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THE SIREN SONG OF UNLIMITED CONTRACTUAL FREEDOM

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Abstract

One frequently cited distinction between alternative entities — such as limited liability companies and limited partnerships — and their corporate counterparts is the greater contractual freedom accorded alternative entities. Consistent with this vision, discussions of alternative entities tend to conjure up images of arms-length bargaining similar to what occurs between sophisticated parties negotiating a commercial agreement, such as a joint venture, with the parties successfully tailoring the contract to the unique features of their relationship.

As judges who collectively have over 20 years of experience deciding disputes involving alternative entities, we use this chapter to surface some questions regarding the extent to which this common understanding of alternative entities is sound. Based on the cases we have decided and our reading of many other cases decided by our judicial colleagues, we do not discern evidence of arms-length bargaining between sponsors and investors in the governing instruments of alternative entities. Furthermore, it seems that when investors try to evaluate contract terms, the expansive contractual freedom authorized by the alternative entity statutes hampers rather than helps. A lack of standardization prevails in the alternative entity arena, imposing material transaction costs on investors with corresponding effects for the cost of capital borne by sponsors, without generating offsetting benefits. Because contractual drafting is a difficult task, it is also not clear that even alternative entity managers are always well served by situational deviations from predictable defaults.

In light of these problems, it seems to us that a sensible set of standard fiduciary defaults might benefit all constituents of alternative entities. In this chapter, we propose a framework that would not threaten the two key benefits that motivated the rise of LPs and LLCs as alternatives to corporations: (i) the elimination of double taxation at the entity level and (ii) the ability to contract out of the corporate opportunity doctrine. For managers, this framework would provide more predictable rules of governance and a more reliable roadmap to fulfilling their duties in conflict-of-interest situations. The result arguably would be both fairer and more efficient than the current patchwork yielded by the unilateral drafting efforts of entity sponsors.

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The Siren Song of Unlimited Contractual Freedom

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One frequently cited distinction between alternative entities — such as limited liability companies and limited partnerships — and their corporate counterparts is the greater contractual freedom accorded alternative entities. Eschewing the supposedly rigid mandatory default rules that characterize American corporate law statutes, the statutes that authorize alternative entities declare as public policy the goal of granting the broadest contractual freedom possible,¹ and permit the parties to the governing instrument to waive any of the statutory or common law default principles of law and to shape their own relationships.

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¹ See 6 *Del. C.* § 17-1101(c) (“It is the policy of [the Limited Partnership Act] to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.”); 6 *Del. C.* § 18-1101(b) (“It is the policy of [the LLC Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”); see also 12 *Del. C.* § 3825(b) (“It is the policy of [the Trust Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of governing instruments”); *PHL Variable Ins. Co. v. Price Dawe Ins. Trust*, 28 A.3d 1059, 1077 (Del. 2011) (The policy of the Delaware Statutory Trust Act is to give maximum effect to freedom of contract); *Olson v. Halvorsen*, 986 A.2d 1150, 1160 (Del. 2009) (“The Delaware LLC Act seeks to give maximum effect to the principle of freedom of contract” (internal quotation marks omitted)); *Elf Atochem N. Am. v. Jaffari*, 727 A.2d 286, 290 (Del. 1998) (“The Delaware [LLC] Act has been modeled on the popular Delaware LP Act. . . . The policy of freedom of contract underlies both the [LLC] Act and the LP Act.”). See generally MARTIN I. LUBAROFF & PAUL M. ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS § 1.2 (1995 & 2010 Supp.) [hereinafter LUBAROFF & ALTMAN].

Consistent with this vision, discussions of alternative entities tend to conjure up images of bargaining similar to what occurs between sophisticated parties bargaining over a commercial agreement, such as a joint venture or licensing agreement, with the parties tailoring a contract to the unique features of their relationship. As judges who collectively have over 20 years of experience deciding disputes involving alternative entities, we use this essay to surface some questions regarding the extent to which this common understanding of alternative entities is sound. In particular, we question whether this understanding diverges from reality in precisely the context in which it is most important: namely, when alternative entities are used as vehicles to raise capital, either directly from ordinary investors or from accredited investors such as pension funds, universities, or foundations.

Based on the cases we have decided and our reading of many other cases decided by our judicial colleagues, we do not discern evidence of arms-length bargaining between the sponsors of the alternative entities and the investors in the governing instruments of alternative entities that raise capital from diverse investors. Rather, these governing instruments seem to be drafted unilaterally by the sponsors and proposed on a take-it-or-leave-it basis to the investors.² Furthermore, these governing instruments — which contain unique provisions that lead to *ad hoc* judicial decisions interpreting specific

² Our anecdotal impressions on the limited extent of actual bargaining correspond to the results of a literature survey. See Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. Corp. L. 295, 317, 323 (2014) (surveying empirical literature on the extent of actual bargaining and finding at best mixed evidence with strong indications of a lack of bargaining in publicly traded alternative entities).

provisions that provide no predictability in future cases — are often poorly drafted and unclear, leading to increased litigation costs and inefficiencies for all parties.

Among the hallmarks of these agreements are broad waivers of all fiduciary duties, including the duty of loyalty.³ Traditionally, the duty of loyalty provided the most meaningful protection to passive investors in corporations and partnerships. Yet at the same time the alternative entity agreements eliminate this bedrock protection, they also fully utilize the expansive contractual freedom authorized by alternative entity statutes to grant managerial discretion.⁴ In approaching these entities, investors therefore cannot rely on their understandings of default principles of law. Instead, they must evaluate entity-specific provisions, ostensibly bargained for on an investment-by-investment basis to protect their interests, and then practice *caveat emptor* by foregoing entities whose governing instruments are too unfavorable. But because bargaining, at best, occurs only

³ Our anecdotal experience corresponds to the results of two empirical studies of the governing agreements of publicly-traded Delaware alternative entities. See Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Entities*, 38 J. Corp. L. 53 (2013); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. Corp. L. 555 (2012) [hereinafter *Evidence*]. Professor Horton finds that 29.41% of LLCs and 57.97% of limited partnerships, representing cumulatively 52.32% of the publicly available agreements reviewed, eliminate all fiduciary duties. Horton, *supra*, at 94. He finds that 47.06% of LLCs and 94.20% of limited partnerships, representing cumulatively 84.88% of the publicly available agreements reviewed, use a contractual “Special Approval” mechanism as the primary protection for interested transactions. *Id.* We discuss the Special Approval mechanism below. Professor Manesh reaches similar results. *Evidence, supra*, at 558 (“Of the 85 firms studied, 75 (or 88%) either totally waive the fiduciary duties of managers or eliminate liability arising from the breach of fiduciary duties.”). He concludes that “the use of fiduciary waiver and exculpation provisions among publicly traded Delaware alternative entities is widespread.” *Id.* at 556. He also finds that “publicly traded alternative entities have either not adopted unincorporate substitutes [for fiduciary protections] or adopted unincorporate substitutes that only trivially constrain managerial discretion.” *Id.* Like us, he infers that sponsors “have largely utilized the freedom of contract to reduce managerial accountability to investors without committing to significant offsetting constraints on managerial discretion.” *Id.*

⁴ See *Evidence, supra* note 3, at 558.

sometimes, and because it is difficult to participate in certain sectors other than through alternative entities, the practical alternatives for a skeptical investor are often stark: invest without adequate protection against self-dealing or avoid the asset class altogether.

