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CONTRACTUALLY ADOPTED FIDUCIARY DUTY

D. Gordon Smith*

The Delaware Supreme Court recently referred to “contractually adopted fiduciary duties.” Although some commentators, including Larry Ribstein, view fiduciary duties as a type of contract term, the notion of contractually adopted fiduciary duties is incoherent. The need to opt in to fiduciary duties would arise in only two circumstances: (1) fiduciary relationships that do not invoke fiduciary duties without contractual authorization, and (2) nonfiduciary relationships in which the parties wish to invoke fiduciary duties that would otherwise be absent. The first category of relationships does not exist, as courts impose fiduciary duties when the structure of a relationship indicates that fiduciary duties are justified, and the second category of cases is rare—and should be nonexistent—as independent contracting parties generally have no reason to opt in to the fiduciary regime because fiduciary duties simply do not make sense outside of fiduciary relationships.

Nevertheless, the issue arises occasionally in judicial opinions, and this Essay offers a simple proposal to clarify the line between fiduciary duties and contractual duties. When a duty arises from the language of a contract, that duty is a contractual duty, but if a duty arises as a matter of common law because the structure of the relationship comports with the description of fiduciary relationships, that duty is a fiduciary duty.

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I. INTRODUCTION

William Gatz was the manager of a Delaware limited liability company that had been formed to develop the Long Island National Golf Course. When Gatz engaged in a conflict-of-interest transaction with the company, the minority investors sued, claiming both a breach of contract and a breach of fiduciary duty. The company's operating agreement contained a provision specifying that any conflict-of-interest transaction must have terms comparable to an arms-length transaction. The Delaware Supreme Court called this provision a "contracted-for fiduciary obligation," and concluded that the agreement "by its plain language, contractually adopts the fiduciary duty standard of entire fairness"¹ In this Article I argue that the Delaware Supreme Court was confused about the proper relationship between fiduciary and contractual duties. My thesis is that the fiduciary duty of loyalty, properly understood, cannot be adopted contractually. I suggest a simple interpretive rule for courts to remove the confusion.²

Fiduciary duty has been described as "messy,"³ "atomistic,"⁴ and "elusive,"⁵ and one commentator recently observed, "fiduciary law has been characterized as one of the least understood of all legal constructs."⁶ Perhaps as a result of these conceptual challenges, law professors traditionally have taught fiduciary law in small portions, complicating the search for overarching principles. In his provocative article, *Are Partners Fiduciaries?*,⁷ Larry Ribstein attempted to "reduce the confusion by arguing for a precise definition of the relationships that give rise to default fiduciary duties."⁸ Ribstein's definition of fiduciary relationships distinguishes centrally managed firms, where fiduciary duty is appropriate, from firms in which all of the owners are active managers, where fiduciary duty is inappropriate.⁹ This definition would result in a

1. Gatz Props., LLC v Auriga Capital Corp., 59 A.3d 1206, 1213, 1216 (Del. 2012).

2. In another part of the opinion, discussed below in Part II, the Delaware Supreme Court questioned the existence of default fiduciary duties in Delaware limited liability companies. In 2013 the Delaware legislature amended the Delaware Limited Liability Company Act, expressly confirming that fiduciary duties exist in Delaware limited liability companies, unless otherwise provided in the LLC agreement. See DEL. CODE ANN. tit. 6, § 18-1104 (West 2014) ("In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern."). The resolution of this issue does not answer the issue addressed by this Essay, namely, whether fiduciary duties may be contractually adopted.

3. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1400 (2002).

4. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 915.

5. Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1743 (2001).

6. Leonard I. Rotman, *Fiduciary Law's "Holy Grail": Reconciling Theory and Practice in Fiduciary Jurisprudence*, 91 B.U. L. REV. 921, 923 (2011).

7. Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209 [hereinafter Ribstein, *Partners*].

8. *Id.* at 212. Ribstein expanded his views in a subsequent article, Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899 (2011) [hereinafter Ribstein, *Fencing*].

