LEGAL REALISM, THE LLC, AND A BALANCED APPROACH TO THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

*Sandra K. Miller**

One of the broad questions raised by this Symposium is whether the law adequately considers disparities in bargaining power in a wide variety of contractual relationships. This Article explores the implications of such disparities in the context of conflicts among investors of limited liability companies ("LLCs") and other so-called "alternative entities."[1]

Should the manager of a hedge fund have unlimited discretion to consider only such interests and factors as her own, with no duty or obligation to consider those affecting the LLC? Should an LLC manager be permitted in his sole discretion to designate persons other than the general partner who will be exculpated from fiduciary duties? At what point in a contractual relationship does the consideration of one's self-interest deprive the other investor of the fruits of a bargain and present a violation of the implied covenant of good faith and fair dealing? This Article suggests that the context of the relationship between the majority and minority investor and/or between the manager and passive investor reveals power disparities that justify a mandatory duty of loyalty and a mandatory duty of care in alternative entities. Even in jurisdictions such as Delaware that permit the contractual elimination of duties, the contractual context of a given dispute continues to be important in determining whether the implied covenant of good faith and fair dealing has been breached.[2]

Mandatory fiduciary duties lay at the heart of internal

* Professor, Economics, Finance, & Taxation Department, Widener University School of Business Administration.

1. For purposes of this discussion, the term "alternative entities" broadly refers to unincorporated business entities providing limited liability to their owners, including the limited liability partnership ("LLP") and the limited liability company ("LLC").

2. *See* DEL. CODE ANN. tit. 6, § 17-1101(d) (2005) (providing that an LLP partner's duties to an LLP or to another partner or person "may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing"); *id.* § 18-1101(c) (providing that the duties of a member or manager of an LLC may similarly be "expanded or restricted or eliminated by provisions in the [LLC] agreement" so long as the agreement does not "eliminate the implied contractual covenant of good faith and faith dealing").

governance law.[3] The LLC movement has sought contractual freedom in structuring business entities.[4] In achieving this contractual freedom, most notably in Delaware, the law has become increasingly unhinged from the traditional moorings that have recognized the need for addressing power disparities in long-term investment relationships. Traditional internal governance law has long supplied the duty of loyalty and the duty of care in recognition of power disparities between manager and investor and between controlling and minority investors.[5] In jurisdictions such as Delaware, fiduciary duties in alternative entities may be eliminated, except that the implied covenant of good faith and fair dealing may never be contractually waived.[6] Thus, an important emerging issue concerns the extent to which the implied covenant of good faith and fair dealing should operate as a constraint upon management conduct.

The purpose of this Article is to explore how legal realism and an appreciation of the human context of LLC relationships can improve internal governance law as applied to alternative business entities. This Article advances three major arguments. First, it argues that empirical research should be used to evaluate the reasonableness of the assumptions underlying competing approaches to internal governance law in the context of alternative business entities. Empirical data on contractual practices and data on patterns of legal representation may be helpful in informing legislative decisions, such as whether to permit the contractual elimination of fiduciary duties. Also, data on managerial violations may be helpful in establishing the most effective agenda for educational initiatives in the legal and business communities. Second, the Article argues that the contractual context of a dispute is critically important in properly interpreting the implied covenant

3. *See* Douglas M. Branson, *Still Square Pegs in Round Holes? A Look at ANCSA Corporations, Corporate Governance, and Indeterminate Form or Operation of Legal Entities*, 24 ALASKA L. REV. 203, 211–12 (2007) (describing the duty of loyalty that is imposed on a corporate director in every transaction and every situation); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 880–82 (tracing the historical development of and general principles underlying fiduciary duties in corporate law).

4. *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 WASH. U. L.Q. 417, 425–26 (1992) (noting that state LLC statutes generally share certain characteristics, including the granting of "freedom from other restrictions on form of governance").

5. *See* Leonard M. Baynes, *Just Pucker and Blow?: An Analysis of Corporate Whistleblowers, the Duty of Care, the Duty of Loyalty, and the Sarbanes-Oxley Act*, 76 ST. JOHN'S L. REV. 875, 883–88 (2002) (explaining the duties of loyalty and care); *see also* Douglas K. Moll, *Shareholder Oppression in Texas Close Corporations: Majority Rule (Still) Isn't What It Used To Be*, 9 HOUS. BUS. & TAX L.J. 33, 34–36 (2008) (discussing the problems that can be associated with majority control in close corporations).

6. *See* §§ 17-1101(d), 18-1101(c).

of good faith and fair dealing. Third, the Article argues that the law-making process itself is very much affected by disparities in power and influence. Academics have a unique role to play in trying, testing, evaluating, and improving legal approaches that serve the entire business community and not just its most affluent and influential members.

Part I of this Article discusses legal realism, its proponents, and a contextual approach to disputes in alternative business entities. Part II argues that an appreciation for the context of the LLC operating agreement is critical to the effective utilization of the implied covenant of good faith and fair dealing as an interpretive tool to enforce the parties' reasonable expectations. Part III discusses political factions and power discrepancies within the law-making community. It argues that academics at business and law schools have a critical role to play in steering the law toward an equitable path that avoids domination by partisan financial interests.

