA are bound by a negligence standard with regard to their monitoring or oversight duties, and evaluating the propriety of the monitoring by managers of LLCs under a negligence standard is sound. It is an efficient and fair standard. It also amounts to an improvement over the gross negligence standard that applies to fiduciaries’ monitoring function under RUPA, ULPA (2001), and ULLCA.<sup>52</sup>

As described earlier, strong arguments favor permitting LLC owners and their agents to construct their own terms regarding the agents’ standard of care and generally

47. *Id.* § 4.01(c)(2). Courts have sometimes referred to the three predicates—good faith, the absence of a conflict, and a reasonable inquiry or investigation—as the “triad” of business judgment, although courts may articulate the components of the triad in somewhat different terms. *See, e.g., Technicolor II*, 634 A.2d at 361 (“*triads* of their fiduciary duty—good faith, loyalty or due care”); *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001) (“triad of fiduciary duties: due care, loyalty, or good faith”).

48. 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the court held that directors must “have informed themselves” prior to making a business decision, of all material information reasonably available to them.” *Id.* at 872 (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). The court concluded that directors “lacked . . . information adequate to reach an informed business judgment.” *Id.* at 878.

49. *Technicolor II*, 634 A.2d at 367 (“[W]e find the defendant directors, as a board, to have breached their duty of care by reaching an uninformed decision . . .”).

50. In *Aronson*, the Delaware Supreme Court stated:

[D]irectors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties. While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence.

473 A.2d at 812.

51. *See supra* note 42. *See also* EISENBERG, *supra* note 21, at 402 (“[D]irectors failure to make due inquiry, or any other simple failure to take action (as opposed to a deliberative decision not to act), does not qualify for protection under the business judgment rule.”).

52. *See supra* note 6 for the duty of care provisions in these prior uniform acts. The prior uniform acts utilize gross negligence as the applicable standard of care, making no distinction between monitoring and discrete decisions or between investigation and decision-making. Gross negligence is the ubiquitous standard.

support societal default rules that mimic the arrangement that most of the parties would agree upon in most cases.<sup>53</sup> Applying these simple and seemingly noncontroversial economic principles here, it is difficult to imagine that most LLC investors and LLC fiduciaries would agree to a monitoring standard of care that is less rigorous than negligence. It seems more likely that most fully informed LLC investors in most cases would demand and be willing to pay for a “reasonable” level of monitoring care from their fiduciaries. Rational fiduciaries should be willing to accept this higher standard for additional compensation, and my intuition is that competition in the capital management market would squeeze the additional compensation that managers are able to extract for the higher standard, making the deal attractive for investors.

The gain in RULLCA—compared to prior uniform acts—in adopting a more rigorous negligence standard for monitoring is more than offset, however, by the harm generated by the ill-conceived adoption in RULLCA of the business judgment rule. Overlaying a business judgment rule on RULLCA’s general duty of care standard, which is based on negligence, is sure to lead to confusion and unintended, inefficient, and unfair outcomes.

Confusion appeared early in regard to the core components of the business judgment. For example, in *Van Gorkom*, the Delaware Supreme Court confused the key standards of negligence and gross negligence, stating that the Trans Union board “was grossly negligent” because it did not act with “reasonable deliberation.”<sup>54</sup> There also have been various articulations of the business judgment standard applicable at decision making. In *Aronson v. Lewis*, the Delaware Supreme Court set the standard of gross negligence,<sup>55</sup> but different formulations, such as “honestly believes” and “rationally believes,” were offered as well.<sup>56</sup>

Perhaps, however, the confusion over the meaning of business judgment is most vividly seen by comparing the traditional business judgment rule, which is well articulated in the *Principles of Corporate Governance*, with Chancellor Allen’s articulation of the business judgment rule in *In re Caremark Int’l, Inc. Derivative Litigation*. As described above, the *Principles of Corporate Governance* set the standard of care at the investigation stage at negligence<sup>57</sup> and at the decision making

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53. See *supra* notes 32-33 and accompanying text.

54. 488 A.2d 881 (emphasis added) (“We conclude that Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal . . .”).

55. *Aronson*, 473 A.2d at 812 (“[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.”).

56. See, e.g., PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c)(3) (1992) (using a “rationally believes” standard). In William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 (2002), three Chancellors from the Delaware Court of Chancery defined the business judgment standard as a gross negligence standard. The authors stated, however, that the Delaware gross negligence standard was a rationality test, which is more lax than traditional gross negligence. “Thus, in corporate cases, Delaware courts have chosen a definition of gross negligence that is even more difficult for a plaintiff to establish than the gross negligence standard normally applied in American tort or criminal cases.” *Id.* at 453.

57. See *supra* note 47.

stage at “rationally believes.”<sup>58</sup> In *Caremark*, Chancellor Allen articulates very different standards under the business judgment rule. Consider the following language:

[C]ompliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through “stupid” to “egregious” or “irrational,” provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests.<sup>59</sup>

On its face, this language from *Caremark* represents a dramatic relaxation of the traditional business judgment standards articulated above. At the investigation stage, Chancellor Allen sets the standard at “good faith,” which certainly is well below a reasonableness or negligent standard that is required under the traditional approach to business judgment.<sup>60</sup> With regard to the standard by which we judge the actual decision itself, Chancellor Allen says that there is none applicable, even in instances where the decision is “stupid,” “egregious,” or “irrational,” as “compliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss. . . .”<sup>61</sup> Again, this amounts to a significant relaxation of the standard of care articulated under the traditional business judgment rule, where a grossly negligent decision may violate the director’s duty.<sup>62</sup>

State courts, therefore, interpreting the meaning of RULLCA’s “subject to the business judgment rule” language can find support for imposing standards at the investigation stage ranging from negligence to “good faith,” and standards at the decision-making stage ranging from gross negligence to no standard whatsoever. This means that managers and controlling members of LLCs operating under RULLCA will have little idea about the standards to which they are held, and members will have little idea about the quality of management they have purchased. As a result, parties forming LLCs are quite likely to misunderstand and misprice a negligence “subject to the business judgment rule” standard, which may lead to unintended, inefficient, and unfair outcomes.

Incorporating the business judgment standard into RULLCA’s duty of care also risks infecting the LLC duty of care with other misdirected concepts that courts (principally Delaware courts) have layered on the business judgment analysis. One such concept, for example, that is a part of business judgment but that should be avoided is the notion of what happens when one of the predicates of business judgment is violated. The most common predicate that is violated is the obligation to make a reasonable investigation.<sup>63</sup> Consider for example a situation in which managers of a

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58. PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c)(3).

59. *In re Caremark Int’l, Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

60. *See supra* note 47 and accompanying text.

61. *In re Caremark*, 698 A.2d at 967.

62. *See supra* note 50 and accompanying text.