Ironically, when investors try to evaluate contract terms, the expansive contractual freedom authorized by the alternative entity statutes hampers rather than helps. Precisely because the statutes lack mandatory terms and permit great flexibility, a profusion of provisions abounds. Unlike corporate certificates of incorporation and bylaws, which are relatively short, alternative entity agreements typically contain ninety-plus pages of dense, complex, and heavily cross-referenced legalese. To digest the contractual prose, the reader must decode multi-layered sentences, incorporate the meaning of defined terms, and be constantly on the watch for more specific provisions elsewhere in the agreement or language that applies “notwithstanding anything to the contrary.” Even when language appears familiar, it often departs subtly from the precise terms interpreted in earlier judicial opinions — and intentionally so. Alternative entity drafters are sophisticated, and they respond quickly to judicial constructions by tweaking or rewriting their provisions. Judicial decisions on alternative entity agreements therefore tend to be *ad hoc* interpretations of specific provisions that do little to advance the development of common understandings among market participants. Because they turn on contractual clauses that frequently differ from case to case, the decisions produce few general principles that could lead to predictable and reliable practices.

Interestingly, because contractual drafting is a difficult task, it is also not clear that even alternative entity managers are always well served by situational deviations from

predictable defaults. Different language sets up the possibility of a different result, creating opportunities for litigation that otherwise might not exist. Greater complexity also increases the possibility for human error, conflicting contractual provisions, and ambiguity, all of which can leave alternative entity managers potentially exposed. The difficulties drafters have in substituting their own bespoke provisions for the equitable principles that have been forged by cases over centuries should not be surprising. After all, these equitable principles emerged in large measure to address the situations involving the exercise of authority by one person over another's property that could not be effectively addressed by contracting.

In light of these problems, it seems to us that a sensible set of standard fiduciary defaults might benefit all constituents of alternative entities. Under this framework, the governing agreement would presumptively waive the investors' ability to hold managers liable for money damages for breaches of the duty of care, while presumptively retaining the traditional fiduciary duty of loyalty. For publicly-traded entities the duty of loyalty would be non-waivable.⁵ The requirement of a non-waivable duty of loyalty in these settings would promote investor confidence, create a predictable body of case law, and enable contract drafters to simplify the tangled web of provisions that currently attempts to substitute for traditional duty-of-loyalty analysis. The framework would not threaten

⁵ Perhaps it would also be beneficial if the duty of loyalty were non-waivable for private entities with a diverse set of investors, in a manner akin to the way that the Securities Exchange Act imposes registration requirements on an issuer whose securities are held by certain number of persons and whose total assets have crossed a certain threshold amount. *Cf* 15 U.S.C.A. § 78l(g) (requiring issuers with assets exceeding \$10,000,000 and a class of equity security held by either 500 persons who are not accredited investors or 2,000 persons to register that security with the SEC).

the two key benefits that motivated the rise of LPs and LLCs as alternatives to corporations: (i) the elimination of double taxation at the entity level and (ii) the ability to contract out of the corporate opportunity doctrine. For managers, it would provide more predictable rules of governance and a more reliable roadmap to fulfilling their duties in conflict-of-interest situations. The result arguably would be both fairer and more efficient than the current patchwork yielded by the unilateral drafting efforts of entity sponsors.

The Motivations For Forming Alternative Entities

To many familiar with the traditional form of American business entity — the corporation — it is likely not apparent why there would be a market demand for alternative entity statutes authorizing complete freedom of contract. After all, American corporate law statutes have few mandatory requirements, particularly when compared to other nations' corporate law statutes. The Delaware General Corporation Law, which has emerged as the market leader, is “broadly enabling”⁶ and designed to facilitate individual tailoring rather than “one-size-fits-all” solutions. Thus, the notion that American corporate statutes contain burdensome and non-waivable provisions that hamper managerial effectiveness is not an intuitively obvious one. To the contrary, the DGCL and its counterparts predominantly offer default rules that can be altered through private ordering via the corporation's certificate of incorporation and bylaws.

⁶ *Williams v. Geier*, 671 A.2d 1368, 1381 (Del. 1996) (“At its core, the Delaware General Corporation Law is a broadly enabling act which leaves latitude for substantial private ordering”); see also Leo E. Strine, Jr., *Delaware's Corporate Law System*, 86 Cornell L. Rev. 1257, 1260 (2001) (describing the DGCL as “largely enabling” and as creating “a wide realm for private ordering”).

Indeed, the primary justification for alternative entity statutes had nothing at all to do with avoiding corporate statutory requirements. Rather, the primary justification for the development of alternative entity statutes was (and remains) minimizing taxes.⁷ Because the federal tax code taxes corporate earnings at both the entity and investor level, but does not impose taxes at the entity level for pass-through entities like traditional general partnerships, the latter have a huge advantage when delivering cash flows to investors. Once it became settled that LPs and LLCs could receive pass-through tax treatment, alternative entities began their meteoric rise in popularity.⁸ Differential tax treatment cannot be blamed on poorly drafted corporate statutes, because none of the mandatory provisions in the corporate codes gives rise to the differential tax regime. The distinction is merely an artifact of federal tax policy.

Of course, there is one important secondary reason why some managers have preferred alternative entities that can be traced to an aspect of corporate law: a desire to

⁷ See Rodney D. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 *Fordham J. Corp. & Fin. L.* 459, 465-66 (2010) (describing tax-driven origins of alternative entity statutes); accord SYMONDS & O'TOOLE, *DELAWARE LIMITED LIABILITY COMPANIES* § 1.01 (2012) (explaining that the 1998 IRS ruling clarifying that limited liability companies qualified for the favorable "pass-through" income taxation given to partnerships spurred the enactment of the Delaware Limited Liability Company Act and the popularity of limited liability companies) (*citing* Rev. Rul. 88-76, 1998-2 C.B.); *Evidence*, *supra* note 3, at 573 ("Firms utilizing the alternative entity form, over the corporate form, do so chiefly because of the favorable 'pass-through' partnership tax treatment that is afforded to alternative entities."). At present, the only meaningful restriction on further increases in the number of publicly traded alternative entities is a continuing limitation of pass-through tax treatment to entities whose income is purely passive, usually firms operating in the oil and gas industry. Horton, *supra* note 3, at 94-95.

