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Fiduciary Duties and Unincorporated Business Entities: In Defense of the Manifestly Unreasonable Standard

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FIDUCIARY DUTIES AND UNINCORPORATED BUSINESS ENTITIES: IN DEFENSE OF THE "MANIFESTLY UNREASONABLE" STANDARD

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I. INTRODUCTION

Much ink has been spilled discussing the fiduciary duties of participants in unincorporated business entities, principally partnerships and limited liability companies.[1] As the law of unincorporated business entities has moved from statute to contract,[2] the debate has shifted from the content of fiduciary duties to whether the

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1. Some recent articles include: J. William Callison & Allan W. Vestal, *The Want of a Theory, Again*, 37 Suffolk U. L. Rev. 719 (2004) (critiquing the Uniform Limited Partnership Act because it lacks a coherent theory to explain the allocation of participant management and information rights and fiduciary duties); J. William Callison, *Blind Men and Elephants: Fiduciary Duties under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1 J. Small & Emerging Bus. L. 109, 159 (1997) (critiquing the contractarian approach of the Revised Uniform Partnership Act); J. Dennis Hynes, *Freedom of Contract, Fiduciary Duties, and Partnerships: The Bargain Principle and the Law of Agency*, 54 Wash. & Lee L. Rev. 439 (1997) [hereinafter Hynes, *Freedom of Contract*] (arguing for freedom of contract in partnership agreements); J. Dennis Hynes, *Fiduciary Duties and RUPA: An Inquiry into Freedom of Contract*, 58 L. & Contemp. Probs. 29 (1995) [hereinafter Hynes, *Fiduciary Duties*] (arguing for unrestrained freedom of contract); Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. Pa. L. Rev. 1609 (2004) (arguing for judicial intervention to address abusive conduct); Allan W. Vestal, *Advancing the Search for Compromise: A Response to Professor Hynes*, 58 L. & Contemp. Probs. 55 (1995) (responding to Hynes and arguing for limitations on freedom of contract). For a view that partners are fiduciaries only in narrow circumstances, see Larry E. Ribstein, *Are Partners Fiduciaries?* 2005 U. Ill. L. Rev. 209 (2005) [hereinafter Ribstein, *Partners*]; Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927 (2004) [hereinafter Ribstein, *Fiduciary Duties*]. For an opposing view that would expand fiduciary duties, see Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 Fla. St. U. L. Rev. 955 (1995), *see also* Tammy Savidge Moore, Student Author, *The Policy of Opting-out of Fiduciary Duties in a Limited Liability Company:* McConnell v. Hunt Sports Enterprises, 42 S. Tex. L. Rev. 183 (2000) (arguing for a "reasonableness" limitation on waivers of fiduciary duty); Larry E. Ribstein, *Fiduciary Duty Contracts in Unincorporated Firms*, 54 Wash. & Lee L. Rev. 537, 540 (1997) [hereinafter Ribstein, *Fiduciary Duty Contracts*] (arguing that fiduciary duties "are simply a species of contract" and that restrictions on waivers of fiduciary duties cannot be justified); Eric Talley, *Taking the 'I' Out of 'Team': Intra-Firm Monitoring and the Content of Fiduciary Duties*, 24 J. Corp. L. 1001 (1999) (arguing that high fiduciary duties induce excessive monitoring).

2. Several sections of the Uniform Partnership Act of 1914, 6 U.L.A. 275 (2001), are expressly made "subject to any agreement [between the partners]." *E.g.* § 18 (rights and duties of partners in relation to the partnership), § 19 (place where partnership books shall be kept), § 25 (right to possess partnership property), § 27 (effect of an assignment of a partnership interest), § 37 (right to wind up the partnership), § 40 (distribution of property after dissolution), § 42 (rights of a retired partner and the estate of a deceased partner),

parties forming these entities should be free to disclaim such duties altogether. Ironically, the relevant statutes—the Uniform Partnership Act of 1914 ("UPA"),[3] the Revised Uniform Partnership Act of 1997 ("RUPA"),[4] the Uniform Limited Liability Company Act of 1996 ("ULLCA"),[5] and the Uniform Limited Partnership Act of 2001 ("ULPA")[6]—suggest the debate is moving in the opposite direction, inasmuch as UPA is virtually silent on mandatory fiduciary duties,[7] while the three later Acts include mandatory fiduciary duties.[8] UPA, however, was drafted against the background of agency law that recognized fiduciary duties in the principal-agent and partner-partner relationship,[9] so the paucity of provisions in UPA mandating fiduciary duties should not be interpreted to mean that such duties were not part of the relationship of the parties. Indeed, as demonstrated below, the structure of UPA suggests that these duties were inherent in the relationship, while the modern acts (RUPA, ULLCA, and ULPA) were intended to replace common law fiduciary duties with statutory provisions.[10] Moreover,

§ 43 (right to an account of the interest of a partner). This drafting technique suggests that other terms (including § 20 and § 21, which impose fiduciary duties on partners) are mandatory. In contrast, the Revised Uniform Partnership Act § 103, 6 U.L.A. 1 (2001), the Uniform Limited Liability Company Act § 103, 6A U.L.A. 553 (2003), and the Uniform Limited Partnership Act § 110, 6A U.L.A. 1 (2003), provide that all provisions, with a few specified exceptions, are default terms.

3. 6 U.L.A. 275 (2001).

4. 6 U.L.A. 1 (2001).

5. 6A U.L.A. 553 (2003).

6. 6A U.L.A. 1 (2003).

7. Historically, partnerships were considered mutual agency relationships, with fiduciary duties of loyalty and care owed from each partner to every other partner. UPA captured this concept, providing in § 4 that the laws of agency apply and in § 9 that "[e]very partner is an agent of the partnership for the purpose of its business." UPA did not codify the fiduciary duties of a partner, likely because its drafters may have felt that it was not necessary to do so, as these agency concepts were so widely known and accepted. Only UPA § 20 and § 21 relate to fiduciary duties, with the former setting forth a disclosure requirement and the latter providing that

> [e]very partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

The comment states why the drafters included § 21: they wanted to make clear that a partner holds partnership property as a trustee so that the partnership could pursue traceable partnership assets in the hands of a partner as a beneficiary of a trust rather than as an ordinary creditor of the partnership. The section thus clarified some doubts arising from existing case law and thereby provided some protection to a partnership against the misconduct of a partner. There is no official comment to § 20; however, it appears likely that the purpose of this section was to make clear that not only partners have a right to information on demand, but so does the legal representative of any deceased partner or partner under legal disability. Indeed, it is somewhat inaccurate to characterize UPA § 20 as setting forth the duty of disclosure, as the common law duty of disclosure is broader than set forth in § 20. *See Appletree Square I LP v. Investmark, Inc.*, 494 N.W.2d 889, 892–93 (Minn. App. 1993) (noting that fiduciary duty of disclosure is broader than the duty to render information on demand). The drafters' decision to forgo codification of core fiduciary duties in UPA only emphasizes how ingrained those duties were.

8. *See* RUPA § 404; ULLCA § 409; ULPA § 408.

9. UPA § 4 provides that "[t]he law of agency shall apply under this act." *See* Alan R. Bromberg, *Crane and Bromberg on Partnership* 390 (West 1968) (suggesting that lawmakers adopting UPA understood that it incorporated common law fiduciary duties); Robert E. Mathews & Justin H. Folkerth, *Ohio Partnership Law and the Uniform Partnership Act*, 9 Ohio St. L.J. 616, 661–62 (1948) (noting the same with respect to Ohio law); Byron D. Sher & Alan R. Bromberg, *Texas Partnership Law in the 20th Century—Why Texas Should Adopt the Uniform Partnership Act*, 12 Sw. L.J. 263, 298–300 (1958) (noting the similarities between Texas common law and the UPA); *see also infra* n. 33 and accompanying text.

10. *See* Alan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. Rev. 523, 532 (1993) (commenting that RUPA was intended "to displace, and not merely to supplement, the common law." (footnote omitted)).

unlike UPA, the later Acts anticipate that parties will seek to bargain out of fiduciary duties and expressly provide considerable freedom to do so.[11] By comparison, many courts interpreting UPA expressed skepticism when it came to enforcing fiduciary waivers.[12] Finally, several states, led by Delaware, have adopted post-RUPA provisions that expand on the freedom of contract provided in RUPA.[13] Bar association and state legislative committees around the country are now, or shortly will be, considering whether to amend their statutes on unincorporated business entities to permit parties, as Delaware has,[14] to disclaim fiduciary duties entirely. This article seeks to inform their deliberations.

The idea of freedom of contract is attractive. After all, why should parties dealing at arm's length not be free to craft any sort of arrangement that they desire, inasmuch as no third parties are adversely affected by their deal?[15] Enforcing agreements as written, it is argued, will increase their certainty and reliability.[16] Presumably, the courts will serve as a safety net if the bargain struck meets the stringent requirements of unconscionability, but aside from that the courts should enforce the bargain as written. Advocates of a robust application of freedom of contract, sometimes called "contractarians," support their view with economic analysis, arguing that freely struck bargains are more economically efficient than bargains that include terms mandated by a state statute.[17]

Arrayed against the contractarians are those that believe that partnerships and limited liability companies are not solely contractual entities; rather, the participants have some moral obligation to one another, an obligation that ought not to be totally eliminated by agreement.[18] Adherents of this view, sometimes called "fiduciarians,"

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11. *See* RUPA § 103; ULLCA § 103; ULPA § 110; *infra* pt. III.

12. *See infra* pt. II.B.

13. *See e.g.* Ga. Code Ann. § 14-9-108(b)(1) (2003), which provides:

> The partner's duties and liabilities may be expanded, restricted, or eliminated by provisions in the partnership agreement; provided, however, that no such provision shall eliminate or limit the liability of a partner for intentional misconduct or a knowing violation of law or for any transaction for which the partner received a personal benefit in violation or breach of any provision of the partnership agreement.

Presumably, under this provision, the partnership agreement could provide for the elimination of the duty of loyalty.

14. Del. Code Ann. tit. 6, § 15-103(f) (2005). The Virginia partnership statute allows waiver of the duty of loyalty by omitting that duty from the provisions that cannot be altered by agreement. Va. Code Ann. § 50-73.81(B) (2005); *see also supra* n. 13 (discussing the Georgia statute).

15. *See* Hynes, *Freedom of Contract*, *supra* n. 1, at 443.

16. *Id.* There is some evidence suggesting that certainty and reliability are not being realized, even in Delaware. *See* Jack B. Jacobs, *Entity Rationalization: A Judge's Perspective*, 58 Bus. L. 1043, 1044–46 (2003) (noting the exceptionally large volume of litigation in Delaware involving unincorporated business entities).

17. *See* Ribstein, *Fiduciary Duty Contracts*, *supra* n. 1, at 541–45; *see generally* Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 1–39 (Harv. U. Press 1991); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & Econs. 425 (1993).

18. *See e.g.* Dickerson, *supra* n. 1; Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 Or. L. Rev. 1209, 1246 (1995) ("I believe that like every civilized society, we must provide a legal model of a trust relationship. Broad and sweeping waivers of fiduciary duties that could undermine such a trust model should not be enforced."); C.A.E. Goodhart, *Economics and the Law: Too Much One-Way Traffic?* 60 Modern L. Rev. 1, 14 (1997) (arguing that a law and economics approach improperly elevates economic efficiency over justice and equity); *see also e.g.* Vestal, *supra* n. 1; Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 L. & Contemp. Probs. 81 (1995).

support their view with theories based on imperfections in the bargaining process, the reasonable expectations of the parties, and the need to police against overreaching and sharp practices. On this view, parties are unable to predict what abuses might be committed by an opportunistic partner.[19]

While the law is evolving in the direction favored by the contractarians, it is clearly not there yet, at least outside of Delaware and a few other states. Rather, the modern acts have struck a middle ground that seems to be widely accepted—parties can contract around fiduciary duties, but not completely. The modern acts generally provide that the parties can limit certain fiduciary duties so long as the limitation is "not manifestly unreasonable."[20] This middle ground, discussed in Part III below, has been subject to criticism from both sides of the debate, with contractarians arguing that its drafters have not gone far enough, and fiduciarians, predictably, that the drafters have gone too far in the direction of contractarians.