9. Ribstein, *Partners*, *supra* note 7, at 212 ("[D]efault fiduciary duties should be confined to relationships that involve the contractual delegation of broad power over one's property.").

narrower application of fiduciary duty than is generally accepted by courts and commentators,¹⁰ a result that Ribstein embraces on the ground that it “protects contracting parties’ ability to delineate their rights and obligations to suit their particular relationships.”¹¹

A few years prior to Ribstein’s publication I published *The Critical Resource Theory of Fiduciary Duty*,¹² which proposed a “unified theory of fiduciary duty” based on the structure of fiduciary relationships.¹³ Ribstein¹⁴ and other commentators¹⁵ have noted similarities in our approaches. Despite the similarities between the Critical Resource Theory (“CRT”) and Ribstein’s theory, our views on fiduciary law differ in at least one important way: Ribstein suggested that we shared a belief that “fiduciary duties are basically contractual,”¹⁶ but the CRT holds that fiduciary duty is distinct from contract.¹⁷ Distinguishing fiduciary duty from contractual duty is fundamental to a correct understanding and application of fiduciary law. As illustrated by *Gatz Properties, LLC v. Auriga Capital Corp.*, described above, confusion over fiduciary duty persists, even among sophisticated judges.

Part II describes the duty of loyalty as a distinctive legal obligation that applies only in fiduciary relationships and is designed to regulate the exercise of fiduciary power. Part III invokes the *Gatz* case to illustrate why “contractual adoption” of fiduciary duty would not be a wise or useful public policy. Part IV offers a simple proposal to clarify the line between the duty of loyalty and contractual duties.

II. THE DUTY OF LOYALTY IN CONTEXT

Larry Ribstein based his theory of fiduciary law on a “paradigm” relationship, in which “an ‘owner’ who controls and derives the residual

10. *Id.* at 232 (“The strong medicine of fiduciary duties is . . . appropriate only for a narrow class of cases.”).

11. *Id.* at 213. Ribstein argues that “[a]pplying fiduciary duties broadly threatens to undermine parties’ contracts by imposing obligations the parties do not want or expect,” *id.*, but this would seem to be true whether fiduciary duties were applied broadly or narrowly. Perhaps anticipating this concern, Ribstein asserts, “The law better serves parties’ contracts by applying fiduciary duties only in the particular settings in which they are most appropriate, thereby clearly notifying parties of the situations where they may need to modify these duties.” *Id.* The notion that contracting parties actually know about or understand fiduciary law is questionable, even in many of the centrally managed firms invoked by Ribstein.

12. Smith, *supra* note 3.

13. *Id.* at 1400.

14. Ribstein, *Partners*, *supra* note 7, at 212 n.15.

15. See, e.g., Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 129 n.24 (2006); Paul B. Miller, *A Theory of Fiduciary Liability*, 56 MCGILL L.J. 235, 276 n.123 (2011) [hereinafter Miller, *Theory*].

16. Ribstein, *Partners*, *supra* note 7, at 212 n.15; cf. Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 987 (2013) [hereinafter Miller, *Justifying*] (classifying CRT as a “reductivist argument” from the law of property).

17. Smith, *supra* note 3, at 1492. Paul Miller treats CRT as a “reductivist argument” holding that “fiduciary duties are not distinctive but are rather derived from other bases of private liability.” Miller, *Justifying*, *supra* note 16, at 980. Although CRT employs the property-like concept of “critical resources,” and acknowledges the ability of parties to tailor fiduciary duties through contract, CRT maintains that fiduciary relationships are distinctive.

benefit from property delegates open-ended management power over property to a ‘manager.’”¹⁸ Although some recognized fiduciary relationships do not fit this agency paradigm,¹⁹ Ribstein was not attempting to explain current legal rules. Rather, he was attempting to justify the imposition of fiduciary duties in certain relationships that are “characterized by separation of ownership and control.”²⁰ According to Ribstein, fiduciary relationships are a subset of economic agency relationships²¹ in which “the fiduciary’s discretion cannot readily be constrained by devices other than fiduciary duties without undermining the owner’s objectives in delegating control.”²² Thus, in Ribstein’s view the key to distinguishing fiduciary relationships from other relationships is the open-ended delegation of management power.²³ CRT describes this feature of fiduciary relationships as the exercise of discretion over a critical resource belonging to another.²⁴ Under both theories the fiduciary duty of loyalty is a distinctive legal obligation²⁵ that adheres only in fiduciary relationships²⁶ and is designed to regulate the exercise of fiduciary power.²⁷

Fiduciaries exercise their power or discretion in the face of incomplete contracts.²⁸ As a result, beneficiaries in fiduciary relationships are always vulnerable to opportunism.²⁹ The potential for opportunism in

18. Ribstein, *Partners*, *supra* note 7, at 215. The CRT uses the term “critical resource” instead of “property” and refers to “discretion” rather than “management power.” Smith, *supra* note 3, at 1402–03. In addition, “delegation” is not required under the CRT, but the fiduciary acts “on behalf of” the owner of the critical resource. *Id.* at 1403. Nevertheless, all of these concepts are almost interchangeable between the two theories, thus leading to the observation that the theories are quite similar.

