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Michael Despres

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## Alternative Entities and Fiduciary Duty Waivers in Delaware

### INTRODUCTION

Since the early 1900s, Delaware has been the preeminent state for businesses to incorporate,<sup>1</sup> with more than half of the current Fortune 500 companies incorporated there.<sup>2</sup> With the emergence of limited liability partnerships and limited liability companies, Delaware has also become the primary formation state for alternative entities. The attractiveness of Delaware to corporations and alternative entities is due both to the favorable legislation and to the competent judiciary found in the state. This is especially true in regards to alternative entities, where the legislature has given large deference to the freedom of contract between the members or partners of these entities. Additionally, the court of chancery's distinct equity jurisdiction has allowed it to specialize in corporate law, giving businesses the reassurance that the Delaware judiciary not only fully understands complex corporate law issues, but also has extensive experience in the practical application of corporate law.<sup>3</sup>

One area of debate in Delaware law surrounds the doctrine of fiduciary duties in the context of alternative entities. In recent years, it has been firmly established that fiduciary duties in alternative entity agreements may be modified, and even waived, as long as done so expressly. This ability to modify and waive fiduciary duties in the alternative entity context has not only brought with it all the benefits of freedom of contract, allowing the parties to define exactly what standards are applicable in specific situations, but has also inherited the downsides of contract law, such as the challenges courts face when interpreting ambiguous agreements. As Delaware courts

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1. LEWIS S. BLACK, JR., DELAWARE DEPARTMENT OF STATE DIVISION OF CORPORATIONS, WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), [http://corp.delaware.gov/whycorporations\\_web.pdf](http://corp.delaware.gov/whycorporations_web.pdf).

2. *Id.*

3. All five of the Chancellors on the court have spent portions of their legal practice at firms in Delaware, with a number of them specializing in complex corporate and commercial matters. See *Judicial Officers of the Court of Chancery*, DELAWARE STATE COURTS, <http://courts.delaware.gov/Chancery/judges.stm> (last visited Dec. 29, 2014).

have been tasked with interpreting these alternative entity agreements, various outcomes have occurred. The result has been unpredictability and lack of met expectations regarding when and what fiduciary duties will apply. This Comment proposes a solution that will increase predictability for the contracting parties while also allowing fiduciary duties to play their traditional role of filling gaps in incomplete contracts.

This Comment begins in Part I by laying out the history and nature of the two common alternative entities—limited liability partnerships and limited liability companies. The nature and history of fiduciary duties are then discussed in Part II, with a focus on their development in the alternative entity context in Delaware. Parts III and IV cover the issues revolving around their waiver, namely increased costs to the entity and unpredictability in judicial decisions, as well as why current contractual interpretative methods in this context are futile. Finally, in Part V, this Comment proposes a possible solution—that Delaware courts should narrowly and strictly construe the “express” requirement, first determining if a fiduciary duty waiver or modifying provision is clear and express, and applying default fiduciary duties when there is material ambiguity in the contractual provision modifying or waiving the fiduciary duty. This solution will be supported by looking at the important nature of fiduciary duties in fiduciary relationships and by showing that the burden should be placed on the fiduciary, in his role as a fiduciary, to explicitly and clearly waive his duties so that all parties are allowed predictability in ordering their business affairs.

## I. ALTERNATIVE ENTITIES IN DELAWARE

Two primary types of alternative entities to the traditional American business entity of the corporation exist in Delaware—the limited liability company (LLC) and the limited liability partnership (LLP). In Delaware, the formation of alternative entities has outpaced the formation of corporations.<sup>4</sup> In 2011, “non-corporate business associations as a percentage of new businesses formed w[as] 75%.”<sup>5</sup> Both entities being relatively new, a primary feature of these

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4. Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53, 94 (2013).

5. *Id.*

alternative business entities is the large allowance for contractual freedom. As these alternative entities have become increasingly more popular in recent years, there has been an increased focus on the legal issues surrounding their establishment, organization, and internal conflicts.

#### *A. Limited Liability Companies*

Limited liability companies were an innovation of the corporate world to bridge the gap between the tax benefits of partnerships and the limited liability of corporations. LLCs benefit from the pass-through tax treatment of partnerships while maintaining the benefit of the corporation structure where each member and manager enjoys limited liability.<sup>6</sup> Originally, the LLC revolution began in Wyoming, with early LLCs having partnership characteristics in regards to entity management, continuity of life, and transferability of ownership.<sup>7</sup> As IRS classifications began to loosen, however, increased flexibility in LLC form began to emerge, birthing one of the current primary characteristics of LLCs—freedom of contract.<sup>8</sup>

The relationship between the members and managers is governed by an operating agreement. In Delaware, the operating agreement is dictated by the Delaware LLC act, which grants LLC founders great discretion in both the substantive and procedural aspects of their operating agreements.<sup>9</sup> Because of these and other benefits, LLCs have gained great support in Delaware and are often the entity of choice. In 2009, there were 70,274 LLCs registered in Delaware compared to just 24,955 corporations.<sup>10</sup> That number increased in 2011 to 93,219 LLCs, with the number of corporations in contrast only increasing to 31,472.<sup>11</sup>

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6. Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 FORDHAM J. CORP. & FIN. L. 445, 447–48 (2008).

7. *Id.* at 451.

8. *Id.* at 453–55, 462.

9. *See generally* DEL. CODE ANN. tit. 6, § 18 (2013).

10. DEL. DIV. OF CORPS., *2011 Annual Report 1* (2011), <http://corp.delaware.gov/2011CorpAR.pdf>.

11. *Id.*

### *B. Limited Liability Partnerships*

As LLCs were beginning to gain steam across the country, limited liability partnerships began to develop.<sup>12</sup> Originating in Texas, LLPs have gained widespread acceptance across the country and are currently the primary organizational structure of professional firms.<sup>13</sup> In its base form, a partnership is essentially just an agreement or contract between parties, though one that is fiduciary in nature. A distinguishing characteristic of the original form of general partnerships is the unlimited liability each partner carries to third parties as well as the fiduciary duty each partner owes to the others.<sup>14</sup> The innovation of LLPs came about as a way to reduce member partners' unlimited liability to third parties. In an LLP the partners are not personally liable, though they still hold a duty to each other.<sup>15</sup> Since its creation, the LLP structure has gained large support in the business world and in Delaware specifically. In 2009, there were 5,488 LP/LPPs in Delaware, growing to 7,287 by 2011.<sup>16</sup>

### *C. Contractual Freedom*

Because both LLPs and LLCs are largely dependent on their operating agreements and such operating agreements are permitted great leeway in their structure and content under the Delaware LP and LLC acts, contractual freedom has played a large role for LLPs and LLCs. In reference to the Limited Liability Company Act, the Delaware legislature has stated, “[i]t is the policy of [the Limited Liability Company Act] to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”<sup>17</sup> The Limited Partnership chapter of the Code states the same policy.<sup>18</sup> Some have even characterized the LLC as “purely a creature of contract,” especially in the context of

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12. LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* 142 (2009).

13. *Id.*

14. *See generally* DEL. CODE ANN. tit. 6, § 15 (2013).

15. *See generally* DEL. CODE ANN. tit. 6, § 17 (2013).