63. Both *Van Gorkom* and *Technicolor II* involved the failure of a board to act reasonably at the investigation stage of a merger. *See Van Gorkom*, 488 A.2d at 874; *Technicolor II*, 634 A.2d at 367.

manager-managed LLC, without any investigation, purchase a very expensive machine that turns out to be worthless. Assume that a reasonable investigation was not made, and if it had been made, the defects in the machine would have been discovered. The Delaware corporate regime would require that the case be considered or, more likely, reconsidered under an intrinsic fairness standard. The most extreme example of this is found in the *Technicolor* litigation, which bounced back and forth for years between the Delaware Chancery Court and the Delaware Supreme Court, due in part to the reconsideration and the resulting appeals on this matter.<sup>64</sup>

One is at a loss regarding the logic of such an approach. The duty to make a reasonable investigation is a *duty* owed, and if the failure to meet that duty causes harm, the violator of the duty should be liable. In short, once the duty is violated, the better approach is to consider the case at that point only a matter of causation and damages. Certainly it makes no sense to go back and re-litigate the matter under another standard, as is done in Delaware.<sup>65</sup>

There is another even more fundamental problem in adopting a business judgment rule as part of RULLCA's duty of care. The business judgment rule amounts to an

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64. In *Technicolor II*, the Supreme Court of Delaware remanded the case to the Chancery Court after concluding that the board had not made a reasonable investigation. 634 A.2d at 345-46. The Chancery Court was ordered to consider the transaction under the intrinsic fairness standard. *Id.*

65. Another misdirected concept attached to the business judgment rule is the practice of considering the business judgment rule as a standard of review instead of a standard of conduct. See EISENBERG, *supra* note 21, at 401-02 (explaining the relationship between a standard of conduct and a standard of review and offering an explanation for the laxness of the business judgment standard). Professor Eisenberg defines a standard of conduct as "how an actor should conduct a given activity or play a given role," and he concludes that the applicable standard is negligence or reasonableness. *Id.* at 401. A standard of review, on the other hand, he explains as "the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief," and that standard he believes is a "rational" standard. *Id.* at 401-02. As explained by Justice Norman Veasey of the Delaware Supreme Court, the standard of conduct establishes the aspirational standard for corporate managers and the standard of review establishes the liability standard. See *Corporate Governance Principles Emerge in Environment of "Competitive Federalism"*, Fed. Sec. L. Rep. (CCH), Feb. 4, 2004, at 5, available at <http://business.cch.com/securitieslaw/news/2-4-04.asp>. Thus, we want corporate managers to act reasonably, but we hold them liable only if their conduct is irrational.

Not only is this a very confusing analysis, but also it is unsound as a matter of policy and economics. The only situation in which courts should enforce a standard that is not an "aspirational" standard and, instead, adopt a different, less desirable standard is in a situation in which the incremental costs generated by moving from the inefficient, non-aspirational standard to the efficient, aspirational standard are greater than the incremental benefits from the move. It is difficult, however, to find any significant differences in the enforcement costs between the two standards.

It may be that the real underpinning for the relaxed standard in business judgment is the belief that negligence is not the efficient standard of care, because it is not the standard of care that most parties, corporate managers and investors, would select in most cases, if they were able to bargain with one another. Investors, for example, may prefer a lax standard as a way to encourage risk-taking and reducing the salaries of corporate managers. See, e.g., WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 243 (2d ed. 2007) ("Liability under a negligence standard therefore would predictably discourage officers and directors from undertaking valuable but risky projects."). If that is the case, negligence is not an aspirational standard, since the parties to the transaction favor a different standard and there are not negative externalities in their choosing any standard that suits them. In short, courts should adopt a clearly articulated efficient standard of care and provide an incentive, *i.e.*, personal liability, for parties to adhere to that efficient standard. Disguising this in confusing procedures and articulations is undesirable.

inefficient standard of care for managers of LLCs. The inefficiency is exacerbated if the LLC business judgment rule is interpreted consistent with Chancellor Allen's language from *Caremark*.

Even the gross negligence standard under the traditional business judgment rule seems overly lax and unlikely to provide an incentive for the level of management skill that most-fully informed LLC parties—LLC owners and their managers or controlling members—would agree on in most cases. It seems unlikely that most investors would turn their money over to LLC fiduciaries who told the investors in clear terms, "We do not warrant that we will act reasonably in regard to your best interests." Fully informed of this, I believe that investors would look for other agents to manage their capital and that competition in the capital management market would provide other reasonably priced managers willing to agree at an attractive price to act reasonably in regard to the pursuit of the best interests of the owners.

Quite obviously, it is even more difficult—indeed for me it is impossible—to conclude that Chancellor Allen's version of the business judgment standard is an efficient standard of care. Imagine the manager or controlling member of an LLC who tells potential LLC investors in clear terms: "I solicit your investment in the LLC that I shall manage, but I do not warrant that I will act reasonably in regard to your best interests, and furthermore I am permitted, with total impunity, to manage your investment in a manner that is stupid, egregious, or irrational." My opinion is that investors would look elsewhere in the capital management market for investments.

Some may disagree with my factual reckoning on this matter, although my opinion of the matter is firmly held. Some may argue that, as a matter of the facts, most parties would settle on a gross negligence standard for the duty of care in an LLC or, if one is attracted to the reckoning of Chancellor Allen, no duty of care. Persuasive arguments can be made, however, in favor of resolving any ambiguity or disagreement on this matter by selecting the higher standard of care.

Professor Ian Ayres has written insightfully about the efficiency-generating qualities that non-majoritarian default rules can have in some cases.<sup>66</sup> Particularly relevant here is his insight into situations in which parties have asymmetrical information about legal rights. In such cases, he argues that setting the default rule "against the more knowledgeable party"<sup>67</sup> may lead to more fully informed bargaining, since the more knowledgeable party, in attempting to bargain his way out of the position he dislikes, will be encouraged to share information with the informationally-disadvantaged party. This line of argument supports a higher standard of care when there is uncertainty about the nature of an efficient duty of care rule.

In my own experience as a transactional lawyer for unincorporated entities, I found in nearly all cases asymmetry of information between managers and investors

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66. See, e.g., Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1397-98 (1992) (using the rule that permits piercing the corporate veil for undisclosed undercapitalization as an example of a default rule that may be non-majoritarian but that may nonetheless promote efficiency through more fully informed bargaining).

67. Ian Ayres, *YA-HUH: There Are and Should Be Penalty Defaults*, 33 FLA. ST. U. L. REV. 589, 597 (2006) ("The 'legal information-forcing' rules are most plausible when there is asymmetric information about the content of the law itself. In the face of asymmetric legal information, a straightforward solution is to set the default against the more knowledgeable party.").



as to the nature of fiduciary duties.<sup>68</sup> Investors often have little or no idea about the statutory standard of care that applies to managers. Managers, on the other hand, are almost invariably in control of the critical entity documents, the operating agreement in the case of LLCs, and have access to and a relationship with the attorney drafting those documents. In short, managers or controlling members and their agent (the attorney they select to generate the initial entity documents) may in most cases have superior information over investors in regard to the statutory duty of care applicable to the entity's managers.