While I am sympathetic to the contractarian view as a theoretical matter, for pragmatic reasons I support the middle ground represented by the modern acts. In short, courts traditionally have been leery of deferring to the agreement that parties strike when unfairness seems palpable. In those instances, courts will imply strained rules of interpretation to reach a "just" result. They will employ, in the words of a great twentieth-century legal scholar, "covert tools"[21] to reach the end that they desire.[22] The

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19. *See e.g.* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 Stan. L. Rev. 211, 249 (1995). Professor Eisenberg argues that limitations on the cognition of beneficiaries of fiduciary duties suggest that at least some waivers should not be enforced by the courts:

> To begin with, because of bounded rationality the beneficiaries could not possibly identify all the varying circumstances to which a general waiver of the duty of loyalty would apply. Furthermore, the beneficiaries would likely be unduly optimistic about the extent to which the manager would deal fairly despite the lack of fiduciary restraints. The availability and representativeness heuristics would enhance such undue optimism: Beneficiaries would tend to give undue weight to their good relationship with the manager at the time of contract formation, because that relationship is vivid, concrete, and instantiated, as compared with the possibility that the manager would exploit the bargain at some point in the future, which is abstract, general, and pallid, and would tend to overestimate the extent to which the present relationship with the manager is a reliable index of the future relationship. Similarly, faulty telescopic faculties would lead the beneficiaries to give undue weight to the present benefits of the relationship as compared to the future costs of the waiver. Finally, beneficiaries would tend to underestimate the risks that the waiver entailed. Thus, a general waiver of the duty of loyalty would inevitably permit unanticipated opportunistic behavior on the part of managers.

Id.; *see also* Hynes, *Fiduciary Duties*, *supra* n. 1, at 44 (citing Professor Eisenberg's challenge to the drafters of RUPA); *but see* Robert W. Hillman, *Business Partners as Fiduciaries: Reflections on the Limits of Doctrine*, 22 Cardozo L. Rev. 51, 51 (2000) (stating "fiduciary duties are largely ineffective in controlling opportunistic behavior by business partners" (footnote omitted)).

20. *See* RUPA § 103; ULLCA § 103; ULPA § 110; *infra* pt. III.

21. Karl Llewellyn, the principle draftsman of Article 2 of the Uniform Commercial Code ("UCC"), wrote that "covert tools are never reliable tools." Karl N. Llewellyn, *Book Review*, 52 Harv. L. Rev. 700, 703 (1939) (reviewing O. Prausnitz, *The Standardization of Commercial Contracts in English and Continental Law* (Sweet & Marshall 1937)). Consistent with that observation, Llewellyn argued that the UCC should deal with the problem of unconscionability directly, and so it did in § 2-302. *See* Carol B. Swanson, *Unconscionability Quandary: UCC Article 2 and the Unconscionability Doctrine*, 31 N.M. L. Rev. 359, 362 (2001) (noting § 2-302 was created to "invit[e] courts to police contracts openly for unfairness instead of using . . . 'covert tools'" (footnotes omitted)). Some courts have employed covert tools. *See e.g. In re Marriage of Gallagher*, 539 N.W.2d 479, 484 (Iowa 1995) (Ternus, J., dissenting) (accusing the majority of resorting to covert tools to avoid addressing a troubling precedent). Some courts eschew covert tools and announce a rather protective or paternalistic view. For example, *Fujimoto v. Au*, 19 P.3d 699, 737–40 (Haw. 2001), where the court treated a limited partnership agreement as a contract of adhesion, thus suggesting that a clause in the agreement that

middle ground of the modern acts is just about right because it recognizes that unrestrained freedom of contract will not be wholly successful in the courts and that it is better to create a standard in advance as to what those limits will be. While one can quibble with the drafters' choice of terms, and some have,[23] a recognizable jurisprudence should develop that will give lawyers drafting these agreements the guidance they need to assure an enforceable agreement.

The middle ground staked out by the drafters of the modern acts also has interesting, albeit indirect, judicial support. Looking at a broad swath of cases considering fiduciary waivers over a number of years reveals an interesting pattern. As a general matter, when courts rule that a fiduciary waiver is unenforceable, the underlying equities support the result, and broad language extolling the fiduciary nature of the parties' relationship is beside the point. On the other hand, when courts enforce a fiduciary waiver, the opinions invariably note the importance of contractual freedom when, in fact, the underlying equities generally favor the same outcome. This jurisprudence thus points to a middle ground, where judicial notions of fairness explain the outcome as well as, or better than, principles of fiduciary duty or freedom of contract. Given this jurisprudence, statutory drafters would be well advised to eschew the contractual freedom reflected in Delaware as, predictably, even the Delaware courts have been slow to enforce the contractual freedom reflected in the Delaware statutes.[24]

Part II reviews the status of fiduciary duties as they existed prior to the modern Acts. Part III reviews the innovations of the modern Acts and Delaware. Part III also examines the meaning, or potential meaning, of the phrase "manifestly unreasonable." Part IV briefly summarizes the academic debate over freedom of contract in the context of unincorporated business entities. Part V sets forth a brief conclusion.

In this article, I refer primarily to the statutory provisions and cases decided under partnership law, inasmuch as many states have modeled their limited liability company statutes on that law. In addition, I have not distinguished between the fiduciary duties of a general partner in a general partnership and a general partner in a limited partnership. As a general matter, the fiduciary duty of a general partner to the limited partnership and

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limited the liability of the general partners to acts involving gross negligence and willful misconduct was unenforceable. Despite the fact that such clauses are common in corporate charters and partnership agreements, the court seemed offended by the clause in this case. In a line of Texas cases, the courts affirmed the idea that a partnership is a fiduciary relationship notwithstanding the fact that the Texas version of RUPA deleted the word "fiduciary" from its version of § 404. *See e.g. M.R. Champion, Inc. v. Mizell*, 904 S.W.2d 617, 618 (Tex. 1995) ("Partners owe each other and their partnership a duty in the nature of a fiduciary duty in the conduct and winding up of partnership business, and are liable for a breach of that duty." (citation omitted)); *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423, 425–26 (Tex. App. Austin 1997).

22. *See e.g.* Edward A. Dauer, *Judicial Policing of Consumer Arbitration*, 1 Pepp. Dis. Res. L.J. 91, 101 (2000) (the courts have "steadfastly searched for—and found—ways to avoid the Supreme Court's preference for arbitration, doing everything just short of blatant disobedience" (footnote omitted)); Susan A. FitzGibbon, *Teaching Unconscionability through Agreements to Arbitrate Employment Claims*, 44 St. Louis U. L.J. 1401, 1416 (2000) ("One may speculate that the court preferred to adjust the agreement using the more 'covert tool' of interpretation because the court's conclusion on this point was not inescapable."); Robert F. Nagel, *The Problem with the Court*, Natl. Rev. 43, 45 (Nov. 21, 2005) (arguing that "[j]udges . . . often view the outcomes of the political process as irrational, unjustifiable, or excessively risky" and thus substitute their own sensibilities for those of the legislature through various conventions of interpretation).

23. *E.g.* Callison, *supra* n. 1, at 158.

24. *See infra* n. 98 and accompanying text.

its partners is substantially the same as the duty of a general partner to his fellow general partners and the general partnership.[25] Finally, this article will focus on the statutory and contractual provisions relating to the duty of loyalty. The duty of loyalty has generated more controversy than the duty of care and implicates more fundamental concerns of contracting parties.[26]

II. FIDUCIARY DUTIES IN UNINCORPORATED BUSINESS ENTITIES

A. *The Uniform Partnership Act of 1914*

UPA, which was approved by the National Conference of Commissioners on Uniform State Laws in 1914, is a modest statute. Its forty-six sections are not typical of a modern day business entity statute. Instead of detailed provisions, UPA's drafters preferred to state broad principles of law, codifying and clarifying the common law of partnerships.[27] On the question of fiduciary duties, the statute is remarkably silent. The word "fiduciary" appears only once, and then only in the title to § 21: "Partner Accountable as a Fiduciary."[28] That section provides

> [e]very partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.

The comment to this section states that the section was included to make clear that a partner held partnership profits as a trustee, so that in the event of the partner's insolvency, "the partnership can claim as their own any property or money that can be traced."[29] In other words, the purpose of the section was not necessarily to define a partner's duties to the partnership—that was already clear under the common law—but to resolve the competing claims of the partnership and creditors of the insolvent partner when the partner held partnership property.

The only other section of UPA that is fiduciary in nature is § 20, which requires partners to "render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner

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25. *Everest Investors 8 v. McNeil Partners*, 8 Cal. Rptr. 3d 31 (Cal. App. 2d Dist. 2003).

26. For a comprehensive discussion of the duty of care in unincorporated business entities, see Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?* 30 Del. J. Corp. L. 343 (2005).

27. For instance, the drafters clarified the common law in provisions such as UPA § 3, which clearly defines "knowledge" and "notice," terms that were often confused in common law cases. *See* William Draper Lewis, *The Uniform Partnership Act*, 24 Yale L.J. 617, 624 (1915). UPA § 8 and § 10 clarified the "existing confusions surrounding the subject of conveyance of real properly to or by a partnership." *Id.* UPA § 41 clarified the liability of a new partner to an existing partnership for pre-existing debts, providing, contrary to some case authority, that the new partner risked only his or her capital contribution and was not personally liable for the partnership's pre-existing debts. *Id.* at 636–37. While UPA tweaked the common law, the drafters expressly rejected the one radical change that was proposed: treating the partnership, for all purposes, as a separate legal entity, distinct from its partners (the "entity" theory). Instead, the drafters elected to continue to consider a partnership as an aggregate of the individual partners. *Id.* at 640–41.

28. UPA § 21.

29. *Id.* at § 21 cmt.

under legal disability."[30] There is no official comment to this section, and Professor William Draper Lewis, the reporter for the project, does not mention it in his article commenting on the Act.[31] Given the structure of UPA, however, it is unlikely that the drafters sought solely to define a fiduciary duty here. Rather, as with other sections, this section was likely intended to clarify a principle of law, probably that a partner's common law duty of disclosure includes disclosure to a former partner's legal representatives.

The idea that the drafters of UPA accepted the common law fiduciary duties as inherent in the partnership relationship is supported by § 9(1) of the Act, which provides that "[e]very partner is an agent of the partnership." The fiduciary duties of agents to their principals were fairly well developed by 1914[32] and clearly included:

a. a duty of loyalty, which includes a duty not to usurp partnership business opportunities, a duty not to compete with the partnership, and a duty not to act adversely to the partnership;
b. a duty of care when acting on behalf of the partnership;
c. a duty to act in good faith and deal fairly with one's co-partners; and
d. a duty to disclose to one's co-partners information material to the conduct of the partnership's business.[33]

The common law concept of the fiduciary duties of partners reached its apex in the 1928 case of *Meinhard v. Salmon*,[34] discussed below.

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30. One might characterize UPA § 22, "Right to an Account," as a section on fiduciary duties. This section entitles a partner to a formal accounting under certain specified circumstances, including "[w]henever other circumstances render it just and reasonable." UPA § 22. Referring to this clause, the comment suggests that if a partner is entitled to an accounting, a "duty" is imposed on the other partners to provide it. *Id.* at § 22 cmt. Thus, both UPA § 20 and § 22 impose duties on partners vis-à-vis one another, but it would be inaccurate in light of traditional usage to refer to these duties as "fiduciary" in nature.