16. DEL. DIV. OF CORPS., *supra* note 10, at 1.

17. DEL. CODE ANN. tit. 6, § 18-1101(b) (2013).

18. DEL. CODE ANN. tit. 6, § 17-1101(b) (2013) (“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.”).

fiduciary duty issues.<sup>19</sup> Chancellors of the Delaware Court of Chancery claim that in their reading of large numbers of operating and partnership agreements, “[a] lack of standardization prevails in the alternative entity arena,” with drafters taking full advantage of the freedom to contract varying characteristic of alternative entities.<sup>20</sup> Although this freedom of contract in the alternative entity arena provides a number of benefits for those involved, it can also lead to confusion in post hoc interpretation of certain provisions. This confusion can be seen in courts’ interpretations of clauses that intend to contract around default fiduciary duties.

## II. FIDUCIARY DUTIES

“A fiduciary relationship is a situation where one person reposes special trust in and reliance on the judgment of another or where a special duty exists on the part of one person to protect the interests of another.”<sup>21</sup> Fiduciary duties were originally an invention of common law and focus on providing equitable relief. Fiduciary duties impose certain duties on one party when that party acts as an agent for the interests of another.<sup>22</sup> Such principle-agent relationships must also carry a level of discretionary power vested in the agent for a fiduciary relationship to arise. Such duties arise because of the control one party has over the assets or interests of the other.<sup>23</sup> Because there are costs associated with specifying and monitoring the fiduciaries’ functions, “[f]iduciary duties are imposed when public policy encourages specialization in particular services, such as money management or lawyering, and when . . . [those] costs . . . threaten to undermine the utility of the relationship to entrustors.”<sup>24</sup>

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19. Kleinberger, *supra* note 7, at 464.

20. Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCs AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Mark J. Loewenstein & Robert W. Hillman eds., 2015), <http://ssrn.com/abstract=2481039>.

21. Metro Ambulance, Inc. v. E. Med. Billing, Inc., No. C.A. 13929, 1995 WL 409015, at \*2 (Del. Ch. July 5, 1995) (quoting Cheese Shop Int’l, Inc. v. Steele, 303 A.2d 689, 690 (Del. Ch. 1973), *rev’d on other grounds*, 311 A.2d 870 (Del. 1973)).

22. 2 TAMAR FRANKEL, THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 127–28 (Peter Newman ed., 1998).

23. *Id.*

24. *Id.*

Thus, the ultimate goal of the fiduciary doctrine is to provide incentives for fiduciary relationships while lowering the risks and costs associated with such relationships.<sup>25</sup> As defined by the Restatement of Agency, “[a]n agent has a fiduciary duty to act loyally for the principal’s benefit in all matters connected with the agency relationship.”<sup>26</sup> In fact, some even hold that fiduciary relationships are designed to satisfy solely the needs of the entrustor and not the fiduciary.<sup>27</sup> Both parties to a fiduciary relationship, however, must gain some benefit from the relationship. Thus, it is understandable that the parties would attempt to contract for a mutually beneficial relationship that satisfies the interests of both the fiduciary and the entrustor.

Fiduciary relationships expose an entrustor to two types of wrongdoing—misappropriation and neglect of the asset’s management.<sup>28</sup> Because of these risks associated with the fiduciary relationship, two types of fiduciary duties have arisen: the duty of loyalty, which governs misappropriation, and the duty of care, which governs negligent mismanagement.<sup>29</sup> The Delaware Revised Uniform Partnership Act (hereinafter DRULPA) describes the elements of the duty of loyalty as: accounting to the partnership and holding as trustee any profits, benefits, or partnership opportunities that arise from the partnership; refraining from dealing with the partnership on behalf of a party that has an adverse interest; and refraining from competing with the partnership.<sup>30</sup> The duty of care is defined by the Act as being “limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”<sup>31</sup> Simply put, the duty of loyalty concerns honesty and the importance of avoiding self-dealing. The duty of care, as its name suggests, requires a fiduciary to exercise care over what he has been entrusted with, to the point of avoiding gross negligence.

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25. *Id.*

26. RESTATEMENT (THIRD) OF AGENCY § 8.01 (AM. LAW INST. 2006).

27. Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 797–802 (1983).

28. Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1047 (1991).

29. *Id.*

30. DEL. CODE ANN. tit. 6, § 15-404(b) (2013).

31. *Id.* § 15-404(c).

Fiduciary duties play a large role in business relationships where one party exercises control over the property of another, such as directors of corporations, managing partners in partnerships, and managers of limited liability companies.<sup>32</sup> Fiduciary duties create an incentive for investors to place their trust in another party, knowing that the fiduciary is constrained by the duties legally imposed on him.<sup>33</sup> Although it could be argued that similar results could be accomplished through oversight or contractual bargaining, fiduciary duties accomplish the goals without the immense expense and difficulty of those other options. The expense of oversight would often exceed, or at the very least minimalize, the entrustor's benefits from the relationship.<sup>34</sup> Similarly, the cost of contractual creation and negotiation can be quite high, especially when attempting to contract for every possible scenario.<sup>35</sup> Additionally, a well-documented history of contract litigation shows that no matter the ex-ante effort in structuring a contract there are always situations left uncovered by the agreement.<sup>36</sup> Fiduciary duties "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."<sup>37</sup> It is perhaps for this very reason that fiduciary duties are mandatory in the corporate context. Although corporations are authorized under the Delaware Code to adopt exculpatory provisions relieving directors from monetary liability for duty of care breaches,<sup>38</sup> equitable remedies must remain. Additionally, exculpatory provisions can never apply to the duty of

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32. *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 850 (Del. Ch. 2012) (footnotes omitted) (quoting *Metro Ambulance, Inc. v. E. Med. Billing, Inc.*, No. C.A. 13929, 1995 WL 409015, at \*2 (Del. Ch. July 5, 1995)) ("Under Delaware law, '[a] fiduciary relationship is a situation where one person reposes special trust in and reliance on the judgment of another or where a special duty exists on the part of one person to protect the interests of another.' Corporate directors, general partners and trustees are analogous examples of those who Delaware law has determined owe a 'special duty.'").

33. FRANKEL, *supra* note 22.

34. *Id.*

35. George M. Cohen, *Interpretation and Implied Terms in Contract Law*, in *CONTRACT LAW AND ECONOMICS* 125, 133 (Gerrit De Geest ed., 2d ed. 2011).

36. *Id.*

37. Strine & Laster, *supra* note 20, at 5.

38. DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

loyalty.<sup>39</sup> These restrictions, however, do not apply in the alternative entity context.

*A. Fiduciary Duties in the Alternative Entity Context*

The Delaware Legislature has determined that both the duty of loyalty and the duty of care may be expanded, restricted, and even eliminated in alternative entities through either the partnership or operating agreements.<sup>40</sup> Often, the interests of contractual freedom are forwarded as the primary reason behind this broad allowance in alternative entities.<sup>41</sup> Initially, this contractual freedom did not include the complete elimination of fiduciary duties. In fact, in 2002, the Delaware Supreme Court doubted the permissibility of eliminating fiduciary duties entirely under DRULPA and emphasized that “scrupulous adherence to fiduciary duties is normally expected” under Delaware jurisprudence.<sup>42</sup> Although in 2004 the Delaware Legislature amended the Delaware LP and LLC acts to explicitly allow the elimination of fiduciary duties through alternative entity operating agreements, this negative view of the court towards the permissibility of eliminating fiduciary duties shows the important role that these duties have played in the business entity context.