In such cases, if lax, gross negligence is the statutory standard for LLCs, under-informed investors may invest and price their investment mistakenly believing that managers are obliged to act reasonably in regard to investors' best interests. Managers may have an economic interest in this inefficient outcome, since, by exploiting the asymmetry of information, they may be able, for example, to extract a higher level of compensation, reflecting a negligence standard of care, while actually being held to a more lax, gross negligence standard.

Bargaining between the parties in such cases is improved, and efficient and fair outcomes are promoted, by adopting negligence as the statutory standard of care for LLCs. Managers or controlling members who want a more lax standard of care can achieve that only by getting the consent of the members of the LLC, which at least to some extent diminishes the informational asymmetry gap. Requiring the consent of investors promotes for them more readily available and cheaper access to information regarding the applicable duty of care.<sup>69</sup>

In summary, states should reject RULLCA's "subject to the business judgment rule" formula. Overlaying the business judgment rule on a negligence standard of care creates an inefficient duty of care provision in RULLCA. It will also confuse both LLC parties and courts, and there is the risk that courts interpreting the "subject to the business judgment rule" language may adopt some or all of the misdirected, confusing and inefficient analyses and interpretations that infect Delaware corporate law.

A better approach for states considering RULLCA, therefore, is to modify RULLCA's standard of care and adopt a clearly articulated negligence standard of care as the default rule, applicable alike to monitoring and discrete actions by managers or controlling members. Not only is a clear negligence standard more efficient and less likely to generate pernicious confusion, but also such an approach will tend to enhance the information available to the parties at bargaining.

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68. Empirical work by Professor Sandra K. Miller generally supports this conclusion. See Miller, *supra* note 19, at 585-86. Her work, she believes, "casts doubt on" the assumption that "operating agreements will be highly negotiated . . ." *Id.*

69. Under RULLCA, parties wishing to opt out of the default standard of care must include the remade standard of care in the operating agreement. The remade duty of care cannot be "manifestly unreasonable" or "authorize intentional misconduct or knowing violation of the law." RULLCA § 110(d)(3) (Supp. 2007).

I make no strong claims regarding the extent to which provisions in the operating agreement are fully understood by investors. My view is that the extent to which investors fully understand terms of the operating agreement vary and that complex, tedious, and lengthy operating agreements have a negative impact on the informational value of the operating agreement. Nonetheless, including terms in the operating agreement always enhances information, compared to a situation where terms are not in the operating agreement. In that regard, my suggestion, which is made later in this article, is that fiduciary duty provisions in the operating agreement should be referenced and described in prominent, bold type on the outside front cover of the operating agreement. See *infra* notes 78-80 and accompanying text.

## 2. *Opting Out of RULLCA's Standard of Care*

RULLCA allows parties to opt out of or reconstitute the statutorily imposed standard of care, subject to only three substantive limitations.<sup>70</sup> First, the duty of care may not be entirely eliminated.<sup>71</sup> Second, the standard of care reconstituted by the parties may not be “manifestly unreasonable.”<sup>72</sup> Finally, the reconstituted standard of care may not “authorize intentional misconduct or knowing violation of [the] law.”<sup>73</sup> RULLCA imposes no particular procedural prerequisites to opting out of or reconstituting the default standard of care, except for a requirement that the reconstituted duty of care standard be contained in the operating agreement.<sup>74</sup>

Opt-out provisions generally can promote efficiency by allowing parties to refashion statutory default rules in situations in which their preferences differ from the terms of the statute.<sup>75</sup> For opt-out provisions to promote maximum efficiency, however, the parties to the opt-out agreement must be fully informed. If a party agrees to opt out of rights that she does not understand or into rights that she does not understand, there is no way to determine whether the transaction enhanced allocative efficiency. One may restate this matter in fairness terms, since a lack of full information on a party's part undermines consent and thus, at least arguably, unfairly subjects a party to the terms of an arrangement to which the party did not consent.

RULLCA's opt-out provisions fail fully to promote efficiency and fairness primarily because the provisions do not address the lack of full information on the part of the parties exercising the opt-out right. As noted earlier,<sup>76</sup> because the LLC's manager or controlling member in most cases controls the entity documents and has the most direct contact with the lawyer drafting the entity documents,<sup>77</sup> the manager or controlling member typically enjoys information superiority over the LLC's investors. The manager or controlling member may also have a strong pecuniary interest in exploiting this information asymmetry. As concerns the duty of care, the LLC manager

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70. RULLCA § 110(d). RULLCA provisions respecting the right to opt out of the duty of care are reproduced in full in Appendix B, *infra*.

71. *Id.* §§ 110(c)(4), 110(d)(3), 110 cmt. d. RULLCA provisions respecting the right to opt out of the duty of care are reproduced in full in Appendix B, *infra*.

72. *Id.* § 110(d). *See infra* Appendix B.

73. *Id.* § 110(d)(4). *See infra* Appendix B.

74. *Id.* § 110(d). *See infra* Appendix B. The nature of the procedural requirements for opting out is important in regard to efficient outcomes. To the extent that procedural requirements drive up costs, opting out of a default provision into a reconstituted provision may become prohibitively expensive, causing the parties to refrain from opting out of what for them is an inefficient default rule. For example, if the value created by opting out is ten but the cost of opting out is twelve, the parties will not exercise the right to opt out.

75. This is the same point, restated slightly, made earlier in Part II of this article. *See supra* notes 32-33 and accompanying text.

76. *See supra* note 68 and accompanying text.

77. I base this factual assumption on my own experience as a transactional lawyer and on conversations and experiences of other lawyers. In my own case, a substantial part of my practice involved non-corporate entities, and I was always engaged to draft the entity documents by the person who would provide the principal management services to the entity. It was clear that my compensation would be controlled by that manager. It was also clear that future business from the client depended upon my satisfying the preferences of the manager of the entity.

may be able to generate pecuniary gain for himself through an inefficient bargain in which he gets paid as if he is operating under a high standard of care while actually being subject to a low standard of care.