19. Smith, *supra* note 3, at 1403.

20. Ribstein, *Partners*, *supra* note 7, at 215. The “separation of ownership and control” is typically associated with corporate law. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 4 (1932) (“The corporate system appears only when this type of private or ‘close’ corporation has given way to an essentially different form, the quasi-public corporation: a corporation in which a large measure of separation of ownership and control has taken place through the multiplication of owners.”).

21. Ribstein, *Partners*, *supra* note 7, at 215 (“A fiduciary relationship is necessarily one of agency in the economic sense because it is characterized by separation of ownership and control. But it does not follow that all economic agencies are necessarily *fiduciary* relationships.” (footnote omitted)).

22. *Id.*

23. *Id.* at 217.

24. Smith, *supra* note 3, at 1402.

25. *Id.* at 1409 (“[T]he *fiduciary* duty of loyalty is distinctive. Although fiduciaries are not the only people who owe a duty of loyalty . . . the content of the duty of loyalty imposed in the fiduciary context is unique. . . . In the fiduciary context, the duty of loyalty requires the fiduciary to adjust her behavior on an ongoing basis to avoid self-interested behavior that wrongs the beneficiary.”).

26. See Paul D. Finn, *The Fiduciary Principle*, in EQUITY, FIDUCIARIES AND TRUSTS 1, 26 (Timothy G. Youdan ed., 1989) (noting that the fiduciary principle “has been used, and is demonstrably used, to maintain the integrity, credibility and utility of relationships perceived to be of importance in a society”).

27. Paul Miller describes “fiduciary power” as “a form of authority wielded by the fiduciary relative to the beneficiary.” Miller, *Justifying*, *supra* note 16, at 1017.

28. See D. Gordon Smith & Jordan C. Lee, *Fiduciary Discretion*, 75 OHIO ST. L.J. 609, 616 (2014).

29. See, e.g., Evan J. Criddle, *Fiduciary Administration: Rethinking Popular Representation in Agency Rulemaking*, 88 TEX. L. REV. 441, 470 (2010) (noting that “all beneficiaries are vulnerable to the fiduciary’s abuse of legally entrusted administrative power over their legal and practical interests”); Evan Fox-Decent, *The Fiduciary Nature of State Legal Authority*, 31 QUEENS L.J. 259, 275 (2005) (asserting that a fiduciary obligation arises “whenever one party unilaterally assumes discretionary power of an administrative nature over the important interests of another, interests that are

the fiduciary context—as opposed to a relationship of independent contractors—is particularly acute because a person who engages a fiduciary agrees to become responsible for the fiduciary’s decisions and actions, at least to the extent that those decisions and actions are not self-interested.³⁰ This responsibility does not always include potential liability to the third party,³¹ but it always involves the beneficiary placing the critical resource or other assets at risk. The fiduciary duty of loyalty requires fiduciaries to sacrifice their own self-interest on behalf of the beneficiaries of the duty³² to protect those beneficiaries from opportunism by the fiduciaries.³³

Although the fiduciary duty of loyalty is imposed by courts, usually without regard to the express or implied terms of any contract, Ribstein describes the duty as “a type of contract term.”³⁴ Characterizing fiduciary duties in this way allows Ribstein to advance the ideal of private ordering.³⁵ Ribstein acknowledges the existence of “default” fiduciary duties—duties implied as a matter of law by courts³⁶—but he rejects “mandatory” fiduciary duties. Default rules of fiduciary law are useful in many relationships because of “the owner’s inability directly to observe, evaluate, and discipline the manager’s performance.”³⁷ Nevertheless, if

especially vulnerable to the fiduciary’s discretion”). On the nature of opportunism in contractual relationships, see D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 *ARIZ. L. REV.* 1, 2 n.3 (2009) (discussing “opportunism” and “moral hazard”).