Because of this important role, the chancery court held in *Auriga Capital v. Gatz Properties (Auriga I)* that fiduciary duties are default rules for LLCs, unless explicitly waived.<sup>43</sup> The court stated that “where the core default fiduciary duties have not been supplanted by contract, they exist.”<sup>44</sup> The chancery court in *Auriga I*

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39. *Id.*

40. DEL. CODE ANN. tit. 6, § 17-1101(d) (2010) (“To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”).

41. DEL. CODE ANN. tit. 6, § 18-1101(b) (2013); DEL. CODE ANN. tit. 6, § 17-1101(b) (2010) (“It is the policy of this chapter to give maximum effect to the principle of freedom of contract.”).

42. *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del. 2002).

43. *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 852 (Del. Ch. 2012).

44. *Id.*

stated two important reasons for the default overlay of fiduciary duties in the LLC context. First, it found that the fiduciary duty defaults allow predictability to measure whether a fiduciary has met her obligations.<sup>45</sup> Second, default fiduciary duties instill confidence in investors investing in Delaware LLCs.<sup>46</sup> Although the Supreme Court of Delaware criticized the chancery court for addressing an issue that was not raised by the parties, it upheld the decision on contractual grounds in *Auriga II*.<sup>47</sup> However, the view of default fiduciary duties under *Auriga I* was followed by the chancery court again in *Feeley v. NHAOCG*, though this time the issue was addressed by the parties.<sup>48</sup> Additionally, in 2013 the Delaware legislature amended the Delaware Code to make it clear that default fiduciary duties do apply to LLCs when they have not been expressly contracted away.<sup>49</sup>

The chancery court's reasoning in *Auriga I* is instructive of the court's views regarding fiduciary duties. Although often regarded as creatures of contract, the court was unwilling to find that the fiduciary duties did not apply to LLCs unless explicitly contracted away.<sup>50</sup> In fact, the court found that they were so fundamental that they were default rules.<sup>51</sup> It is important to note that the reasons for the importance of fiduciary duties articulated by the court in *Auriga I* are still relevant. The court's views that defaults allow predictability to measure whether a fiduciary has met her obligations has been shown to be an important insight, as the courts' decisions since have shown a lack of predictability in attempting to interpret fiduciary duty modification provisions.

This great flexibility in contracting the boundaries of when fiduciary duties apply has been extensively utilized by alternative entities in Delaware. In a study of 85 publicly traded alternative entities, "75 (or 88%) either totally waive the fiduciary duties of managers or eliminate liability rising from the breach of fiduciary

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45. *Id.* at 853.

46. *Id.* at 854.

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

48. *Feeley v. NHAOCG, LLC*, 62 A.3d 649, 659–63 (Del. Ch. 2012).

49. DEL. CODE ANN. tit. 6, § 18-1101(c) (2013).

50. *Auriga Capital Corp.*, 40 A.3d at 852.

51. *Id.*

duties.”<sup>52</sup> Additionally, looking exclusively at publicly traded alternative entities, “47.06% of limited liability companies and 94.20% of limited partnerships (cumulatively 84.88%) have operating agreements with special approval provisions, creating a strong presumption that a transaction complies with fiduciary requirements.”<sup>53</sup> Beyond this, another “29.41% of limited liability companies and 57.97% of limited partnerships (cumulatively 52.32%) have operating agreements that eliminate fiduciary duties altogether.”<sup>54</sup>

Although these figures solely represent publicly traded Delaware alternative entities, they give an insight into the popularity of such fiduciary duty waiving provisions by the drafters of alternative entity agreements.

Despite there being no standardized language for waiving of fiduciary duties, there has developed a somewhat commonly used pattern. The following is a provision that roughly illustrates the pattern the court of chancery has most often seen in LLP waiver provisions:

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.<sup>55</sup>

The provision seeks to replace any traditional duties that would be owed to investors with only those that are contractually specified. The term “Indemnitee” is meant to cover all potential defendants in addition to the General Partner. However, as pointed out by Chancellors Strine and Laster, “[t]here are agreements . . . that omit particular parties, leaving them exposed to traditional fiduciary duty

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52. Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 558 (2012).

53. Horton, *supra* note 4, at 94 (footnotes omitted).

54. *Id.* (footnotes omitted).

55. Strine & Laster, *supra* note 20, at 15.

claims.”<sup>56</sup> It is suspected that “these omissions are examples of the human errors that inevitably creep in during any lengthy drafting assignment.”<sup>57</sup> Additionally, there are other agreements that, rather than explicitly eliminate fiduciary duties, instead depend on detailed contractual provisions to replace the traditional fiduciary duties.<sup>58</sup>

The popularity of waiver provisions demonstrates that founders of alternative entities believe there are a number of advantages to their adoption. However, fiduciary duty waiver provisions have also resulted in complications during the post hoc litigation stage.

### III. SUPPORT FOR LIMITING FIDUCIARY DUTIES IN ALTERNATIVE ENTITIES

There are a number of reasons why both principals and agents may wish to limit fiduciary duties within alternative entity agreements. First, there is a cost the principal must pay for fiduciary duties to be applied. Ribstein describes this cost through an example:

[I]f the fiduciary-to-be believes that there is a 50% chance of having to forgo a deal worth \$100,000, this represents a \$50,000 opportunity cost (ignoring the time value of money) of becoming a fiduciary. The fiduciary-to-be similarly would take into account the need to devote time unselfishly to the business. Before making the leap to fiduciary status, the fiduciary-to-be would want to be assured of being compensated for these sacrifices. The beneficiary, in turn, would be willing to compensate the fiduciary for forgoing self-advantage only if this would produce an adequate payoff. The deal the parties are likely to reach will depend on the costs and benefits of fiduciary duties . . . .<sup>59</sup>

In other words, the fiduciary would need to be rewarded sufficiently to compensate for the lost benefits he would have gained by acting in an opportunistic fashion. Consequently, the entrustor would need to gain a benefit from the enforcement of the fiduciary duties that would outweigh the expense of enforcing them on the fiduciary. By waiving certain aspects of fiduciary duties, such as allowing self-

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56. *Id.* at 16 n.20.

57. *Id.*

58. *Id.*

59. Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 WASH. & LEE L. REV. 537, 543 (1997) (footnote omitted).

dealing in certain scenarios, the entrustor is not required to economically compensate the fiduciary for his lost benefits, thus potentially decreasing the cost of the relationship.

A second potential benefit of waiving or limiting fiduciary duty requirements is that it can reduce impediments to the fiduciary's exercise of discretion. "Fiduciary duties arise in relationships in which it is in the beneficiary's interest to delegate open-ended decision-making power to the fiduciary. Yet fiduciary duties can undermine the main purpose of delegating power to the fiduciary by impeding the fiduciary's exercise of discretion."<sup>60</sup> This can be particularly troubling for investors who have invested in the alternative entity as part of a diversified portfolio. Such members would prefer greater risks be taken by the entity, but by placing the risk on a single manager, it may force the fiduciary to act more cautiously than would be preferred in a diversified portfolio.<sup>61</sup>

Finally, there may be an increased cost in enforcing fiduciary duties.<sup>62</sup> Assuming for the moment that the presence of fiduciary duties would not constrain all opportunistic behavior, it would then fall on the principal members of the entity to enforce those duties through litigation. If fiduciary duties are clearly and explicitly waived, this cost could be avoided. However, as will be discussed below, waivers are often not done in a clear enough manner to avoid future litigation over what and when fiduciary duties actually apply, and thus litigation often occurs regardless. Similarly, this benefit of decreased litigation costs would only occur if *all* fiduciary duties are waived. If all fiduciary duties are waived, the only potential litigation would revolve around simply whether the default duties apply or not, rather than their exact contractually established boundaries. A common practice, however, is the modifying or piecemeal adoption of fiduciary duties in conjunction with a waiver, rather than a complete waiver alone. As a result, increased litigation, rather than less, is often the consequence.