31. Lewis, *supra* n. 27.

32. *See id.* at 638 (noting "our partnership law [referring to the UPA] is but a branch of the law of agency").

33. For some early agency cases supporting these fiduciary duties, see *Pollock v. Skelton*, 15 Ga. App. 1 (Ga. App. 1914) (duty of loyalty and good faith); *Bedford Coal & Coke Co. v. Parke Coal Co.*, 89 N.E. 412 (Ind. App. 1909) (same); *De Hart v. De Hart*, 67 A. 1074 (N.J. 1906) (duty of care); *Restatement (First) of Agency* § 13 (1933) (duty of loyalty). For early partnership cases, see *Whitney v. Dewey*, 158 F. 385, 391 (9th Cir. 1907) (loyalty and good faith); *Nelson v. Matsch*, 110 P. 865 (Utah 1910) (disclosure); *see also Latta v. Kilbourn*, 150 U.S. 524, 540 (1893) (duty not to compete). The U.S. Supreme Court in *Latta v. Kilbourn* set forth a rather comprehensive statement of a partner's fiduciary duty:

> [It is] well settled that one partner cannot, directly or indirectly, use partnership assets for his own benefit; that he cannot, in conducting the business of a partnership, take any profit clandestinely for himself; that he cannot carry on the business of the partnership for his private advantage; that he cannot carry on another business in competition or rivalry with that of the firm, thereby depriving it of the benefit of his time, skill, and fidelity without being accountable to his copartners for any profit that may accrue to him therefrom; that he cannot be permitted to secure for himself that which it is his duty to obtain, if at all, for the firm of which he is a member; nor can he avail himself of knowledge or information, which may be properly regarded as the property of the partnership, in the sense that it is available or useful to the firm for any purpose within the scope of the partnership business.

Id. at 541.

34. 164 N.E. 545 (N.Y. 1928).

B. Meinhard v. Salmon *and its Progeny*

Partnership fiduciary duties, which, as noted above, were based on the law of agency in UPA, were somewhat transformed by the 1928 case of *Meinhard v. Salmon.* This case, with its famous dictum by Judge Cardozo that the standard of behavior that one joint venturer owes to another is "[n]ot honesty alone, but the punctilio of an honor the most sensitive,"[35] seemed to raise the bar for the behavior of a partner and particularly so when one considers the facts of the case. Salmon and Meinhard formed a joint venture[36] to lease and operate certain commercial property in the New York City. The lease ran for twenty years. Prior to its expiration, Salmon, who was the managing venturer (Meinhard being a "silent partner"), negotiated an enlargement and extension of the lease for his own account without consulting Meinhard, who sued and prevailed.

To the extent that the case holds that one partner cannot usurp a partnership business opportunity, it is an uncontroversial application of the duty of loyalty. However, the case seems to do more than that. First, Cardozo's broad dictum suggests that the duty of loyalty is an abstract, boundless duty. Indeed, a less quoted sentence supports this view: "Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation."[37] Second, this venture was formed to operate for the length of the lease; arguably, Salmon should have no fiduciary obligation to further Meinhard's interests beyond that term. Perhaps *Meinhard* ought not to be read as broadly as Cardozo's dictum suggests because Salmon was managing the venture and, as such, had a greater duty to Meinhard than he would have had if they been equally involved in the management of the venture.[38] In any event, the case does announce a robust concept of fiduciary duty, a concept that has undoubtedly influenced judicial attitudes towards waivers of fiduciary duties.

1. Fiduciary Waivers Not Enforced

Meinhard did not discuss the enforceability of waivers or modifications of the high fiduciary duty that it announced. Its strongly moralistic tone, however, suggests that waivers would not be sympathetically reviewed by courts operating under UPA and, indeed, that has been the case, with some exceptions. Several cases are frequently cited for the proposition that a waiver of a fiduciary duty is not enforceable.[39] While these

35. *Id.* at 546.

36. *Id.* at 545–46. A joint venture is a partnership for a limited purpose. All of the rules relating to partnerships apply to joint venturers. *See* J. Dennis Hynes & Mark J. Loewenstein, *Agency, Partnership, and the LLC: The Law of Unincorporated Business Enterprises* 262 (6th abr. ed., LexisNexis 2003).

37. 164 N.E. at 548. This aspect of *Meinhard* has been overruled statutorily in jurisdictions that have adopted RUPA § 404(e), which provides: "A partner does not violate a duty or obligation under this Act or under the partnership agreement merely because the partner's conduct furthers the partner's own interest."

38. *See Wirum & Cash Architects v. Cash*, 837 P.2d 692 (Alaska 1992) (describing the duties of a managing partner); *Cronin v. McCarthy*, 637 N.E.2d 668, 675 (Ill. App. 1st Dist. 1994) ("Where one party is the senior or managing partner, his obligation to deal fairly and openly and disclose completely is heightened."); *see generally* Ribstein, *Partners*, *supra* n. 1 (arguing that *Meinhard* should be read narrowly to mandate fiduciary duties only when one partner has broad powers over another's property).

39. *Wartski v. Bedford*, 926 F.2d 11 (1st Cir. 1991) (applying Massachusetts law); *BT-I v. Equitable Life Assurance Soc. of the U.S.*, 89 Cal. Rptr. 2d 811 (Cal. App. 4th Dist. 1999); *Labovitz v. Dolan*, 545 N.E.2d 304 (Ill. App. 1st Dist. 1989); *Appletree*, 494 N.W.2d 889.

cases seem to turn on the fiduciary nature of a partnership, in fact they generally could have been decided on narrower grounds. For instance, in *Labovitz v. Dolan*,[40] an Illinois appellate court decision, the limited partnership agreement allocated to the general partner, the defendant, full management authority and provided that he "in his sole discretion shall determine the availability of Cash Flow for distribution to Partners."[41] The plaintiff alleged that the defendant violated his fiduciary duty by making only nominal distributions of cash flow, despite significant taxable income, and then sought to purchase the interests of the limited partners at a thirty-three percent discount from book value.[42] The appellate court, reversing the trial court, found in favor of the plaintiff, holding

> despite having such broad discretion, [the defendant] still owed his limited partners a fiduciary duty, which necessarily encompasses the duty of exercising good faith, honesty, and fairness in his dealings with them and the funds of the partnership. It is no answer to the claim that plaintiffs make in the case that the partners have the right to establish among themselves their rights, duties and obligations, as though the exercise of that right releases, waives or delimits somehow, the high fiduciary duty owed to them by the general partner—a gloss we do not find anywhere in our law. On the contrary, the fiduciary duty exists concurrently with the obligations set forth in the partnership agreement whether or not expressed therein. Indeed, at least one of the authorities relied upon by defendants is clear that although "partners are free to vary many aspects of their relationship *inter se* . . . they are not free to destroy its fiduciary character."[43]

A couple of comments regarding this holding are in order. First, the court did not need to suggest that the partnership agreement "releases, waives or delimits" any fiduciary duty, inasmuch as the partnership agreement in question did not, by its terms, expressly disclaim fiduciary duties. Second, and more importantly, the case could have been resolved on the narrower ground of contractual good faith. As a matter of general contract principles, when an agreement assigns a party an exclusive right, that party cannot use its contract right to disappoint the reasonable expectations of the other party.[44] If the defendant did not have a legitimate business reason to withhold distributions to the limited partners, then an implication arises that the defendant was acting in bad faith.[45] That appeared to be the case here.

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40. 545 N.E.2d 304 (Ill. App. 1st Dist. 1989).

41. *Id.* at 306.

42. *Id.* at 305.

43. *Id.* at 310 (citations omitted).

44. *See Fortune v. Natl. Cash Register Co.*, 364 N.E.2d 1251, 1256 (Mass. 1977) (holding that an employer could not terminate an employee at will for the purpose of avoiding commissions that were earned by, and would otherwise have been paid to, the employee); *Schafer v. RMS Realty*, 741 N.E.2d 155, 179 (Ohio App. 2d Dist. 2000) (holding that a partner's capital call to "squeeze out" co-partner breached fiduciary duty, even if allowed under the agreement); *see generally* John D. Calamari & Joseph M. Perillo, *The Law of Contracts* 460 (4th ed., West 1998); Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 899–901 (1988) (noting that good faith looks to how parties perform their agreement).

45. *See e.g. Restatement (Second) of Contracts* § 205 cmt. d (1981) (including within the concept of "bad faith" the "abuse of a power to specify terms"). In *Labovitz*, the general partner had the power to specify the allocation of cash flow, a power he abused and thus exercised in bad faith. 545 N.E.2d at 313.

To a similar effect is *Wartski v. Bedford*,[46] where one partner complained that his co-partner usurped a business opportunity that rightfully belonged to the partnership or should have been shared with him. The partnership was a shareholder in a corporation that owned patent rights developed by the plaintiff together with certain other assets. The corporation was experiencing financial difficulties and the defendant purchased the corporate securities owned by the outside investors for a nominal sum, thereby enabling those investors to realize a tax loss. When the corporate assets were subsequently sold for a substantial amount of money, plaintiff claimed that defendant had breached a fiduciary duty by usurping the business opportunity.[47] The United States Court of Appeals for the First Circuit upheld a jury verdict in favor of the plaintiff, affirming the finding below that the defendant breached his fiduciary duty to the plaintiff by usurping a business opportunity that, in fairness, should have been offered to the partnership.[48]

The appellate court opinion mentions, but does not discuss, an agreement among the shareholders that prohibited the sale of shares unless the shares were first offered to the corporation, and if it declined to purchase the shares, to the other shareholders. Thus, the defendant was *contractually* obligated to offer to the partnership the shares that he proposed to purchase. The plaintiff, as one of two general partners, could have protected his interests by causing the partnership to exercise its right of first refusal. It was unnecessary, therefore, for the court to even consider fiduciary duty or the corporate opportunity doctrine. Nevertheless, the court cited Cardozo's dictum and said the defendant would be held to "the 'punctilio of honor' fiduciary standard."[49] In that context, the partnership agreement, which stated that "General Partners shall not be prevented from engaging in other activities for profit, whether in research and development or otherwise, and whether or not competitive with the business of the partnership,"[50] would not be interpreted to permit this conduct. Moreover, the court said, even if this contract language was susceptible of such an interpretation, the plaintiff would still prevail, because a partner's fiduciary duty "cannot be negated by the words of the partnership agreement."[51] Again, we see a court condemning a waiver that was not at issue.