⁸ Chrisman, *supra* note 7, at 466.

limit the risks posed by the corporate opportunity doctrine.⁹ The corporate opportunity doctrine was something sponsors wished to avoid because it was seen as inhibiting to the ability of entity sponsors. The idea, as we understand it, went like this. A sponsor operating in a particular industry, such as the energy arena, wishes to raise capital from investors for a particular project, such as exploiting a natural gas field. The sponsor wishes to form an entity for that particular project. The sponsor does not want the entity to have a claim to all future opportunities in the natural gas industry that might come to the sponsor's attention. The sponsor fears that if the project was pursued using a corporation, and the sponsor then identified other natural gas opportunities, such as fields in the same region, the corporation's stockholders could sue the sponsor for breach of the duty of loyalty under the theory that the corporate opportunity doctrine required the sponsor to pursue the other opportunities through the corporation. To address this concern, the drafters of alternative entity statutes decided that it would be prudent to

⁹ See Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. Corp. L. 295, 306 (2014) (explaining the need in some businesses for corporate opportunity protection). For the classic statement of the corporate opportunity doctrine, see *Guth v. Loft, Inc.*, 5 A.2d 503, 272-73 (1939) (“[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation’s business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.”); Eric Talley, *Turning Servile Opportunities to Gold: A Strategic Analysis of the Corporate Opportunities Doctrine*, 108 YALE L. J. 277, 279 (1998) (explaining that the corporate opportunity doctrine is “the law’s attempt to regulate circumstances in which a corporate officer or director may usurp new business prospects for her own account without first offering them to the firm. The doctrine — a subspecies of the fiduciary duty of loyalty — has been a mainstay in the corporations law of virtually every state for well over a century.”).

permit the entity's governing agreement to restrict or limit the fiduciary duties that the managers of the entity might otherwise owe.¹⁰

As a policy basis for using alternative entities, this does not seem to us to be all that substantial. The case law under the corporate opportunity doctrine hardly suggested that the doctrine provided a genuine basis for fear for any entity manager that proceeded in a careful and thoughtful manner. But for present purposes, what is most important is that this policy basis was rapidly addressed by corporate drafters themselves. In 2000, for example, the DGCL was amended specifically to provide a safe harbor against corporate opportunity claims through the inclusion of a provision in the Certificate of Incorporation renouncing any interest of the corporation in any business opportunities that are presented to the corporation's officers or directors.¹¹ Thus, to the extent the corporate opportunity doctrine might once have tipped the scales in favor of alternative entities, it no longer should.

Another argument often made in favor of alternative entity statutes is that they allow for the elimination of fiduciary duties and the establishment of a purely contractual relationship between entity managers and investors.¹² As judges who have seen our fair share of alternative entity disputes, we do not immediately grasp why this would be seen

¹⁰ *See, e.g.*, 6 *Del. C.* § 18-1101(c) (“To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement”).

¹¹ 8 *Del. C.* § 122(17).

¹² *See generally Evidence, supra* note 3, at 562-63 (summarizing and contrasting the positions of the “fiduciary traditionalists” with the “contractarians,” who argue that private parties should be able to contractually modify and fully eliminate fiduciary duties).

as a compelling advantage. Fiduciary duties emerged as a non-waivable common law overlay in the corporate area because the statutory drafters recognized the difficulty of developing provisions that would provide an efficient and fair path forward in all of the diverse circumstances that businesses confront. Wishing to avoid the prescriptive codes common in civil law nations, American corporate law drafters took an enabling approach with relatively few, albeit very important, statutory requirements and relied upon the judicial enforcement of fiduciary duties to ensure fairness. Moreover, through the business judgment rule, equity itself was mindful of the need for managers to have the flexibility to innovate and the incentives to take good faith risks in the pursuit of profit, and thus of efficiency concerns.

Delaware's experience in the 1960s with a comprehensive revision of the DGCL illustrates this approach. That revision was undertaken with the guidance of one of America's leading corporate scholars, Ernest Folk of the University of Virginia, and with input from prominent corporate lawyers from across the nation. At the time, American courts and corporate practitioners had nearly a century of experience working with the combination of general corporation statutes and the equitable overlay of fiduciary duties. The distinguished group of experts who carefully examined and rewrote the DGCL, section by section, had the opportunity to craft statutory language that, if followed, would conclusively resolve the competing interests of managers and investors and foreclose any judicial inquiry under equitable principles. They declined to take that approach, recognizing that a rigid set of statutory rules could not properly balance the interests of managers and investors and achieve both efficiency and fairness across the diverse and

ever-changing circumstances that corporations face in a dynamic economy. They opted instead to maintain corporate law's two-fold tradition: first, a broadly enabling statute that nevertheless contains important and fairness-enhancing mandatory rules, such as requirements for the regular election of directors, stockholder votes on major transactions like mergers and sales of substantially all assets, and a stockholder right to access corporate books and records for a proper purpose; and second, an equitable overlay of fiduciary duties, enforced primarily by the ability of stockholders to sue directors in the courts for breach of their duty of loyalty.¹³

To date, the best minds in corporate law continue to think this policy balance is the sensible one, because it remains difficult to craft more specific statutory language that will balance efficiency and fairness concerns as effectively as an approach that uses an equitable overlay of fiduciary duties in combination with a more flexible enabling statute. The corporate bar is diligent, savvy, and market-sensitive. The corporate bar regularly proposes statutory changes when a consensus emerges on a more effective method for authorizing corporate action or when a judicial decision or other development focuses attention on a new area. Yet despite decades of effort, the corporate bar has yet to propose, much less achieve, an all-encompassing statute that obviates the need for fiduciary duties. Given the diligence and expertise of the corporate bar, it hardly seems

¹³ See *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437, 439 (Del. 1971) (“[I]nequitable action does not become permissible simply because it is legally possible.”); Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) (“[I]n every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a *cestui que trust* to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.”).

likely that some obvious solution is waiting to be found. Nor does it seem likely that a perfectly anticipatory code could be drafted if only we had a better class of scribes.