Two adjustments in RULLCA's opt-out provision would ameliorate the pernicious effects of this asymmetry of information and thus promote efficient and fair outcomes. First, the RULLCA provision requiring opt-out terms to be contained in the operating agreement should be supplemented by a rule requiring a prominent, concise statement in plain English on the outside front cover page of the operating agreement describing and explaining the essential terms of the opt-out and the reformulated standard of care. The statement should clearly cross-reference the complete opt-out provision, if it appears elsewhere in the document.<sup>78</sup>

RULLCA's provision requiring that the opt-out be contained in the operating agreement is sound, because it increases, at least somewhat, the likelihood of full information on the part of investors about the terms of the opt-out. Even with this provision, however, full information on the part of investors is problematic. For example, if the opt-out provision is buried on page twenty-two of a complex and tedious thirty page operating agreement, it seems unlikely that most investors would come to understand the terms of the provision. While perfection in regard to full information is never possible, a prominent legend describing the opt-out and placed prominently on the outside front cover page of the operating agreement would seem in a cost-benefit analysis to make a lot of sense. The cost of including such a statement would be minimal, and it may in a significant number of cases enhance the understanding of investors regarding the quality of management they are actually purchasing.<sup>79</sup>

The second adjustment that would improve RULLCA's opt-out provision is to raise the mandatory floor for the duty of care. RULLCA permits parties to a LLC to opt out of the statutory standard of care and adopt any standard of care short of allowing managers to engage in "intentional misconduct or knowing violation of law." To enable the parties to adopt such an exceeding low standard of care promotes, on balance, inefficient and unfair outcomes. The mandatory floor for duty of care for

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78. This can be modeled on the Securities and Exchange Commission practice, which has for decades required prospectuses to describe or cross-reference on the outside front cover page of the document important investment information. For example, Item 501 of Regulation SK, 17 C.F.R. § 229.501 (2008), which is incorporated by reference into Registration Form S-3, 2 CCH Fed. Sec. L. Rep. § 7151, requires the issuer to state on the "outside front cover page of the prospectus . . . [a] cross-reference to the risk factors section . . . [and to] [h]ighlight this cross-reference by prominent type or in another manner." Item 503(c) of Regulation SK, 17 C.F.R. § 229.503(c) (2008), describes risks that must be disclosed in the prospectus.

79. My suggestion would be to amend RULLCA section 110(d) to add the following language: "Any reduction in the statutory standard of care must be prominently, concisely and clearly explained and disclosed on the first page of the operating agreement." The proposal does not provide specific language necessary to meet the "prominently, concisely and clearly" criteria. This should be left to the parties, along with the residual risk that the default standard will be applicable, if they fail to meet the three criteria designed to promote full information. While this will increase transaction costs somewhat, principally due to the residual risk if the promoting party gets it wrong, fiduciaries, who likely will be controlling the construction of the documents, including the operating agreement, will have a strong self interest in constructing a disclosure that meets the criteria and thus promotes full disclosure.

mangers of LLCs should be gross negligence, under which LLC managers would be liable for conduct that amounts to or is worse than gross negligence.

Normally, one thinks of readily accessible, unlimited opt-out provisions as enhancing efficiency, because such provisions enable parties to pursue their own preferences when those preferences differ from the majoritarian preferences that, hopefully, at least, are normally reflected in efficient default standards. Efficiencies generated by an opt-out may depend, however, on fully informed parties. If, because of a lack of full information, parties opt out of more efficient arrangements into less efficient arrangements, opt-out provisions actually generate inefficiency.<sup>80</sup>

Such inefficient opt-outs seem likely under RULLCA's provisions that set the mandatory floor at the very lax "intentional misconduct" standard. As described above in this section, LLC managers usually enjoy a material informational advantage over investors. Provisions in an operating agreement reconstituting the default standard of care into an extremely lax standard of care, especially when such provisions are buried in long and complex operating agreements, are unlikely to be understood by many investors. While my view, described above, is that a prominent statement on the outside front cover page of the operating agreement would provide some relief for under-informed LLC investors, it will not cause all investors to be fully informed in all transactions. The likelihood is that, even with the statement, managers will continue to be able to exploit their informational superiority by constructing inefficient transactions regarding their reconstituted duty of care. A higher mandatory floor, therefore, will enhance efficiency and fairness by limiting this conduct.

The benefits of eliminating these inefficient and unfair transactions, however, must be compared to the economic costs associated with raising the mandatory floor of the duty of care. The economic costs are understood best as the inability of fully-informed parties to pursue an arrangement that suits their preferences. Under a "gross negligence" floor, parties that prefer an "intentional misconduct" standard of care are forced to accept a gross negligence standard of care. The costs here are the inefficiency and unfairness of forcing the parties to accept an arrangement that they do not prefer.

Such costs from imposing the higher mandatory floor of gross negligence, however, seem to be minimal. The reason is that it is quite unlikely that in many cases fully-informed parties would ever agree on a standard of care below gross negligence. From the investors' side of the transaction, it seems to me highly unlikely that fully-

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80. See generally, Richard A. Booth, *Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies*, 1 J. SMALL & EMERGING BUS. L. 55 (1997). Although clearly favoring LLC fiduciary rules that permit generous opting out, Professor Booth defends the limitations the ULLCA imposes on the complete opting out of fiduciary duties. He concludes that permitting parties an unlimited right to opt out of the ULLCA's fiduciary standards "is too easy." *Id.* at 64. "A statute that allows for total waiver would likely undercut serious bargaining between the parties . . . [and] would allow the more informed party simply to insist on a total waiver without specifying the nature of the conflict expected." *Id.* at 61.

See also Loewenstein, *supra* note 28. Loewenstein explained, "[T]he relevant operating or partnership agreement may be very long and complex. Terms that relate to fiduciary duties may not be collected in one section; instead, terms . . . may appear in various sections dealing with management, distributions, repurchase of units, etc." *Id.* at 28. Later he noted that "the investor may not, in fact, be fully informed or sufficiently sophisticated . . ." *Id.* at 28-29.

informed investors would turn over their capital to managers under an arrangement that permitted managers to act in ways that amounted to an extreme deviation from ordinary care (or worse). From the managers' side, competition in the capital management market suggests to me that managers would not be able to extract a very high price to accede to the investors' preference for a higher level of management skill. Thus, it is difficult to conclude that fully-informed parties in an LLC would, at least in many cases, settle on a standard of care authorizing managers to act in a manner that amounted to an extreme deviation from ordinary care.

My reckoning, therefore, is that imposing a higher, gross negligence mandatory floor on RULLCA's standard of care enhances efficiency and fairness.

In summary, for a duty of care provision to achieve maximum efficiency and fairness, the statutory standard must be subject to inexpensive, limited opt-out rights. RULLCA's opt-out provisions are inexpensive to use, requiring only that the reconstituted duty of care be contained in the operating agreement. To enhance efficient bargaining between or among LLC parties, however, states in adopting RULLCA should also condition opting out on a prominent, concise and intelligible statement or disclosure on the outside front cover page of the operating agreement, stating and explaining the results of the opt-out. This would add little to the costs of opting out and may help ameliorate the asymmetry of information between the LLC manager. Finally, RULLCA's opt-out provisions should set a mandatory floor on the standard of care at gross negligence. Because of asymmetrical information, permitting parties to opt into extremely low standards of care is inefficient.