30. Both Ribstein and Smith focus their examination of fiduciary law on the duty of loyalty. See Ribstein, *Fencing*, *supra* note 8, at 904 (“Parties’ self-interest usually can motivate them to act reasonably carefully where they are effectively disciplined by the product and job markets. But a self-dealing fiduciary’s self-interest can overwhelm these extra-legal constraints. This intuition supports defining the fiduciary duty in terms of loyalty rather than care.”); Smith, *supra* note 3, at 1409 (“[T]his conception of fiduciary duty is limited to the duty of loyalty, as opposed to the duty of care. References to a ‘fiduciary duty of care’ are common, and fiduciaries routinely owe a duty of care. Of course, many other people also owe a duty of care. More importantly, while the content of that duty of care may be stated in terms of ordinary negligence or gross negligence, depending on context, the intensity of the duty of care is not dependent on whether the person acting is a fiduciary.” (footnote omitted)). Even in the case of self-interested decisions, the beneficiary may be responsible to a third party, but the fiduciary can be forced to compensate the beneficiary for any breach of fiduciary duty, thus offsetting this external liability.

31. In other words, not all fiduciary relationships fit the “agency model” presumed by Ribstein. For example, physicians, priests, and other counselors often form fiduciary relationships but typically do not fit the agency model. See Smith, *supra* note 3, at 1423 n.98.

32. *Id.* at 1410–11 (“While any action that harms the beneficiary might in some sense constitute a breach of loyalty, courts typically reserve the label ‘loyalty’ for self-interested actions.”).

33. *Id.* at 1402 (“[T]he duty of loyalty that is the essence of *fiduciary* duty protects beneficiaries against opportunistic behavior by fiduciaries.”).

34. Ribstein, *Partners*, *supra* note 7, at 215.

35. “Private ordering” here is used as a near synonym for “contracting” or “transacting.” See D. Gordon Smith et al., *Private Ordering with Shareholder Bylaws*, 80 *FORDHAM L. REV.* 125, 127 n.12 (2011).

36. Ribstein, *Partners*, *supra* note 7, at 218 (“[T]he parties agree to fiduciary duties by contracting for the particular kind of relationship in which default fiduciary duties apply.”). For an extended discussion of Ribstein’s views on default fiduciary duties, see Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 *WASH. & LEE L. REV.* 537 (1997).

37. Ribstein, *Partners*, *supra* note 7, at 217. According to Ribstein, “classic” examples of fiduciary relationships are public corporations and trusts: “In these situations the owners’ costs of obtaining information necessary to manage on a day-to-day basis are high, so that ex post judicial review of conflicts of interest is potentially valuable.” *Id.*

the parties wish to avoid application of fiduciary law, Ribstein would allow them to do that completely. Under this view, fiduciary duties are within the control of the parties in that they can decide whether to form a fiduciary relationship.

Somewhat slighted in Ribstein's analysis is the reason an owner wishes to control a manager. Quite simply, the owner is concerned about the possibility that the manager will deplete the owner's property. As noted above, the owner does not have this same risk when entering into a relationship with an independent contractor. Thus, while a beneficiary may choose to contract out of fiduciary duties, an independent contracting party generally would not think to "contract in" to the fiduciary regime. Indeed, in the absence of a delegation of managerial power or exercise of discretion over a critical resource, the fiduciary duty of loyalty simply does not make sense.

The foregoing analysis also suggests the value of the fiduciary duty of loyalty as a default rule in fiduciary relationships. Beneficiaries in these relationships are vulnerable to opportunism by fiduciaries,³⁸ and the fiduciary duty of loyalty not only protects those relationships once formed,³⁹ but "emboldens parties to enter into contractual relationships even where some discretion is left unconstrained."⁴⁰ This furthers the fundamental value of promoting entrepreneurial action.⁴¹

III. CONTRACTUAL ADOPTION OF FIDUCIARY DUTY

The introduction of this Essay describes *Gatz Properties, LLC v. Auriga Capital Corp.*, in which the Delaware Supreme Court introduced the notion of "contractually adopted fiduciary duties."⁴² The need to "opt in" to the fiduciary duty of loyalty could arise in only two circumstances: (1) fiduciary relationships that do not invoke a duty of loyalty without contractual authorization and (2) nonfiduciary relationships in which the parties wish to invoke a duty of loyalty that would otherwise be absent. The latter relationships will be discussed in Part IV. *Gatz* is a peculiar example of the former relationships. In this Part I argue that *Gatz* illustrates why allowing "contractual adoption" of the fiduciary duty of loyalty would not be a wise or useful public policy.