The corporate experience makes us skeptical that the drafters of the governing instruments of alternative entities are likely to have greater success in attempting to provide contractually for all reasonably conceivable circumstances. It takes only a moderate degree of self-awareness and modesty to recognize that the human mind cannot foresee every potential situation that could arise after contracting. All contracts necessarily will be incomplete. But assuming that drafters could anticipate all future states of the world, a fully complete contract still would be beyond the parties' power. After all, contracting is costly. Trying to identify, negotiate, and draft language to address every eventuality would take so much time and require such a large investment of resources that the deal itself would never happen. To top it off, language is an inexact instrument. No matter how carefully the drafters draft, complex provisions in commercial agreements inevitably produce degrees of vagueness and areas of ambiguity, and the potentially different interpretations are particularly likely to be found by lawyers who are reading purposefully for arguments to make for their clients in the context of a specific dispute. By definition, the cases that are litigated will be those where skilled advocates can argue plausibly for competing interpretations; otherwise the case would not be brought. And we have not yet introduced the simple possibility of human error, either by the drafters, the party-interpreters, or the judge deciding the case. Sadly, the

normative ideal of rational parties contracting efficiently to allocate risks is just that — an ideal.¹⁴

It seems to us, therefore, that of the three major motivations for preferring alternative entities to corporations, two are canards. The overarching dream of a complete contract cannot be realized in a world of human frailty, and the specific manifestation of contracting around the corporate opportunity doctrine can be readily achieved in the corporate form. Only the tax code remains as a meaningful advantage, and achieving favorable tax treatment does not require complete freedom of contract. Therefore we will not run afoul of a core purpose of the alternative entity vehicle by positing that some degree of standardization could well be desirable.

The Contradictory Complexity of the “Market Standard” for Conflict-of-Interest Transactions

To suggest that entities designed to raise capital from diverse investors benefit from a degree of standardization is hardly heretical. Standardization reduces transaction costs and facilitates trading in liquid markets.¹⁵ Although we do not pretend to have done a comprehensive review of the alternative entity cases, much less of the key provisions of

¹⁴ An extensive scholarly literature discusses the impossibility of complete contracting. For an accessible introduction to the area that focuses on Delaware alternative entities, see Mohsen Manesh, *Express Contract Terms and the Implied Contractual Covenant of Delaware Law*, 38 J. Corp. L. 1 (2013).

¹⁵ See E. ALLEN FARNSWORTH, *CONTRACTS* § 4.26 (3d. ed. 2004) (noting that standardization in contracts reduces costs and risks); see also Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, passim & 763 (1997) (discussing the benefits of standard contract terms and explaining that an “[w]hen a firm incorporates in a particular state, it adopts that state's mandatory corporate law rules, and it adopts any or all of that state's default terms by choosing not to customize an alternative term. In effect, these rules operate as standard contract terms: they are the same for all firms that adopt them, and many firms do in fact adopt them.”).

the governing instruments of a statistically significant sample of alternative entities, our profession requires us to read a large number of decisions in which we and our judicial colleagues undertake the daunting task of deciphering alternative entity agreements that routinely run for ninety-plus pages. It appears to us that lack of standardization prevails in the alternative entity arena, imposing material transaction costs on investors with corresponding effects for the cost of capital borne by sponsors. And it is not clear to us that contractual freedom has generated offsetting benefits.¹⁶ To illustrate the problem we see, we will focus on the provisions used to simultaneously empower and constrain decision making by the general partner of an LP or its LLC analog, the managing member. For simplicity, we use the language of the LP, where most litigation has occurred to date, even though LLCs now predominate.¹⁷

A major difficulty facing alternative entity investors is the illusion of familiarity and the reality of divergence. A degree of surface-level standardization has begun to occur, with alternative entity agreements coalescing around particular features and concepts. At present, however, this superficial standardization is overwhelmed by diversity in implementation, which limits the efficacy of precedent and creates fertile opportunities for future litigation. Moreover, as exemplified by the decision-making

¹⁶ Professor Horton reports that Moody's raised the risk profile for twenty-six publicly traded limited partnerships that it monitors, relative to public corporations with comparable financial metrics, because of the ability of alternative entity agreements to waive or limit fiduciary protections and the widespread use of such provisions. Horton, *supra* note 3, at 59.

¹⁷ See Rodney D. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 Fordham J. Corp. & Fin. L. 459 (2010) (documenting explosive growth of LLCs and their prevalence relative to other alternative entities and corporations).

provisions in publicly-traded master limited partnerships (MLPs), the contractual provisions that drafters use are mind-numbingly complex. Having repeatedly engaged in the head-hurting task of parsing these provisions, we believe that to the extent a “market standard” exists for conflict transactions in the alternative entity space, it is an odd and arguably ineffective one.¹⁸

The following provisions roughly illustrate the pattern we see. The agreement starts by broadly eliminating all duties other than contractual duties.¹⁹ A typical provision states:

Except as expressly set forth in this Agreement, neither the General Partner nor any other Indemnitee shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner or Assignee and the provisions of this Agreement, to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of the General Partner or any other Indemnitee otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of the General Partner or such other Indemnitee.

The term “Indemnitee” is usually defined broadly to include the General Partner, “any Person who is or was an Affiliate of the General Partner,” and “any Person who is or was a . . . director . . . of . . . the General Partner,” thereby covering all potential defendants.²⁰

¹⁸ Professor Horton remarks on the complicated nature of operating agreements and the fact that “[a] provision often takes on a different meaning once the reader considers cross-references and defined terms.” Horton, *supra* note 3, at 83. He notes that “[s]imilar provisions in two agreements can lead to different results, and it would be a work of folly to attempt to explain every possible permutation.” *Id.* Like us, he also notes that the agreements “are remarkably similar in structure and language. By way of example, the fiduciary elimination provision (to the extent there is one) is almost always contained in Section 7.9 . . . , regardless of the law firm that drafts it, and the agreements use language that is remarkably similar” *Id.*

¹⁹ Professor Manesh found that out of 85 publicly traded Delaware alternative entities in existence in June 2011, 42 (49%) fully eliminated fiduciary duties. *Evidence, supra* note 3, at 575.

This provision has a few notable features. Most importantly, it purports to replace all duties that otherwise would be owed to investors with contractually-specified duties. The agreements tend to preserve only portions of the traditional duty of loyalty. In traditional corporate law, one of the bottom law duties is the duty that a self-dealing transaction be fair to the corporation. Although a great deal of complexity has been introduced over the years into that doctrine — e.g., procedural means such as a majority of the minority vote that can have an effect on the doctrine’s application — in its pure form, the doctrine subjected an interested fiduciary to liability even if the fiduciary acted in good faith unless the transaction was substantively fair to the corporation.²¹

Most LP agreements now eliminate this scienter-free aspect of the duty of loyalty and leave in its place a liability standard that exposes LP managers and others who would traditionally be considered fiduciaries to the LP to liability only if they act in subjective bad faith.²² In fact, these agreements often go further and cut off any inquiry into the

²⁰ There are agreements, however, that omit particular parties, leaving them exposed to traditional fiduciary duty claims. We suspect these omissions are examples of the human errors that inevitably creep in during any lengthy drafting assignment (including the preparation of judicial opinions). Other agreements do not clearly and explicitly eliminate fiduciary duties but rather rely on detailed contractual provisions to displace fiduciary standards. *See Horton, supra* note 3, at 74 (discussing cases in which provisions failed to include particular defendants or claimants); *Evidence, supra* note 3, at 576 (finding that 43 out of 85 firms do not eliminate fiduciary duties but provide broad exculpation for all fiduciary duty claims).