## B. Duty of Loyalty

### 1. The RULLCA Standard

RULLCA's duty of loyalty provisions<sup>81</sup> are better than the Act's duty of care provisions. RULLCA's loyalty provisions are also an improvement over the poorly designed loyalty provisions found in RUPA,<sup>82</sup> ULPA (2001),<sup>83</sup> and ULLCA.<sup>84</sup>

RULLCA's default loyalty provisions combine specific loyalty rules and a residual right in courts to continue to develop loyalty principles and rules through the common law process. The Act's specific loyalty rules prohibit or limit four types of conduct by LLC fiduciaries.<sup>85</sup> First, the fiduciaries are not to profit from the conduct of the LLC.<sup>86</sup> Second, the fiduciaries are not to usurp for their own benefit a LLC opportunity.<sup>87</sup> Third, the fiduciaries are not to deal with the LLC as a party

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81. RULLCA § 409(b), (e), (f). *See infra* Appendix A.

82. RUPA § 404(b). *See supra* note 7.

83. ULPA (2001) § 408(b). *See supra* note 7.

84. ULLCA § 409(b). *See supra* note 7.

85. RULLCA's basic loyalty provisions are contained in three subsections. RULLCA § 409(b)(1)-(3). *See infra* Appendix A. Section 409(b)(1) limits two types of disloyal conduct: prohibiting a fiduciary's profiting from conducting the LLC's business and prohibiting a fiduciary's usurpation of a LLC opportunity. *Id.* § 409(b).

86. *Id.* § 409(b)(1)(A). *See infra* Appendix A.

87. *Id.* § 409(b)(1)(C). *See infra* Appendix A.

with an interest adverse to the interests of the LLC.<sup>88</sup> Finally, the LLC fiduciaries are not to compete with the LLC.<sup>89</sup>

These discrete loyalty provisions are similar on their face to loyalty provisions found in RUPA, ULPA (2001), and ULLCA.<sup>90</sup> Unlike those prior acts, however, RULLCA does not make the four discrete loyalty rules exclusive. While the prior uniform acts all state that the “duty of loyalty is *limited* [emphasis added]” to the four discrete rules,<sup>91</sup> RULLCA, on the other hand, declares that a manager’s “duty of loyalty . . . *includes* [emphasis added]” the four distinct loyalty obligations.<sup>92</sup>

RULLCA’s loyalty provisions<sup>93</sup> eliminate a part of the confusion found in the internally inconsistent loyalty provisions in RUPA, ULPA (2001), and ULLCA. For example, as stated above, all three of the prior acts, like RULLCA, prohibit a fiduciary from assuming an adverse position to the entity.<sup>94</sup> The three prior acts, however, go on to permit fiduciaries to do business with and lend money to the LLC.<sup>95</sup> Obviously, the prohibition against assuming an adverse interest cannot be reconciled with lending money (or transacting business), because, to use the simplest example, when a fiduciary loans money to her entity, her personal interest is to receive the most interest

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88. *Id.* § 409(b)(2). *See infra* Appendix A. RULLCA section 409(e), however, allows a “defense to a claim [that a fiduciary assumed a position adverse to the LLC, if the transaction] . . . is fair to the limited liability company.”

89. *Id.* § 409(b)(3). *See infra* Appendix A.

90. *See supra* note 7.

91. *See supra* note 7 for the loyalty provisions of RUPA, ULPA (2001), and ULLCA.

92. RULLCA § 409(b) (Supp. 2007) (emphasis added). *See infra* Appendix A.

93. Although RULLCA eliminates some of the confusing provisions from prior uniform acts, one feature of RULLCA’s loyalty provisions remains somewhat curious. RULLCA section 409(e), which is reproduced in Appendix A, *infra*, provides a defense in instances where the LLC fiduciary’s duty of loyalty is compromised by his dealing with the LLC as a party with “an interest adverse to the company.” In such cases, the section states, “It is a defense . . . that the transaction was fair to the limited liability company.” This is the generally applicable, common law corporate rule regarding conflicted transactions by corporate fiduciaries. Corporate fiduciaries generally are not absolutely prohibited from engaging in conflicted transactions. Instead, the propriety of such a transaction is evaluated under a rigorous intrinsic fairness test. *See, e.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (evaluating a parent-subsidiary merger under the intrinsic fairness standard, which placed the burden on the board of UPO and UOP’s majority shareholder, Signal, to demonstrate the fairness to UOP’s minority shareholders of the merger of UOP into Signal).

The oddity of RULLCA section 409(e), therefore, is not that conflicted transactions are accorded a fairness defense but is, instead, that the defense is limited to transactions involving an adverse interest and not extended to other conflicted transactions proscribed by RULLCA.

Nonetheless, RULLCA’s approach appears to generate little if any inefficiency. Even if parties would have some preference for a fairness defense to all the specific loyalty rules, RULLCA provides generous and inexpensive opt-out rules. In addition some of RULLCA’s specific loyalty rules contain an implicit fairness defense. For example, the doctrine prohibiting fiduciaries from usurping opportunities is fundamentally a common law rule that prohibits fiduciaries from taking an opportunity that, in fairness, should have gone to the entity. *See, e.g.*, *Northeast Harbor Golf Club, Inc. v. Harris*, 661 A.2d 1146 (Me. 1995) (describing various tests for corporate opportunities). *See also* PRINCIPLES OF CORPORATE GOVERNANCE § 505 (2008) (providing the general fiduciary rule regarding corporate opportunities and a definition of a “corporate opportunity”).

94. RUPA § 404(b)(2), ULLCA § 409(b)(2), and ULPA (2001) § 408(b)(2). *See supra* note 7.

95. *See* RUPA § 404(f) (fiduciary “may lend money to and transact other business with the partnership”); ULLCA § 409(f) (fiduciary “may lend money to and transact other business with the company”); ULPA (2001) § 408(f) (fiduciary “may lend money to and transact other business with the partnership”). *See supra* note 7.

possible, while the clearly adverse interest of the entity is to pay the least interest possible. RULLCA eliminates this confusing inconsistency<sup>96</sup> by omitting any reference to the right of a fiduciary to lend money or transact other business.<sup>97</sup>

The most important improvement in RULLCA's loyalty provisions over the loyalty provisions of RUPA, ULPA (2001), and ULLCA, however, is the non-exclusivity of RULLCA's four specific loyalty rules. This non-exclusivity leaves courts free to interpret a fiduciary's duty of loyalty by reference to loyalty notions developed through the common law. This, in turn, enables courts to provide a remedy for fiduciary misconduct that is novel or otherwise missing from the list of discrete loyalty provisions found in the Act.<sup>98</sup> Properly understood and interpreted by courts, this approach will enhance efficiency and promote fair outcomes.<sup>99</sup>

Courts operating under the RULLCA loyalty formula can and should closely mine corporate jurisprudence for worthwhile loyalty rules and analyses. At the core of corporate loyalty jurisprudence is the sensible principle that managers owe a higher fiduciary duty to shareholders when managers' actions are conflicted.<sup>100</sup> This notion of enhanced fiduciary duties in conflicted situations is not new, nor is it unique to corporate fiduciaries. For example, trustees of trusts, are similarly subjected to higher standards when they engage in conflicted transactions with their trusts.<sup>101</sup> Retaining

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96. The comment accompanying section 409 characterizes the provision in RUPA, ULPA (2001), and ULLCA as "anachronistic and potentially confusing" and provides some explanation for why the provision was included in prior acts. RULLCA § 409 (Supp. 2007), cmt. e.