It is clear, therefore, that there are valid reasons why both the principal and the agent may wish to waive fiduciary duties in an alternative entity. However, as will be discussed in Part IV, there are

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60. *Id.* at 549.

61. *Id.*

62. *Id.* at 550.

complications that arise when alternative entity agreements attempt to do more than simply waive the fiduciary duties, but rather attempt to apply portions of them in some circumstances while waiving them in others. This is further complicated when it is unclear to whom such provisions apply.

#### IV. ISSUES CAUSED BY WAIVING FIDUCIARY DUTIES

Although the method of completely waiving fiduciary duties uses somewhat standard language, complications arise when the parties attempt to add back in specific aspects of fiduciary duties in the agreement after having explicitly eliminated the applicability of fiduciary duties generally or when the waiver of fiduciary duties is not done in a clear and express way. The courts' interpretations of the LLC and LLP acts have firmly established the rule that fiduciary duty waivers and modifying provisions must be express.<sup>63</sup> The problem, however, is how narrowly and strictly the court holds the drafting parties to this "express" requirement. The question must be asked: if the waiving and modifying of fiduciary duties is convoluted and ambiguous, but may still be parsed out of the document, is it actually express? Or, should the express standard require clear and exact wording before it will be honored by the courts?

The resulting problems caused by ambiguous and convoluted fiduciary duty provisions can be broken down into two broad categories—increased costs (both ex-ante and ex-post) and unpredictability.

##### *A. Increased Costs*

The waiving of fiduciary duties and then the attempted adding back in of specific fiduciary aspects could arguably be increasing, rather than protecting against, greater financial expense to alternative entities. This increased expense may occur in two ways: ex-ante structuring of the partnership or operating agreement and ex-post litigation over fiduciary duty issues.

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63. See *In re Atlas Energy Res., LLC*, C.A. No. 4589-VCN, 2010 WL 4273122, at \*10 (Del. Ch. Oct. 28, 2010); *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451, at \*8–11 (Del. Ch. Apr. 20, 2009); see also *Kelly v. Blum*, 2010 WL 629850, at \*11–12 (Del. Ch. Feb. 24, 2010) (noting that contractual alterations of traditional fiduciary duties must be explicit).

First, in regards to ex-ante structuring, as discussed previously, it is quite impossible to contract for every potential occurrence.<sup>64</sup> For this very reason, fiduciary duties have remained mandatory in the corporate context.<sup>65</sup> Fiduciary duties fulfill the role of “an equitable gap-filler,” going beyond the narrow restrictions of the good faith requirement.<sup>66</sup> When a party attempts to add back in fiduciary duties for potential future situations, the drafter must anticipate not only what situations may occur, but also the parties that will be involved. This becomes even more difficult when considering the ever-growing complexity of the business world. With each new year, more complex and innovative deals, transactions, and methods are devised in corporate practice. Predicting what may be a standard even five years from now has become precarious at best. Such detailed contracting for every eventuality is impractical. Given the complexity and time involved, including legal fees and time spent in negotiating, contracting can be prohibitively expensive.<sup>67</sup>

Second, in regards to ex-post litigation, there is the potential for an increased expense from litigating ambiguous provisions that modify fiduciary duties. Because the language often contains some ambiguity in regards to the precise facts of the situation and the parties covered, petitioners are usually able to draft a complaint that will at least get past dismissal.<sup>68</sup> Some have recognized a “surface-level standardization” in these provisions, but quickly point out that “this superficial standardization is overwhelmed by diversity in implementation . . . creat[ing] fertile opportunities for future litigation.”<sup>69</sup> Considering that a great deal of provisions that evoke some form of fiduciary duty utilize the “gross negligence” language, it is usually possible for petitioners to draft a complaint that alleges such gross negligence.<sup>70</sup>

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64. Cohen, *supra* note 35.

65. Strine & Laster, *supra* note 20, at 9–12.

66. Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 853 (Del. Ch. 2012).

67. Strine & Laster, *supra* note 20, at 12.

68. *Id.* at 25.

69. *Id.* at 14.

70. *Id.* at 25.

*B. Unpredictability in Judicial Decisions*

More troublesome than the financial cost is the possibility of unmet expectations and unpredictability that comes with this flexibility in contracting around fiduciary duties. Because of the potential ambiguity in these provisions when diversely implemented, predicting the results of the court in each situation is difficult to say the least. This inability of knowing how the court will rule in specific factual situations leaves both the fiduciary and the petitioners with a lack of predictability regarding what fiduciary duties will apply. Fiduciaries are unclear what their specific duties are under each situation, and the petitioners cannot be certain when and how they are protected by the default fiduciary duties. Given that freedom of contract's main purpose is to allow parties to determine how certain situations will be dealt with, it is ironic that freedom of contract in this context creates more unpredictability.

This problem is best highlighted by the lead in paragraph of the opinion in *Kahn v. Portnoy*:

Limited liability companies are primarily creatures of contract, and the parties have broad discretion to design the company as they see fit in an LLC agreement. With this discretion, however, comes the risk—for both the parties and this Court—that the resulting LLC agreement will be incomplete, unclear, or even incoherent.

In this case, plaintiff alleges that the director defendants breached their fiduciary duties to the company . . . . As the company in this case is an LLC, the fiduciary duties of the directors are defined in the LLC agreement. This agreement, however, explicitly imports and modifies the familiar and well defined fiduciary duties from Delaware corporate law. The result is a company whose directors are governed by a modified version of the fiduciary duties of directors of Delaware corporations. Unfortunately, the agreement in this case fails to clearly articulate the contours of these contractual fiduciary duties. The result is an LLC agreement that provides an ambiguous definition of fiduciary duties and is *open to more than one reasonable interpretation*.<sup>71</sup>

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71. *Kahn v. Portnoy*, 2008 WL 5197164, at \*1 (Del. Ch. Dec. 11, 2008) (emphasis added).

The result of this ambiguity was the court not being able to hold that one position was the only permissible interpretation, and thus the court was unable to award a motion to dismiss, leading to further litigation.<sup>72</sup> This problem is compounded by the fact that because of the unique nature of fiduciary duties current contract interpretation methods, such as contextualism and textualism, are insufficient to resolve potential ambiguities.

*1. Contextualism and textualism are insufficient for resolving the ambiguity*

Contract interpretation is one of the least settled and most contentious areas of current contract doctrine.<sup>73</sup> Two primary polar positions of contractual interpretation, namely contextualism and textualism, have developed to compete for the center stage in contract doctrine. However, both are insufficient for resolving the ambiguity in fiduciary duty modifying waivers. Both interpretation methods developed out of a need to align contradictory interpretations of contractual provisions. But, fiduciary duty waivers do not boil down simply to another contractual provision, and thus neither contextualism nor textualism can resolve their common ambiguities.