The Delaware Supreme Court's opinion in *Gatz* stands in contrast to the lower court opinion by Chancellor Leo Strine who referred to the contractual fairness provision in that case as an "arms-length mandate."⁴³ Chancellor Strine held that the manager's behavior in *Gatz* constituted a

38. Smith & Lee, *supra* note 28, at 620 ("Although incomplete contracts are inevitable, contracting parties routinely create fiduciary relationships, in which one party (the beneficiary) seems especially vulnerable to opportunism by the counterparty (the fiduciary).").

39. See Finn, *supra* note 26.

40. Smith & Lee, *supra* note 28, at 631.

41. D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1536 (2013).

42. *Gatz Props., LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1214 (Del. 2012).

43. *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 858 (Del. Ch. 2012).

breach of this contractual provision, as well as a breach of the duty of loyalty, which he said applies to managers of Delaware limited liability companies as a default matter.⁴⁴

The Supreme Court affirmed Chancellor Strine's holding that the manager was "subject to fiduciary duties and that he breached them," but it affirmed "exclusively on contractual grounds."⁴⁵ The Delaware Supreme Court chastised Chancellor Strine for discoursing on "default fiduciary duties," concluding, "[w]here, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction."⁴⁶

The Delaware courts and legislature have been exploring the boundaries of fiduciary and contractual duties in noncorporate business entities for many years. In a 2000 opinion involving a limited partnership then-Vice-Chancellor Leo Strine interpreted § 17-1101(d)(2) of the Delaware Revised Uniform Limited Partnership Act⁴⁷ as authorizing "the elimination, modification, or enhancement of [traditional] fiduciary duties in the written agreement governing the limited partnership."⁴⁸ On appeal the Delaware Supreme Court highlighted this "questionable statutory interpretation" and observed, "[t]here is no mention in [the statute] that a limited partnership agreement may *eliminate* the fiduciary duties or liabilities of a general partner."⁴⁹ In response to this opinion the Delaware legislature amended the limited partnership statute in 2004 to

44. *Id.* at 851 ("[B]ecause the LLC Act provides for principles of equity to apply, because LLC managers are clearly fiduciaries, and because fiduciaries owe the fiduciary duties of loyalty and care, the LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties.").

45. *Gatz Props.*, 59 A.3d at 1214.

46. *Id.* at 1218.

47. This section of the Act provided in relevant part:

(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, (1) any such partner or other person acting under the partnership agreement shall not be liable to the limited partnership or to any such other partner or to any such other person for the partner's or other person's good faith reliance on the provisions of the partnership agreement, and (2) the partner's or other person's duties and liabilities may be expanded or restricted by provisions in the partnership agreement.

DEL. CODE ANN. tit. 6, § 17-1101 (2000).

48. *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, No. CIV.A. 15754, 2000 WL 1476663, at *10 (Del. Ch. Sept. 27, 2000). Vice-Chancellor Strine cited an earlier opinion by then-Chancellor William Chandler, supporting the view that partners in a limited partnership could eliminate fiduciary duties altogether. *See Sonet v. Timber Co.*, 722 A.2d 319, 323 (Del. Ch. 1998) ("Considering § 17-1101(d) of the Delaware Revised Uniform Limited Partnership Act's apparently broad license to enhance, reform, or even eliminate fiduciary duty protections, it is unclear how the market goes about pricing the value of protections afforded to limited partners in any particular flavor of limited partnership.").

49. *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167-68 (Del. 2002). The Court also referred to Vice-Chancellor Strine's statement as "dubious dictum." *Id.* at 168.

expressly allow for the elimination of fiduciary duties in the partnership agreement.⁵⁰

Also in 2004, this same provision made its way into the Delaware Limited Liability Company Act (“DLLCA”),⁵¹ which applied in *Gatz*. Both statutes also contain a provision expressing the “policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of [partnership or limited liability company] agreements.”⁵² Interpreting these provisions, the Delaware courts allow for complete waiver of fiduciary obligation.⁵³ In *Gatz* Chancellor Strine took up the companion question: if the participants in an LLC are silent about fiduciary duties, should the courts impose fiduciary duties as default rules even though the DLLCA does not expressly provide for them?