²¹ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (“The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.”) (*citing Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952)).

²² *See, e.g., Brinckerhoff v. Enbridge Energy Co., Inc.*, 2011 WL 4599654, at *8 (Del. Ch. Sept. 30, 2011) (interpreting a limited partnership agreement that included a provision stating: “[n]otwithstanding anything to the contrary set forth in this Agreement, no Indemnitee shall be liable for monetary damages to the Partnership, the Limited Partners, the Assignees or any other

good faith of an interested fiduciary by stating that the use of certain procedures or the existence of certain conditions dispositively resolves any question about the validity or fairness of a transaction and immunizes the interested fiduciary from liability.²³

Another feature of this provision is that it fails to define exactly who owes these contractual duties and to whom they are owed. Presumably the duty to carry out a contractual obligation is owed in the first instance by the party whom the contract designates to carry out the obligation.²⁴ But in an alternative entity, the manager of the LLC or the general partner of the LP, as the case may be, ultimately is responsible for ensuring that the entity carries out its obligations. In other words, the contractual standard does not address the concept of oversight, which is a familiar one in corporate law. The duty to carry out a contractual obligation is likewise presumably owed to the counterparties under the contract, who can therefore sue for breach. The contractual

Persons who have acquired interests in the Units, for losses sustained or liabilities incurred as a result of any act or omission if such Indemnitee acted in good faith.”).

²³ For example, the LLC agreement at issue in *In re Atlas Energy Resources, LLC*, included a provision that which provided that:

[W]henever a potential conflict of interest exists or arises between any Affiliate of the Company, on the one hand, and the Company or any Group Member, on the other, any resolution or course of action by the Board of Directors in respect of such conflict of interest shall be permitted and deemed approved by all Members, and shall not constitute a breach of this Agreement ... or of any duty existing at law, in equity or otherwise, including any fiduciary duty, if the resolution or course of action in respect of such conflict of interest is (i) approved by Special Approval, (ii) approved by the vote of holders of a majority of the Outstanding Common Units (excluding Common Units held by interested parties), (iii) on terms no less favorable to the Company than those being generally available to or available from unrelated third parties or (iv) fair and reasonable to the Company, taking into account the totality of the relationships between the parties involved (including other transactions that may be particularly favorable to the Company).

2010 WL 4273122, at *7 (Del. Ch. Oct. 28, 2010).

²⁴ *Gotham P’rs, L.P. v. Hallwood Realty P’rs, L.P.*, 817 A.2d 160, 172 (Del. 2002) (“It is a general principle of contract law that only a party to a contract may be sued for breach of that contract.”).

standard does not address whether the appropriate enforcer of contractual duties is the entity itself or the diverse limited partners and their assignees. Put differently, the contractual standard does not address the distinction between direct and derivative actions, also familiar in corporate law and one which alternative entity defendants regularly raise.

At the same time that the standard provision eliminates all but contractual duties, the agreements often contain indemnification and exculpation provisions that suggest the duties may continue. For example, in a case where the defendants argued vigorously that they owed no duties other than contractual duties, the indemnification provision stated:

The General Partner, [the manager of the General Partner], each of their respective directors, members, partners, shareholders, officers, employees, agents and affiliates . . . (each an “Indemnitee”) shall be indemnified and held harmless by the Partnership to the fullest extent legally permissible under and by virtue of the laws of the State of Delaware, as amended from time to time, from and against any and all loss, liability and expense (including, without limitation, losses due to trade errors caused by such persons, judgments, fines, amounts paid or to be paid in settlement and reasonable attorney’s fees and expenses) incurred, or suffered by the Indemnitee in connection with the good faith performance by the Indemnitee of his, her or its responsibilities to the Partnership *provided, however, that an Indemnitee shall not be indemnified for losses resulting from his, her or its gross negligence, willful misconduct or violation of applicable laws . . .*²⁵

In the corporate context, gross negligence is the traditional standard for pleading and later proving a breach of the fiduciary duty of care when the standard of review is the business

²⁵ *Paige Capital Mgmt., LLC v. Lerner Master Fund LLC*, 2011 WL 3505355, at *42 (Del. Ch. Aug. 8, 2011) (emphasis added); *accord Lazard Debt Recovery GP, LLC. v. Weinstock*, 864 A.2d 955, 975-76 (Del. Ch. 2004) (discussing alternative entity agreement that eliminated fiduciary duties but contained a carve-out to exculpation for loss or damage “due to willful misconduct, bad faith, or gross negligence of the General Partner”).

judgment rule.²⁶ To include the concept of gross negligence as a basis for indemnification suggests that common law fiduciary duties persist.²⁷ In other words, the inclusion of such a provision provides a basis for arguing that the manager of the entity can be sued for a breach of the duty of care, notwithstanding the otherwise broad waiver of fiduciary duties in the governing agreement, which typically includes severe limitations on the traditional duty of loyalty. As might be expected, the decisions generated when provisions of this type have come into play in real world challenges by investors of conflict transactions implemented by alternative entity managers yield little in the way of general principles of sound governance.

For starters, the structure of alternative entities and the provisions in their governing agreements have led to a particularly odd pattern of routine veil piercing. Most alternative entities have no human fiduciary. Rather, most limited partnerships have a general partner that is another business entity.²⁸ Likewise, most LLCs have a

²⁶ See *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

²⁷ Professor Manesh catalogs the various formulations of exculpatory provisions that he found in alternative entity agreements, including three that failed to exculpate for breaches of the duty of care and five that denied exculpation for conduct constituting gross negligence. See *Evidence*, *supra* note 3, at 576-78.