The basic premise behind the two interpretation methods is simple. Textualism proposes that contracts and agreements are formed between sophisticated parties, who have carefully negotiated and understood the terms of the agreement they have entered into. Thus, when interpreting provisions of the agreement, the parties would prefer that the court look at the carefully drafted language, and nothing beyond.<sup>74</sup> In opposition to the textualism rationale, contextualism recognizes that not all contracts or agreements are entered into between sophisticated parties. Rather than carefully negotiated wording, often provisions are simply copied from prior precedents and offered to the other party as a take-it-or-leave-it proposition. Contextualism, therefore, looks at all of the pre- and

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72. *Id.*

73. Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23, 25 (2014).

74. Robert E. Scott, *Text versus Context: The Failure of the Unitary Law of Contract Interpretation*, in *THE AMERICAN ILLNESS: ESSAYS ON THE RULE OF LAW* 312, 314 (2013).

post-contractual evidence in an attempt to determine what the parties intended when they came to a “meeting of the minds.”<sup>75</sup>

Each polar end of the interpretation spectrum carries with it its own weaknesses. For textualism to truly reflect the intentions of the parties, the idea that unsophisticated parties enter into agreements must be ignored. On the other hand, contextualism depends on the courts’ ability to always parse out the actual intent of the parties, even though at least some parties would rather not turn over such control to the courts, fearing a substantial risk that the courts will erroneously infer the parties’ intent.<sup>76</sup>

The weaknesses of contextualism and textualism are incompatible with the world of alternative entity agreements, and fiduciary duty modifying provisions. Contextualism by its very nature requires the court to look beyond the language of the agreement in an attempt to infer the parties’ intentions or, in other words, to determine what they would have drafted if they were now in the judge’s position. However, if there is one thing that is consistent throughout recent Delaware decisions on fiduciary duty waivers, it is that the waiver must be express.<sup>77</sup> Thus, when there is an actual ambiguity regarding whether a fiduciary duty applies, the rule laid out by the court itself prohibits the court from looking at outside evidence and considering the context of the agreement when determining the parties’ intent.

Unfortunately, the strength of contextualism is the weakness of textualism. Where contextualism allows the court to try and determine the intents of the parties beyond the simple language of the agreement, textualism is bound to the four corners of the document. When fiduciary duty waivers are clear, this does not pose a problem. The difficulty, however, arises when such provisions are convoluted or contradictory. Similarly, textualism’s weaknesses become even more prevalent in the context of fiduciary duty modifying provisions. A large portion of LLC agreements are not negotiated between sophisticated parties, but are drafted by one party and offered to investors or other parties as is. Such agreements often come in a take-it-or-leave-it package, with fiduciary duty waivers being neither negotiated nor often fully understood.

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75. *Id.* at 314.

76. *Id.* at 315.

77. *See* cases cited *supra* note 62.

Although it is established that both parties have a good faith duty of diligence to understand the agreements they enter into, as will be shown, often the complete waiving of fiduciary duties and then the piecemeal addition of certain duties is convoluted, confusing, and contradictory on its face. Thus, a purely textualistic interpretation of these agreements does not reflect the intent of the parties and does harm to one or both parties.

An example of the court looking at the plain language within the four corners of the agreement can be seen in the court of chancery's holding in *Continental Insurance Co. v. Rutledge & Co.*, where the court held that in interpreting provisions to modify a general partner's duty of loyalty, traditional principles of contract construction apply.<sup>78</sup> In so doing, the court attempted to "distill and enforce the reasonable, shared expectations of the parties at the time they contracted."<sup>79</sup> In *Continental Insurance* the court expressed that it was not necessary to look beyond the express contractual language, holding that it was able to discern the expectations of the parties from the clear language of the agreement, since it was not overly ambiguous. The court held that the relevant provision did not address situations of the general partner engaging in self-dealing within the partnership. Thus, the court found that the default fiduciary duty of loyalty applied.<sup>80</sup>

Unfortunately, more difficulty is often seen in interpreting fiduciary duty waiver provisions that are contradictory in nature. As the court is confined to the four corners of the agreement, the original intent of both parties cannot be sufficiently considered. In *Bay Center Apartments Owner LLC v. Emery Bay PKI, LLC*, the plaintiffs pled a breach of fiduciary duty.<sup>81</sup> Vice Chancellor Strine began by acknowledging that under the Delaware LLC Act, there was great flexibility in negotiating fiduciary duties, but that absent "a contrary provision in the LLC agreement," the traditional fiduciary duties apply to the members of the LLC.<sup>82</sup> The defendants in the suit claimed that all of the fiduciary duties had been waived, while the

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78. *Continental Ins. Co. v. Rutledge & Co.*, 750 A.2d 1219, 1236 (Del. Ch. 2000).

79. *Id.*

80. *Id.* at 1235–36.

81. *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

82. *Id.* at \*8.

plaintiffs claimed that the traditional fiduciary duties had been preserved. To support these views, the parties had cited to two separate and, as the court acknowledged, “seemingly contradictory provisions of the LLC Agreement.”<sup>83</sup> The provisions stated:

Section 6.1 *Relationship of Members*. Each Member agrees that, to the fullest extent permitted by the Delaware Act and except as otherwise expressly provided in this Agreement or any other agreement to which the Member is a party: . . . (b) *The Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other.*

Section 6.2 *Liability of Members*. . . . *Except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise.*<sup>84</sup>

As the court acknowledged, the agreement both stated that the members of the LLC owed each other the default fiduciary duties, but also none other than the kind imposed by the agreement itself. It would thus seem that the agreement in the same breath imposed traditional fiduciary duties and limited duties only to contractual duties, which does not include those defined as fiduciary. To overcome this apparent contradiction, the court utilized a textualist approach, choosing a particular reading that would not render either provision meaningless.<sup>85</sup> To do this, the court held that it was possible for Section 6.1(b) to be read as “expressly impos[ing] the default fiduciary duties,” thus allowing them to be imposed by the Agreement and not be included in the duties waived by Section 6.2.<sup>86</sup> The court based this reading on the contractual interpretation maxim that, “given ambiguity between potentially conflicting terms, a contract should be read so as not to render any term meaningless.”<sup>87</sup>

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83. *Id.*

84. *Id.* (quoting LLC Agreement §§ 6.1, 6.2 (emphasis added)).

85. *Id.*

86. *Id.*

87. *Id.* at \*9 (quoting *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 741 (Del. Ch. 2008)).

Because of the contradictory language of the provisions, it is difficult to determine if the drafters' intent truly was what the court determined it to be. If, perhaps, the drafters did structure the agreement to have the exact meaning that the court held, it would still seem quite reasonable at the outset for one of the parties to not fully understand what fiduciary duties were owed by the fiduciary in the agreement. This ambiguity obviously leaves both parties without proper notification of their duties or the duties owed them. Although the court briefly states that the importance of fiduciary duties tipped the scales in favor of their finding, it would seem, given the textualist approach to contractual interpretation the court employed, that the opposite could also have just as easily occurred.