Chancellor Strine made a strong case for default fiduciary duties in Delaware limited liability companies by analogizing to corporate law,⁵⁴ invoking statutory clues,⁵⁵ and reasoning from the structure of the manager’s relationship to the business entity.⁵⁶ Chancellor Strine also read the foregoing statutory developments as supportive of default fiduciary duties:

If the equity backdrop I just discussed did not apply to LLCs, then the 2004 [amendment] would have been logically done differently. Why is this so? Because the Amendment would have instead said something like: “The managers, members, and other persons of the LLC shall owe no duties of any kind to the LLC and its members except as set forth in this statute and the LLC agreement.”⁵⁷

As noted above, the Delaware Supreme Court affirmed Chancellor Strine’s holding, but added:

50. DEL. CODE ANN. tit. 6, § 17-1101(d) (2014) (stating that a partner’s “duties may be expanded or restricted or eliminated by provisions in the partnership agreement”).

51. *Id.* § 18-1101(c).

52. *Id.* §§ 17-1101(c), 18-1101(b).

53. *See, e.g.*, *Gerber v. Enter. Prods. Holdings, LLC*, No. 5989-VCN, 2012 WL 34442, at *13 (Del. Ch. Jan. 6, 2012) (“Alternate entity legislation reflects the Legislature’s decision to allow such ventures to be governed without the traditional fiduciary duties, if that is what the . . . governing document provides for, and allows conduct that, in a different context, would be sanctioned.”).

54. *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 849 (Del. Ch. 2012) (“The Delaware LLC Act does not plainly state that the traditional fiduciary duties of loyalty and care apply by default as to managers or members of a limited liability company. In that respect, of course, the LLC Act is not different than the DGCL, which does not do that either.”).

55. *Id.* at 850 (“[T]he rules of equity apply in the LLC context by *statutory mandate*, creating an even stronger justification for application of fiduciary duties grounded in equity to managers of LLCs to the extent that such duties have not been altered or eliminated under the relevant LLC agreement.”); *id.* at 852 (“[W]hy would the General Assembly amend the LLC Act to provide for the elimination of (and the exculpation for) ‘something’ if there were no ‘something’ to eliminate (or exculpate) in the first place?”).

56. *Id.* at 850–51 (“The manager of an LLC has more than an arms-length, contractual relationship with the members of the LLC. Rather, the manager is vested with discretionary power to manage the business of the LLC.”) (footnotes omitted).

57. *Id.* at 851 (citing *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at *9 (Del. Ch. May 7, 2008), in which the court found that an agreement containing this language waived all fiduciary duties except those provided for by contract).

[T]he merits of the issue whether the LLC statute does—or does not—impose default fiduciary duties is one about which reasonable minds could differ. Indeed, reasonable minds arguably could conclude that the statute—which begins with the phrase, “[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties)” —is consciously ambiguous. That possibility suggests that the “organs of the Bar” (to use the trial court’s phrase) may be well advised to consider urging the General Assembly to resolve any statutory ambiguity on this issue.⁵⁸

This statement by the Delaware Supreme Court bears the fingerprints of then-Chief Justice Myron Steele, who has long endorsed contractual freedom regarding fiduciary duties in noncorporate business entities. In a 2007 law review article, Chief Justice Steele concluded that “parties to contractual entities such as limited liability partnerships and limited liability companies should be free . . . to adopt or reject any fiduciary duty obligation by contract.”⁵⁹ In a 2009 law review article, Chief Justice Steele took an even stronger position, arguing “that default fiduciary duties violate the strong policy favoring freedom of contract enunciated by Delaware’s legislature,” and that “the costs of default fiduciary duties outweigh the minimal benefits that they provide.”⁶⁰ Although the Supreme Court opinion in *Gatz* did not attempt to counter Chancellor Strine point by point, it appears that Chief Justice Steele was attempting to preserve that argument for another day. In the meantime, another decision from the Court of Chancery added weight to Chancellor Strine’s conclusion.⁶¹ The Delaware legislature has now resolved the issue with an amendment in 2013, expressly confirming that fiduciary duties exist in Delaware limited liability companies, unless otherwise provided in the LLC agreement.⁶²