²⁸ See 6 *Del. C.* § 17-101(5) (“‘General partner’ means a person who is named as a general partner in the certificate of limited partnership or similar instrument . . . and who is admitted to the limited partnership as a general partner”); *id.* § 17-101(14) (“‘Person’ means a natural person, partnership (whether general or limited), limited liability company, trust . . . , estate, association . . . , corporation . . . or any other individual or entity (or series thereof)”). See generally Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. Small & Emerging Bus. L. 73 (1997) (discussing the origins and implications of corporate general partners).

managing member that is another business entity.²⁹ These governing fiduciaries are often corporations, and often have human beings who serve as directors.³⁰ Under traditional principles of entity law, so long as the governing fiduciary was well-capitalized and not a sham, it and it alone should owe fiduciary and contractual duties to the alternative entity and its investors. The governing fiduciary's own directors and investors should bear no direct liability to the alternative entity's investors unless those investors can satisfy the difficult task of piercing the governing fiduciary's corporate veil. But, those traditional principles of corporate law have been put to the side in the contractual world of alternative entities. Under *USACafes*³¹ and its progeny, it has become routine in Delaware and other states to treat the directors of the governing entity of an alternative entity as owing contractual and fiduciary duties directly to the alternative entity and its investors.³² The governing instruments of alternative entities do little to address this situation. Instead, they seem to assume that the individual fiduciaries of the governing

²⁹ See 6 Del. C. § 18-101(10) (“‘Manager’ means a person who is named as a manager of a limited liability company in, or designated as a manager of a limited liability company pursuant to, a limited liability company agreement or similar instrument under which the limited liability company is formed.”); *id.* § 18-101(12) (“‘Person’ means a natural person, partnership (whether general or limited), limited liability company, trust . . . , estate, association . . . , corporation, . . . or any other individual or entity (or series thereof) . . .”).

³⁰ Hamilton, *supra* note 28, at 85 (“[W]here limited partnerships are used today, it is the norm to use a corporation as the sole general partner.”).

³¹ *In re USACafes, L.P. Litig.*, 600 A.2d 43 (Del. Ch. 1991).

³² See, e.g., *Wallace v. Wood*, 752 A.2d 1175, 1180-81 (Del. Ch. 1999) (citing *USACafes* and finding that the directors of a corporate general partner owed fiduciary duties to the partnership and its limited partners); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners*, 2001 WL 1641239, at *8 (Del. Ch. Dec. 4, 2001) (holding that the affiliates of a general partner who exercise control over the limited partnership's assets may owe fiduciary duties to both the partnership and the limited partners).

entity will owe default fiduciary duties directly to the alternative entity and its investors and to then tailor those duties in the governing instrument.³³

Consistent with this analogy, the governing instruments tend to accord the so-called independent directors of the governing entity with a status similar to the status of corporate directors in the traditional public company corporate context. Thus, a corporate managing members' independent directors are often called on to approve conflict transactions between the managing member and the alternative entity, and that approval is given liability-limiting effect. But, of course, there is a fundamental difference that is elided. An independent director of a corporation is accorded that status precisely because she has no conflict of interest and is not subject to any material influence that would prevent her from acting solely in the best interests of the corporation and its stockholders *qua* stockholders and thus is well positioned to act to protect against any unfair proposals from managers who do suffer from conflicts of interests. But an independent director of a corporation that is a managing member of an LLC owes a fiduciary duty to act in that corporation's best interest, and is not in a direct fiduciary position as to the alternative

³³ For example, in *In re Encore Energy Partners LP Unitholder Litigation*, 2012 WL 3792997, at *7-8 (Del. Ch. Aug. 31, 2012), the Court of Chancery examined a limited partnership agreement which provided that "Except as expressly set forth in this Agreement, neither the General Partner nor any other Indemnitee shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner" The agreement defined Indemnitee to include any "Affiliate of the General Partner." Affiliate was, in turn, defined to include any person, including both natural persons and business entities, who had the power to direct or cause the direction of the management and policies of any other person. The Court of Chancery explained that construing the definition of affiliate in accordance with its literal terms meant that the directors of the General Partner were affiliates, and were therefore Indemnitees under the partnership agreement who owed those duties "expressly set forth in [the limited partnership agreement]" and "whatever nonwaivable default obligations the implied covenant of good faith and fair dealing imposes." See also *Gerber v. EPE Holdings, LLC*, 2013 WL 209658, at *6 (Del. Ch. Jan. 18, 2013) (interpreting similar provisions in the same manner).

entity and its investors.³⁴ Thus, the independent directors of a managing member of an LLC are placed in a conflict situation when they are employed to act to ensure that the managing member does not benefit itself at the unfair expense of the alternative entity.

We suppose that more imaginative minds than ours could connect this inherently conflicted status to the liability standards of the kind we have highlighted, and contend that the provisions that can be plausibly read as exposing these directors to the possibility of monetary damages liability for breaching their duty of care is a response to the inherent conflict they face. Perhaps an argument could be made that, by exposing them to liability against which most corporate directors are exculpated by use of a Section 102(b)(7) provision, alternative entity governing instruments provide a countervailing contractual fairness guarantee that corrects for the conflict faced by these fiduciaries. Likewise, by conditioning any liability-immunizing effect of the employment of certain procedural protections on their good faith use, alternative entity agreements could be providing a similar contractual check on this inherent conflict.

³⁴ See *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 2000 WL 1476663, at *19-20 (Del. Ch. Sept. 27, 2000) (explaining the structural conflict that exists when the directors of a corporate general partner owe fiduciary duties both to the corporate general parent and its owners and to the limited partnership and its unitholders); see also LUBAROFF & ALTMAN § 11.2.11 (explaining that after *USACafes*, “a director of a corporate general partner [is] in a position of having to deal with potentially conflicting and irreconcilable fiduciary duties (the director’s traditional fiduciary duty to the stockholders of the corporation of which it is a director, and the director’s new partnership fiduciary duty)”); *id.* (explaining that before *USACafes*, many practitioners believed that the limited partners did not have a claim against the directors of the corporate general partner but only against the corporate general partner itself and that an advantage of that approach was that it “would avoid putting directors in the situation of having potentially conflicting and irreconcilable fiduciary duties to stockholders of the corporation and to limited partners of the limited partnership”).

The cases, however, cast doubt on the idea that the liability standards in alternative entity governing instruments reflect such a high-minded, careful consideration of the unusual role of the human beings who serve as fiduciaries of general partners and managing members. Nor do the cases suggest that these standards are the result of bargaining between entity managers who wish to limit their own liability and investors who want to be able to hold them and their human fiduciaries accountable.