A third frequently cited case is *Appletree Square I Limited Partnership v. Investmark, Inc.*,[52] which involved a sale by the defendant general partner of its partnership interests to the plaintiffs, who were limited partners. The partnership's sole asset was a building, the structural steel of which was coated with asbestos-based fireproofing that was deteriorating and releasing fibers. The defendant was allegedly aware of this problem, but the plaintiffs were not. In the course of negotiating the transaction, the plaintiffs asked the defendant to provide "'any information that you have not already sent to us which would be material to our investors' participation in this

46. 926 F.2d 11 (1st Cir. 1991).
47. *Id.* at 14–18.
48. *Id.* at 22.
49. *Id.* at 20.
50. *Id.* at 21.
51. 926 F.2d at 20 (citation omitted).
52. 494 N.W.2d 889 (Minn. App. 1993).

development.'"[53] The defendant demurred, saying it did not know what information would be material to the investors. When the asbestos problem later became known to the plaintiffs, they sued on several theories, including breach of fiduciary duty. The defendant cited the partnership agreement which, like ULPA, required the general partner to provide partners with "all information that may reasonably be requested."[54] The defendant argued that because plaintiffs did not request information about asbestos, it acted consistently with its statutory and contractual duties. The Minnesota appellate court reversed a trial court finding in favor of the defendant, holding that the defendant's common law fiduciary duty of disclosure, which requires disclosure of all known information that is material to the affairs of the partnership, superseded the statute and partnership agreement.[55] As to contractual limitations on fiduciary duties, the court said that "where the major purpose of a contract clause is to shield wrongdoers from liability, the clause will be set aside as against public policy."[56]

As in *Labovitz* and *Wartski*, the court in *Appletree* ventured where it need not have gone. The plaintiffs asked for all material information related to the building, as they had a right to do under the statute and the partnership agreement. This defendant refused to provide it and thus was clearly in breach of the agreement. There is no question that the asbestos contamination was material and the defendant was allegedly aware of it. While it may have sought to beg off of its contractual and statutory obligation by claiming it did not know what would be considered material, this is hardly a defense to its breach. It would have been a more difficult case if the plaintiffs never asked for the information, a case the court decided in dicta here. Even then, the case could have been decided on narrower grounds than breach of fiduciary duty, perhaps fraudulent concealment or intentional misrepresentation.[57]

A fourth frequently cited case is *BT-I v. Equitable Life Assurance Society of the United States*,[58] which involved the purchase of a mortgage loan on partnership property by the sole general partner of the partnership. The general partner purchased the loan at a steep discount and, when the partnership was unable to pay the loan, it foreclosed.[59] The California appellate court reversed a lower court judgment in favor of the general partner, holding that the conduct of the general partner breached its fiduciary duty to the partnership.[60] The opinion is not a model of clarity and fails to identify what fiduciary duty the defendant breached. The court cites UPA to the effect that a partner has a fiduciary duty to account to the partnership for any profits derived by the partner from transactions connected to the partnership business.[61] But the court does not conclude that this statutory duty was breached in this case, as indeed it could not because no profit

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53. *Id.* at 891.
54. *Id.* at 893.
55. *Id.* at 892–93.
56. *Id.* at 893.
57. There is some indication in the case that the statute of limitations may have run on these claims. 494 N.W.2d at 894.
58. 89 Cal. Rptr. 2d 811 (Cal. App. 4th Dist. 1999).
59. *Id.* at 814.
60. *Id.* at 817–18.
61. *Id.* at 815.

was identified as a result of the acquisition of partnership debt. The court does cite two decisions in other jurisdictions holding that a general partner that acquires a partnership obligation cannot foreclose on partnership assets,[62] but the facts of those cases are distinguishable. In one, the court held that the secret acquisition of secured debt of the partnership was a breach of the partner's disclosure obligation,[63] and in the other that the purchase violated the limited partners' personal right of first refusal to acquire the obligation.[64] In *BT-I*, however, neither of those circumstances was present. Rather, the court's holding seems to be a visceral reaction to the conduct of the general partner. In any case, much of the opinion is devoted to discussing the waiver issue, concluding that the partnership agreement did not permit this conduct and, if it did, the agreement would not be enforced.

What was objectionable about the conduct of the general partner in *BT-I* was that by acquiring partnership debt, it placed itself in a conflict position; that is, it placed itself in a position in which it would inevitably either act in a way that was not in the best interests of the partnership or in a way that would harm its own interests.[65] It is fair to say that this action violates the partner's duty of loyalty.[66] The partnership agreement did not in any respect waive the duty of loyalty. The closest provision that was relevant was one providing that the general partner had broad powers to refinance and restructure partnership debt, but no obligation to contribute additional funds to avoid a foreclosure. It is quite a stretch to argue that this provision permitted the general partner to *acquire* the debt. Although *BT-I* is not a case that could have been decided on a narrower ground than breach of fiduciary duty (assuming the plaintiff prevails), it is another example in which the court uses expansive language to reject the effectiveness of a waiver that, in fact, is not a waiver at all.[67]

While a careful reading of *Labovitz*, *Wartski*, *Appletree*, and *BT-I* leaves room for argument that fiduciary waivers may be enforceable because, arguably, language in the opinions denying the enforceability of a waiver is dicta, the cases do demonstrate the

62. *Id.* at 815 (citing *Thomas v. Schmelzer*, 796 P.2d 1026, 1032–33 (Idaho App. 1990); *Ebest v. Bruce*, 734 S.W.2d 915, 922 (Mo. App. 1987)).

63. *Thomas*, 796 P.2d at 1032.

64. *Ebest*, 734 S.W.2d at 922.

65. RUPA § 404(b)(2).

66. *See e.g. Constr. Techniques, Inc. v. Dominske*, 928 F.2d 632, 638 (4th Cir. 1991) (commenting that, as a matter of law, "the situation in which [employee] placed himself when, as part owner of [supplier], he became an employee of [supplier's] sole customer is a situation in which the presence of adverse interests threatens the fiduciary relationship between principal and agent"); *see generally Restatement (Third) of Agency* § 8.03 (6th tent. draft 2005) ("An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship.").

67. To a similar effect are *Triple Five of Minnesota, Inc. v. Simon*, 280 F. Supp. 2d 895 (D. Minn. 2003) and *Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg*, 265 Cal. Rptr. 330 (Cal. App. 4th Dist. 1989). In *Triple Five*, the "waiver" in question was a clause that provided that no partner could be found liable to another partner absent fraud or gross negligence. 280 F. Supp. 2d at 901. This clause did not limit the complaining partner's claim for improper usurpation of a business opportunity or breach of the duty of disclosure. *Id.* In *Tri-Growth*, the waiver allowed partners in a real estate partnership to acquire property that competed with property owned by the partnership. 265 Cal. Rptr. at 332 n. 12. The court held that this provision did not allow a partner to acquire property that the partnership was seeking to acquire. *Id.* at 336–37; *see also Lyall v. Grayco Builders, Inc.*, 180 A.D.2d 7, 15 (N.Y. App. Div. 1st Dept. 1992) (holding that partnership agreement that partners could participate in other projects did not allow usurpation of partnership opportunity).

influence of *Meinhard*. More importantly, they support the observation that when courts deny the enforceability of a fiduciary waiver, other factors or the underlying equities support the outcome. Because the focus of the opinions, however, is on the fiduciary aspects of the relationship of the parties, these and other cases[68] demonstrate the continuing importance of fiduciary duties and suggest that courts will view waivers skeptically, at best. It is fair to speculate that these courts would also read narrowly a statutory provision that permitted waiver. This is the subject of Part III below. The next section considers cases in which courts operating under UPA have enforced fiduciary waivers. With respect to these cases, we might ask whether this represents a different judicial philosophy, or whether something else explains the outcome. In any event, cases upholding fiduciary waivers are, to some extent, the mirror image of those that deny enforcement: When courts enforce a fiduciary waiver, the equities of the case generally support the outcome and judicial language embracing contractual freedom is, for that reason, somewhat superfluous.

2. Fiduciary Waivers Enforced

A wonderful example of these cases is *Sonet v. Timber Company, LP*.[69] Under the partnership agreement, the general partnership had sole discretion to decide upon, and recommend to the limited partners, the terms of a conversion, or merger. The limited partners alleged, among other things, that notwithstanding this broad grant of power, the general partner owed to the limited partners the default fiduciary duties set forth in the Delaware Revised Uniform Limited Partnership Act.[70] The court framed the issue as, "what controls the governance process in the context of limited partnerships—the partnership agreement or common law fiduciary duty doctrines?"[71] The court resolved this issue with a forceful statement that "the unambiguous terms of the partnership agreement have the effect of limiting the court's review of the transaction presently in dispute."[72] Later in the opinion, the court restated its holding with a statement that seemed to embrace freedom of contract with little opportunity for future attack on the principle: "Thus, I think it a correct statement of the law that principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions so plain."[73]

68. *E.g. Triple Five*, 280 F. Supp. 2d at 901–02 (holding that provision in partnership agreement that partners would only be liable for "fraud or gross negligence" would not negate claim for breach of fiduciary duty because agreement cannot destroy the fiduciary nature of a partnership relationship); *Fujimoto*, 19 P.3d at 741 (providing exculpatory clause relieving the general partner from vicarious liability held unenforceable as inconsistent with UPA); *Knopke v. Knopke*, 837 S.W.2d 907, 915 (Mo. App. 1992) (unqualified managerial authority subject to fiduciary duty); *Schafer*, 741 N.E.2d 155 (holding that actions taken consistent with partnership agreement subject to fiduciary duties).

69. 722 A.2d 319 (Del. Ch. 1998).

70. *Id.* at 321. Plaintiff alleged that the terms of the conversion were unfair to the limited partners. The limited partners had a right to vote on the transaction, but had not yet done so at the time of the lawsuit. While not stated by the court, apparently the plaintiffs sought some sort of injunctive relief.

71. *Id.* at 320.

72. *Id.* (footnote omitted).

73. *Id.* at 322.

On its face, then, this case would seem to overcome the residual effect of *Meinhard* and the whole notion of non-waivable fiduciary duties. However, a few aspects of this case are worth noting. First, while the partnership agreement granted the general partner "sole discretion" to recommend the terms of the conversion, the deal required the approval of sixty-six percent of the limited partners. Second, the case was brought before the limited partners had voted; indeed, the proxy statement had not yet been distributed.[74] Thus, the court may have determined (although it did not so state) that the plaintiffs' claims were not yet ripe for adjudication. If the limited partners fail to approve the deal, the complaint becomes moot. On the other hand, if the proxy statement did provide full disclosure (and the court noted that the plaintiff did not complain about the adequacy of disclosure[75]) and if the limited partners then approved the transaction, the equities would seem to lie with the general partner. All the court decided in this case was that the limited partners could protect themselves: "[T]heir remedy is the ballot box, not the courthouse."[76] While there would be some measure of judicial review had this involved a corporate merger in which the directors had a conflict of interest similar to that of the general partner, that review would be limited to determining whether the plaintiffs demonstrated that the terms of the transaction were so "unequal as to amount to a gift or waste of corporate assets,"[77] a rather difficult burden for a complainant to satisfy. In short, this was an easy case to announce an embrace of freedom of contract; plaintiff had little, if anything, to complain about.

While *Sonet* is a relatively easy case to fit into the rubric, the well-known case of *Singer v. Singer*[78] poses a challenge. *Singer* involved a family partnership engaged in oil production. Two of the partners (the defendants) purchased, for their own account, real property that at least one of the plaintiff partners previously had indicated the partnership might have an interest in purchasing. The plaintiffs sought a constructive trust and prevailed in the trial court. On appeal, the appellate court reversed, relying, in part, on this provision in the partnership agreement:

> *Each partner shall be free to enter into business and other transactions for his or her own separate individual account*, even though such business or other transaction may be in conflict with and/or competition with the business of this partnership. Neither the partnership nor any individual member of this partnership shall be entitled to claim or receive any part of or interest in such transactions, *it being the intention and agreement* that any *partner will be free to deal on his or her own account to the same extent and with the same force and effect as if he or she were not and never had been members of this partnership.*[79]

74. 722 A.2d at 327.

75. *Id.*

76. *Id.* at 326.

77. *Fliegler v. Lawrence*, 361 A.2d 218, 221 (Del. 1976); *see also R.S.M. Inc. v. Alliance Capital Mgt. Holdings LP*, 790 A.2d 478, 498 (Del. Ch. 2001) (noting that "the ratification vote obviates any generalized fairness inquiry"); *In re General Motors Class H Shareholders Litig.*, 734 A.2d 611, 616 (Del. Ch. 1999) ("Because the shareholders were afforded the opportunity to decide for themselves on accurate disclosures and in a non-coercive atmosphere, the business judgment rule applies, and the plaintiffs must, to avoid dismissal, plead that the [complained of transactions] were wasteful." (citation omitted)).

78. 634 P.2d 766 (Okla. Civ. App. 1981) (internal quotation marks omitted).

79. *Id.* at 768 (emphasis in original).