97. See RULLCA § 409 (Supp. 2007), reproduced in Appendix A, *infra*. Other confusing provisions in the prior uniform acts that are eliminated in RULLCA are the provisions stating that a fiduciary of a partnership or a LLC "does not violate a duty or obligation under [the Act] . . . merely because the . . . conduct furthers the . . . [fiduciary's] own interest." See RUPA § 404(e), ULPA § 408(e), and ULLCA § 409(e).

98. The comment to section 409 reports that "After lengthy discussion . . . the conference decided that . . . in the very complex and variegated world of LLCs, it is impracticable to cabin all LLC-related fiduciary duties within the 'corral' created by RUPA." ULLCA § 409 cmts. a & b (Supp. 2007). Bill Callison has suggested that this line of reasoning supports the omission of any fiduciary duties in statutes governing unincorporated associations. See J. William Callison, "The Law Does Not Perfectly Comprehend . . .": *The Inadequacy of the Gross Negligence Duty of Care Standard in Unincorporated Business Organizations*, 94 KY. L.J. 451, 485 (2005-06) ("[S]tate legislatures should excise fiduciary duty statements from the [limited liability company] statutes they enact.").

99. This approach enhances efficiency and fairness in two different ways. First, the uncabined, flexible approach of RULLCA, leaving courts free to address evolving types of loyalty problems, is likely the approach that most fully-informed parties would take to deal with the matter of the loyalty obligation of managers. Specifically, cabined loyalty duties create risks for investors that would seem unacceptable. It would seem to provide an incentive for managers to exploit the limited loyalty provisions by constructing unfair arrangements that fall outside the discrete duties.

Second, the approach of RULLCA provides an incentive for more fully-informed bargaining. Any opt out of the default loyalty rules must be contained in the operating agreement. RULLCA § 110(d), reproduced in Appendix B, *infra*. Expanding the default duty of loyalty beyond the four discrete rules means that managers are more likely to go to investors for the investors' express consent for managers' proposed action. This increases the likelihood that investors are aware of the conflicted conduct and thus give their true consent to the conflicted transaction.

100. See, e.g., *Weinberger*, 457 A.2d 701 (applying the heightened intrinsic fairness test of a conflicted merger transaction).

101. 2A AUSTIN W. SCOTT, SCOTT ON TRUSTS: THE LAW OF TRUSTS § 170.25 (William F. Fratcher ed., 4th ed. 1987). Specifically,

this broad loyalty principle in RULLCA gives courts the flexibility to apply enhanced standards to conflicted transactions, as those transactions evolve over time.

The proportionality test is a good example of the benefit of a generally articulated loyalty provision that allows courts to respond to evolving transactions. Although sometimes referred to as an “enhanced business judgment” standard,<sup>102</sup> the proportionality test is fundamentally a loyalty rule that is based on the principle of applying higher fiduciary standards to conflicted fiduciary transactions. It is an intermediate standard that falls between the business judgment rule and the intrinsic fairness rule and is applied in situations in which the fiduciary’s act is somewhat, but not deeply, conflicted.<sup>103</sup> In such cases, fiduciaries are assigned the burden to demonstrate that they acted reasonably both at the information gathering stage and at the actual decision-making stage.<sup>104</sup> Thus, the proportionality standard is more strict than the business judgment standard, where the burden is on the plaintiff and the fiduciary is obliged at the decision-making stage only to refrain from acting grossly negligent. The proportionality standard, however, is less strict than the intrinsic fairness standard, where the defendant must bear the burden of establishing that the transaction was entirely fair. Therefore, the proportionality test is an intermediate fiduciary standard fashioned by courts to apply in situations that are perceived as involving the fiduciary in an intermediate level of conflict.

The proportionality standard is a sensible development in corporate loyalty standards. Not all conflicts are the same, and applying an intermediate fiduciary standard for conflicts that do not rise to the level of deep conflicts seems an appropriate rule. Under RULLCA’s un-cabined loyalty provisions, courts should be expected over time to identify certain situations that are appropriate for the application of the proportionality standard.<sup>105</sup>

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As long as [a trustee] . . . is not acting in his own interest the standard fixed for his behavior is only that of a reasonable degree of care, skill, and caution. But when the trustee acts in his own interest in connection with the performance of his duties as trustee, the standard of behavior becomes more rigorous.

*Id.* See also *Succession of Simpson*, 311 S.2d 67, 72 (La. App. 1975).

102. The proportionality standard was articulated in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), and as a result is often also referred to as the “*Unocal* test.” The standard was applied in the important case of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

103. The *Unocal* court used the term “specter” of a conflict to describe these situations. *Unocal*, 493 A.2d at 954 (“omnipresent specter that a board may be acting primarily in its own interests”).

104. See *id.*

105. As originally conceived, the proportionality test was applied to evaluate the propriety of management’s response to unsolicited takeover bids. See, e.g., *Revlon*, 506 A.2d at 173. While the applicability of the standard has not expanded greatly, the court in *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), applied the proportionality test to a friendly merger where there was at the time no competing bidder for the target company. Specifically, the court applied the standard to evaluate the propriety of deal protection provisions (i.e., provisions that made it difficult for another, subsequent bidder to compete for the target) that had been put into a friendly definitive merger agreement. *Id.* at 934. The court offered the following explanation of the “omnipresent specter of such conflict” it saw in such cases:

There are inherent conflicts between a board’s interest in protecting a merger transaction it has approved, the stockholders’ statutory right to make the final decision to either approve or not approve a merger, and the board’s continuing responsibility to effectively exercise its fiduciary duties at all times after the merger agreement is executed.

*Id.*



In summary, RULLCA's default loyalty rules, which are a mixture of specific prohibitions and authorization for continued common law development, generally should lead to efficient and fair outcomes for parties in LLCs. RULLCA's loyalty rules are an improvement over the loyalty rules of RUPA, ULPA (2001), and ULLCA, because RULLCA's provisions eliminate some confusing provisions and, more importantly, permit courts to continue the sensible evolution of the duty of loyalty for LLCs.