The record in actual cases rarely, if ever, reflects that any bargaining at all occurred over the governing instrument. Instead, it is almost always the case that the manager or general partner's counsel drafted the governing instrument and investors were only given the choice to sign up or not, but not to bargain over its terms. Consistent with this pattern, the cases almost always involve the managers and their human directors arguing that the governing instrument eliminated or severely constricted the fiduciary duties owed to the alternative entity and that if the procedures in the instrument were literally followed, that investors had their full contractual expectations satisfied and could not press a claim that a conflict transaction was unfair to the alternative entity and unjustly enriched the manager.³⁵ Put simply, there is no hint that the arguable retention

³⁵ See, e.g., *In re Atlas Energy Resources, LLC*, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010) (noting that the defendants argued “that the LLC Agreement completely eliminated [the general partner’s] directors’ and officers’ fiduciary duties and replaced them with a contractually defined duty of good faith that Plaintiffs have not adequately alleged was breached”); *Brickwell Partners v. Wise*, 794 A.2d 1, 2 (Del. Ch. 2001) (“According to the defendants, the [Limited Partnership Agreement] precludes the plaintiff’s claims for breach of fiduciary duty.”); *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009) (“The defendants claim that the parties took full advantage of [the statutory] flexibility by eliminating all fiduciary duties in the LLC Agreement.”)

of due care liability to the investors or the proscription of bad faith conduct was in fact intended to provide genuine protection to investors.

What has resulted from these exercises in unilateral drafting are cases that turn on the unique and often seemingly contradictory terms of specific governing instruments. Admittedly, some drafters have taken a very stark and straightforward approach to drafting contractual procedures that, if followed, are dispositive of any investor challenge to an interested transaction. For example, in *Kahn v. Icahn*, the court held that a provision in a limited partnership agreement that provided that “[a]ny Partner, Record Holder or Affiliate thereof . . . may compete, directly or indirectly, with the business of the Partnership [A]nd neither the Partnership nor any of the Partners or Record Holders shall have any right to participate in such other business interests or ventures or to receive or share in any income derived therefrom” was a provision that clearly allowed the limited partnerships general partner to make investments without first presenting the opportunities to the limited partnership.³⁶ But in the more typical situation, although the defendants argue that the contract provides a dispositive procedural standard that immunizes the defendants from liability and that requires dismissal of the complaint, the contractual language purporting to waive fiduciary duties is laden with scienter-based qualifiers that invite a consideration of whether the humans involved in the entity’s

³⁶*Kahn v. Icahn*, 1998 WL 832629 at *2-4 (Del. Ch. Nov. 12, 1998).

governing process have acted in good faith.³⁷ Unsurprisingly, the ensuing judicial decisions have results that yield few general principles.

In situations where a key party — such as a managing member selling or buying assets from an LLC — has a self-interest, then freighting procedural safe harbors with scienter-based qualifiers necessarily tends to generate issues of fact that cannot be resolved on the face of a pleading.³⁸ Similarly, because the governing instruments often can be rationally read as contemplating liability for gross negligence,³⁹ it is often possible to craft a dismissal-proof complaint against alternative entity managers by focusing on arguable process deficiencies when such a complaint against corporate directors would not survive judicial review because of the existence of an exculpatory charter provision.⁴⁰

³⁷ As Adolf Berle recognized, “The moment . . . that ‘good faith’ is introduced in the picture the fiduciary principle is raised. The phrase implies good faith towards someone, arising out of some previous relation.” *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1054 (1931).

³⁸ See, e.g., *Kelly v. Blum*, 2010 WL 629850 (Del. Ch. Nov. 10, 2009) (denying a motion to dismiss in a case where the LLC agreement exculpated managers for all conduct except “willful or fraudulent misconduct or willful breach of . . . contractual or fiduciary duties under this Agreement” because the plaintiff had alleged facts that, if true, indicated that the managers acted willfully); *Continental Ins. Co. v. Rutledge & Co, Inc.*, 750 A.2d 1219 (Del. Ch. 2000) (declining to enter summary judgment where a factual question existed as to whether the behavior that the general partner engaged in was covered by the provisions in the LP agreement that modified the general partner’s duty of loyalty to the limited partners).

³⁹ LUBAROFF & ALTMAN § 11.2.4 (noting that exculpation provisions in limited partnership agreements “typically provide[] that there is liability . . . if such loss or liability is attributable to the general partner’s gross negligence or willful misconduct”).

⁴⁰ Compare *Forsythe v. ESC Fund Management Co.*, 2007 WL 2982247, at *7-9 (Del. Ch. Oct. 9, 2007) (denying the defendants motion to dismiss in a case where the general partner was only liable under the partnership agreement for “acts or omissions resulting from bad faith, willful misconduct, gross negligence, or a material breach of the Partnership Agreement” and finding that the plaintiffs had stated a claim that the general partner acted with gross negligence because the general partner had not exercised oversight over the partnership activities), and *Albert v. Alex Brown Management Services, Inc.*, 2005 WL 2130607, at *5-8 (Del. Ch. Aug. 26, 2005) (finding that the plaintiffs, limited partners in an investment fund, had alleged facts sufficient to survive a motion to dismiss in a case where the partnership agreement exculpated the general partner unless its conduct constituted “gross negligence or intentional misconduct” when the plaintiffs

Aside from often resulting in a need for discovery and thus larger litigation costs, these contractual liability standards have generated mixed substantive results. In a number of cases, managing members, general partners, and their human fiduciaries have suffered damage awards for failing to comply with their duties.⁴¹ But it is also the case that contractual liability standards have generated judicial decisions that leave investors with no remedy because of the court's need to be faithful to the contract, even in circumstances when the court itself harbored serious doubt that the alternative entity had gotten a fair shake.⁴²

There is another profound danger that this adventure in attempting in one generation to master a contractual approach to issues that centuries of our forebears have been unable to tackle by contracting presents — and that is for contract law itself. When situations arise when the managers of alternative entities have appeared to act in ways that are grossly unfair to investors but in literal compliance with the explicit safe harbor provisions of the agreement, plaintiffs can be expected to latch on to the statutorily-

had alleged that the general partner breached its duty of care to the limited partnership by devoting inadequate time and attention to the management of the funds), *with Malpiede v. Townson*, 780 A.2d 1075, 1095 n.71 (Del. 2001) (“[P]roving the existence of a valid exculpatory provision in the corporate charter entitles directors to dismissal of any claims for money damages against them that are based solely on alleged breaches of the board's duty of care.”).

⁴¹ See, e.g., *Gelfman v. Weeden Investors, L.P.*, 859 A.2d 89 (Del. Ch. 2004); *Auriga Capital Corp. v. Gatz Properties, LLC*, 40 A.3d 839 (Del. Ch. 2012), *aff'd Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012); *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 855 A.2d 1059 (Del. Ch. 2003).