I. LEGAL REALISM AND THE ROLE OF EMPIRICAL RESEARCH ON INTERNAL GOVERNANCE LAW

For the last twenty years, the law-and-economics school has led the way toward the creation of a highly flexible business entity, providing opportunities to contractually eliminate the duty of loyalty and the duty of care that has long applied to directors of corporations.[7] Jensen and Meckling advanced the "nexus of contracts" conception of the firm, under which the business entity was regarded as a standard form contract.[8] The contractarian approach values efficiency above all else and argues that the most efficient arrangement is to allow parties to freely bargain for legal duties.[9]

Unfortunately, contractarians have not tested the assumptions on which this free bargaining theory rests. Subpart A discusses the special risks that investors face when investing in privately held entities, such as LLCs. In so doing, this Subpart revisits the fundamental policy interests that are furthered by mandatory fiduciary duties. Subpart B discusses competing approaches to fiduciary duties in the context of LLCs. Subpart C discusses legal realism and its implications for empirical research on LLC governance. Subpart D provides a discussion of empirical studies

7. *See generally* LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 119–35 (2009) (providing an overview of the alternatives to corporations that have emerged over the last twenty years).

8. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

9. David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 DEL. J. CORP. L. 491, 493 (2004).

that have focused on legal representation of controlling and minority investors and on fiduciary duties. It concludes by arguing that further empirical research should be done to illuminate the expectations of minority and controlling investors with regard to management responsibilities. Also, it suggests that further research be done—especially research of an interdisciplinary nature—to explore the links between legal requirements, business culture, and business success.

A. The Special Risks Faced by the Private LLC Investor

As noted by Judge Easterbrook and Professor Fischel, "Corporate law, both statutory and judicial, is best understood as a set of standard terms that lowers the costs of contracting."[10] Fiduciary duties, including the duty of loyalty and the duty of care, are standard terms that respond to the costs of monitoring management. Commentators had initially emphasized the importance of monitoring with regard to the public company where there is a separation between those who manage the firm and those who bear its risks.[11] However, Easterbrook and Fischel pointed out that monitoring is equally important in the private entity.[12] Although those who manage and bear the risk are frequently the same in private firms, a variety of other risks remain. Such hazards include the risk that those in control will prefer themselves with regard to ordinary and extraordinary transactions, the risk of deadlock, and the risk created by the fact that the private company is illiquid and presents a restrictive market for private investments.[13]

The need for judicial monitoring and statutory constraints to address the hazards of power imbalances has become apparent as LLC litigation has proliferated over the last twenty years. Cases involving duty of loyalty breaches ranging from the theft of assets to the usurpation of company opportunities are legion.[14] Clearly, oppression remedies for the minority LLC investor who has been locked into a company, but locked out of company benefits, are of growing importance in the alternative entity context.

B. Competing LLC Governance Regimes

There are four major approaches, or viewpoints, to addressing fiduciary duties in alternative entities. The first is the traditional

10. Frank. H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 283 (1986).

11. *See id.* at 277.

12. *See id.* at 278–79.

13. *See id.* at 278–79, 290.

14. *See* Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More than a Decade of Experimentation?*, 32 J. CORP. L. 565, 588 & nn.133–35 (2007).

approach, which makes the duty of loyalty and duty of care mandatory.[15] The second is to use the duty of loyalty and the duty of care as default terms that can be varied but not eliminated by express contract.[16] The third is to provide the duty of care and the duty of loyalty as default terms that can be not merely modified, but altogether eliminated.[17] The fourth viewpoint is to assume no fiduciary duties at all as the default rule, and to require the parties to expressly contract for each fiduciary duty desired.[18]

The fourth approach listed above represents the most extreme contractarian viewpoint, which has been expressed by Chief Justice Myron T. Steele of the Delaware Supreme Court.[19] Justice Steele argues that the benefits of default fiduciary duties are outweighed by costs, that there are benefits to clearly delineating the situations where fiduciary duties apply, and that a narrow approach to duties inheres in the contractual nature of the duties.[20] Justice Steele criticizes the use of default legal duties and instead suggests that duties be applied only when the parties themselves expressly adopt such duties in the LLC operating agreement.[21]

The empirical research discussed below, while far from definitive, suggests that there are market failures and imbalances in the legal representation of controlling and minority investors.[22] Such market failures tend to point to the need for mandatory minimum implied fiduciary duties or at least default duties that

15. *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) (holding that directors and officers owe fiduciary duties of care and loyalty).

16. The original draft of the Uniform Limited Liability Company Act permitted the modification, but not the elimination, of duties. *See* Sandra K. Miller, *What Remedies Should Be Made Available to the Dissatisfied Participant in a Limited Liability Company?*, 44 AM. U. L. REV. 465, 511–13 (1994).

17. *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (2005); *see also* Kelly v. Blum, No. 4516-VCP, 2010 Del. Ch. LEXIS 31, at * 54 (Del. Ch. Feb. 24, 2010).

18. This viewpoint has not yet been reflected in a court decision but has been expressed in other venues. For example, the position of Myron T. Steele, Chief Justice of the Delaware Supreme Court, has been summarized as follows: "If it is not absolutely clear in the agreement what duties apply, if any, then the implied covenant of good faith and fair dealing is the duty that will apply." Delaware Corporate and Commercial Litigation Blog, *Updates on Delaware Law and Alternative Entity Law*, http://www.delawarelitigation.com/2010/04/articles/commentary/updates-on-delaware-corporate-law-and-alternative-entity-law (Apr. 29, 2010) ("[T]he better policy decision is to apply the implied covenant of good faith and fair dealing to LLC agreements that do not otherwise specify what duty applies, as opposed to the traditional panoply of fiduciary duties."); *see also* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Liability Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 233–42 (2009) (arguing that courts should adopt a policy of no default fiduciary duties based on freedom of contract and economic efficiency).