Singer seems to embrace a very robust view of contractual freedom,[80] allowing partners to compete with the partnership and thus enforcing a waiver of a fundamental aspect of the duty of loyalty. The case should not, however, be read so broadly. Interestingly, the claim was not brought by the partnership. Rather, the plaintiffs were partners other than the defendants who sued on a theory that the plaintiffs, the defendants, and certain others (the Trachtenbergs) had formed an oral partnership to exploit opportunities in the area where the purchased real estate was located. If true, plaintiffs would avoid the waiver. The appellate court found the proof of this oral partnership lacking, [81] but by pursuing this theory, the plaintiffs seemed to have weakened their case. The Trachtenbergs, who were allegedly partners in this oral partnership, denied that such a partnership existed and did not participate in the case.[82] This evidence likely added to the negative view that the court had of the plaintiffs. Moreover, defendants' actions were not truly competitive with the partnership. It is not the case that the defendants, by pursuing oil production on the disputed property, would in any way jeopardize the business of the partnership. Finally, the opportunity to purchase the real estate may not have been deemed to be a "partnership opportunity."[83] The partnership would likely to have to raise additional capital to acquire and exploit the opportunity. In effect, a new partnership would have to be formed if any of the partners did not wish to participate or chose to participate at a reduced level of participation.

Other cases are to a similar effect—apparently embracing full contractual freedom, but not posing the issue starkly.[84] Consider, for instance, the well-known case of *McConnell v. Hunt Sports Enterprises*,[85] which involved a limited liability company that was formed to acquire and operate a professional hockey franchise in Columbus, Ohio. The promoter of the venture became discouraged when the city's voters failed to approve a sales tax measure to fund a new stadium and he refused (albeit without consulting the other members of the company) to agree to private financing. Some members of the limited liability company then formed a new group to seek the franchise with that same private lender. In litigation that followed, the promoter claimed that the new group improperly competed with the limited liability company, a claim that required an interpretation of this provision of the operating agreement:

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80. *See* Hynes, *Fiduciary Duties*, *supra* n. 1, at 41–43.

81. *Singer*, 634 P.2d at 770.

82. *Id.* at 771 n. 12.

83. Professors Bromberg and Ribstein suggest that "[t]he court may reach the same result without an explicit agreement by holding that the narrow scope of the partnership permitted outside dealings." Alan R. Bromberg & Larry E. Ribstein, *Bromberg and Ribstein on Partnership* vol. II, § 6.07, 6:90–:91 (Aspen L. & Bus. 1994).

84. For example, see *Exxon Corp. v. Burglin*, 4 F.3d. 1294 (5th Cir. 1993), a case in which the general partner, purchasing limited partners' interests, did not disclose confidential information regarding oil reserves on partnership property, as it was permitted to do under the partnership agreement. This posed the issue as to whether the waiver of the fiduciary duty to disclose would be enforceable, and the court held that it was. However, here the selling limited partners had other options to acquire the information, and the general partner had an independent business justification for not disclosing the information. Under these circumstances, the court held that the defendant-general partner did not breach a fiduciary duty. Like the *Sonet* case, the language of the case embraces a robust view of freedom on contract, although the equities independently favored the party that depended on the contract provision.

85. 725 N.E.2d 1193 (Ohio App. 10th Dist. 1999).

Members May Compete. Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.[86]

The Ohio appellate court affirmed a lower court decision that, in light of the operating agreement of the limited liability company, the members in the new group did not violate their fiduciary duties to the limited liability company. The opinion included predictable language on the freedom to contract: "[A] contract may define the scope of fiduciary duties between parties to the contract."[87] The court never acknowledged that, in light of the behavior of the promoter, the members of the new group were perfectly justified in pursuing the franchise. Due to the promoter's conduct, the original venture was essentially defunct and it had, at best, only a theoretical interest in pursuing a franchise. Indeed, the court affirmed the dismissal of a claim for tortious interference with business relations brought by the promoter because, in short, the limited liability company had no expectation of obtaining a franchise because it rejected private financing.[88]

Suppose, however, that the facts of *McConnell* were slightly different and that the original limited liability company and the new group both actively pursued a franchise in direct competition with one another. Would the court have ruled the same way? With these assumed facts, a court would more closely scrutinize the contract language and might well conclude that the relevant provision that permitted competition "in other business ventures" meant only that members could own, say, a basketball franchise with a season that overlapped the hockey season, but did not permit competition for the same hockey franchise. It is easy to imagine a court saying that it is unlikely that the parties anticipated direct competition for the very opportunity that the limited liability company was organized to pursue and if the parties had that intent they would have expressed it more clearly.

That a court would consider construing a competition waiver narrowly, to prohibit competition for the same opportunity, is well illustrated by *Tri-Growth Centre City, Ltd. v. Silldorf, Burdman, Duignan & Eisenberg*.[89] In this case, a limited partner, knowing that the partnership was interested in acquiring a parcel of property adjacent to the partnership property, acquired the property by agreeing with the seller to an accelerated closing date. When the partnership sued, seeking a constructive trust, the limited partner defended on the basis of a provision in the private offering memorandum stating that any partner could "acquire other real property interests adjacent to or competing with the Partnership real property" and a provision in the partnership agreement that allowed any partner to "acquire other real property which competes, directly or indirectly, with the Property of this Partnership."[90] After concluding that, under the circumstances, the defendant-limited partner owed a fiduciary duty to the partnership, the court determined that the fiduciary waiver did not excuse the defendant's

86. *Id.* at 1206 (internal quotation marks omitted).
87. *Id.* at 1215.
88. *Id.* at 1217.
89. 265 Cal. Rptr. 330 (Cal. App. 4th Dist. 1990).
90. *Id.* at 332 n. 2 (internal quotation marks omitted).

conduct because the limited partner used confidential information in acquiring the property.[91] The only information the partner used, however, was the partnership's interest in the property. Moreover, the fiduciary waiver in the partnership agreement (together with the offering memorandum) seemed to have expressly contemplated that which took place in this case. There is no other explanation why the offering memorandum expressly mentions acquisition of adjacent property.[92]

Interestingly, *Tri-Growth* does not reach the question as to whether the fiduciary duty waiver is unenforceable because it negates the fiduciary nature of a partnership. Rather, the court opted for a reading of the provision that avoided the question. It seems fair to conclude that even a Delaware court confronted with that situation, or the hypothetical based on *McConnell*, would reach the same result.

When faced with difficult case on the equities, Delaware courts seek an equitable solution. In *Werner v. Miller Technology Management, LP*,[93] for instance, a recent case before the Delaware Chancery court, the issue was whether plaintiff's self-dealing claim against the general partner was barred by the partnership agreement, which provided that "[a]n action may not be commenced by any Limited Partner under this Agreement unless brought within six months after the actions or circumstances giving rise to such cause of action have occurred."[94] Plaintiff argued that this provision did not apply, because his claim was not one "under this Agreement." The court agreed, giving a narrow interpretation to the limitation provision. Arguably, the claim did arise under the agreement, since the relationship of the parties, and any duties that the defendant had to the plaintiff, arose only because of their contractual relationship.

Indeed, in *Elf Atochem North America, Inc. v. Jaffari*,[95] a case decided by the Delaware Supreme Court four years before *Werner*, the Court decided that an arbitration clause applied to the plaintiff's claim for breach of fiduciary duty, construing "under this agreement" broadly to capture breaches of fiduciary duty. The plaintiff sought to maintain a derivative action on behalf of a limited liability company against the manager of the company. The arbitration provision was in the operating agreement, to which the limited liability company was not a party.[96] On that basis, the plaintiff argued that the limited liability company was not bound to arbitrate the dispute. The Court rejected that argument, reasoning that the parties to the operating agreement wanted all of their disputes to be subject to arbitration. Similar reasoning in *Werner* would have barred plaintiff's claim.

It is obviously easier for a court to order arbitration than to sanction direct competition by a fiduciary. The *Werner* court implicitly acknowledged the effect of

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91. *Id.* at 336.

92. In addition, if a partner did not know that the partnership was seeking to acquire that parcel, a court would likely not characterize that partner's conduct as competition with the partnership.

93. 831 A.2d 318 (Del. Ch. 2003).

94. *Id.* at 332 (internal quotation marks omitted).

95. 727 A.2d 286 (Del. 1999).

96. Delaware has since amended its law to make clear that a limited liability company is bound by the operating agreement. Del. Code Ann. tit. 6, § 18-101(7) (2005) ("A limited liability company is bound by its limited liability company agreement whether or not the limited liability company executes the limited liability company agreement.").

equitable considerations in its choice of interpretations: "[I]n the absence of a clearly expressed contractual provision to the contrary, this court will apply normal equitable limitations principles."[97] *Werner* is thus a classic example of a court resorting to covert tools—here a questionable rule of interpretation—to reach an equitable result. Delaware courts have read other partnership provisions narrowly to reach equitable results.[98] In the corporate arena, the Delaware courts have shown a willingness to rely on the (non-waivable) obligation of good faith to address a claim of breach of the duty of care, a duty that had been waived in the articles of incorporation.[99] The truly difficult cases—

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97. 831 A.2d at 333.

98. *See e.g. Gelfman v. Weeden Investors, LP*, 859 A.2d 89, 111–12 (Del. Ch. 2004) (providing that partnership agreement protecting decisions of the general partner "so long as such . . . decision [was] not reasonably believed by the General Partner to be inconsistent with the overall purposes of the Partnership" was constrained by concepts of fiduciary duty (footnote omitted)); *Solar Cells, Inc. v. True North Partners, L.L.C.*, 2002 WL 749163 at **4–6 (Del. Ch. Apr. 25, 2002) (providing that despite contract provision in which noncontrolling partner waived conflicts of interest on behalf of controlling partner, court imposed entire fairness test on controlling partner to justify merger in which controlling partner had conflict of interest); *see also VGS, Inc. v. Castiel*, 2000 WL 1277372 at *4 (Del. Ch. Aug. 31, 2000). In *Castiel*, the court, expressly relying on equitable maxims, found a fiduciary duty between managers of a limited liability company. In light of that fiduciary duty, a written consent of the two managers agreeing to a merger of the limited liability company with a second entity would be set aside, despite a statutory provision in Delaware that allowed action by less than unanimous written consent. The Vice Chancellor asserted:

> The General Assembly never intended, I am quite confident, to enable two managers to deprive, clandestinely and surreptitiously, a third manager representing the majority interest in the LLC of an opportunity to protect that interest by taking an action that the third manager's member would surely have opposed if he had knowledge of it. My reading of § 18-404(d) is grounded in a classic maxim of equity—"Equity looks to the intent rather than to the form."

Id.

A Delaware court that limited the reach of a statutory provision in light of general equitable provisions may well do the same with a contractual provision. Moreover, one could characterize the default provisions of the limited liability company statute, which governed in this case, as no more than the terms incorporated into the parties' operating agreement. On that level, then, the court is simply failing to enforce the operating agreement. As to the claim that the defendants' fiduciary duty to the plaintiff was also a term incorporated into the operating agreement and it applied in this case, one should note that the defendants did not breach a fiduciary duty to the limited liability company, but rather to a fellow manager. The court provided no support for the novel idea that a manager of a limited liability company owes a fiduciary duty to a fellow manager. Undoubtedly, the conduct of the defendants was troubling, but, except for the intervention of equitable doctrines, clearly legal. When a court finds that a contractual waiver of a fiduciary duty is manifestly unreasonable, it is, simply, refusing to enforce a contract on equitable grounds, exactly what the court did in *Castiel*.