When agreements are convoluted, contradictory, and unclear, the court's attempt to apply traditional textualist contractual interpretation leaves both parties with unpredictability and unmet expectations. An example of this unpredictability is seen in the interpretation in *Gelfman v. Weeden Investors, L.P.*, where again the court was required to determine what fiduciary duties applied in a partnership agreement that was not at all clear on its face.<sup>88</sup> As Chancellor Strine put it in the published opinion, "the drafters took a more (shall we say) textured approach" to modifying the default fiduciary duties.<sup>89</sup> Excerpts of the relevant portions of the partnership agreement demonstrate just how confusing these waivers can be:

6.10 Liability of the General Partner. (a) Neither the General Partner nor . . . directors [or] officers . . . of the General Partner shall be liable . . . for errors in judgment or for any acts or omissions taken in good faith.

. . . .

6.11 (a) Unless otherwise expressly provided herein, (i) whenever a conflict of interest exists or arises between the General Partner or any of its Affiliates, on the one hand, and the Partnership, any Limited Partner or Any Assignee, on the other hand . . . the General Partner shall resolve such conflict of interest, take such action or provide such terms considering, in each case, the relative

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88. *Gelfman v. Weeden Investors, L.P.*, 792 A.2d 977 (Del. Ch. 2001).

89. *Id.* at 984.

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interests of each party to such conflict, agreement, transaction or situation and the benefits and burdens relating to such interests, any customary or accepted industry practices, and any applicable generally accepted accounting practices or principles. In the absence of bad faith by the General Partner, the resolution, action or terms so made, taken or provided by the General Partner shall not constitute a breach of this Agreement. . . . (b) Whenever in this Agreement or the Operating Partnership Agreement the General Partner is permitted or required to make a decision (i) in its “sole discretion” or “discretion,” with “complete discretion” or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership, the Limited Partners or the Assignees. . . . Each Limited Partner . . . hereby agrees that any standard of care or duty imposed in this Agreement, . . . or under the Delaware Act or any other applicable law, rule or regulation shall be modified, waived or limited in each case as required to permit the General Partner to act under this Agreement . . . and to make any decision pursuant to the authority prescribed in this Section 6.11(b) so long as such action or decision does not constitute gross negligence or willful or wanton misconduct and is not reasonably believed by the General Partner to be inconsistent with the overall purposes of the Partnership.<sup>90</sup>

In reference to this agreement’s provisions, the court stated that it “ha[s] a head-spinning quality upon first reading.”<sup>91</sup> The court went even as far as stating that provisions of the agreement were “baffling in certain respects.”<sup>92</sup> The tone and wording of the court’s opinion shows the difficulty the court faced in interpreting an alternative entity agreement where a lack of information was present. The court implicitly admits to being required to dig deep into the language of the agreement, even turning a negatively worded Proviso phrase positive to try and glean some plausible interpretation.<sup>93</sup> Additionally, the court admits that its reading results

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90. *Id.* at 984–86 (quoting Partnership Agreement §§ 6.10, 6.11).

91. *Id.* at 986.

92. *Id.*

93. *Id.* at 986–87.

in a “harsh” and “rather odd” interpretation.<sup>94</sup> It would seem, then, that the court held strictly to a textualist contractual interpretation method, implicitly acknowledging that at least one party’s expectations may not have been met. With a lack of information, it can never be certain that the court will come to the same conclusion that both parties intended when the agreement was drafted, thus potentially leaving at least one party’s expectations unfilled and with a lack of predictability in its business affairs.

There have been times, however, where the court has strictly and narrowly construed the rule that fiduciary duty waivers must be explicit. In *In re Atlas Energy Resources, LLC*, the court was faced with determining if the following provision applied to controlling unitholders:

[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 transaction that may be particularly favorable to the Company).<sup>95</sup>

The court held that it was “especially wary of eliminating [fiduciary] duties in the context of a publicly traded limited liability company without sufficient evidence within the contractual language of the parties’ intent to do so.”<sup>96</sup> Thus the court went on to explain that the controlling unitholders’ fiduciary duties would not be disclaimed unless expressly done so in the previous provision or

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94. *Id.* at 986.

95. *In re Atlas Energy Res., LLC*, C.A. No. 4589-VCN, 2010 WL 4273122, at \*6–7 (Del. Ch. July 20, 2010).

96. *Id.* at \*7.

somewhere else in the agreement.<sup>97</sup> Although the provision waived some fiduciary duties, the court strictly held to the rule requiring clear and explicit waivers, and held that “[t]he contractual language of [the provision] does not purport to resolve conflicts of interest between [controlling] and . . . minority unitholders.”<sup>98</sup>

Beyond the weaknesses of textualism and contextualism in the context of fiduciary duty waivers, treating provisions dealing with fiduciary duty waivers as standard contractual provisions is flawed in itself. Neither of these contractual interpretation methods is sufficient in the fiduciary duty modification context because, although the waiving or modifying of fiduciary duties is done through provisions in the partnership or LLC agreement, fiduciary duties are not species of implied contract terms. By modifying the boundaries of fiduciary duties, the parties are in a sense attempting to mutate fiduciary duties into contractual terms, and thus the courts face the temptation to approach such provisions as they would other contractual provisions. The problem with treating fiduciary duties as contractual terms, is that it

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.<sup>99</sup>

Contract interpretation is based on the presumption “that the parties will act in a mutually self-interested manner” with each party being “responsible for securing their interests in dealings with the other.”<sup>100</sup> In contrast to contractual interpretation, it is assumed in fiduciary law “that the parties are interacting for the exclusive benefit of one of them—the beneficiary.”<sup>101</sup> Thus, by the very nature of

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97. *Id.*

98. *Id.*

99. D. Gordon Smith & Jordan C. Lee, *Fiduciary Discretion*, 75 OHIO ST. L.J. 609, 622 (2014).

100. *Id.* at 622 n.65 (quoting Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 982 (2013)).

101. *Id.*

fiduciary duties, such provisions demand a different interpretive approach than other contractual provisions.

Because of the nature of fiduciary duties, the established requirements for waiving fiduciary duties, and the inherent weaknesses in both textualism and contextualism, the current framework utilized by the courts in determining which fiduciary duties apply leaves parties a lack of predictability in court decisions and the possibility of unmet expectations and misconstrued intent.

#### V. PROPOSED SOLUTION

Courts should narrowly construe the current rule that fiduciary duty waivers must be expressly contracted away, requiring that only clear and unambiguous waiving or modifying of fiduciary duties will be upheld. As has been shown, looking at extrinsic evidence or the context of the agreement is inappropriate when precedent requires that a waiver be express, and textualism does not have the ability to properly protect the intentions of both parties when it treats fiduciary duty provisions the same as any other contractual provision. Indeed, as mentioned above, fiduciary duty provisions are more than a contractual provision and applying the same contractual interpretation methodologies does harm to the fiduciary duty doctrine. For these reasons, unless a provision that seeks to limit fiduciary duties is clear and explicit, the court should find that the default duties apply. The relative analysis of the court would thus be to determine first if the duties have been modified expressly in a clear and explicit way. If they have, the court should uphold the agreement, supporting the alternative entity underlying doctrine of freedom to contract. However, if the provisions are ambiguous, convoluted, or contradictory, the court should find that the provisions do not meet the minimum standard of expressly waiving or modifying the duties, and thus are unenforceable, with the default fiduciary duties being in force.