19. *See* Steele, *supra* note 18, at 233–42.

20. *Id.* at 240–42.

21. *Id.*

22. *See infra* Part I.D.

cannot be fully eliminated. Without built-in duties that are not dependent upon express contracting, internal governance law may unfairly favor the controlling investor and the LLC manager at the expense of nonmanaging LLC investors and minority investors.

John M. Cunningham, a principal drafter of the original New Hampshire Limited Liability Company Act,[23] has convincingly argued that Delaware law unfairly favors affluent LLC members who can afford the luxury of legal representation.[24] Cunningham explains, "[A]lthough many millions of multimember LLCs are formed by members who cannot afford the assistance of lawyers with LLC fiduciary expertise, the fiduciary provisions of many LLC acts have been drafted principally to protect the interests of LLC promoters and managers who *can* afford these lawyers."[25]

As discussed in Subpart D below, evidence suggests that minority LLC investors may not be as frequently represented by legal counsel as controlling members. The empirical research further suggests that a great number of LLC agreements that are adopted have been superficially considered, if at all.[26]

Law-and-economics scholars posit that Pareto efficiency is achieved if it is impossible to change things such that at least one person is better off without making another person worse off.[27] Under a cost-benefit analysis, if a change from mandatory fiduciary duties to no default fiduciary duties at all were to be made, the change would make sense if the gain to the gainers is more than the loss to the losers, assuming that there are no adverse side-effects that produce additional negative consequences.[28] The fourth approach to duties—that all duties should be specifically contracted for because their costs outweigh their benefits—is seriously flawed. The costs of all members of the community must be weighed against the benefits to all members of the community, not just its most sophisticated and/or affluent constituents. Arguably it would be cheaper for LLC syndicators and managers to *not* have to contract around default fiduciary duties. However, one must consider the efficiency question from the standpoint of all members of the community, not just a fragment representing the elite. Based upon

23. N.H. REV. STAT. ANN. § 313:1 (1993) (current version at N.H. REV. STAT. ANN. §§ 304-C:1–:85 (2005)).

24. *See generally* John M. Cunningham, *Reforming LLC Fiduciary Law: A Brief for the Unrepresented*, BUS. L. TODAY, Nov.–Dec. 2009, at 51 (analyzing Delaware fiduciary duty law and its impact upon unrepresented and less sophisticated LLC investors).

25. *Id.* at 51.

26. *See infra* notes 41–59 and accompanying text.

27. ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 17 (5th ed. 2008); *see also* Robert J. Rhee, *Bonding Limited Liability*, 51 WM. & MARY L. REV. 1417, 1446 (2010).

28. For a discussion on application of Pareto efficiency in enterprise law, see Rhee, *supra* note 27, at 1446–50.

both anecdotal and empirical information, a great number of people will not be sophisticated and affluent, may not have legal representation, and may not have an LLC operating agreement in place. A significant sector of our economy consists of small business owners and ordinary consumer and investors for whom default fiduciary duties are highly efficient.[29] A regime offering default fiduciary duties is preferable on grounds of both fairness and efficiency.

C. Legal Realism Challenges the Hypothetical Market

Setting aside the issue of whether policy goals other than efficiency should establish standards for investor/management conduct, and assuming that efficiency is indeed the critical policy goal, contractarians seem to make a number of very large assumptions about human conduct and markets. Do we know anything about these markets specifically? Who are the markets' participants? How do they behave? Who stands to gain by imposing built-in duties of honesty and care? Who stands to lose by building in these duties? How realistic is it to anticipate that participants can and will contractually identify what duties they want to assume and what duties they wish to shed? Can contractual self-protection really be obtained, is it cost effective, and might there be other effects at work that may produce other direct or indirect costs or benefits?

The ease with which contractarians sidestep fundamental questions about the contractual playing field was poignantly captured by then-Professor Allan W. Vestal, when recounting the following academic joke at a Washington and Lee University symposium:

> An ethicist, a political scientist, and an economist were stranded on a desert island. They had no food or water, no means of transportation or communication. Sitting on the beach, they pondered their fate. The ethicist declared that it would be acceptable for them to eat one of their number if that would enable the others to live. The political scientist suggested that they vote on whether to eat one of their number, and if so, who. The economist laughed and announced that she had a way to get them off the island without having to eat anybody. She cleared her throat and began: "First, assume a rather large boat . . . ."[30]

Assumptions about how humans behave in real-life contexts

29. *See generally* Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243 (2009).

30. Allan W. Vestal, *"Assume a Rather Large Boat . . .": The Mess We Have Made of Partnership Law*, 54 WASH. & LEE L. REV. 487, 534 (1997).

may differ radically from assumptions about human behavior in a hypothetical market. Proponents of legal realism have much to offer those who wish to consider what, if any, mandatory constraints should apply to monitor business conduct in alternative business entities. Legal realism emerged in the 1930s and was a rather diverse approach to law that emphasized the importance of grasping the practical, real-life consequences of the law.[31] As one scholar noted, "The collection of ideas a later age has come to call 'legal realism' was, as the English legal theorist Neil Duxbury has said, 'more a mood than a movement,' and though united in their critique of 'formalism' its various factions were very divided."[32] A Yale group of academics suggested studying law in action by using social-scientific investigation techniques, such as court studies, industry studies, etc.[33] Other realists sought to ascertain the actual impact of legal doctrines given the business realities of day-to-day life. At Yale University, scholars reanalyzed legal doctrines to assess whether they served a valid and defensible social function. For instance, William O. Douglas questioned the meaningfulness of the "frolic and detour" rule in light of businessmen managing risks.[34] In addition, Douglas conducted large-scale empirical studies of bankrupt debtors.[35]