Another recent case demonstrating the equitable tendency of the Delaware Chancery Court is *Haley v. Talcott*, 864 A.2d 86, 98 (Del. Ch. 2004). This case involved an attempt by a fifty percent owner of a limited liability company to obtain judicial dissolution of the limited liability company, on the grounds of deadlock, over the objections of his co-owner, who argued that the limited liability company operating agreement included an exit provision that precluded judicial dissolution. *Id.* at 87–88. The court sided with the plaintiff because under the exit provision, plaintiff would still be liable on a mortgage that he had personally guaranteed. The court thus concluded that it was not "equitable to force [the plaintiff] to use the exit mechanism in this circumstance." *Id.* at 98. The exit provision was unconditional and, aside from equitable considerations, the court cited no reason why the provision should not apply under the circumstances. While noting the contractual nature of a limited liability company, the court interestingly failed to enforce the agreement of the parties. *Id.*

99. *See e.g. In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 287–91 (Del. Ch. 2003); *see generally* Mark J. Loewenstein, *The Quiet Transformation of Corporate Law*, 57 S.M.U. L. Rev. 353, 371–73 (2004) (discussing *In re Walt Disney Co. Derivative Litig.*). My view of the *Disney* case—that it is a breach of care case disguised as a good faith case—is an admittedly cynical one, not shared by all scholars. *See e.g.* Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456, 487–88 (2004) (characterizing the *Disney* case as one in which the Disney directors abdicated their responsibilities to the company's CEO and that abdication meant that they did not act in good faith); *see also* E. Norman Veasey, *Musings from the Center of the Corporate*

cases involving disparate bargaining power, a fiduciary duty waiver, harm to the weaker party, and a holding that affirms contractual freedom—are yet to appear in the reporters.[100] Against this background, I now turn to the approach of RUPA, which some critics view as limiting contractual freedom.[101]

III. THE INNOVATIONS OF MODERN ACTS AND THE DELAWARE STATUTE (INCLUDING A DISCUSSION OF THE "MANIFESTLY UNREASONABLE" STANDARD)

A. The Statutory Provisions

In contrast to UPA, RUPA is a large and complex statute, with numerous defined terms and sixty substantive provisions, many of which are quite detailed. Not content with the common law of fiduciary duties for agents and partners, RUPA's drafters departed from UPA's approach. Section 404(a) of RUPA makes clear that a partner's fiduciary duties are limited to a duty of loyalty and a duty of care.[102] Subsections (b) and (c) then specify what those duties consist of, roughly tracking the duties of loyalty and care recognized at common law.[103] While good faith is not listed as a fiduciary duty, subsection (d) makes clear that the duty does apply, albeit not as a fiduciary duty. Subsections (e) and (f) modify the duty of loyalty, with (e) stating that a partner does not violate a duty merely because the partner's conduct "furthers the partner's own interests," and (f) providing that a partner may transact business with the partnership on the same basis as non-partners.[104]

The partners' duties, fiduciary or otherwise, as set forth in § 404, are subject to contractual modification, within these limitations set forth in § 103(b) of RUPA:

Universe, 7 Del. L. Rev. 163, 171 (2004) ("That the chancellor's decision on the motion to dismiss last year in [*Disney*] was not a mere gross negligence case but an alleged breach of good faith case is clear to me on the facts."). On the other hand, it is worth noting that *Disney* represents the rare use of the good faith concept, a use that focused on the process (or lack thereof) employed by the board to approve an allegedly excessive employment contract. Because the Disney charter precluded director liability for breach of the duty of care, plaintiffs' case hinged on convincing the court that they had alleged something more than a care violation. Under those circumstances, it is unsurprising that the court was persuaded that a good faith violation had been alleged. *See also In re Abbott Laboratories Derivative Shareholders Litig.*, 325 F.3d 795, 809–11 (7th Cir. 2003) (illustrating an instance in which the court, faced with a provision in Abbott's corporate charter that exculpated the directors from liability for breach of the duty of care, found that the plaintiffs had adequately alleged a breach of fiduciary duty of good faith as a result of the directors' failure to adequately respond to regulatory violations).

100. Even a strong contractarian such as Professor Ribstein has apparently conceded that, under the right circumstances, a court would not enforce an explicit waiver of fiduciary duties. In the context of arguing that under UPA courts have enforced waivers of fiduciary duties and when they have set aside an agreement the case actually involved a question of interpretation, not a question of public policy. In that context, he wrote: "No case has had to confront a waiver that explicitly allowed an agent to completely forsake its fiduciary role. It may be that a court in such a case would not allow the apparently authorized conduct." Ribstein, *Fiduciary Duties*, *supra* n. 1, at 951. In that context, he may be saying that a court should not enforce the waiver, although he does not quite go that far.

101. *See e.g.* Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 Bus. Law. 45, 54–61 (1993).

102. RUPA § 404(a) provides: "The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c)."

103. The common law may have characterized the duty of good faith as a fiduciary duty. *See supra* n. 33 and accompanying text.

104. RUPA § 404(f).

(b) The partnership agreement may not:

. . .

(3) eliminate the duty of loyalty under Section 404(b) . . . , but:

(i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, *if not manifestly unreasonable*; or

(ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

(4) unreasonably reduce the duty of care under Section 404(c) . . . ;

(5) eliminate the obligation of good faith and fair dealing under Section 404(d), but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, *if the standards are not manifestly unreasonable*; . . .[105]

The Delaware statute poses no such limitations, expressly providing that a party's fiduciary duties "may be expanded or restricted or eliminated by provisions in the partnership agreement."[106]

B. Does RUPA Limit the Contractual Freedom in Comparison to UPA?

Professor Ribstein argues that RUPA has the effect of limiting the ability of the parties to waive fiduciary duties or contract out of the fiduciary duty of care.[107] But are his concerns legitimate? Professor Ribstein argues, for instance, that partners are prevented from "letting a managing partner enter into contracts with the partnership on behalf of the partner's management company"[108] and that this is unfortunate because the limitation "precludes worthwhile contracts."[109] Such a contract would, of course, violate the duty of loyalty under § 404(b)(2), which requires that a partner refrain from dealing with the partnership on behalf of a party having an interest adverse to the partnership. The question then becomes whether, under § 103(b), it would be manifestly unreasonable if the partnership agreement provided that such a contract would not violate the partner's duty of loyalty. Suppose that the partnership agreement did so provide, with no limitations on the consideration that would be payable by the partnership under the management agreement. It seems that, under those circumstances, a court is likely to hold either that such a provision is unenforceable because it is manifestly unreasonable, or is enforceable only if it is fair to the partnership. But the same result is likely under UPA as well, where a court would hold either that the partnership agreement cannot absolve a party of a breach of fiduciary duty or that, if unfair, the management agreement undercuts the purpose of the partnership agreement

105. *Id.* at § 103(b) (emphasis added). For comparable provisions, see ULLCA § 103; ULPA § 110.
106. Del. Code Ann. tit. 6, § 17-1101(d).
107. *See e.g.* Ribstein, *supra* n. 101.
108. *Id.* at 58.
109. *Id.* ("Mandatory fiduciary duties also are bad policy because they preclude worthwhile contracts.") (footnote omitted).

and therefore the managing partner lacked the authority to enter into it. Under either UPA or RUPA, it is difficult to imagine a court upholding a management agreement negotiated by the managing partner that is clearly unfair to the partnership.[110] This leaves open a question of just what the term "manifestly unreasonable" means, the subject of the next section.

C. *The Meaning of the Term "Manifestly Unreasonable"*

1. A Framework for Thinking about the Manifestly Unreasonable Standard

Criticism that the term is vague is certainly well taken, but in that regard, the term is not unique in the law. Surely the same can be said of numerous other critical standards in the law: "manifestly unjust," "unconscionable," etc. Moreover, the term appears in several provisions of the Uniform Commercial Code (and elsewhere),[111] and the courts have thus applied the term for years.[112] The law is dependent on such concepts to implement some underlying policy. The critical normative question, then, is whether the underlying policy is justifiable. In the case of a limitation on waivers of fiduciary duties, as demonstrated above, the chances are significant that courts will find ways to hold a waiver unenforceable.

While there are relatively few cases that specifically address the meaning of manifestly unreasonable as it appears in various statutes,[113] case law does shed some light on the term. For instance, one court cited, with approval, the definition of "manifest" in Black's Law Dictionary:

110. Arguably, Delaware law would enforce such an agreement, but perhaps not, as more fully considered in Part II above.

111. *See* U.C.C. §§ 1-201(28), 1-302(b), 2-309(3) (2003 amendments), 2A-103(u), 4-103(a), 8-402(c)(1), 8-403(c), 9-603(a).

112. Interestingly, while numerous cases apply the concept, they rarely explain why a provision is found manifestly unreasonable. For a few examples of the many cases applying, without discussion, the manifestly unreasonable standard, see *Badgett Constr. & Dev. Co. v. Kan-Build, Inc.*, 102 F. Supp. 2d 1098, 1104–06 (S.D. Iowa 2000); *Mitchell Buick & Oldsmobile Sales, Inc. v. McHenry Savings Bank*, 601 N.E.2d 1360 (Ill. App. 2d Div. 1992); *Gornicki v. M&T Bank*, 617 N.Y.S.2d 448, 450 (N.Y. Sup. 1994); *see generally* Elliot M. Surkin, *When Joint Venturers Can't Agree: The Buy-Sell Revisited* pt. VII (ALI-ABA Course of Study Materials, Modern Real Estate Transactions, Course No. SL004 July 27–30, 2005) (available at Westlaw, ALI-ABA database and Lexis, CLE library, ALIABA file using search terms "SL004 & surkin"); Caryl B. Welborn, *Managing Investors Liability in the Real Property Venture* pt. II(D)(1) (ALI-ABA Course of Study Materials, Modern Real Estate Transactions, Course No. SL004 ALI-ABA 681, 702, July 27–30, 2005) (available at Westlaw, ALI-ABA database and Lexis, CLE library, ALIABA file using search terms "SL004 & welborn") (arguing the term manifestly unreasonable is likely to lead to confusion).

113. *See e.g. Baron v. Strawbridge & Clothier*, 646 F. Supp. 690, 698 (E.D. Pa. 1986) (holding "manifestly unreasonable" means beyond "the outer limits of permissiveness"); *F.B.I. Farms, Inc. v. Moore*, 798 N.E.2d 440, 447 (Ind. 2003) (providing that in considering whether restrictions on the transfer of corporate stock were manifestly unreasonable, the court listed several relevant factors); *Roof Depot, Inc. v. Ohman*, 638 N.W.2d 782, 785 (Minn. App. 2002) (same, applying Minnesota law); *see generally* Robert R. Keatinge, Ann Conaway Anker & Paul L. Lion III, *Internal Disputes and Break-Ups: Colorado, California, and Delaware* (ALI-ABA Course of Study Materials, Limited Liability Entities: 2005 New Developments in Limited Liability Companies and Limited Liability Partnerships, Course No. VMF0317 March 17, 2005) (available at Westlaw, ALI-ABA database and Lexis, CLE library, ALIABA file using search terms "vmf0317 & lion") (noting the paucity of judicial authority).

> Evident to the senses, especially to the sight, obvious to the understanding, evident to the mind, and not obscure or hidden, and is synonymous with open, clear, visible, unmistakable, indubitable, indisputable, evident, and self-evident.[114]

Another court made clear that the challenged provision must be considered in light of the circumstances at the time of contract.[115] If the party challenging a waiver in a partnership agreement or operating agreement is sophisticated, courts will likely impose on that party a heavy burden of proof. Drawing on the standards for a directed verdict, a waiver might be found manifestly unreasonable "only in the clearest of cases, where the facts are undisputed and reasonable minds could draw but one" conclusion.[116] In this regard, prior dealings between the parties and practices in the business in which the entity is engaged would be important factors.[117] And, as indicated in a Fifth Circuit case cited in a comment to RUPA § 103, where the parties are of equal bargaining power, a waiver would rarely be denied enforcement.[118] Finally, it seems fair to observe, based on cases in which waivers have been considered by the courts,[119] that the following factors would be material to a court's determination as to whether a provision is manifestly unreasonable:

a. *Did the Waiver Clearly and Unambiguously Relate to the Conduct at Issue?*

If a court is to set aside a contract provision, it should do so only if such a finding is necessary to the result. As noted above, courts have often held waivers unenforceable when the decision could have rested on other grounds. Under RUPA, courts will have to be more disciplined, and if a contract provision is to be set aside, the court will have to identify reasons why it is manifestly unreasonable. Faced with that imperative, courts must be sure that that is indeed the issue that they face.