The issue of default fiduciary duties in Delaware limited liability companies has been resolved by the Delaware legislature, but the notion of “contractually adopted fiduciary duties” remains conceptually puzzling. Generally speaking, courts impose fiduciary duties whenever the structure of a relationship suggests that fiduciary duties are justified (and the parties have not contracted out of fiduciary duties). The Delaware Supreme Court should have done this in *Gatz*, as Chancellor Strine did in his lower court opinion. Courts need not wait for contractual authorization, though they may look to contract for expansions or restrictions on traditional duties. Thus, in most relationships parties do not “opt in” to

58. *Gatz Props.*, 59 A.3d at 1219.

59. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 4 (2007).

60. Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 223–24 (2009).

61. See *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 663 (Del. Ch. 2012).

62. DEL. CODE ANN. tit. 6, § 18-1104 (West 2013) (“In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.”).

fiduciary duties, except to the extent that they choose to organize themselves in fiduciary relationships.⁶³

IV. A SIMPLE PROPOSAL

The notion of “contractually adopted fiduciary duties” introduced by the Delaware Supreme Court opinion in *Gatz* would make sense only under the assumption that managers of Delaware limited liability companies are not subject to the fiduciary duty of loyalty as a default term. Outside of this context—that is, fiduciary relationships that do not invoke a duty of loyalty without contractual authorization—the only context in which “contractually adopted fiduciary duties” might have traction is nonfiduciary relationships in which the parties wish to invoke a duty of loyalty that would otherwise be absent. Independent contracting parties often demand some form of loyalty—for example, an obligation not to compete is essentially a demand that the constrained party behave loyally—but they generally would not think to “contract in” to the fiduciary regime because the fiduciary duty of loyalty simply does not make sense outside of fiduciary relationships. Nevertheless, as described below, this has happened, and I propose a simple test for courts that might face this issue in the future: when a duty arises from the language of a contract, that duty is a contractual duty, but if a duty arises as a matter of common law because the structure of the relationship comports with the description of fiduciary relationships, that duty is a fiduciary duty.

Occasionally parties in a fiduciary relationship impose contractual obligations that look like fiduciary duties. This was Chancellor Strine’s view of the parties in *Gatz*, and he dealt with this contractual provision appropriately, interpreting the term to discern the intention of the contracting parties as he would with any other contract term.⁶⁴ In other instances, nonfiduciaries may attempt to invoke fiduciary duties by contract. The best known example of this phenomenon in Delaware law is *Cantor Fitzgerald, L.P. v. Cantor*, in which three limited partners were contractually subjected to a “duty of loyalty” designed to prevent them from competing with the limited partnership.⁶⁵ Traditionally limited partners have not owed fiduciary duties to the partnership because they do not exercise discretion over the affairs of the partnership.⁶⁶ In this case, however, then-Vice-Chancellor Myron Steele reasoned:

63. Ribstein, *Partners*, *supra* note 7, at 218 (“[S]ince one can choose from among various fiduciary and nonfiduciary standard forms, an unsophisticated party can choose to enter into a fiduciary-type contract and seek the fiduciary’s advice.”).

64. *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 857 (Del. Ch. 2012).

65. *Cantor Fitzgerald, L.P. v. Cantor*, 724 A.2d 571, 574 (Del. Ch. 1998). The Limited Partnership Agreement in that case stated, “[e]ach Partner acknowledges its duty of loyalty to the Partnership and agrees to take no action to harm (or that would reasonably be expected to harm) the Partnership or any Affiliated Entity.” *Id.* at 580.

66. In a post-trial opinion in *Cantor*, Vice-Chancellor Steele acknowledged exceptions to this rule when limited partners exercised control over the partnership or the general partner, thus creating a fiduciary relationship. *Cantor Fitzgerald, L.P. v. Cantor*, No. 16297, 2000 WL 307370, at *20–21 (Del. Ch. Mar. 13, 2000).