Beyond what has already been discussed, this method should be adopted by the courts for two reasons. First, fiduciary duties play an important role in the business entity environment, and thus when there is an ambiguity as to whether they should apply, their benefits should support a deference to finding that they exist. Second, because the relationship is, at its core, a fiduciary one, and it is generally the fiduciary who wishes to waive his duties, the burden

should be on the fiduciary to be as clear and explicit as possible when waiving those duties.

*A. The Importance of Fiduciary Duties Supports Deference in Holding That They Apply*

The importance of fulfilling one's fiduciary duties in a fiduciary relationship was expressed quite vividly in the famous opinion penned by Judge Cardozo in *Meinhard v. Salmon*:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.<sup>102</sup>

With such language as "the punctilio of an honor the most sensitive," it is evident how important some have held fiduciary duties to be. Surely, it is difficult to argue that Judge Cardozo would hold such duties inapplicable when it is unclear whether an ambiguous provision in an agreement may or may not be attempting to waive such duties.

Fiduciary duties are owed when one exercises stewardship over the property of another. These relationships are often formed through contract. However, over the course of our legal history, courts discovered that the contracts themselves were not sufficient to protect the parties. Indeed, the court found that fiduciary duties were needed to fill the gaps within these special types of contractual relationships. As a result, fiduciary duties took an important role in both the corporate and partnership worlds. However, as the desire

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102. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (citation omitted).

for more flexible business entities emerged, so did the need for greater contractual freedom. This contractual freedom though, as discussed above, has now bled into the fiduciary duties context, allowing even the duties that emerged to protect against deficiencies in contracts to be contracted themselves and then interpreted in the same manner as any other contractual provision.

Thus, the first reason why deference should be given to finding that fiduciary duties apply is that contractual provisions are unable to fulfill the same role. Simply because contractual freedom is a compelling interest does not mean that it is also sufficient to protect the parties involved. The problem with this contractual approach to fiduciary duties is clear. Fiduciary duties are meant to be gap fillers when an agreement is not explicitly applicable to a certain situation or party. But when the provision of the agreement deals with fiduciary duties themselves, what is left to fill in the gaps of an ambiguous agreement? The answer for other portions of the agreement would generally be fiduciary duties, but such a protection is not available to fiduciary duty waivers themselves. Thus, when an agreement is ambiguous regarding the limiting of fiduciary duties, the court should give deference to finding that they apply, rather than going through an elaborate exercise of finding some plausible interpretation of the provision.

Contractualists would argue against this stance, contending that the freedom of contract allows the parties to determine for themselves the level and division of risk they wish to bear. Indeed, this country's economic history is based on the notion of freedom, allowing parties to contract for what they will, how they will. However, as pointed out by a leading scholar of the economics and jurisprudence of contract law, restrictions on contracting may be efficient when the market is inefficient, which it often is.<sup>103</sup> The market can fail in at least two ways—monopolies and imperfect information (specifically, buyer misperception of risks, buyer misperception of changes in risks, and imperfect seller information).<sup>104</sup>

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103. Richard Craswell, *Freedom of Contract*, THE COASE LECTURE SERIES 1, 3 (Coase-Sandor Inst. for Law & Econ., Working Paper No. 33, 1995).

104. *Id.* at 5–18.

Additionally, there is fallacy in treating fiduciary duty provisions as any other contractual provisions because of the method employed in determining if a fiduciary fulfilled his duties. In the fiduciary duty context, the judge's role is to determine if the fiduciary acted appropriately within the scope of his discretion.<sup>105</sup> However, contract provision interpretation is "often framed in the terms of a hypothetical bargain," attempting to determine the result that the parties themselves would have chosen if they could have anticipated the situation they currently find themselves in.<sup>106</sup>

Second, there are also public policy reasons supporting the court giving deference to finding that fiduciary duties apply when an alternative entity's agreement is ambiguous on the question. Fiduciary duties of loyalty and care incentivize fiduciaries to act in the best interest of the entrustor. Fiduciary duties encourage honesty, good faith, prudence, and care in the exercise of the fiduciary's duties. Accordingly, ambiguity in the waiver or limiting of such duties can reasonably be construed to incentivize the opposite—acting in self-interested ways, and exercising fiduciary roles with at least some negligence or lack of total care.

This is not to say that fiduciary duties should be applicable to all business entities. There are certainly alternative entities whose objectives would be hampered by the enforcement of fiduciary duties. Surely it could not be argued that all waiving of fiduciary duties is done in a self-interested motivation by the drafters.<sup>107</sup> However, the potential that such provisions will lead to an increase in self-interested dealing and lack of care is no logical stretch. Although there are surely extralegal constraints that may refrain certain opportunistic dealing even without fiduciary duties applied, a party's "potential gains from such behavior often may be large enough to swamp such incentives."<sup>108</sup> Therefore, "supported by the frequency of cases involving unfair behavior," it would appear that "the benefits of legally enforceable fiduciary-type duties in supplementing extralegal incentives may seem to outweigh the

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105. Smith & Lee, *supra* note 99.

106. *Id.*

107. *See supra* Part III.

108. Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 234.

costs.”<sup>109</sup> Although full fiduciary duties may not be desirable in every business entity, because of the incentives they create, the court should lean towards finding fiduciary duties, rather than not. As one has observed:

The open-ended nature of fiduciary duty reflects the law’s longstanding recognition that devious people can smell a loophole a mile away. For centuries, the law has assumed that (1) power creates opportunities for abuse and (2) the devious creativity of those in power may outstrip the prescience of those trying, through ex ante contract drafting, to constrain that combination of power and creativity. For an attorney to advise a client that the attorney’s drafting skills are adequate to take the place of centuries of fiduciary doctrine may be an example of chutzpah or hubris (or both).<sup>110</sup>

Given a situation where an agreement does not explicitly and very clearly show that both parties knew and understood the duties to be waived, the court should give deference to the finding that fiduciary duties, which inherently incentivize fiduciaries to fulfill their duties to their best ability, apply.

Third, due to the nature of the fiduciary relationship, these contracts often contain complex tasks that the entrustor cannot measure easily on his own, thus making express contracting problematic.<sup>111</sup> This is especially true when one of the parties is a lay person, as is often the case with investors in publicly traded alternative entities. The idea of the fiduciary relationship is to have the fiduciary do something for the entrustor that the entrustor cannot do for herself, so it is improbable to monitor the fiduciary to see if he is acting in an appropriate way, especially when the entrustor has exposed herself to further liability by entering into an agreement in which the fiduciary has waived parts of his fiduciary duties.<sup>112</sup> Thus, a party may not know or understand every possible situation or nuance to contract for and being able to contract for every

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109. *Id.*

110. CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 14.05[4][a][ii] (1994).

111. Cohen, *supra* note 35.

112. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1212–14 (1995).

situation is already on its face prohibitively expensive. Add to that the many parties that may not be able to account for a majority of possible future situations, let alone the more complex, nuanced situations that may arise. Shifting such a risk to the entrustor almost seems to undermine the fiduciary relationship at its base, leading to a mindset that the entrustor should have been able to predict what protection she needed before she even knew what needed protection. Thus, there are some who characterize fiduciary duties “as a hypothetical bargain—that is, contract terms the parties themselves would have agreed to in the absence of transaction costs.”<sup>113</sup>

Finally, both freedom of contract and the concept of textualism assume that there is at least some resemblance of equal bargaining power. However, while that may be true in some contexts, for many others it is a fallacy—many investments, including private equity, venture capital, real estate, and hedge funds, are done through investment limited partnerships.<sup>114</sup> In many of these situations, there is no bargaining over the content of the agreements. These are take-it-or-leave-it investments, where the fiduciary drafts, and thus dictates, his own fiduciary duty limits. As Chancellors Strine and Laster have observed, “[i]n approaching these entities, investors . . . cannot rely on their understandings of default principles of law . . . [but] 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.”<sup>115</sup> The Chancellors go on to observe that “because bargaining, at best, occurs only 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.”<sup>116</sup> Therefore, the contractualist argument that fiduciary duty waivers are products of bargained for agreements is often not true in today’s publicly

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113. Ribstein, *supra* note 59, at 541.