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114. *Black's Law Dictionary* 962 (Bryan A. Garner ed., 6th ed., 1990) (cited with approval in *Morgan Buildings & Spas, Inc. v. Turn-Key Leasing, Ltd.*, 97 S.W.3d 871, 880 (Tex. App. 5th Dist. 2003)).

115. *F.B.I. Farms*, 798 N.E.2d at 444 (considering whether restrictions on the transfer of corporate stock were manifestly unreasonable). Courts determining whether a commercial contact is unconscionable are also instructed to consider such factors: "The basic test is whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." U.C.C. § 2-302 cmt. 1.

116. *Bates v. Stagg*, 404 P.2d 530, 531 (Colo. 1965) (noting a standard for directed verdict).

117. *Rapp v. Dime Savings Bank of N.Y.*, 408 N.Y.S. 2d 540, 546 (N.Y. App. Div. 2d Dept. 1978) (holding time restrictions imposed by bank on withdrawals not manifestly unreasonable because the "time restrictions are fully in accord with general banking usage"); *see also McCullough v. General Motors Corp.*, 577 F. Supp. 41, 47 (W.D. Tenn. 1982) (noting that "determination of these issues requires a careful consideration of the purpose and effect of the time limitation, the commercial setting in which the contract was executed, the reasonableness of the time limitation at the time of contracting"); U.C.C. § 1-302 cmt. 1 (2001) (recognizing the importance of prior course of dealing and usage of trade in determining whether a provision is manifestly unreasonable).

118. *PPG Industries, Inc. v. Shell Oil Co.*, 919 F.2d 17, 19 (5th Cir. 1990); *see e.g.* Keatinge, Anker & Lion III, *supra* n. 113, at 93 ("[The manifestly unreasonable standard] is intended to discourage overreaching by a partner with superior bargaining power since the courts may refuse to enforce an overly broad exculpatory clause.").

119. *See generally* Sarah Howard Jenkins, *Preemption & Supplementation under Revised 1-103: The Role of Common Law & Equity in the New UCC*, 54 S.M.U. L. Rev. 495, 520–23 (2001) (collecting cases construing the term "manifestly unreasonable" in the UCC).

b. *From an* Ex Ante *Perspective, was any Party Adversely Affected by the Waiver?*

In a general partnership, if each partner has the freedom to compete with the partnership, no partner can complain that the waiver is unfair. On the other hand, if the general partners in a limited partnership are freed from their duty of loyalty, the limited partners are at risk and the waiver should be scrutinized. A waiver could nonetheless be entirely reasonable if, as in *Sonet*, the facts provide some other protection for the limited partners. Moreover, if the limited partners and the general partners are of equal bargaining power, the burden on the limited partners to demonstrate that a waiver is manifestly unreasonable should be great.

c. *Would Enforcement of the Waiver Damage the Partnership in a Way that the Parties Could Not Have Anticipated When the Waiver was Executed?*

The importance of this factor might be illustrated in a partnership organized to, say, enter into a master lease for a commercial office building in an urban area. The partners would typically agree that they should be allowed to "compete," that is, invest in or develop other properties that might compete for tenants with the partnership's building. This is typically viewed as an acceptable risk. However, if some members of the partnership were to bid against the partnership when the master lease came up for renewal, the partnership might be damaged in a way that the partners did not anticipate when they entered into the agreement. This is not the sort of competition that the parties anticipated, and the waiver, if so interpreted, may be manifestly unreasonable. Nevertheless, the waiver should be enforceable if evidence supports an interpretation that this was consistent with the parties' *ex ante* intent.

d. *Was the Partnership Closely Held or More Widely Held?*

Clearly, an agreement negotiated among a few parties is distinguishable from one that is presented to numerous investors on a non-negotiable basis. In the latter case, the agreement is akin to corporate articles of incorporation and will likely be viewed more skeptically by the courts. The contents of articles of incorporation are defined and limited by corporate statutes in a way that a partnership agreement or operating agreement for a limited liability company is not. But to some extent that is because corporate law contemplates a division between ownership and control that also describes the relationship between investors in a quasi-public partnership or limited liability company and the managers of the entity.[120] Indeed, in some cases the investors in these entities will receive an offering memorandum and, some time later, a signature page for a partnership or operating agreement without having seen, much less negotiated, the terms of such an agreement. The point here is not that corporate fiduciary terms should be imported into partnership or operating agreements, but rather that in light of the

120. *See* Frankel, *supra* n. 18, at 1253–66 (arguing for limitations on waivers of the fiduciary duties of "public fiduciaries").

similarities between quasi-public unincorporated business entities and corporations, it is inevitable that courts will scrutinize fiduciary waivers in widely-held unincorporated business entities.

2. Reexamining Cases Upholding Waivers under UPA

Critics have suggested that RUPA is more restrictive than UPA in permitting the parties to waive fiduciary duties in their partnership agreement. The implicit suggestion of such critics is that courts will view waivers that are enforced in UPA partnership agreements as manifestly unreasonable. Put differently, these critics seem to be arguing that courts have been enforcing waivers that *are* manifestly unreasonable. This argument seems somewhat implausible on its face, but is worthy of examination.

In his article criticizing RUPA, and speculating that it will change the way courts view cases, Professor Hynes cites two cases that would come out differently under RUPA, *Singer v. Singer*, which is discussed above, and *Riviera Congress Associates v. Yassky*.[121] As to *Singer*, the question might be posed as follows: Is a provision in a general partnership agreement among a limited number of equally sophisticated parties manifestly unreasonable if construed to permit one or more partners to pursue a business venture in which the partnership might have an interest, but is not competitive with the business of the partnership? As properly posed, the answer a court would likely give seems fairly predictable. Indeed, under the circumstances, there was nothing unreasonable about the agreement of the parties. Posing the issue in alternative language, such as whether a waiver of the duty not to compete is manifestly unreasonable, would misstate the case and disserve the goal of understanding its holding. The broad waiver contained in the agreement, however, would as an abstract proposition support an argument that the partners could actually compete with the partnership. But the nature of the partnership business was such that competition was not a meaningful problem, given the perfectly competitive market for oil and gas. This explains why the partners agreed to such a broad waiver and why it is problematic to read the decision too broadly.

Riviera Congress, the second case cited by Professor Hynes, is even less of a problem under the manifestly unreasonable standard, as it arguably did not even involve an express, forward-looking waiver. Rather, this was a case in which the defendants formed a limited partnership for the purpose of acquiring certain real property and leasing that property to an entity they controlled. This proposed self-dealing was fully disclosed to the limited partners when the limited partnership was organized. Subsequently, general partners consented to an assignment of the lease that released them, in their capacity as tenants, from an obligation to the limited partnership. The limited partners brought a derivative action seeking to recover the lost rent and claiming that the release was invalid since it involved self-dealing.

The New York court rejected the self-dealing claim because disclosures in the prospectus given to the limited partners to solicit their investment in the deal disclosed that the limited partnership would be leasing the property to an entity controlled by the

121. 223 N.E.2d 876 (N.Y. 1966).

general partners and that the lease could be assigned if the assignee assumed the obligations under the lease.[122] In the partnership agreement, the limited partners acknowledged receipt of the prospectus and represented that they were relying on it.[123] In other words, the limited partners could hardly complain of a transaction specifically contemplated in the offering document. Rather, and significantly, the court noted that a trial would determine whether the defendants acted "honestly and in good faith."[124] Thus, plaintiffs were not without a remedy if the defendants exercised their contractual right to assign the property in bad faith.[125] However, and as the court conceded, there was no justification to hold that the assignment itself was invalid.

Considering the application of RUPA to the facts of *Riviera Congress* raises two questions: First, did the partnership agreement waive the general partners' duty of loyalty and second, if so, was the waiver manifestly unreasonable? As to the first question, this case may not have involved a forward-looking waiver. The partnership, after all, was formed to enter into a self-dealing lease. While the limited partners were complaining of the assignment of this lease, they might just as well have complained about the lease itself. Consider, then, a claim by the limited partners brought immediately after formation of the partnership seeking to enjoin the lease on the basis that it constitutes a breach of the general partners' duty of loyalty. The claim is obviously frivolous, as was the claim that consent to assignment involved impermissible self-dealing. Rather, with respect to the initial lease, and the subsequent decision to consent to an assignment of the lease, the question is whether the general partners exercised their discretion in good faith, a limitation that RUPA wisely preserved. The issue in *Riviera Congress* might thus be framed as follows: Is a limited partnership agreement that contemplates the lease of partnership property to an entity controlled by the general partner manifestly unreasonable? As in *Singer*, it would appear that the agreement is not unreasonable at all, much less manifestly so.

3. Lack of Alternatives

Professor Hynes has suggested that judicial review of fiduciary waivers be tested by a standard of unconscionability,[126] arguing that such a standard will limit the

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122. *Id.* at 877; *see also Bassan v. Inv. Exch. Corp.*, 524 P.2d 233, 236 (Wash. 1974) ("Partners may include in the partnership articles practically any agreement they wish and if the asserted self-dealing was actually contemplated and specifically authorized with a method for determining, in advance, the amount of the profit it would not, ipso facto, be impermissible and deemed wrongful." (citation omitted)).

123. *Riviera Congress*, 223 N.E. 2d at 877.

124. *Id.* at 880.

125. This issue, on remand, would have been difficult to resolve because the Court of Appeals gave no hint as to how good faith would be measured under these circumstances. Presumably, if the defendant consented to assignment solely to protect the assets of the assigning entity, and knowing that the assignee would be unable to honor the lease, a claim of bad faith may be made out.

126. Hynes, *Fiduciary Duties*, *supra* n. 1, at 52–54; *but see* George W. Dent, Jr., *Gap Fillers and Fiduciary Duties in Strategic Alliances*, 57 Bus. Law. 55, 72 (2001) ("If there is a difference between [the manifestly unreasonable standard and the unconscionability standard] it is slight."). Oregon has substituted the concept of unconscionability for the manifestly unreasonable standard. Or. Rev. Stat. Ann. § 67.015(2)(b)(A) (2005) ("[P]artnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not unconscionable."). One court has drawn on unconscionability jurisprudence to decide whether a provision is manifestly unreasonable, *Oxford Resources Corp. v. Jenkins*, 642 N.Y.S.2d 488 (N.Y. City Civ. Ct. 1996), while several others have held that the manifestly unreasonable standard was independent of

instances in which a partnership agreement is rendered unenforceable, resulting in agreements that are more certain and reliable. Assuming that the goal is to provide some opportunity for judicial review of questionable fiduciary waivers, the unconscionability standard is not appropriate. As an initial matter, substituting an unconscionability standard for a manifestly unreasonable standard would have the same legal effect as a statutory provision that allowed an elimination of the duty of loyalty, because a court will not enforce an unconscionable contract.[127] The common law has adopted the notion that unconscionable contracts are unenforceable, and drafters of a partnership statute would have to provide that fiduciary waivers are enforceable even if unconscionable to change that common law result. Such a statute would not be introduced, much less enacted, so that expressly providing for a review based on unconscionability adds nothing to a statute.