It is perhaps more than a coincidence that we turn toward legal realism in 2010, after the most significant financial crisis since the Great Depression.[36] The crushing realities of human greed and market and regulatory failures are difficult to erase. It is increasingly difficult to retain faith in the invisible hand of the market against the backdrop of Disney's $130 million severance package to Michael Ovitz for fourteen short months of service,[37]

31. *See* Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 812 (1935) ("The law is not a science but a practical activity, and myths may impress the imagination and memory where more exact discourse would leave minds cold."); *see also generally* Michael Steven Green, *Legal Realism as Theory of Law*, 46 WM. & MARY L. REV. 1915 (2005) (outlining the development of and foundational principles underlying legal realism).

32. *See* Robert W. Gordon, *Professors and Policymakers: Yale Law School Faculty in the New Deal and After*, *in* HISTORY OF THE YALE LAW SCHOOL 75, 99 (Anthony T. Kronman ed., 2004) (footnote omitted) (quoting NEIL DUXBURY, PATTERNS OF AMERICAN JURISPRUDENCE 69 (1995)).

33. *Id.*

34. *See* William O. Douglas, *Vicarious Liability and Administration of Risk I*, 38 YALE L.J. 584, 585–94 (1929). For a contemporary discussion of this legal rule, see generally Young B. Smith, *Frolic and Detour*, 23 COLUM. L. REV. 444 & 716 (1923).

35. *See* William O. Douglas, *Some Functional Aspects of Bankruptcy*, 41 YALE L.J. 329 (1932).

36. *See generally* Paul Krugman, *How Did Economists Get It So Wrong?*, N.Y. TIMES, Sept. 6, 2009 (Magazine), at 36.

37. *See* Rita K. Farrell, *Delaware Justices Uphold Ruling on Disney Severance*, N.Y. TIMES, June 9, 2006, at C6.

Enron's creative off-balance sheet accounting,[38] and Bernard Madoff's multibillion dollar Ponzi scheme.[39]

A renewed appreciation for legal realism was evident in President Obama's articulation of the qualities that are important for the selection of outstanding Supreme Court justices. In connection with his approach to selecting a replacement on the Supreme Court for Justice Souter, President Obama explained:

> I will seek someone who understands that justice isn't about some abstract legal theory or footnote in a case book. It is also about how our laws affect the daily realities of people's lives—whether they can make a living and care for their families; whether they feel safe in their homes and welcome in their own nation.
>
> I view that quality of empathy, of understanding and identifying with people's hopes and struggles as an essential ingredient for arriving at just decisions and outcomes.[40]

There is indeed heightened concern for the day-to-day impact of legal and public policies upon ordinary citizens. This renewed appreciation for the real-life impact of public policies may be due in part to contemporary pressures of a complicated financial crisis, a string of business scandals, global environmental issues, and antiterrorist measures raising serious constitutional questions.

D. Empirical Research on Internal Governance

There is remarkably little empirical research on choice of business entity investors, investor expectations, contractual practices, and rates of success and failure in joint undertakings.[41] No one has attempted to identify the extent to which investors are actually aware of their legal and ethical responsibilities toward co-venturers. No research has been done to determine what types of

38. *See* Kurt Eichenwald, *Questions Were Answered at Board's Investigation*, N.Y. TIMES, Feb. 13, 2002, at C9.

39. *See* Diana B. Henriques & Jack Healy, *Madoff Jailed After Pleading Guilty to Fraud*, N.Y. TIMES, Mar. 13, 2009, at A1.

40. President Barack Obama, Remarks by the President on Justice David Souter (May 1, 2009), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-justice-david-souter.

41. *But see* J. Robert Brown, Jr. & Sandeep Gopalan, *Opting Only In: Contractarians, Waiver of Liability Provisions, and the Race to the Bottom*, 42 IND. L. REV. 285 (2009) (analyzing empirical evidence of waiver liability provisions and finding that all but one of the Fortune 100 companies studied had a waiver of liability provision); Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001) (providing an empirical analysis of whether the choice of business entity is related to the advising attorney's familiarity and prior experience working with the law and concluding that the choice of entity appears to be made based upon the inherent characteristics of the entity).

legal protections investors would like to have.[42] Yet, some contractarians have made sweeping statements that it is inefficient to impose default fiduciary duty protections.[43] Do most investors really understand what they are giving up when they give up fiduciary duty protections? Who are most investors and how well-represented are they?

Unfortunately, we lack a coherent process for predicating state and federal legislative changes on empirical findings.[44] At this point, only two studies have been done concerning the LLC contractual playing field for majority and minority LLC investors. The first study focused on LLCs in California, Delaware, New York, and Pennsylvania;[45] the second study concerned LLCs in Colorado, Delaware, Kentucky, Minnesota, Montana, and New York.[46] While far from definitive, both studies raise serious questions as to whether controlling and minority investors are equally well-represented by legal counsel.[47] They also raise questions about the degree to which investors execute LLC operating agreements that are thoughtfully tailored to the specific problems inherent in a particular deal.[48]

The first study analyzed the responses of 770 attorneys in California, Delaware, New York, and Pennsylvania and found a

42. *See* Michael K. Molitor, *Eat Your Vegetables (or at Least Understand Why You Should): Can Better Warning and Education of Prospective Minority Owners Reduce Oppression in Closely Held Business?*, 14 FORDHAM J. CORP. & FIN. L. 491, 579–80 (2009) (suggesting an educational initiative and an information-gathering approach under which states would gather data on contractual choices small business owners would like to make regarding the private ordering of their relationships).