## 2. *Opting Out of RULLCA's Standard of Loyalty*

RULLCA grants parties broad authority to opt out of the fiduciary duty of loyalty.<sup>106</sup> The opt-out provisions are drafted in a somewhat convoluted fashion. More importantly, however, the opt-out provisions fail adequately to promote fully-informed decision-making regarding opt-outs.

Section 110(c)(4) states that the "operating agreement may not eliminate the duty of loyalty."<sup>107</sup> That provision, however, is made subject to a series of statutory exceptions, the net effect of which is that the only substantive limit that RULLCA imposes on the scope of an opt out of the duty of loyalty is that the opt out cannot be "manifestly unreasonable."<sup>108</sup> More specifically, if not "manifestly unreasonable," the statute permits the parties in the operating agreement to opt entirely out of all of the Act's discrete loyalty obligations (the obligations not to profit from the conduct of the business, not to usurp a LLC opportunity, not to deal with the LLC as an adverse party, and not to compete with the LLC). Then, for good measure, the statute permits the operating agreement to "alter any other fiduciary duty."<sup>109</sup> The only procedural requirement to the opt-out is that the opt-out provision must be contained in the operating agreement.<sup>110</sup>

A broad and inexpensively accessible right on the part of parties to opt out of default loyalty rules promotes outcomes that are efficient and fair. As described earlier, the nature of the duties that entity agents owe to the entity owners is essentially a private matter without material adverse externalities.<sup>111</sup> In such cases, economic value is created by allowing parties whose preferences differ from majoritarian preferences to remake the default rules in ways that suit themselves.

My own experience supports the conclusion that significant value is often created by allowing LLC parties ready access to loyalty opt-out rights. My non-corporate deals were often promoted and managed by an entrepreneur with skills in a particular industry or business. These entrepreneurs typically had a strong desire to continue otherwise to be involved in the industry, either personally or through other entities in which they had an interest. The entrepreneurs in most of those cases were unwilling to act as manager for the entity, or for that matter even to promote the deal in the first place, unless they could get a waiver of the strict loyalty provisions. Without a waiver

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106. RULLCA § 110(d). *See infra* Appendix B.

107. *Id.* § 110(c)(4). *See infra* Appendix B.

108. "Subject to the 'not manifestly unreasonable' standard, [subsection 110(d)] empowers the operating agreement to eliminate *all* aspects of the duty of loyalty listed in Section 409." *Id.* § 110, cmt. d (1).

109. *Id.* § 110(d)(3). *See infra* Appendix B.

110. The operating agreement may also authorize "disinterested and independent persons after full disclosure of all material facts" to approve a transaction that otherwise would violate the duty of loyalty provisions. *Id.* § 110(e). *See infra* Appendix B.

111. *See supra* notes 25-29 and accompanying text.

of the strict loyalty provisions, the entrepreneurs would likely, or perhaps certainly, be exposed to liability for transactions that amounted to competition with the entity, dealing with the entity as an adverse party, and usurping entity opportunities.<sup>112</sup>

In light of such circumstances, the “manifestly unreasonable” floor on the right to opt-out of the statutory duty of loyalty may be about right. Although the standard is admittedly somewhat vague, it is broadly permissive, which is necessary to ensure the creation of economic value and efficient outcomes.<sup>113</sup> Consider, for example, the possibility of raising the floor on the loyalty opt out from a “manifestly unreasonable” standard to a “reasonable” standard and the impact that would have on the type of transactions I describe in the immediately preceding paragraph. Requiring that the opt-out must be “reasonable” may create unacceptable risks for capable and experienced managers, since they would be less certain that a provision in the operating agreement permitting them, for example, to compete with the entity would be “reasonable.”

While the standard for opting out of RULLCA’s loyalty duties may be set about right, the process for opting out needs adjustments. As described earlier, for opt-outs to achieve maximum efficiency, the access to the right must be inexpensive for the parties and promote fully informed decision-making.<sup>114</sup> Access by the parties to the right to opt out of RULLCA’s loyalty provisions is cheap, since the only procedural requirement is that the opt-out be contained in the operating agreement.<sup>115</sup> The problem, however, is that RULLCA’s opt-out provisions do not promote fully-informed decision-making by the parties.

Unlike the loyalty opt-out provisions in prior uniform acts,<sup>116</sup> RULLCA permits the parties to opt out of all of the specific statutory loyalty requirements without identifying the particular types of conflicted transactions that are authorized by the

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112. In my last stint in practice I often used non-corporate entities to structure deals in the horse industry. In a typical transaction the non-corporate entity may invest in thoroughbred horses, which would be bred, raced and perhaps sold. The manager of the entity inevitably would be someone deeply involved in the horse business. This meant that the manager would certainly be competing with her entity in purchasing, selling, racing and breeding horses. In addition to competing with the non-corporate entity, the manager would be at risk for a claim that she usurped entity opportunities. Finally, the manager may be an owner of a farm where the entity horses were boarded, thus putting her in the position of an adverse party to the entity. It was this involvement by the manager in the horse business, however, that created the experience and skill necessary for the success of the entity’s enterprise.

To a lesser degree, I also did deals in oil and gas drilling programs and in real estate ventures. I found in those transactions similar situations in which managers of the entity were otherwise engaged in the industry and thus involved in conflicted transactions.

113. I am in favor of more restrictive opt-out rights in regard to the statutory duty of care, defending that limitation on opting-out as enhancing efficiency and fairness. In the case of the statutory loyalty provisions, however, a restrictive limitation on the opt out right will generate unacceptable levels of economic costs by denying the parties the opportunity to enter into value, creating conflicted transactions. In considering duty of care opt-outs, I was unable to find any material value creation in allowing managers to operate under extremely lax standards of care.

114. See *supra* notes 34-36 and 74 and accompanying text.

115. RULLCA § 110(d) (Supp. 2007). See *infra* Appendix B.

116. See, e.g., ULLCA § 103(b)(2), which states that an “operating agreement may not: . . . (2) eliminate the duty of loyalty under Section 409(b) . . . , but the agreement may: (i) identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable . . . .” (emphasis added).

remade loyalty provisions.<sup>117</sup> This ability to opt out by general, rather than specific, language in the operating agreement will encourage the elimination of the statutory duty of loyalty in situations in which the parties are less than fully informed. It enables the informationally-privileged parties, the managers, to construct broadly phrased opt-out provisions that will be less explicit and thus more difficult for investors to understand.<sup>118</sup>

In addition to a requirement of specificity in opt-out language, opting out of the statutory duty of loyalty should be predicated on a prominent and concise statement in plain English on the outside front cover of the operating agreement that explains the terms of the opt-out and cross references the complete opt-out provision, if it appears elsewhere in the operating agreement. This is the same suggestion made in connection with the rules respecting duty of care opt-outs,<sup>119</sup> and it is made here again for the same reason as before. Highlighting opt-out terms prominently on the outside of the LLC operating agreement makes it more difficult to bury an opt-out in the middle of a long operating agreement, and this will heighten the visibility of information available to investors.<sup>120</sup>