Second, the jurisprudence that has developed under the unconscionability standard does not seem appropriate because of the generally accepted requirement that a complaining party prove procedural unconscionability as well as substantive unconscionability. To satisfy procedural unconscionability, a plaintiff must demonstrate that he or she lacked "meaningful choice,"[128] which, in the context of a financial investment, will be highly problematic. Presumably, an investor has a nearly limitless number of alternative investment vehicles. The fact, however, that the investor had other alternatives should not mean that the waiver is unassailable. A party to a partnership agreement has different expectations than, say, a consumer purchasing a product or service from a merchant. In the consumer transaction, the consumer knows that he or she is dealing at arm's length and, to a large extent, the principle of *caveat emptor* should limit the ability of the consumer to challenge the terms of the transaction. By contrast, a person entering into a partnership agreement has the expectation of entering into a longer term relationship with co-partners, all of whom share a common profit-making goal. In such a relationship, a party may be more focused on the economic aspects of the partnership than on provisions relating to competition, disclosure, and self-dealing. Although this view is somewhat paternalistic, courts are likely to be sympathetic to an investor who was approached as a potential partner and, understandably, trusted the promoter, even if no formal fiduciary duty existed between the parties at the time.[129] Any statutory standard of judicial review that does not contemplate this sympathy will surely be abused.

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unconscionability. *See Fundacion Museo De Arte Contemporeneo De Caracas-Sofia Imber v. CBI-TDB Union Bancaire Privee*, 996 F. Supp. 277 (S.D.N.Y. 1998), *aff'd*, 160 F.3d 146 (2d Cir. 1998) (UCC Article 4 case); *Hart Engineering Co. v. FMC Corp.*, 593 F. Supp. 1471, 1480 (D.R.I. 1984) (In a claim related to a goods transaction, the court held that the manifestly unreasonable standard cannot be invalidated by the doctrine of unconscionability.); *Loucks v. New Holland Mfg., Inc.*, 1993 WL 152288 (Minn. App. May 11, 1993) (warranty provision); *see generally* Jenkins, *supra* n. 119, at 516.

127. *Restatement (Second) of Contracts* § 208.

128. *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965); *see generally* Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. Pa. L. Rev. 485 (1967) (suggesting that unconscionability consists of procedural and substantive aspects).

129. UPA § 21 requires a partner to account for any profit made in formation of the partnership. While RUPA § 404 dropped this concept, courts may be inclined to recognize a duty to account for profits earned in the formation of the partnership, if the complaining partner can demonstrate that a relationship of trust and confidence was established during the formation of the partnership.

Finally, the established jurisprudence under the unconscionability standard is ill-suited to review fiduciary waivers.[130] Some waivers that would not pass muster in a consumer context likely should be acceptable in the context of a partnership. For instance, judicial review of a waiver of the duty of care in the context of medical services has little relevance to an identical waiver in a financial partnership. On the other hand, waivers of the duty of loyalty in an employment context may be enforceable when a similar waiver in the partnership context may be manifestly unreasonable. The nature of the relationship of the parties and their reasonable expectations should play a more important role in examining fiduciary waivers in partnership agreements than in other settings.

IV. THE ACADEMIC DEBATE: CONTRACTARIANS V. FIDUCIARIANS

The debate between the contractarians and fiduciarians is set forth in several well-written articles[131] and it would serve little purpose to recount those debates in any detail. A brief review of the fundamental fault lines of the debate is, however, worthwhile in order to place the suggestion of this article in the context of that debate. Generally, contractarians and fiduciarians tend to focus on history, the role of bargaining, and economic efficiency.

A. *History*

The historical importance of fiduciary duties in partnerships does not mean, of course, that fiduciary duties must be mandatory in contemporary unincorporated business entities. But the historical fact does mean that investors, particularly limited partners and limited liability company members in a manager-managed limited liability company, may well have an expectation that those managing the enterprise are their fiduciaries. While this is an empirical assertion, it seems at least plausible, if not compelling. Indeed, the common law origins of fiduciary duties rest on an intuition about what people expect, and there is no reason to believe that those expectations have changed over time. More importantly, courts may view such managers as presumptive fiduciaries. These expectations influence judicial decisions and ought to be considered by statutory drafters as well.

One answer to the historical argument is that unincorporated business entities have always been contractual in nature, with courts honoring the parties' agreement to waive common law fiduciary duties. Thus, one might argue, fiduciary duties have never been mandatory and common law duties have been subject to contractual modification. This argument, however, both understates the common law influence on fiduciary duties and overstates the role of private ordering. As to the former, Part II above demonstrates that the common law commitment to recognizing fiduciary duties is so well-ingrained that it amounts to a "mandatory" provision. Indeed, the drafters of UPA felt no need to include

130. *See* Ribstein, *Fiduciary Duty Contracts*, *supra* n. 1, at 567 (1997) ("[A]n unconscionability standard has the virtue of integrating enforceability of fiduciary duty waivers into the general law of contracts. For this reason, unconscionability may be too narrow a basis of invalidation to satisfy anticontractarians." (footnote omitted)).

131. *See supra* n. 1 and accompanying text.

those fiduciary duties in the uniform Act. As the ability to contractually modify these duties, this article demonstrates the significant limitations placed on this freedom by the courts.

B. Lack of Bargaining

Unincorporated business entities can be closely held, with the terms of the partnership or operating agreement negotiated by the parties in an arm's length negotiation, or the entity may be widely, if not publicly, held. In this section, I consider only the latter, such as operating or partnership agreements of real estate syndicators. Such agreements bear similarities to corporate articles of incorporation, which investors typically do not negotiate.

Contractarians argue that corporate investors are not in need of any special protection and that the investment decision that they face is entirely different from that of a consumer faced with an adhesion contract. Corporate investors have an array of investment opportunities, including corporations with a broad range of governance and capital structures, unincorporated business entities with a nearly infinite variety of terms, mutual and exchange-traded funds, certificates of deposits and bank savings accounts, etc. Each of these investment opportunities competes within categories and across categories for investor dollars. As one critic has said, "[t]his wide range of choices among 'adhesion' contracts means, in effect, that there is no such thing as an adhesion contract."[132]

Contractarians necessarily assume a degree of sophistication among investors in corporations and unincorporated business entities that may not be warranted. Particularly with respect to unincorporated business entities, the relevant operating or partnership agreement may be very long and complex. Terms that relate to fiduciary duties may not be collected in one section; instead, terms that relate to fiduciary duties may appear in various sections dealing with management, distributions, repurchase of units, etc. Contractarians respond that this does not matter, as voluntary contracting is presumptively efficient, and the contract should therefore be enforced. That may or may not be the case, but it is irrelevant. The real question is not whether a court should enforce any particular waiver, but whether it will. If a court will not, then it is fair to ask whether statutory drafters should anticipate this judicial response. If, in fact, courts employ covert tools to avoid enforcement of fiduciary duty waivers, then such contracts cannot efficiently allocate risks among the parties. Instead, it may be more efficient if the statute, against which these agreements are drafted, anticipated the likely judicial response.

C. Efficient Mandatory Rules

The idea that any voluntary agreement reached between two competent, fully informed parties with roughly equal bargaining power should be enforced because it is economically efficient to do so is relatively uncontroversial. When the promoter of an

132. Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1, 13 (1990).

unincorporated business entity seeks consent from the investor/partner or member, one or more of these elements may be lacking. The investor may not, in fact, be fully informed or sufficiently sophisticated; or the investor may not be in a position to bargain with the promoter. Of course, these factors, standing alone or in the aggregate, ought not to be sufficient to set aside a waiver or any other term of the relevant agreement. If they were, a market economy would grind to a halt, or at least slow down markedly. Investors would face fewer investment opportunities, and those available may not provide the risk/reward ratio that many investors seek. If the enforceability of a waiver is not assured—and in most jurisdictions it is not—then the promoter and the sophisticated investors cannot accurately price a proposed deal. In this environment some mandatory rules may prove to be more efficient than voluntary contracting.

Indeed, mandatory rules may be efficient. For instance, some commentators have argued (persuasively, in my view) that corporate management should be passive when faced with a hostile takeover.[133] Such a policy would enhance, and make more efficient, the market for corporate control. This, of course, conflates the idea of the efficiency that arises from voluntary bargaining with another sort of market efficiency. Under the former, shareholders may well agree to exchange lower executive compensation for greater flexibility on management's part to resist a hostile takeover. Even if this lowered the value of the shareholders' stockholdings, it is unassailable from a contractarian perspective, as the parties to the contract may value the resulting bargain greater than any other bargain. From society's perspective, perhaps this is less than ideal and an appropriate opportunity for mandatory rules. While, strictly speaking, the hypothetical bargain described here does not give rise to externalities, society as a whole may have a legitimate interest in maintaining an efficient market for corporate control.

This concept carries over to limitations on waivers. An investor may well be willing to waive the promoter's duty of loyalty—freely permitting competition, for instance—in exchange for a lower fee. But if there were doubts about the enforceability of the waiver, the promoter may value the waiver lower than he otherwise would. The uncertainty is a cost that the investor will bear, with no corresponding benefit if the investor would not challenge competition by the promoter consistent with their agreement. Thus, a mandatory rule that limits waivers removes uncertainty (or at least reduces uncertainty), giving the parties greater certainty in their bargain. This redounds to the market as a whole, rather than any particular transaction, as certainty is a good shared by all participants. Indeed, under this analysis one of the important arguments of contractarians—"[that] parties should be able to opt out of fiduciary duties to avoid costly unpredictability"[134] that results from judicially imposed mandatory rules—is stood on its head. By statutorily specifying the limits of a waiver, somewhat less unpredictability is provided.

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133. Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161 (1981).

134. Butler & Ribstein, *supra* n. 132, at 43 (footnote omitted).

Moreover, mandatory fiduciary duties or limitations on waivers provide a check on agency costs that are not otherwise policed.[135] By assumption, there is no public market for the investments described here, so the disciplining effect of the market for "corporate" control is absent. While managers may value reputational effects, it is unclear, especially with respect to the promoters of unincorporated business entities, how powerful this effect is.

V. CONCLUSION

Critics of the manifestly unreasonable standard decry its uncertainty and ambiguity. One critic wrote that the term is "largely undefined in existing law, nebulous, and unworkable in practice."[136] These criticisms are well taken; it is indeed uncertain, ambiguous, nebulous, and many other adjectives that suggest lack of clearly defined limits. The term may, however, prove workable in practice. One might object to any standard of judicial review on the basis of its uncertainty, but that is the nature of judicial review. Once one decides that there is a role for the courts to play, the purpose of the articulated standard is to provide some guidance for consistent decision making by the courts. The manifestly unreasonable standard has the potential to do that as well as any standard in private law. The legislatures adopting this standard have sent an unmistakable message to the courts—the agreement of the parties is to be given considerable, but not complete, deference. Agreements should be set aside only in extreme cases, where the unreasonableness of the agreement is manifest. Naturally, it will take some time for a body of precedent to develop, but other standards, such as a simple unreasonable standard or an unconscionability standard, would not achieve what the legislature sought to achieve.

The suggestion set forth in this article, supporting a statutory limitation on waivers of fiduciary duties, is informed by the realities of the judicial system. When faced with an obvious injustice that would result from enforcement of a fiduciary waiver, courts will find a way around the provision. It may be that they should not, but they will. It is not enough for a legislature to provide, as the Delaware legislature has, that it is the policy of its Act "to give maximum effect to the principle of freedom of contract," because such a provision does not speak to the difficult cases that courts face. "Freedom of contract" presumably exists even in the absence of a statutory provision that extols its importance. Courts that have developed the common law concepts of unconscionability and the unenforceability of certain adhesion contracts did so in the shadow of a public policy favoring freedom of contract. The real question for statutory drafters is whether they prefer judicially-developed limits on the freedom of contract, or a legislatively-derived solution. This article argues for the latter.

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135. In addition, the existence of judicial relief for fiduciary breaches may encourage investment. *See* Frankel, *supra* n. 18, at 1276 ("Although [limiting the ability of parties to waive fiduciary duties may] seem paternalistic, they can be justified by concerns that, 'once badly burned,' entrustors will refrain from entering into fiduciary relationships, to the great detriment of society as a whole.").

136. Callison, *supra* n. 1, at 158 (footnote omitted).