Where a fiduciary duty of loyalty is expressly written into an agreement, or where authority is granted to include this provision at a later time, I must conclude that the parties bargained for the provision. That Delaware courts uphold bargained-for fiduciary duties contained in limited partnership agreements is crucial to the orderly management of, and the related, economic success of, those limited partnerships.⁶⁷

Vice-Chancellor Steele referred to this “duty of loyalty” as a “fiduciary duty,” which caused a fair amount of uncertainty regarding the content and analysis of the provision.⁶⁸ In the end, however, he interpreted the provision like any other contract term: “The duty of loyalty proclaimed in the 1996 Partnership Agreement requires no dependency upon a default concept to a narrow definition derived from corporate common law. The scope of the duties owed by the parties must be determined by reference to the nature of this particular business enterprise.”⁶⁹

The noncorporate entity statutes in Delaware contemplate the possibility that fiduciary duties may be “expanded,”⁷⁰ but few people even attempt to impose the fiduciary duty of loyalty outside of fiduciary relationships. Delaware courts have explored the expansion of fiduciary law beyond its traditional boundaries in cases involving creditors,⁷¹ but these cases do not involve a contract attempting to impose fiduciary obligations in the creditor relationship.⁷² Rather, the courts are weighing a policy whether to allow for enforcement of fiduciary duties by creditors when a firm is insolvent.⁷³ In the context of preferred shareholders the

67. 724 A.2d at 582. *Cantor*’s invocation of “bargained-for fiduciary duties” has never been cited by another court, but the Delaware Supreme Court in *Cantor* accepted the notion of a “contractually-imposed fiduciary duty of loyalty.” *Cantor v. Cantor Fitzgerald, L.P.*, 755 A.2d 387, (table) (Del. 2000).

68. The parties debated whether a limited partner without management responsibilities could possibly be subjected to a fiduciary duty of loyalty. *Cantor*, 2000 WL 307370, at *22. Under the analysis in this Essay, this sort of contractual imposition of fiduciary obligation would be impossible, but in his post-trial opinion, Vice-Chancellor Steele seemed to invite such contract provisions:

The duty of loyalty that parties may impose upon one another by mutual assent in a contract, whether management, operational, or governance responsibilities follow or not, is a mutual exchange of a promise to treat one another with good faith, trust, confidence and candor. It is a promise articulated to define a mutually agreed relationship explicitly beyond that of any “implied” duty of good faith in an ordinary contract. This is hardly a shocking expectation to seek and to bargain for even in the harsh, competitive world of brokering Treasuries.

Id.

69. *Id.*

70. DEL. CODE ANN. tit. 6, §17-1101(d) (2014) (limited partnerships); *id.* §18-1101(c) (limited liability companies).

71. *See, e.g.*, *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (“[C]reditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”).

72. *Cf. Frederick Tung, The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 817 (2008) (arguing that “[p]rivate contracting alone should be effective to shift managers’ loyalties in favor of creditors”).

73. *Gheewalla*, 930 A.2d at 101 (“When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”).

Delaware courts seem actively hostile to the contractual invocation of fiduciary principles, applying a rule of strict construction when interpreting the terms of preferred stock.⁷⁴ Perhaps not surprisingly, given the analysis in Part II, the demand for the fiduciary duty of loyalty is not high absent an open-ended delegation of management power or the exercise of discretion over a critical resource belonging to another.

V. CONCLUSION

In this Article I have argued that the nature of the duty of loyalty can be important in cases where the parties invoke fiduciary concepts in their contracts. In the wake of statutory amendments in Delaware this issue seems unlikely to arise in fiduciary relationships, and in nonfiduciary relationships, most parties do not wish to invoke a fiduciary duty of loyalty. When contracting parties invoke fiduciary concepts, however, the only sensible approach for courts is to interpret those provisions as they interpret other contract terms.⁷⁵

74. See D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 840-44 (2004).

75. A distinct set of problems arises from treating fiduciary duty as a species of implied contract terms. See Smith & Lee, *supra* note 28, at 622 (“One problem is that viewing fiduciary duties as contract terms implies that judges should craft particular rules for the parties. Often framed in terms of a hypothetical bargain, this approach urges judges to choose the result the parties would have chosen had they anticipated the situation at issue, but this sort of reasoning is quite different from deciding simply whether the fiduciary acted appropriately within the scope of her discretion.” (footnotes omitted)).