43. *See, e.g.*, Steele, *supra* note 18, at 233–42.

44. This lack of a coherent process becomes clear when one examines the legislative process in the United Kingdom ("U.K.") in connection with the U.K. Law Commission. The U.K. Law Commission conducts extensive legislative reports that include survey data related to a wide variety of legislative changes in the United Kingdom. For a list of U.K. Law Commission Reports, see Law Commission Reports, http://www.lawcom.gov.uk/lc_reports.htm (last visited Aug. 26, 2010). The general mission of the U.K. Law Commission is "to keep the law under review and to recommend reform where it is needed." Law Commission Home Page, http://www.lawcom.gov.uk (last visited Aug. 26, 2010).

45. Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351 (2003).

46. Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609 (2006).

47. *See* Miller, *supra* note 45, at 398–99; Miller et al., *supra* note 46, at 628–29.

48. *See* Miller, *supra* note 45, at 399 ("Over two-thirds of all practitioners replied 'Yes' when asked whether they believe that that many in-state or out-of-state LLC agreements are based on form agreements that are not extensively negotiated."); Miller et al., *supra* note 46, at 621–22 (finding that a substantial majority of practitioners had "sometimes or often" drafted simple LLC agreements that did not account for individual client preferences).

disparity in the legal representation of majority and minority LLC investors.[49] An average of 56% of respondents reported that they frequently represented majority LLC owners while an average of 20% reported frequently representing minority LLC owners.[50] A less pronounced disparity, but a disparity nevertheless, was found in majority/minority representation in the second study as well. There, approximately 84% of respondents reported either often or sometimes representing controlling LLC members, as compared to the 67% who often or sometimes represented minority owners.[51]

Both studies challenge the notion that most LLC owners retain attorneys who thoughtfully draft LLC operating agreements tailored to the specifics of their business arrangements. In the first study, approximately two-thirds of respondents indicated that they believe that many LLC agreements are based on form agreements that are not extensively negotiated.[52] In the second study, approximately 85% indicated that they sometimes or often form no-frills, simple LLC agreements for a modest fee.[53]

Also, the studies raise questions about the extent to which attorneys are properly trained in understanding fiduciary duties and well-versed in the relevant LLC law, and thus whether they are well-positioned to secure the best contractual protections for their clients. For instance, in the first study, about 56% of Pennsylvania practitioners incorrectly answered "No" when asked if an LLC member is entitled to a buyout upon dissociation before the company winds up.[54] The second study found that relatively few attorneys outside of Delaware (19%) had attended continuing legal education seminars concerning fiduciary duties of LLC members within the last twelve months.[55]

It should be noted that in a third study on contractual practices concerned with Fortune 100 companies, the articles of incorporation of those companies were reviewed to determine if they contained a contractual provision reducing the legal liability for a breach of fiduciary duties.[56] This study by Professors Brown and Gopalan showed that in all states offering the opportunity to reduce the level of liability for breach of the duty of care, every company except for one had opted for the provision that achieved the maximum protection from legal liability.[57] As the authors noted, "[O]ne

49. Miller, *supra* note 45, at 351.
50. *Id.* at 388.
51. Miller et al., *supra* note 46, at 618.
52. Miller, *supra* note 45, at 383, 399.
53. Miller et al., *supra* note 46, at 636, 642.
54. Miller, *supra* note 45, at 393.
55. Miller et al., *supra* note 46, at 618, app. D at 645.
56. *See* Brown & Gopalan, *supra* note 41.
57. *Id.* at 309–10. PepsiCo. was the only nonfederally-incorporated, nonmutual company whose articles of incorporation did not contain a waiver of liability provision. *Id.*

categorical rule was merely replaced by another."[58] They argue that when faced with a choice, management will race to the bottom to act in its self-interest to achieve the least legal liability possible.[59]

In summary, the contractarian approach to fiduciary duties presupposes perfect market conditions—that is, the existence of majority and minority investors who are equally poised to bargain for optimal fiduciary duty protections. Yet, thus far, studies suggest that controlling and minority investors may not be equally represented by counsel. They may not be actively bargaining for optimal protections. Further, their attorneys may not have a perfect understanding of the law. Prior to making legislative changes, lawmakers should consider the impact of any proposed changes upon various segments of the business community. In evaluating a legislative change, the legal realist quite properly considers the real-life implications in the day-to-day business world and the long-term impact of the new rule upon business culture.

II. LEGAL REALISM, BUSINESS CULTURE, AND THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

While a detailed discussion of mandatory fiduciary duties appears elsewhere,[60] this Part focuses upon the implied covenant of good faith and fair dealing in the context of alternative entity disputes.[61] It argues that a highly formalistic interpretation of the LLC operating agreement can prevent the law from enforcing reasonable expectations under such an agreement. A miserly, excessively formalistic interpretation of the LLC operating agreement runs the risk of undermining the spirit of the contract, leaving the LLC member without a remedy for conduct that technically complies with the agreement, but in substance denies the member the fruits of the bargain. On the other hand, an overly broad interpretation of the implied covenant of good faith could frustrate the policy interest in freedom of contract and undermine the parties' legitimate efforts to contractually determine their obligations under the LLC operating agreement. The examples below illustrate the value in adopting a balanced approach to the implied covenant of good faith and fair dealing.

A. The Context, Contractual Certainty, Fairness, and Impact on Business Culture

One of the important things that legal realism offers to the

58. *Id.* at 288.

59. *See id.* at 289–90.

60. *See generally* SANDRA K. MILLER, LIMITED LIABILITY COMPANIES: A COMMON CORE MODEL OF FIDUCIARY DUTIES (2009).

61. For additional discussion on this topic, see generally Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 AM. BUS. L.J. 279 (2009).

world of alternative business entities is its appreciation for the context of the conflict at issue.[62] The context of a conflict between an unknown buyer and seller in an isolated sale of a product is different from that of a conflict between two LLC members who have owned a business together for years. Both are contractual relationships, but the reasonable expectations of the parties and the extent of reliance each party places on the other varies in each setting. Typically, the reasonable expectations and reliance interests will be greater in nature and scope where the parties are involved in a long-term relational contract than in an isolated transaction for the sale of goods or services.[63] While there may be exceptions, in many instances, one's financial and personal risks with respect to a long-term relational contract will be greater than those risks presented by the one-time sale. Further, in the setting of a long-term relational contract memorialized in an LLC operating agreement, a good faith duty to cooperate may be something for which the parties would likely have negotiated had they foreseen the circumstances surrounding a given dispute.[64]

The capacity to achieve contractual certainty and contractual control over the business relationship is likely to be an important policy goal when the parties have chosen to form an LLC and to enter into an LLC operating agreement.[65] However, even if the LLC has been organized in Delaware, an excessively formalistic approach to the LLC operating agreement can rob the law of fairness. While the policy interest in contractual certainty must be considered, the interest in enforcing the contract and preserving the spirit of the bargain must not be overlooked.

Professor Deborah A. DeMott has emphasized the importance of context in the application of the implied covenant of good faith.[66] She has noted that some of the early Delaware cases considering the implied covenant of good faith involved the relationship between issuers and holders of debt securities, a highly specialized context.[67] Professor DeMott observes that in the context of examining issuers and holders of debt securities, a narrow approach to the implied

62. *See id.* at 307–09 (discussing the role of context in determining members' duties in an LLC).

63. *See* Deborah A. DeMott, *Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043, 1059–61 (1995).

64. *See* ROBERT HILLMAN, THE RICHNESS OF CONTRACT LAW 152–54 (1997).

65. *See* DeMott, *supra* note 63, at 1046.

66. *See id.* at 1057–62.

67. *Id.* at 1058–59 (discussing Katz v. Oak Indus. Inc., 508 A.2d 873 (Del. Ch. 1986), which involved a troubled company and an offer made to holders of debt securities in which the court concluded that the implied covenant of good faith had not been breached). In her discussion, DeMott also cited Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1520 (S.D.N.Y. 1989), in which a court outside of Delaware expressed concern that "unbounded and one-sided elasticity . . . would interfere with and destabilize the market"). DeMott, *supra* note 63, at 1058 n.57.

covenant of good faith may be appropriate in light of the strong policy interest in furthering certainty and market stability in the debt securities market.[68] However, she notes, "In contrast [to the debt securities market], in general contract law and the law of sales, the implied covenant often operates more robustly. In particular, in contracts defining long-term relationships of mutual interaction or cooperative endeavor, courts have long given the duty a relatively expansive reading."[69]

Delaware courts have repeatedly announced that implying obligations through the implied covenant of good faith and fair dealing is a cautious enterprise.[70] This caution grows out of an appreciation for the legislative intent to give maximum effect to the contract between the parties.[71] However, the implication of the covenant of good faith and fair dealing is sometimes absolutely vital in order to give effect to the contract between the parties.

Context plays a slightly different role in allegations of fiduciary duty breaches and in allegations of the violation of the implied covenant of good faith and fair dealing. In connection with fiduciary duty breaches, the status of the parties, the nature of the conduct, and the expectations of conduct given the status of the parties are the focal points of the analysis.[72] In breach-of-implied-covenant cases, the context continues to be important, but not with reference to the status of the parties as such. Context is important insofar as it sheds light on the agreement between the parties. Various factors—the sophistication of the parties, the nature and scope of past understandings, common usage in the industry, and the type of transaction involved—may all play a role in interpreting the contract and in assessing whether there has been foul play in denying a party the benefit of the bargain.[73] Whether the context is one in which the parties could have readily self-protected may also have a bearing on the court's willingness to rely upon the implied covenant of good faith and fair dealing.[74]

68. *See* DeMott, *supra* note 63, at 1059.

69. *Id.*

70. *See, e.g.*, Kelly v. Blum, No. 4516-VCP, 2010 WL 629850, at *13–14 (Del. Ch. Feb. 24, 2010); Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 888 (Del. Ch. 2009); Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co., No. Civ.A. 1668-N, 2006 WL 2521426, at *5–6 (Del. Ch. Aug. 25, 2006).

71. *See Blum*, 2010 WL 629850, at *10.

72. *See, e.g.*, *Blum*, 2010 WL 629850, at *10–11; *ReliaStar*, 2006 WL 2521426, at *4–6.

73. *See, e.g.*, Nemec v. Shrader, 991 A.2d 1120, 1125–29 (Del. 2010); *ReliaStar*, 2006 WL 2521426, at *5–7.

74. *See, e.g.*, Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027, at *28 (Del. Ch. Apr. 29, 2005) ("Indeed, the implied covenant may only be invoked where it is '*clear* from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of [their agreement] had they thought to negotiate with respect to that matter.'" (quoting Cincinnati SMSA

A judicial reluctance to conclude that the implied covenant of good faith and fair dealing was breached can be seen in some controversies in which both parties had legal representation and ample opportunity to adopt express contractual protections. A greater willingness to imply a breach of the covenant of good faith and fair dealing may occur where the act or failure to act may be of the sort that is difficult to protect against. Contrasting contexts and differences in the ability to self-protect can be seen in two recent cases—*Airborne Health, Inc. v. Squid Soap, LP*,[75] involving an acquisition agreement between an unrelated soap maker and a cold remedy manufacturer, and *Clancy v. King*,[76] involving a limited partnership dispute between a divorcing husband and wife. In *Airborne Health, Inc. v. Squid Soap, LP*, a cold remedy manufacturer sought a declaratory judgment that it was not liable under an asset purchase agreement after it was unable to provide earn-out payments under the contract.[77] In signing this agreement, the cold remedy manufacturer ("Airborne") failed to disclose that there was a class action suit pending against it in California for false and misleading advertising.[78] Eventually, the class action suit was settled for $23.5 million, and actions by the Federal Trade Commission and thirty-two state attorneys general would culminate in other settlements amounting to over $43 million, all of which prevented the purchaser from making its earn-out payments to the soap maker.[79]

The Delaware Chancery Court failed to find fraud on Airborne's part because in signing the agreement, Airborne made no broad legal representation about the existence of any pending litigation generally; the agreement merely concerned whether there was any litigation affecting Airborne's ability to close.[80] Also, the court failed to hold that the purchaser breached its implied covenant of good faith and fair dealing, and noted that implying specific obligations based on these covenants is a "cautious enterprise," particularly where the parties could readily have drafted express contractual provisions.[81] It is noteworthy that the seller had stated that Airborne's failure to perform the earn-out was due to financial pressure, rather than to the exercise of contractual discretion in bad faith.[82] The context was also significant. The implied covenant of good faith was being interpreted in the context of a relationship

Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998))).

75. 984 A.2d 126 (Del. Ch. 2009).

76. 954 A.2d 1092 (Md. 2008).

77. *Squid Soap*, 984 A.2d at 130, 132, 136.

78. *Id.* at 134.

79. *Id.* at 134–35.

80. *Id.* at 140–43.

81. *Id.* at 146 (quoting Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998)).

82. *Id.* at 147.

between two sophisticated investors, both of whom had time to perform their due diligence tasks, as well as abundant opportunities to draft express contractual covenants.

Clancy v. King presents the interpretation of the implied covenant of good faith in the context of a partnership relationship involving a discretionary decision to use a book franchise, which was difficult to police.[83] Clancy, the defendant and former husband of the plaintiff, was a successful author of popular "techno-thriller" novels.[84] Both Clancy and his former wife, King, originally owned a 49% limited partnership interest and a 1% general partnership interest in the book franchise partnership.[85] Subsequent to their separation, King filed suit and acquired all rights to manage the partnership through an order entered by the trial court.[86] Prior to the marital separation, the partnership had entered into a joint venture with a literary company, and the joint venture acquired the rights to market a television miniseries and paperback books modeled after Clancy's novels.[87] Another author was hired to write "Clancyesque" books.[88] After the marital separation, Clancy withdrew his permission to have the joint venture use his name in marketing future books, a decision that had the effect of reducing the partnership's share of the joint venture profits from 75% to 25%.[89] King initiated a lawsuit alleging that Clancy breached his fiduciary duty to her.[90] The trial court ruled in King's favor and the intermediate appellate court affirmed. The Court of Appeals of Maryland—the highest court in the state—reversed.[91]

The court scrutinized the limited partnership agreement and ultimately focused on the agreement, rather than on the existence of fiduciary duties. It took the position that traditional fiduciary duties had been modified and that under the terms of the partnership agreement, Clancy had the discretion to withdraw permission to use his name in connection with the joint venture, so long as the decision was not made in bad faith.[92] The Court of Appeals of Maryland redefined the issue as whether Clancy had violated the implied covenant of good faith and fair dealing by withdrawing permission to use his name in the joint venture.[93] The

83. Clancy v. King, 954 A.2d 1092, 1095–97 (Md. 2008).
84. *Id.* at 1095.
85. *Id.*
86. *Id.* at 1099.
87. *Id.* at 1095–96.
88. *Id.* at 1096.
89. *Id.* at 1097 & n.8.
90. *Id.* at 1097.
91. *Id.* at 1111.
92. *See id.* at 1101–04, 1106, 1109–11.
93. *Id.* at 1110 ("Clancy only needed to act in good faith toward his business partners, even if such actions actually were adverse to the interests of [the limited partnership].").

court quite appropriately appreciated the context in which the implied covenant of good faith arose. It observed that Clancy may not act to impair the value of the joint venture to the partnership "out of personal spite" toward his former wife and business partner.[94] In so doing, the court cited several other decisions indicating that the exercise of contractual discretion could not be exercised to injure either a firm, venture, or business partner, and that it must be reasonable.[95] Ultimately, the court properly remanded the case to determine if Clancy acted in bad faith for purposes of obtaining personal retribution.[96] It was careful to point out, however, that the issue was not whether the defendant had acted in the best interests of the partnership, since "[a] fiduciary, under appropriate circumstances, may acquire and enforce legal rights against the firm for which he or she serves as a fiduciary."[97]

In contrast to the context of *Airborne*, the situation in *Clancy* presented little opportunity for the parties to self-protect against the exercise of discretion in connection with the book franchise. Further, the history of the parties' relationship (i.e., their divorce) may have led the court to scrutinize the allegations of bad faith with greater care than it would have had the parties been engaged in a purely commercial, arms-length relationship. The contrast between the *Airborne* and *Clancy* cases illustrates the very different challenges that are presented as the implied covenant of good faith and fair dealing shifts from the impersonal commercial setting to the personal relational context, with all of its subtleties and complexities.