⁴² See, e.g., *Norton v. K-Sea Transp. Partners L.P.*, 67 A.3d 354, 366-67 (Del. 2013) (finding that, although the plaintiff had pled facts that indicated that the general partner “used its position to extract an excessive amount of compensation” and that would permit the court to infer that the general partner may not have acted in good faith, the general partner had followed the requirements of the limited partnership and that the plaintiffs claims could not survive a motion to dismiss).

required bottom line of the implied covenant of good faith and fair dealing.⁴³ In traditional contract law, the implied covenant is a carefully interpreted one that only applies “when the express terms of the contract indicate that the parties would have agreed to the obligation had they negotiated the issue.”⁴⁴ When the contract specifically covers the situation, the implied covenant cannot be used to vary its meaning.⁴⁵ As important, the contractual use of the term good faith in that context is far different from the use of good faith by cases in equity addressing the duties of fiduciaries. In that contractual context, good faith is a confined concept dealing with the requirement that a party not take action to defeat the expectations clearly implied by the explicit terms of the

⁴³ See 6 *Del. C.* § 18-1101(e) (“A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) . . . provided, that *a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.*”) (emphasis added); 6 *Del. C.* § 17-1101(e) (“A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) . . . provided, that *a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.*”) (emphasis added).

⁴⁴ *Nemec v. Shrader*, 991 A.2d 1120, 1127 n.20 (del. 2010) (quoting *Fitzgerald v. Cantor*, 1998 WL 842316, at *1 (Del. Ch. Nov. 10, 1998); see also *Auriga Capital Corp. v. Gatz Properties*, 40 A.3d 839, 853-54 (Del. Ch. 2012) (“The implied covenant is to be used cautiously and does not apply to situations that could be anticipated, which is a real problem in the business context, because fiduciary duty review typically addresses actions that are anticipated and permissible under the express terms of the contract, but where there is a potential for managerial abuse. For these reasons, the implied covenant is not a tool that is designed to provide a framework to govern the discretionary actions of business managers acting under a broad enabling framework like a barebones LLC agreement.”) (internal citations omitted), *aff’d* 59 A.3d 1206 (Del. 2012).

⁴⁵ *Allied Capital Corp. v. GC-SUN Holdings, L.P.*, 910 A.2d 1020, 1032-33 (Del. Ch. 2006) (“implied covenant analysis will only be applied when the contract is truly silent with respect to the matter at hand, and only when the court finds that the expectations of the parties were so fundamental that it is clear that they did not feel a need to negotiate about them.”).

agreement.⁴⁶ In the corporate fiduciary context, good faith is the state of mind of a loyal fiduciary bound to advance the best interests of the stockholders.⁴⁷

We fear that judges faced with cases where faithful adherence to the broad exculpatory and safe harbor provisions of alternative entity agreements would seem to excuse unfair self-interested behavior — for example, because the explicit procedural steps were taken that immunized a transaction from scrutiny even under a bad faith standard — will be tempted to wield the implied covenant as a substitute for the very fiduciary duties that the agreements explicitly eliminated. If the implied covenant begins to take on this role, the predictability of the law will suffer in two important ways. Not only will the well understood default principles of fiduciary duty be rendered less dependable as a method for investors and managers to form relationships and run businesses, but the potential expansion in the role of the implied covenant could render contractual expectations less predictable, thereby raising the cost of contracting and deterring the formation of some relationships.

It is not clear to us that this patchwork of outcomes provides systemic benefits to investors, or even managers. For investors, the detriments are obvious. Because there

⁴⁶ 23 WILLISTON ON CONTRACTS § 63:22 (4th ed. 2002) (“As a general principle, there can be no breach of the implied promise or covenant of good faith and fair dealing where the contract expressly permits the actions being challenged, and the defendant acts in accordance with the express terms of the contract.”).

⁴⁷ See *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 755 (Del. Ch. 2005) (“To act in good faith, a director must act at all times with an honesty of purpose and in the best interests and welfare of the corporation.”) *aff’d*, 906 A.2d 27 (Del. 2006); see also Leo E. Strine, Jr., Lawrence A. Hammermesh, R. Franklin Balotti, & Jeffrey M. Gorris, *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. 629, 644 (2010) (“[G]ood faith is the defining term that Delaware Courts employing the business judgment rule standard of review use to articulate the state of mind required of a loyal fiduciary exercising corporate powers.”).

are no reliable defaults, investors are either required to become diligent and expert readers of alternative entity agreements, which may involve the expenditure of material costs for legal advice, or to blindly accept the risks of investing in asset classes where no dependable protection against self-dealing and other conflicts of interest exists. Because those detriments are unrelated to the primary reason alternative entities are attractive to investors — the tax benefits — it is not clear why investors should wish or need to incur them. Given the reality that many of the accredited investors who invest in non-public alternative entities are themselves fiduciaries, such as pension funds who invest on behalf of ordinary Americans who depend on those investments to pay for their retirement, these detriments cannot be shrugged off as something only incurred by the affluent and thus not a public policy concern.

For managers, the freedom to impose one's own draft has been a decidedly mixed blessing, as many managers have found themselves exposed to liability as a result of their own infelicitous drafting.⁴⁸ Rather than being able to draw on market experiences and practices that have been generalized from other cases, managers implementing their own playbook have often been flagged for violations by courts or had to pay to settle cases more expensively than might have been the case if they had simply been operating under general default principles of corporate law.

⁴⁸ See, e.g., *Kahn v. Portnoy*, 2008 WL 5197164, at *13 (Del. Ch. Dec. 11, 2008) (declining to grant the defendants' motion to dismiss in a case where the provisions of the LLC agreement were ambiguous and noting that, with the broad discretion given to parties to craft an LLC agreement "comes the risk-for both the parties and this Court-that the resulting LLC agreement will be incomplete, unclear, or even incoherent.").

For all these reasons, it remains unclear to us that the common understanding of alternative entity governance as intensely contractual and as reflecting efficient situational-specific bargaining is an apt one, at least as it applies to alternative entities raising capital from diverse investors. Rather, the experience with litigated cases suggests that alternative entity governing instruments are not the products of negotiation, but are drafted solely by entity managers. Those governing instruments seem to achieve little in terms of wealth-creating efficiency beyond what can be achieved under current “broadly enabling” corporate law statutes, which already provide for the ability to avoid liability under the corporate opportunity doctrine. In fact, if alternative entity statutes were amended to: 1) provide for a default standard that no liability exists for breach of the duty of care absent a contractual provision imposing such liability; and 2) provide that where a governing instrument of a managing member or general partner specifies that certain directors have a duty solely to consider the best interests of the alternative entity and its investors, their actions will be entitled to the same deference as would be given to independent directors of a corporation, then it is not clear why, as a matter of systemic efficiency much less fairness, that the fiduciary duty principles of loyalty that apply in the corporate context should be subject to elimination.