114. Jeffrey E. Horvitz, *Fiduciary Duty Waivers of LPs May Expose Sponsors*, PENSIONS & INV., Oct. 14, 2013, <http://www.pionline.com/article/20131014/PRINT/310149994/fiduciary-duty-waivers-of-lps-may-expose-sponsors>.

115. Strine & Laster, *supra* note 20, at 3.

116. *Id.* at 3–4.

traded alternative entity environment. The result, thus, is fiduciaries waiving their own fiduciary duties without any bargaining between parties.

*B. Fiduciaries Must Be Explicitly Clear in Waiving Their Duties Since, by the Very Nature of the Relationship, They Owe Duties to the Entrustor*

The rule requiring that fiduciary duties be modified expressly should be narrowly and strictly construed, in part because it is often the fiduciary himself attempting to limit his duties, thus acting in a self-interested manner, rather than for the good of the entrustor:

In varying degrees the relationships expose entrustors to extraordinary risks. Entrustors must entrust power or property to the fiduciaries because the fiduciaries could not perform their services effectively otherwise, yet this exposes entrustors to the risk that the fiduciaries will appropriate the entrusted property or interest, or misuse the power entrusted to them. The appropriation or abuse of power can result in a loss that far exceeds the potential gain from the fiduciaries' services.<sup>117</sup>

Being placed in the role of a fiduciary, the fiduciary must make decisions in the best interest of the entrustor. For this reason, the courts have “note[d] the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly.”<sup>118</sup> It is this very relationship of trust that requires that a fiduciary waiving his duties not do so lightly, but rather clearly and explicitly. If a fiduciary is to lower the expectations placed on him by the law, the entrustor has a right to be fully aware and knowledgeable regarding the level of protection she is afforded. In a sense, when attempting to limit his fiduciary duties, a fiduciary must not violate those same fiduciary duties. This is not to say that he may not limit his fiduciary duties in his own interest, for it would seem nonsensical to argue that that is not often a primary motivating reason for such waivers, but he must do so with

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117. Frankel, *supra* note 112, at 1212.

118. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 168 (Del. 2002).

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no intent to harm the entrustor. In other words, the waiving of the fiduciary duties must be fully understood by both parties, so that both the entrustor and the fiduciary know exactly the modified nature of their fiduciary relationship.

For such a high standard of understanding and notice to be met, the waiving of the fiduciary duties must be as explicit and clear as possible, as the rule implicitly demands. If there is any ambiguity or uncertainty regarding whether fiduciary duties apply to certain parties or actions, then the courts should find that they by default apply, in essence placing the burden firmly on the fiduciary. Thus, only in the most express and clear situations will a fiduciary be able to waive his duties, leaving those entrustors who in good faith believe they are protected to in fact be protected. This proposed solution will not only allow for increased notice, but also will incentivize more careful drafting of LLC and partnership agreements.

*C. Arguments Against not Enforcing Fiduciary Duty Waivers*

There are a number of arguments against not enforcing fiduciary duty waivers, or in other words, honoring the waivers even when ambiguous. First, to be clear, the proposition of this Comment is not that fiduciary duty waivers should not be honored in the alternative entity context, but rather that when such waivers are ambiguous in the context in which they are being asked to be enforced, that the judiciary strictly and narrowly construe the rule that the waivers must be express—requiring all waivers and modifying provisions be explicit, clear, and unambiguous. If the relevant provisions do not meet this standard, then the court should find that the default fiduciary duties apply.

One argument against not upholding fiduciary duty waivers is that the ex-post harm to the beneficiary by the fiduciary is the same as enforcing any other contract even though one party may feel regret because in the end the contract favored one party over the other.<sup>119</sup> The fundamental problem with this argument is the treating of fiduciary duties like any other contractual element or duty. Fiduciary duties are more than that. Fiduciary duties exist beyond

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119. Ribstein, *supra* note 59, at 551.

the contract and stem from the relationship itself. Indeed, the nature of fiduciary duties is to fill in the gaps of the contract that creates the fiduciary relationship. Thus, comparing the waiving of fiduciary duties to any other contractual provision, such as an agreement on consideration, is overly simplistic and misses the point of the duties themselves.

Addressing the interpretation issue, some argue that “courts can deal with this sort of question, as they have with other interpretation issues, on a case-by-case basis.”<sup>120</sup> As discussed in detail above, such a cavalier approach to ad hoc decision making is not appropriate in the fiduciary duty context. Additionally, the interpretative methods of fiduciary duties of a necessity require a variation from those of traditional contractual provisions. Although the importance of freedom of contract cannot be disputed, neither can the importance of parties being able to have their expectations realized in the context of their fiduciary duties and rights.

In the end, a great deal of the arguments against not enforcing fiduciary duty waivers are based on the principle of freedom of contract. Freedom of contract is a primary reason that a number of entities organize themselves as LLCs and LLPs in Delaware, and thus freedom of contract cannot just be swept aside. However, by entering into one of these alternative entities, the parties have manifested a desire to be part of a fiduciary relationship, with all of the fiduciary duties that come with such a relationship. This Comment does not propose that fiduciary duties trump the freedom of contract, only that fiduciary duties are of such importance in the business world that, if parties are to utilize the freedom of contract in the drafting of alternative entity agreements, they must do so with heightened precision and clarity so as to ensure that all parties involved are fully aware of the fiduciary duties they owe and are owed.

## VI. CONCLUSION

As the popularity and wide acceptance of alternative entities has increased, issues surrounding the contractual freedom inherent in them have surfaced. In particular, courts have been faced with the

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120. *Id.* at 570.

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difficult task of interpreting fiduciary duty waivers in LLC and partnership agreements. Because of the fundamental role that fiduciary duties have played in the business law context, as well as the important benefits that continue to be realized from their recognition, attempts to waive fiduciary duties should be scrutinized by the courts. Although the Delaware legislature clearly allows for the waiver or modification of these duties, the current rule requires that such waivers or modifications be done expressly. The courts should narrowly and strictly construe this rule. Unless a provision is explicitly clear regarding which fiduciary duties do and do not apply, and to whom they apply, the courts should find that default traditional duties of loyalty and care are in force. Thus, whenever there is material ambiguity regarding fiduciary duty provisions, the courts should first determine if the standard of clear and explicit modification has been met, and if not, end the interpretation there, finding that the default duties apply. This proposed solution will promote more careful agreement drafting, decreased litigation costs over ambiguous provisions, increased predictability to all parties involved, and increased protection for those who believe they are protected.

*Michael Despres\**

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\* J.D. candidate, April 2016, J. Reuben Clark Law School, Brigham Young University. I would like to thank Professor Matthew Jennejohn for his assistance and support in writing this Comment.