B. Hopeful Directions Recognizing the Important Role of the Implied Covenant of Good Faith and Fair Dealing

Fortunately, several recent cases demonstrate the courts' appreciation for the context of the LLC dispute and the important role played by the implied covenant of good faith and fair dealing with regard to the exercise of discretion under an LLC operating agreement. For example, in *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, the plaintiff contended that the defendant, Emery Bay PKI, violated the implied covenant of good faith and fair dealing by failing to require that its affiliate perform mandatory managerial duties.[98] The defendants had allegedly renegotiated a loan that diverted cash flow from the parties' joint project, thus avoiding the trigger of a personal guarantee and capital calls.[99]

94. *Id.* at 1109.
95. *See id.* at 1107–08.
96. *Id.* at 1110–11.
97. *Id.* at 1104.
98. Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451, at *6–7 (Del. Ch. Apr. 20, 2009).
99. *Id.* at *9–10.

Further, legitimate claims against the managing affiliate were not pursued by the defendant. The court held that the allegations concerning the diversion of funds and self-interested refusal to pursue claims against the affiliate were sufficient to withstand a motion to dismiss on the grounds that the defendant violated the implied covenant of good faith.[100]

Thus, although the Delaware Chancery Court does not endorse a broad interpretation of the implied covenant of good faith, it is willing to imply a violation of the implied covenant of good faith in the face of specific acts or omissions that have the effect of denying the plaintiff the benefit of the bargain.[101]

Similarly, in *ULQ, LLC v. Meder*, the sole LLC manager was the seventy-percent majority owner and had appointed the plaintiff, a ten-percent owner of the LLC, to manage its debt collection business.[102] The LLC operating agreement provided that a manager could be removed with or without cause whenever it was in the best interest of the LLC.[103] After being terminated by the manager for allegedly abusing other employees, the plaintiff sued the LLC, arguing that he was removed in breach of the LLC operating agreement.[104] The plaintiff argued that he was terminated in bad faith in order to benefit the remaining investors because at the time, his interest could be purchased at no cost by the other members.[105] The appellate court affirmed the trial court's denial of the defendant's request for summary judgment on the implied covenant of good faith claim.[106] The appellate court emphasized that the LLC operating agreement had not given the LLC absolute, uncontrolled discretion to dismiss an officer, emphasizing that under Georgia law, every contract imposed a duty of good faith and fair dealing.[107] It further noted that where the manner of performance is more or less discretionary, the parties are bound by good faith.[108]

III. THE ROLE OF ACADEMICS

It is critically important for LLC internal governance law to develop in a way that brings fairness and efficiency to all segments of the business community, rather than just the most affluent sectors or just management. To this end, it is important for academics to stay involved in the development of LLC internal

100. *Id.* at *10.

101. It should be noted, however, that the opinion in *Bay Center* was delivered at an early stage of litigation and should be followed with care.

102. ULQ, LLC v. Meder, 666 S.E.2d 713, 715–16 (Ga. Ct. App. 2008).

103. *Id.* at 715.

104. *Id.* at 716.

105. *Id.*

106. *Id.* at 721.

107. *Id.* at 717 (citing Hunting Aircraft v. Peachtree City Airport, 636 S.E.2d 139, 139–41 (Ga. Ct. App. 2006)).

108. *Id.*

governance law. The impact of the law on the small business entrepreneur and on those who do not have legal counsel should not be overlooked. The business community is comprised of a multitude of businesses—not just those that are represented by transactional lawyers at prominent law firms who have an interest in skewing the law toward the highly negotiated contract.

Empirical research should be expanded to provide data to inform decisions regarding LLC legislation. Stronger ties between law and business schools are recommended, as are expanded initiatives to foster ethics training in both business and law schools.

CONCLUSION

This Article has explored how legal realism and an appreciation of the human context of LLC relationships can improve internal governance law applicable to alternative business entities. Legal realism looks to real-life contexts to assess the implications of competing legal approaches. Although far from conclusive, empirical data suggests that the contractual playing field for controlling investors and minority investors may not be level. Such disparities may well justify mandatory limits on the alteration of traditional fiduciary duties. In jurisdictions where traditional fiduciary duties may be eliminated, the contractual context continues to be important in determining whether there has been a breach of the covenant of good faith and fair dealing. The sophistication of the parties, the nature and scope of past understandings, common usage in the industry, and the type of transaction involved all help determine whether a violation of the covenant of good faith has occurred. In the end, academics have a unique role to play in evaluating and improving legal doctrines governing the majority-minority relationship in alternative business entities. Because the financial interests of academics are arguably independent of particular segments of the legal and business communities, academics may be in the best position of all to ensure that the law develops fairly to fully protect all members of the community, and not just the most affluent and influential segments.