In summary, RULLCA's retention of a broadly available loyalty opt-out provision based on a "manifestly unreasonable" standard is sound in light of the value that often is created when managers are able to engage in conflicted transactions. For maximum efficiency, however, such a broadly available opt-out must be accompanied by provisions that promote fully-informed decision-making, and it is here that RULLCA falls short. While RULLCA's requirement that the opt-out be included in the operating agreement enhances the information available to investors regarding the nature of the duty of loyalty, improvements in information could be made if RULLCA required the opt-out provisions specifically to describe the types of conflicted activities permitted and further required that the outside front cover page of the operating agreement offer

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117. RULLCA's duty of loyalty provisions "include" the duties not to profit from the conduct of the LLC, not to usurp an LLC opportunity, not to deal with the LLC as a party with an interest adverse the LLC, and not to compete with the LLC. RULLCA § 409(b)(1)-(3) (Supp. 2007). *See infra* Appendix A. The right to eliminate those particular duties of loyalty is not predicated on any specific description of the types of conflicted transactions anticipated. *Id.* § 110(d)(1) (Supp. 2007). *See infra* Appendix B. Elimination of other components of the duty of loyalty is predicated on specific identification of activities. *Id.* § 110(d)(2). *See infra* Appendix B.

118. While this may seem a small point, an example may suggest that specificity in opt-out provisions will indeed enhance informed decisions. Consider an example again based on my prior work as an attorney in the horse industry. *See supra* note 112. Assume that the manager for the LLC is deeply engaged in all aspects of the thoroughbred horse business. Language in the LLC operating agreement stating that "the manager shall have no duty . . .", and then tracking the language from RULLCA section 110(d)(1), *infra* Appendix B, may be nearly incomprehensible to investors. On the other hand, specific language stating that "it is agreed that the manager may continue to buy and sell thoroughbred horses in her own right, whether or not such sales involve the manager in competition with the LLC . . ." is easily understandable by investors.

This problem could be fixed in the statute by eliminating all of RULLCA section 110(d)(1). *See infra* Appendix B. This would leave the following language in RULLCA section 110(d): "If not manifestly unreasonable, the operating agreement may . . . identify specific types of categories or activities that do not violate the duty of loyalty . . ."

119. *See supra* notes 78-80 and accompanying text.

120. *See supra* notes 78-80 and accompanying text.

a concise and clear description of the opt-out terms and cross reference the full opt-out provisions as they appear in the operating agreement.

#### IV. CONCLUSION

The Revised Uniform Limited Liability Company Act is NCCUSL's latest offering of a uniform act to govern non-corporate entities, specifically, in this case, limited liability companies. History suggests that RULLCA will play a significant part in defining the rules governing limited liability companies. Limited liability companies have become popular as a way for investors to achieve single taxation and limited liability. Uniform acts promulgated by NCCUSL have over the years been popular with state legislatures.

Unfortunately, NCCUSL has once again in RULLCA offered a set of fiduciary duty and opt-out provisions that are materially deficient. While RULLCA's provisions differ somewhat from prior uniform acts and offer some improvements in the area of managers' duty of loyalty, considered as a whole, RULLCA's fiduciary duties are no better, and may be even worse, than the fiduciary duty provisions found in RUPA, ULPA (2001), and ULLCA. Like those prior uniform acts, RULLCA's fiduciary provisions will facilitate managers exploitation of information asymmetry and their desire and ability to construct and profit from inefficient, unfair management arrangements with the owners of LLCs.

The burden, therefore, will pass to state legislatures during the adoption process to fix the problems created by NCCUSL. Mechanically, this will not be hard to do, and part of the purpose of this article is to point out simple changes in RULLCA's fiduciary provisions that would promote fairness and efficiency in outcomes. The issue is whether state legislatures can break free from inertia—the unwillingness to allocate valuable legislative time to consider particular parts of any uniform act that is presented to them—and from the spell cast upon them by the interests of business managers.

It is here where those interested in law reform should step forth. It is a worthwhile cause to promote business laws that are sensible, fair, and efficient.

## APPENDIX A

RULLCA section 409 states:

- (a) A member of a member-managed liability company owes to the limited liability company and subject to Section 901(b), the other members the fiduciary duties of loyalty and care stated in (b) and (c).
- (b) The duty of loyalty of a member in a member-managed limited liability company includes the duties:
  - (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member:
    - (A) in the conduct or winding up of the company's activities.
    - (B) from a use by the member of the company's property; or
    - (C) from the appropriation of a limited liability company opportunity;
  - (2) to refrain from dealing with the company in the conduct or winding up of the company's activities as or on behalf of a party having an interest adverse to the company; and
  - (3) to refrain from competing with the company in the conduct of the company's activities before the dissolution of the limited liability company.
- (c) Subject to the business judgment rule, the duty of care of a member of a member-managed liability company in the conduct and winding up on the company's activities is to act with the care that person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company. In discharging duties under this subsection, a member may rely in good faith upon opinions, reports, statements, or other information provided by another person that the member reasonably believes is competent and reliable source for the information.
- (d) A member shall discharge the duties under this [act] or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.
- (e) It is a defense to a claim under section (b)(2) and any comparable claim in equity or at common law that the transaction was fair to the limited liability.
- (g) In a manager-managed limited liability company:
  - (1) subsections (a), (b), (c) apply to the manager or managers and not the members;
  - (2) the duty stated under subsection (b)(3) continues until winding up is completed;
  - (3) subsection (d) applies both to members and managers;
  - (4) subsection (f) applies only to members; and
  - (5) a member of a manager-managed limited liability company does not have any fiduciary duty to the limited liability company or to any other member solely by reason of being a member.

## APPENDIX B

RULLCA section 110 states:

- (c) An operating agreement may not:
  - (1) . . . .
  - (4) subject to subsections (d) through (g), eliminate the duty of loyalty, the duty of care, or any other fiduciary duty;
  - (5) subject to subsection (d) through (g), eliminate the contractual obligation of good faith and fair dealing under Section 409(d);
  - (6) . . . .
- (d) If not manifestly unreasonable, the operating agreement may:
  - (1) eliminate the duty:
    - (A) to account, as required in Section 409(b)(1) and (g) to the limited liability company and to hold a trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company's business, from a use by the member of the company's property, or from the appropriation of a limited liability company opportunity;
    - (B) to refrain, as required in Section 409(b)(2) and (g), from dealing with the company in the conduct or winding up of the company's business as or on behalf of a party having an interest adverse to the company; and
    - (C) to refrain, as required by Section 409(b)(3) and (g), from competing with the company in the conduct of the company's business before the dissolution of the company.
  - (2) identify specific types or categories of activities that do not violate the duty of loyalty;
  - (3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law;
  - (4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and
  - (5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under Section 409(d);
- (e) The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts.