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A Good Faith Revival of Duty of Care Liability in Business Organization Law

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A GOOD FAITH REVIVAL OF DUTY OF CARE LIABILITY IN BUSINESS ORGANIZATION LAW

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I. INTRODUCTION

The core fiduciary duties of care and loyalty have long been the most important and controversial theories of director liability in corporate law.[1] The Delaware response to exploding director care liability has been a robust business judgment rule eroding the duty of care itself, coupled later with complete statutory exculpation for duty of care liability. Shareholder efforts to circumvent those director protections have placed increasing pressure on the express exceptions to statutory exculpation in general and good faith in particular. The anti-exculpatory role of good faith arguably was expanded by a narrow self-benefit conceptualization of the duty of loyalty. That pressure was most recently expressed in the 2006 release of *In re the Walt Disney Co. Derivative Litigation* ("*Disney IV*"),[2] a nearly ten-year saga[3] testing the conceptual limits of good faith while concluding Disney directors were not liable.[4] While the Disney directors were arguably negligent, the shareholder plaintiffs failed to prove the directors acted in bad faith, and thus, absent actionable personal benefit, the directors' decisional conduct was protected by the business judgment rule as well as statutory exculpation.[5]

This article canvases the modern contours of the core corporate fiduciary duties of care and loyalty to challenge conventional wisdom and to demonstrate that the peripheral duty of good faith is a distinct concept but not a separately actionable fiduciary duty. Delaware statutory exculpation and indemnification law as well as its business judgment rule lean heavily on a requirement of conceptual good faith as the minimum price of protected director conduct. Properly conceived, bad faith operates to deconstruct those

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1. *See generally* Claire Moore Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. Colo. L. Rev. 111 (1993).
2. 2006 WL 1562466 (Del. June 8, 2006).
3. *Id.* at *1.
4. *Id.*
5. *Id.* at **27, 32.

protections, which is a more proper and limited role for a duty that is extremely difficult to define and prove. Moreover, confining good faith to this role allows it to serve a justified policy goal designed to increase liability for unjustifiable behavior bordering on intentional misconduct. By stripping away exculpation, indemnification, and business judgment rule protections, bad faith reinvigorates the core duty of care to an ordinary negligence standard requiring only proof of a breach of the ordinary negligence duty, corporate harm, and causation.

The good faith reinvigoration of duty of care liability requires further re-examination of the 1993 Delaware Supreme Court opinion in *Cede & Co. v. Technicolor, Inc.* ("*Cede II*"),[6] a case that conflated liability standards for a breach of the fiduciary duties of care and loyalty by allowing directors to escape care liability, like loyalty liability, by showing that the director conduct was "entirely fair" to the corporation and its shareholders. The "entire fairness" standard more appropriately addresses the fairness of director personal benefit and conflict of interest transactions. While statutory exculpation makes this error irrelevant in most cases, statutory exculpation is not available upon proof of bad faith, thus mandating judicial correction of *Cede II* to avoid using an irrelevant entire fairness test to shield care liability. Given these corporate fiduciary duty missteps—and the trend to adopt statutes approving *ex ante* contractual elimination of the duties of care and loyalty in unincorporated business organizations including limited liability companies—careful attention is required to prevent these corporate errors from invading unincorporated law, particularly in Delaware.

This article explores the rich vein of corporate duty of care, loyalty, and good faith law to determine useful parallels applicable to the unincorporated enterprise. Entity differences aside, the two "fiduciary" contexts share a similar operating environment. A few modern cases demonstrate the ease with which courts move between the two organization paradigms to find applicable principles and law. For example, a recent case determined that KPMG, a Delaware general partnership, was obligated to indemnify and advance legal fees of employees and partners.[7] Judge Kaplan moved with seamless ease between partnership and corporate law precedents, citing the common agency law roots relative to indemnification and modern statutory developments relative to permissive and mandatory elements of indemnification in corporate, partnership, and limited liability company law.[8] Predictably, Judge Kaplan neglected to explain the relevance of the segue that seized upon corporate law to resolve partnership questions. Judge Kaplan's approach is systematic and thus requires adherents of unincorporated law to predict the application of corporate precedent to resolve unincorporated disputes.

While directors are not corporate agents,[9] directors nonetheless act on behalf of the shareholders and thus are properly characterized as fiduciaries.[10] Moreover, corporate

6. 634 A.2d 345 (Del. 1993).

7. *U.S. v. Stein*, 435 F. Supp. 2d 330, 356 n. 119 (S.D.N.Y. 2006).

8. *Id.* at 353–55.

9. Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm. & Mary L. Rev. 1597, 1601 (2005) ("[C]orporate officers are fiduciaries because they are agents.").

10. Austin W. Scott, *The Fiduciary Principle*, 37 Cal. L. Rev. 539, 540 (1949) ("A fiduciary is a person who undertakes to act in the interest of another person."). Fiduciary obligation originated in equity and arose

officers are fiduciaries because of their agency status.[11] Many owners of an unincorporated entity are quite often agents and fiduciaries because they act on behalf of the entity and other owners *inter se* as well as when dealing with third parties. Under the Uniform Partnership Act of 1914 ("UPA") and the Uniform Partnership Act of 1997 ("RUPA"), every general partner, *qua* partnership status, has an equal right to participate in management[12] and is a statutory agent of the partnership.[13] The Uniform Limited Partnership Act of 1976, as amended in 1985 ("RULPA"), and the Uniform Limited Partnership Act of 2001 ("ULPA 2001") provide that every general partner has the right to manage partnership business[14] and is a statutory agent,[15] while no limited partner has either right, both *qua* their status as a general or limited partner.[16] The Uniform Limited Liability Company Act of 1996 ("ULLCA") provides that a member of a member-managed limited liability company has an equal right to participate in management[17] and is a statutory agent,[18] while a member of a manager-managed limited liability company has neither.[19] The Revised Uniform Limited Liability Company Act ("Re-ULLCA") similarly provides for management rights[20] but eliminates statutory agency authority of any member or manager, thereby relying upon common law agency principles.[21]

Because both agents and trustees are types of fiduciaries, directors,[22] officers, and partners owe fiduciary duties to the entity and the other owners.[23] Often those duties are stated in the organization statutes,[24] but in other cases they arise by virtue of the nature

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from a relationship of "trust" and "confidence," but "[t]he term 'fiduciary' itself was adopted to apply to situations falling short of 'trusts,' but in which one person was nonetheless obliged to act *like* a trustee." Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 880 (1988) (footnote omitted).

11. *See* Johnson & Millon, *supra* n. 9, at 1601.

12. UPA 1914 § 18(e), 6 U.L.A. 275 (2001); RUPA § 401(f), 6 U.L.A. 1 (2001).

13. UPA 1914 § 9(1); RUPA § 301(1).

14. RULPA § 403(a), 6A U.L.A. 125 (2003); ULPA 2001 § 406(a), 6A U.L.A. 1 (2003).

15. RULPA § 403(a); ULPA 2001 § 402(a).

16. RULPA § 303(a); ULPA 2001 § 302.

17. ULLCA § 404(a)(1), 6A U.L.A. 553 (2003).

18. ULLCA § 301(a)(1).

19. ULLCA §§ 301(b)(1) (agency), 404(b) (management).

20. Re-ULLCA § 407(b)(1), (c)(1) (available at http://www.law.upenn.edu/bll/ulc/ullca/2006annual meeting_approvedtext.htm).

21. Re-ULLCA §§ 107 (general principles of law and equity apply), 301(a).

22. Like unincorporated law, corporate fiduciary duty law emerged from agency and trust law. Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 Nw. U. L. Rev. 651, 651 (2002).

23. Whether the fiduciary duty of care is owed directly to entity owners as opposed to either the entity alone or to the entity and the owners jointly is largely a matter of statutory language. However, the question has little significance beyond the issue of whether an injured member has standing to sue for an alleged violation of the duty of care directly or must bring the action derivatively and on behalf of the entity itself. The characterization is important because, unlike a direct suit, a derivative suit is subject to a number of procedural limitations designed to protect the balance of power between management and owners to decide who has the power to cause the entity to sue a manager for mismanagement. While a line of cases addresses the direct/derivative distinction through the rights/duty question, those cases can be generally reconciled with the superior approach of analyzing the question from the direct harm or injury approach. Daniel S. Kleinberger, *Direct Versus Derivative and the Law of Limited Liability Companies*, 58 Baylor L. Rev. 63, 106–10 (2006).

24. *See e.g.* UPA 1914 § 21(1); RUPA § 404(a)–(c); ULPA § 403(a); ULPA 2001 § 408(a)–(c); ULLCA § 409(a)–(c); Re-ULLCA § 409(a)–(c); Allan G. Donn, *Contractual Modification of Fiduciary Duties for*

of the fiduciary relationship. The hallmark of a fiduciary duty is the duty of loyalty,[25] and both partners[26] and directors[27] have been described as fiduciaries. Unlike the duty of loyalty, the duty of care is not uniquely fiduciary in character, and thus, while some courts and statutes refer to the duty of care as a fiduciary duty, that characterization is both inaccurate[28] and unfortunate.[29]

Delaware law is important to corporate law because so many corporations are incorporated in that state.[30] Delaware has, therefore, developed the richest vein of corporate case law including that on the scope and nature of fiduciary duties. In Delaware, common law, not statutes, provides fiduciary duties. Corporate director fiduciary duties are therefore derived from common law fiduciary principles applicable to trustees and agents and commonly referred to in Delaware as a fiduciary "triad" of care, loyalty, and good faith. Because directors of a public corporation face massive financial liability for violations of the duty of care that can have enormous financial consequences, Delaware first developed a robust business judgment rule to negate liability not involving gross negligence. When that standard proved too onerous, the Delaware legislature adopted a statutory exculpation standard that eliminated director care liability involving even gross negligence. Since that time, cases have been framed

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Delaware Unincorporated Business Entities, 7 J. Passthrough Entities 17, 17–18, 20–22 (2004).

25. *Restatement (Third) of Agency* § 8.01 (6th tent. draft 2005) ("[An] agent has a fiduciary duty to act loyally for the principal's benefit."); *Restatement (Second) of Trusts* § 170(1) (1959) ("[The] trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary."). The trust rule has been described as the "sole interest" rule. Some scholars argue the duty should be reduced to acting merely in the best interest of the beneficiary. *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?* 114 Yale L.J. 929 (2005); Melanie B. Leslie, *In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein*, 47 Wm. & Mary L. Rev. 541 (2005); Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 Geo. L.J. 67, 112 (2005).

26. *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd." (citation omitted)).

27. *Pepper v. Litton*, 308 U.S. 295, 306–07 (1939) ("A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its *inherent fairness* from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside." (footnote and citations omitted, emphasis added)).

28. *Compare Restatement (Third) of Agency* § 8.01 ("[An] agent has a fiduciary duty to act loyally for the principal's benefit.") *with id.* at § 8.08 ("[An] agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances."); *see id.* at § 8.08 rptr. n. cmt. b (stating that "[t]he duties . . . in this section are duties of performance, not duties of loyalty" and acknowledging that some courts and statutes describe the duty of care as fiduciary in nature).

29. William A. Gregory, *The Fiduciary Duty of Care: A Perversion of Words*, 38 Akron L. Rev. 181, 183 (2005).

30. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 Yale L.J. 553, 556 (2002). Between 1996 and 2000, eighty-five percent of companies that incorporated outside their home state chose Delaware. *Id.* at 577–78.

to avoid exculpation. Statutory exculpation is subject to four important exceptions. Because none of the exceptions arguably relate to the duty of care, it is commonly assumed that monetary damages for breaches of the duty of care are a rare distant memory. At the same time, at least two and arguably three of the exceptions specifically preserve monetary liability for breaches of the duty of loyalty as well as for acts or omissions not in good faith.

As shareholders naturally gravitate to couching claims in terms of loyalty and bad faith to escape the exculpation provision, directors characterize the same conduct as a product of carelessness to invoke exculpation. Unfortunately, encouraged by an overbroad business judgment rule, Delaware case law regarding director misconduct has been conceptually cavalier regarding the theoretical boundaries separating care and loyalty, with the latter too often narrowly defined by the presence of director personal benefit. Inevitably, unable to carry the burdens put upon it by a narrow loyalty definition, care expanded. The result was a finding of massive director liability in 1985 in *Smith v. Van Gorkom*.[31] Statutory exculpation statutes immediately followed attempting to rein-in care liability. Not surprisingly, given arguably independent and disinterested directors, the recent spate of cases ending in 2006 with *Disney IV*[32] sought to escape statutory exculpation by arguing bad faith because loyalty itself is assumed to require personal benefit.

Unlike loyalty, good faith permits self-interested conduct, so the issue becomes abuse rather than benefit—especially in cases involving abdication of management duty or passive oversight failures.[33] And unlike bad faith, disloyalty can occur even unintentionally, and so the issue becomes breach instead of abuse. While these features of good faith undoubtedly preserve its independent significance in director misconduct cases, good faith is ill-suited as a liability standard. Proving intentionally bad behavior is quite difficult, and good faith shares common features with care and loyalty, two radically different bases of liability. Bad faith conduct is certainly intentionally careless and probably disloyal as well, at least if loyalty is defined more broadly to require an element of devotion. Care liability traditionally requires the shareholder to carry the burden of proving duty, breach, harm, and causation whereas valid loyalty claims shift the burden of proof to the director to prove entire fairness, at least in self-dealing cases. In 1993, Delaware case law reacted to this predicament in *Cede II*[34] by erroneously subjecting culpable breaches of duty of care to an entire fairness standard.[35]

This article chronicles these developments and argues a better construct would revitalize loyalty by eliminating the cabin-in feature requiring self-benefit and focusing on the positive aspects of devotion to duty. This "loyalty approach" frees bad faith to

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31. 488 A.2d 858 (Del. 1985).

32. 2006 WL 1562466.

33. DeMott, *supra* n. 10, at 900. Comparing the obligation of good faith to the fiduciary obligation of loyalty, DeMott observed: "Most importantly, if a fiduciary obligation constrains a person's discretion in a particular matter, the obligation is breached if the person acts self-interestedly. Good faith obligation, on the other hand, permits actions that are self-interested; the key question is abuse, not benefit to the actor." *Id.* (footnote omitted).

34. 634 A.2d 345.

35. *Id.* at 361.

operate more naturally to deconstruct the otherwise applicable business judgment rule and statutory exculpation. As a result, care would be tested under its normative ordinary negligence standard, thus allowing care to assume a more natural role to undergird loyalty. Admittedly, this shifts emphasis in Delaware corporate law to disloyal conduct, but disloyalty, at least when defined to include a lack of positive devotion, is more naturally intuitive and appealing as a standard of conduct in a post-Enron world. Ultimately, case law would evolve to determine the proper scope and contours of a lack of devotion invoking director liability. In the meantime, with few exceptions, unincorporated entity law has thus far avoided *ex ante* statutory exculpation by shifting the emphasis to the proper course for *ex ante* contracts among the fewer owners to narrow or limit the more robust duties of loyalty and care. The judicial challenge in that environment is to determine the private law and public policy boundaries of permissive contractual domain.

II. DELAWARE CORPORATE FIDUCIARY DUTY LAW

A modern understanding of Delaware director fiduciary duties normally begins with the 1993 Delaware Supreme Court view in *Cede II* that collectively treats good faith, loyalty, and due care as the triads of fiduciary duty.[36] The triadic formulation was repeated in 1995 in *Cinerama, Inc. v. Technicolor, Inc.* ("*Cede III*"),[37] in 1998 in *Malone v. Brincat*,[38] and in 2001 in *Emerald Partners v. Berlin*;[39] and it has been used repeatedly in Delaware case law since 1993.[40] In many areas of the law, standards of conduct and standards of liability are the same but not so in corporate fiduciary duty law.[41] Mostly, corporate law divergence between duty and liability standards can be justified because, unlike other areas of law where conduct alone is involved, corporate law requires directors[42] to make complex, inherently outcome-risky decisions.[43] Linked conduct and decision rules are therefore necessary to encourage and tolerate *ex ante* decisions that might have been different if made with *ex post* hindsight.[44] Unfortunately, because loyalty, care, and good faith are not uniformly triadic, divergent corporate law standards must account for varying policies that do not easily co-exist.

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36. *Id.*

37. 663 A.2d 1156, 1164 (Del. 1995).

38. 722 A.2d 5, 10 (Del. 1998).

39. 787 A.2d 85, 90 (Del. 2001).

40. Charles Hansen, *Sowing the Seeds of Confusion: The Ephemeral Triad*, 73 Aspen L. & Bus. Corp. 1, 2 (2002).

41. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and Its Progeny as a Standard of Review Problem*, 96 Nw. U. L. Rev. 449, 450 (2002) [hereinafter Allen, Jacobs & Strine, *Critique*]; William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 Del. J. Corp. L. 859, 867–68 (2001) [hereinafter Allen, Jacobs & Strine, *Function over Form*]; Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 Fordham L. Rev. 437, 437–38 (1993).

42. Del. Code Ann. tit. 8, § 141(a) (2005) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

43. Eisenberg, *supra* n. 41, at 463.

44. Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 Harv. L. Rev. 625, 632 (1984).

This has lead to intolerable confusion and incoherence.[45] In order to sort out the confusion, first the nature of the duty and liability of each triad duty formulation must be better understood.

A. Duty of Care and the Business Judgment Rule

In Delaware, the scope of the standard of conduct for directors is derived from their statutory obligation to manage the business and affairs of the corporation,[46] but is otherwise determined under common law.[47] In Delaware corporate law, director duty of care was arguably not fully embraced and articulated until 1963,[48] when the Delaware Supreme Court determined that directors owe "that amount of care which ordinarily careful and prudent men would use in similar circumstances."[49] That case, *Graham v. Allis-Chalmers Manufacturing Co.*, involved directors' alleged negligent failure to install a system of watchfulness to detect and prevent corporate harm resulting from illegal employee price fixing.[50] The Court determined that the directors had no actual or imputed notice of such activity and thus no liability under a duty of care.[51] Various articulations of the duty of care[52] include a "subjective element" to act in a manner the director "reasonably believes to be in the best interests of the corporation" as well as "with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[53] However, a claim involving an alleged breach of the ordinary negligence duty of care is subject to the business judgment rule,[54] meaning that director liability will not be imposed absent gross negligence.[55] Modern formulations of the business judgment rule are several,[56] but regardless of whether in statutory or common law form, the business judgment rule

45. *Compare* Lyman Johnson, *After* Enron*: Remembering Loyalty Discourse in Corporate Law*, 28 Del. J. Corp. L. 27, 35–37 (2003) [hereinafter Johnson, *After* Enron] *with* Lyman Johnson, *The Modest Business Judgment Rule*, 55 Bus. Law. 625, 645–49 (2000) [hereinafter Johnson, *Modest Rule*]; Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 Del. J. Corp. L. 787, 789 (1999) [hereinafter Johnson, *Rethinking*].

46. Del. Code Ann. tit. 8, § 141(a).

47. R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 Bus. Law. 1337, 1337–38 (1993).

48. Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 Del. J. Corp. L. 971, 982–83 (1994). Justice Horsey was the author of the *Cede II* and *Cede III* Delaware Supreme Court opinions.

49. *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (1963) (relying on *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891) (holding that directors should be held to the actions of "ordinarily prudent and diligent men")).

50. *Id.*

51. *Id.*

52. Model Bus. Corp. Act ("MBCA") § 8.30(a)–(b) (2005) (Directors must (i) act "in good faith"; (ii) act "in a manner the director reasonably believes to be in the best interests of the corporation" (subjective); and (iii) "discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances" (objective).).

53. *Principles of Corp. Governance* § 4.01(a) (proposed final draft, ALI 1992); Eisenberg, *supra* n. 41, at 439–40.

54. *Principles of Corp. Governance* § 4.01(a).

55. Allen, Jacobs & Strine, *Critique*, *supra* n. 41, at 450.

56. Balotti & Hanks, Jr., *supra* n. 47, at 1337.

absolves directors from liability even when the duty of care may otherwise have been implicated.

Modern corporate formulations of the business judgment rule provide that the business judgment rule constitutes "a presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[57] Without an abuse of discretion, the business judgment will be respected and the party challenging the decision will have the burden to establish facts rebutting the presumption.[58] Importantly, the business judgment rule is only available to "disinterested" directors who "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[59] In this context, individual director self-interest may be overcome by disclosure of all material facts and the approval of the majority of the disinterested directors.[60]

The American Law Institute's *Principles of Corporate Governance* provides that:

> A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer: (i) is not interested . . . in the subject of the business judgment; (ii) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and (iii) rationally believes that the business judgment is in the best interests of the corporation.[61]

The Model Business Corporation Act states a different standard for a director's duty of care[62] from liability for alleged breaches of that duty.[63]

All formulations of the business judgment rule have two operative effects—a procedural presumption that shields director decisions from judicial review and a substantive aspect that shields directors from personal liability.

> The rule operates as both a procedural guide for litigants and a substantive rule of law. As a rule of evidence, it creates a "presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company." The presumption initially attaches to a director-approved transaction within a board's

57. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (citations omitted). Other related formulations exist with slightly different language and effect. For example, the American Law Institute *Principles of Corporate Governance* § 4.01(c) provides that "[a] director or officer who makes a business judgment in good faith fulfills the duty," provided that person is not interested in the subject matter, is properly informed, and "rationally believes that the business judgment is in the best interests of the corporation." The fulfillment language creates a safe harbor rather than the presumptive approach of Delaware law. Douglas M. Branson, *The Rule That Isn't a Rule—The Business Judgment Rule*, 36 Val. U. L. Rev. 631, 632 (2002); Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 Bus. Law. 1355 (1993). MBCA § 8.31 likewise states a modified form of the business judgment rule.

58. *Aronson*, 473 A.2d at 812.

59. *Id.* (citations omitted).

60. *See e.g.* Del. Code Ann. tit. 8, § 144(a)(1).

61. *Principles of Corp. Governance* § 4.01(c).

62. MBCA § 8.30.

63. *Id.* at § 8.31.

> conferred or apparent authority in the absence of any evidence of "fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment."[64]

The procedural aspect is mostly superficial in that the plaintiff already has the burden of proof and can only satisfy that burden by proving gross negligence, causation, and damages.[65]

On a far more serious level, the *Aronson* formulation of the business judgment rule has been criticized as fundamentally flawed and overbroad.[66] While not challenging the procedural aspects of the *Aronson* formulation,[67] the substantive aspects of the *Aronson* formulation needlessly conflate the duty of care with the liability for breach thereof. Specifically, the "business judgment rule should not be regarded as a generalized liability shield," nor as a presumption that the duty of care was not breached.[68] It certainly should not be regarded as a substantive standard for reviewing whether conduct breached duty of care in the first instance.[69] Rather, the business judgment rule is best understood merely as "a policy of judicial non-review."[70] The proper force of the business judgment rule, therefore, simply blocks judicial review of the quality of a business decision, regardless of whether or not ordinary care was exercised.[71] Stated another way, a poor but rational decision should never be evidence of the failure to exercise due care at the least. The decision itself only becomes evidence of lack of due care when it is not rational. While it is common to characterize conduct as unreasonable, it is rare to characterize it as irrational.[72] In these cases, decisional liability would attach only where the decision itself cannot be rationally explained and the directors fail to provide a single rational reason for conduct such as developing a plant that they knew could not be operated profitably.[73] Liability does not attach merely by reason of an unreasonable decision; rather, the decision must be irrational. Otherwise, the process itself is the proper focus.

The duty of care travels much farther than the decision itself and incorporates the question of whether an unreasonable decision-making process was used to make the decision.[74] In these cases, even a fortunate or good decision might be preceded by a negligent or deficient process. While a favorable outcome or good decision likely means the plaintiff will not be able to prove the corporation suffered any harm, the analysis is different. The duty of care also covers process failures such as inattention or nonfeasance where no decision was made. Thus, the risk of an overbroad business judgment rule is the conceptual failure to review process independent of any actual

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64. *Cede II*, 634 A.2d at 360 (citations omitted).
65. Balotti & Hanks, Jr., *supra* n. 47, at 1345.
66. Johnson, *Modest Rule*, *supra* n. 45, at 625.
67. *Id.* at 628.
68. *Id.*
69. *Id.* at 628–30.
70. *Id.* at 631 (emphasis omitted).
71. Johnson, *Modest Rule*, *supra* n. 45, at 632.
72. Eisenberg, *supra* n. 41, at 443.
73. *Selheimer v. Manganese Corp. of Am.*, 224 A.2d 634, 646 (Pa. 1966).
74. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83, 91 (2004).

decision. Where directors employ an unreasonable process or unreasonably fail to employ a reasonable process to carry out their duties to manage the business and affairs of the corporation, liability should attach under the duty of care. Such liability is independent of the quality of any decision that was made as a result, provided only that the plaintiff can establish corporate harm as a result and that the unreasonable conduct was the cause of that harm.

This analysis helps explain the liability outcome in *Van Gorkom*[75] in which the Delaware Supreme Court held that the directors were liable for approving a sale of the company arguably below its true fair market value. While the decision to sell the company at the specific price was certainly not irrational—it involved a premium of fifty percent above the stock market price—the directors arguably failed to implement a fair process to inform themselves of the true value of the company. Because of the process failures, the decision itself was not a result of an informed business decision. Therefore, the *Aronson* business judgment rule did not shield the directors who arguably failed to exercise reasonable care.[76]

Van Gorkom chilled the market for directors and eventually prompted Delaware and other states to adopt exculpatory statutes.[77] Delaware's version allows the articles of incorporation to provide *ex ante* monetary liability exculpation, provided the conduct did not involve a breach of the duty of loyalty, "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," payment of unlawful dividends, or a transaction in which the director obtained an "improper personal benefit."[78]

Because the substantive *Aronson* formulation of the business judgment rule is overbroad, it operates to subsume the duty of care.[79] This is in turn masks the proper inquiry into whether the duty of care itself has been breached—a question quite separate and apart from whether liability should attach to that breach. Moreover, nightmarish distinctions are required to apply the duty of care and the business judgment rule together. In *Cede II*, the Court noted that it had "consistently held that the breach of the duty of care, without any requirement of proof of injury, is sufficient to rebut the business judgment rule."[80] But how do you rebut the rule that itself presumes care was not breached?[81]

The conflation of the duty of care into the business judgment rule has had further troubling aspects. Most serious is that proof of a breach of duty of care shifts the burden

75. 488 A.2d 858 (Del. 1985).

76. *Id.* at 872–75. Some argued the case was inaccurate because the process failures were not a product of gross negligence. Allen, Jacobs & Strine, *Critique*, *supra* n. 41, at 458. However, this criticism misses the mark precisely because it fails to appreciate the difference between process failures (ordinary negligence standard) and decisional failures (gross negligence standard under the business judgment rule).

77. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 Bus. Law. 1207, 1209–10 (1988).

78. Del. Code Ann. tit. 8, § 102(b)(7); *see* Douglas M. Branson, *Assault on Another Citadel: Attempts to Curtail the Fiduciary Standard of Loyalty Applicable to Corporate Directors*, 57 Fordham L. Rev. 375, 380 (1988).

79. *See* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions through the Business Judgment Rule*, 62 Tex. L. Rev. 591, 594, 602–07 (1983).

80. *Cede II*, 634 A.2d at 371.

81. Johnson, *Rethinking*, *supra* n. 45, at 804.

to the directors to prove the entire fairness of the transaction.[82] Prior to *Cede II*, the entire fairness review was limited to cases involving a breach of the duty of loyalty.[83] Fortunately, the entire fairness standard was satisfied in *Cede III*,[84] but the better-reasoned approach would have been to keep the burden of proof on the plaintiff to establish a breach of duty of care, corporate harm, and causation. This was the approach taken by Chancellor Allen in the first *Cede* trial where it was determined that, even if the board breached the duty of care, the corporation was not harmed thereby.[85] In any event, the Delaware exculpatory provision will most likely shield a director from liability even in unfair transactions involving gross negligence.[86]

B. *Duty of Loyalty*

After *Cede III*, the primary problems addressed above considered subsuming the duty of care into the substantive aspects of the business judgment rule, thereby diminishing duty of care as well as shifting the burden of proof to the director if care is breached to prove the entire fairness of the transaction.[87] But those aspects are simply further elements of the general erosion of fiduciary duties.

The next erosion relates to the duty of loyalty. Delaware corporate directors owe a fiduciary duty of loyalty to the corporation and its shareholders.[88] Given that Delaware adopted an exculpatory statute in 1986 following the 1985 Delaware Supreme Court decision in *Van Gorkom*, it should not be surprising that loyalty assumes more importance. The Delaware exculpatory statute lists four specific exceptions.[89] Because none of the exceptions relate to duty of care, the statute by design immunizes Delaware directors from monetary damages for an alleged breach of the duty of care. What remains after exculpation? Those seeking to impose liability upon corporate directors must assert one of the exceptions to statutory exculpation.[90] One exception

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82. *Cede III*, 663 A.2d at 1162; *Cede II*, 634 A.2d at 361 ("If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the 'entire fairness' of the transaction to the shareholder plaintiff." (citations omitted)).

83. Bud Roth, *Entire Fairness Review for a "Pure" Breach of Duty of Care: Sensible Approach or Technicolor Flop?* 3 Del. L. Rev. 145, 161 (2000).

84. *Cede III*, 663 A.2d at 1165.

85. *Cinerama, Inc. v. Technicolor, Inc.*, 1991 WL 111134 at *3 (Del. Ch. June 24, 1991).

86. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004? A Retrospective on Some Key Developments*, 153 U. Pa. L. Rev. 1399, 1428 (2005).

87. In Delaware, the business judgment rule operates as a presumption that the director acted in good faith and without self-dealing (loyalty as defined in Delaware). That presumption may be rebutted by well-pled facts that, assumed as true, suggest a director acted fraudulently, in bad faith, or engaged in self-dealing (in the usual sense of personal gain). When properly pled, the business judgment rule no longer applies, and the directors bear the burden to prove that the transaction was entirely fair. *Grobow v. Perot*, 539 A.2d 180, 187 (Del. 1988); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987). The exacting entire fairness standard of review is a fairness inquiry that has both a process and substantive component. Self-dealing directors must meet a process standard of "fair dealing" and a substantive standard of "fair price." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). The Court does not defer to the substantive decisions of the directors but itself must be satisfied as to entire fairness. *Id.* at 710.

88. *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus. Law. 393, 397–98 (1997).

89. Del. Code Ann. tit. 8, § 102(b)(7).

90. *In re Lukens, Inc. Shareholders Litig.*, 757 A.2d 720, 734 (Del. Ch. 1999).

provides that statutory exculpation does not apply to any breach of a director's duty of loyalty.[91] Yet another provides that statutory exculpation does not apply to acts or omissions "not in good faith or which involve intentional misconduct or a knowing violation of law."[92] As a consequence of these two exceptions, and perhaps a third prohibiting improper personal benefit, director liability remains for breaches of loyalty as well as for acts or omissions that are not in good faith.[93]

Given the obvious importance claims sounding in loyalty rather than care, how does one characterize director behavior as one or the other? Corporate law loyalty discourse tends to be highly contextual, condemning or approving particularized behavior with near moral overtones.[94] As a result, it is not uncommon to find examples of disloyal conduct admonished because of context rather than a broader generalized statement. Because of frequency of occurrence, many cases focus on a narrow personal benefit or self-interest to distinguish loyalty from care cases. Illustrations include an allegation that directors with "no improper personal reason" favored one group of shareholders does not state a claim for breach of loyalty;[95] the essence of a loyalty claim asserts that a director misused power over corporate property to derive personal benefit;[96] alleged disclosure violations do not implicate loyalty absent a showing the directors received a personal benefit;[97] and, because care and loyalty are distinct, liability depends on a breach of the duty of care and not loyalty or good faith unless director motivations are present.[98]

However, there remains reasonable disagreement over whether there are adequate measures to properly distinguish breach of loyalty from breach of care claims.[99] These are often contextual but nonetheless illustrate the difficulty in easily categorizing a claim as purely care or purely loyalty. Illustrations include mere absence of a conflict in

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91. Del. Code Ann. tit. 8, § 102(b)(7)(i).

92. *Id.* at § 102(b)(7)(ii).

93. Johnson, *After* Enron, *supra* n. 45, at 31–32.

94. Some would argue that fiduciary duty moral rhetoric has no purpose for economic actors; rather, fiduciary duties are much like other contractual undertakings. Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & Econ. 425, 427 (1993). Others argue that while fiduciary relationships may and often do arise by contract, the duties of that special relationship, unlike strictly non-fiduciary contractual relationships, have a special character defined more by private law norms. DeMott, *supra* n. 10, at 887 ("[C]ontract law doctrines operate so differently from fiduciary obligation that to invoke them, even vaguely, . . . confuses the analysis. For starters, these creatures of contract law are controlled by the parties' manifest intention; fiduciary obligation sometimes operates precisely in opposition to intention as manifest in express agreements. The terms of an express agreement are surely not irrelevant to the fiduciary obligation analysis, but once a court concludes that a particular relationship has a fiduciary character, the parties' manifest intention does not control their obligations to each other as dispositively as it does under a contract analysis."); *see also* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. Rev. 595 (1997); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 Wash. L. Rev. 1 (1990); Johnson, *After* Enron, *supra* n. 45, at 47–48.

95. *In re GM Class H Shareholders Litig.*, 734 A.2d 611, 618 (Del. Ch. 1999).

96. *Steiner v. Meyerson*, 1997 WL 349169 (Del. Ch. June 13, 1997).

97. *Frank v. Arnelle*, 1998 WL 668649 at *10 (Del. Ch. Sept. 16, 1998); Lawrence A. Hamermesh, *Calling off the* Lynch *Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 Vand. L. Rev. 1087, 1100 (1996).

98. *Lukens*, 757 A.2d at 731–32.

99. Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law after* QVC *and* Technicolor*: A Unified Standard (and the End of* Revlon *Duties?)*, 49 Bus. Law. 1593, 1625 (1994); Johnson, *After* Enron, *supra* n. 45, at 34–36.

interest is not adequate to either fulfill loyalty or distinguish it from care;[100] in a contest for corporate control, director duties are not easily categorized as care or loyalty;[101] evidence of disloyalty includes, but is not limited to, motives of entrenchment, fraud, abdication of director duties, and the sale of vote;[102] a breach of loyalty can be unintended and can occur even when action is taken in good faith;[103] loyalty is implicated when a director seeks to thwart the lawful action of the company's shareholders;[104] and a fiduciary may act disloyally for many reasons other than pecuniary gain and, regardless of motive, if director duties are consciously disregarded.[105]

As a result, breaches of oversight and disclosure duties are not clearly identified as care violations because of the presence of actual or inferred intent and motive. For example, abandoning oversight responsibility can constitute either a care or loyalty violation;[106] a reckless or intentional breach of care in oversight can be construed as a breach of good faith not available for exculpation;[107] and director duty "to observe proper disclosure requirements derives from the combination of the fiduciary duties of care, loyalty, and good faith."[108] At the very least, these examples illustrate that it is not always easy to determine whether care or loyalty is invoked in an isolated manner, that disloyal conduct may occur in good faith, and that good faith permits self-interest. Before the exculpatory provision, these overlaps were less important. Now that care is the isolated duty, loyalty and good faith are more important.

The most widely articulated definition of the duty of loyalty in Delaware corporate law is found in the early *Guth* case:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, *not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain* from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.[109]

So stated, the duty of loyalty includes the negative duty to "refrain" from harmful conduct but, importantly, also the positive duty to "affirmatively" protect the interests of

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100. *In re Santa Fe P. Corp. Shareholders Litig.*, 669 A.2d 59, 67 (Del. 1995); *Ivanhoe Partners*, 535 A.2d at 1345.

101. *Santa Fe P. Corp. Shareholders*, 669 A.2d at 67.

102. *Cede II*, 634 A.2d at 363, 367.

103. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988).

104. *Wis. Inv. Bd. v. Peerless Sys. Corp.*, 2001 WL 32639 at *1 (Del. Ch. Jan. 5, 2001).

105. *Nagy v. Bistricer*, 770 A.2d 43, 48 n. 2 (Del. Ch. 2000).

106. *Cede II*, 634 A.2d at 363.

107. *McCall v. Scott*, 250 F.3d 997, 1000–01 (6th Cir. 2001); *In re Abbott Laboratories Derivative Shareholders Litig.*, 325 F.3d 795, 809–11 (7th Cir. 2003).

108. *Malone*, 722 A.2d at 11 (footnote omitted).

109. 5 A.2d at 510 (emphasis added).

the corporation. While the duty to refrain has been referred to as one to avoid betrayal, the affirmative duty is less well understood and may be referred to as encompassed by the notion of positive devotion.[110] In this sense, the duty of loyalty creates an obligation of devotion that can be breached by abdication of that duty, including innocent dereliction of the positive duty of oversight or disclosure. Failure to perform as required without more and without deliberate bad faith can, therefore, constitute disloyal conduct. While *Guth* involved personal benefit in the form of a corporate opportunity, that alone is not a requisite to a breach of the duty of loyalty. While a court may hesitate to attach liability to a mere disloyal abdication of duty not connected to a personal benefit, that is a decidedly different matter than whether the duty was breached in the first place. Loyalty breaches can exist independent of corporate harm, and the claim in such cases is based upon disgorgement of the personal benefit. It is not a defense that the corporation itself was not harmed.[111] In most cases, corporate harm exists as the basis of the lawsuit. The search is for a liability theory and not the harm.

Many disloyal acts are intentional and when so are usually thought to include an element of bad faith. But bad faith is not a prerequisite to disloyal behavior since a director could disregard an unknown duty of oversight or disclosure with all good intention, nevertheless causing great harm to the corporation.[112] Indifference to their duty to protect is adequate to breach the duty of loyalty.[113] This independent feature requires a review of the role of good faith as well as its scope.

C. *Good Faith*

While good faith has a long history in Delaware corporate law,[114] its prominence has recently taken center stage as shareholders struggle to hold directors accountable for alleged corporate harm not involving director personal benefit or conflict of interest transactions. The absence of personal benefit excludes the harm from a loyalty claim under a narrow conception of loyalty that does not include the positive element of devotion.[115] This directs the claim to the duty of care, which is protected by a robust business judgment rule that presumes good faith and otherwise requires a showing of

110. Johnson, *After* Enron, *supra* n. 45, at 30.

111. *Guth*, 5 A.2d at 510 ("If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interest so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation.").

112. *Strassburger v. Earley*, 752 A.2d 557, 566–67, 581 (Del. Ch. 2000). In *Earley*, corporate directors breached fiduciary duty of loyalty to minority stockholders by causing the corporation to repurchase eighty-three percent of its outstanding shares from its two largest shareholders, under circumstances that benefited no one except the selling stockholders and the corporation's president. Two of the four directors who approved the repurchases were held liable for rescissory damages even though the two were not unjustly enriched, had not obtained a special benefit, and had not acted in bad faith or with intent to harm the minority shareholders. The directors violated their duty of loyalty because they subordinated the minority's interests to the conflicting interest of their selling stockholder employer in exiting its investment.

113. *Emerald Partners*, 2001 WL 115340 at **21–22.

114. Veasey & Di Guglielmo, *supra* n. 86, at 1439.

115. *See supra* pt. II.B.

gross negligence.[116] Moreover, even gross negligence is protected by statutory exculpation that is itself subject to four exceptions including good faith.[117] Good faith is thus the Achilles heel of both the business judgment rule and statutory exculpation.

Some corporate statutes positively require directors to act in good faith.[118] The allegation of good faith is an overt attempt to characterize director conduct in a way that allows statutory exculpation.[119] Still other statutes condition permissive indemnification on good faith conduct.[120] Other statutes excuse director liability for self-interested transactions if the transactions are approved by disinterested directors acting in good faith.[121] As a consequence, even though no Delaware case has determined that a director is liable for violating the duty of good faith, none can deny the importance of the directors acting in good faith.[122] At the very least, bad faith conduct will not qualify for statutory exculpation, even if not disloyal,[123] will not qualify for permissive indemnification,[124] and will not qualify for protection under the business judgment rule.[125]

Given this considerable judicial and statutory presence of good faith, scholarly commentary on the role and definition of good faith has been extensive.[126] Litigation has not been far behind. The recent series of events involving the Walt Disney Company litigation is an excellent example.[127] The Disney litigation began as a shareholder

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116. *See supra* pt. II.A.

117. *Id.*

118. *See e.g.* N.Y. Bus. Corp. L. § 717(a) (McKinney 2003); MBCA § 8.30 (director good faith); MBCA § 8.42 (officer good faith).

119. *See* Del. Code Ann. tit. 8, § 102(b)(7); *supra* nn. 91–108 and accompanying text.

120. *See e.g.* Del. Code Ann. tit. 8, § 145(a)–(b).

121. *See e.g. id.* at § 144(a)(1); *see also* discussion of the concept of independence, in Donald C. Clarke, *The Independent Director in Chinese Corporate Governance*, 31 Del. J. Corp. L. 125, 150–75, 201–16 (2006).

122. Melvin A. Eisenberg, *The Duty of Good Faith in Corporate Law*, 31 Del. J. Corp. L. 1, 6–12 (2006).

123. Del. Code Ann. tit. 8, § 102(b)(7).

124. *Id.* at § 145(a)–(b).

125. *Aronson*, 473 A.2d at 812.

126. Scholarly literature has also explored far more extensively the role of good faith to corporate fiduciary duties. *See e.g.* Matthew R. Berry, Student Author, *Does Delaware's Section 102(b)(7) Protect Reckless Directors from Personal Liability? Only If Delaware Courts Act in Good Faith*, 79 Wash. L. Rev. 1125 (2004); Deborah A. DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 25 Wake Forest L. Rev. 15 (1990); Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty and Permitted Harm*, 22 Fla. St. U. L. Rev. 955 (1995); Tara L. Dunn, *The Developing Theory of Good Faith in Director Conduct: Are Delaware Courts Ready to Force Corporate Directors to Go Out-of-Pocket after* Disney IV? 83 Denv. U. L. Rev. 531 (2005); Eisenberg, *supra* n. 122; Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 Duke L.J. 1 (2005); Jaclyn J. Janssen, Student Author, In re Walt Disney Company Derivative Litigation*: Why Stockholders Should Not Put Too Much Faith in the Duty of Good Faith to Enhance Director Accountability*, 2004 Wis. L. Rev. 1573 (2004); Timothy J. Keenan, *Board of Directors Approval Clauses in Corporate Contracts: The Duty of Good Faith*, 9 J. Corp. L. 931 (1984); John L. Reed & Matt Neiderman, *"Good Faith" and the Ability of Directors to Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty*, 29 Del. J. Corp. L. 111 (2004); Thomas Rivers, Student Author, *How To Be Good: The Emphasis on Corporate Directors' Good Faith in the Post-Enron Era*, 58 Vand. L. Rev. 631 (2005); David Rosenberg, *Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach*, 29 Del. J. Corp. L. 491 (2004); Hillary A. Sale, *Delaware's Good Faith*, 89 Cornell L. Rev. 456 (2004); Karolyn Knaack Steves, Student Author, *Directors' Duty to Protect the Corporation from Harm: Good Faith in Board Oversight after* Caremark, 35 Tex. J. Bus. L. 32 (1998).

127. Robert Baker, Student Author, In re Walt Disney*: What It Means to the Definition of Good Faith, Exculpatory Clauses, and the Nature of Executive Compensation*, 4 Fla. St. U. Bus. Rev. 261 (2005); Dunn, *supra* n. 126; Janssen, *supra* n. 126.

derivative nonpre-suit demand case alleging misconduct by the Disney Board in connection with the hiring and termination of Michael Ovitz.[128] Specifically, the complaint alleged general breach of fiduciary duties and nondisclosure claims in approving a lucrative employment contract for the new president Ovitz and then fourteen months later approving a $140 million payout under a "no fault" termination clause in his employment contract.[129] The Chancery Court granted a motion to dismiss the fiduciary duty and waste claims against the board for the failure to make pre-suit demand[130] and the disclosure claim for a failure to state a proper claim.[131] Reviewing the case de novo,[132] the Delaware Supreme Court affirmed most of the dismissals with prejudice except that it determined that the fiduciary duty and waste claims against the board were affirmed without prejudice.[133] This permitted plaintiffs to file an amended complaint on remand to the Chancery Court.[134] On remand, following a denial of a new motion to dismiss the amended complaint[135] and a successful motion to exclude expert testimony on the basis it was directed to Delaware law and not the facts of the case,[136] the case was finally tried on its merits.[137]

In evaluating the fiduciary duty claims, Chancellor Chandler first determined that loyalty was not implicated by the facts. Corporate officers and directors may not use "their position of trust and confidence to further their private interests"[138] "not shared by the stockholders generally."[139] Rather, the duty of loyalty "mandates that the best interest of the corporation and its shareholders [take] precedence"[140] over any personal interest of the officer or director, and thus loyalty does not provide any safe harbor for divided loyalty.[141] Unfortunately, the court then proceeded to define loyalty narrowly as implicated classically by the receipt of a personal benefit not shared with all shareholders or standing on both sides of a transaction (conflict of interest).[142] The court determined that Ovitz did not breach his duty of loyalty as a director or officer by accepting the termination payment.[143] He was no longer an officer or director when the payment was received, he played no part in the decision-making process for his termination, and, because he was entitled to the payment under the terms of his contract, ordinarily prudent

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128. *In re the Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 351 (Del. Ch. 1998).
129. *Id.* at 352–53.
130. *Id.* at 380.
131. *Id.*
132. *Brehm v. Eisner*, 746 A.2d 244, 253 (Del. 2000).
133. *Id.* at 267.
134. *Id.*
135. *In re the Walt Disney Co. Derivative Litig.* ("*Disney II*"), 825 A.2d 275, 291 (Del. Ch. 2003).
136. *In re the Walt Disney Co. Derivative Litig.*, 2004 WL 550750 at *1 (Del. Ch. Mar. 9, 2004).
137. *In re the Walt Disney Co. Derivative Litig.* ("*Disney III*"), 2005 WL 2056651 (Del. Ch. Aug. 9, 2005).
138. *Id.* at *33 (quoting *Guth*, 5 A.2d at 510).
139. *Id.* (quoting *Cede II*, 634 A.2d at 361).
140. *Id.* (quoting *Cede II*, 634 A.2d at 361).
141. *Id.* (citing *Weinberger*, 457 A.2d at 710).
142. *Disney III*, 2005 WL 2056651 at *33 (citing *Cede II*, 634 A.2d at 362, in turn citing *Nixon v. Blackwell*, 626 A.2d 1366, 1375 (Del. 1993)).
143. *Id.* at **37–38.

persons would not call for further inquiry.[144] No other director breached a duty of loyalty because there was no allegation of personal benefit or conflict of interest.[145]

The court also determined that no board member violated the duty of good faith. Acknowledging that the Delaware courts have not been clear as to whether good faith is a separate actionable duty, the court defined good faith by the absence of bad faith, which has been described as authorizing a transaction for a purpose that is not in the best interests of the corporation or that the director knows violates applicable positive law (refrain duty).[146] Action taken to harm the company is a "disloyal act in bad faith,"[147] and the reason why the director so acted is irrelevant.[148] As such, a claim of bad faith includes evidence that a director intentionally placed his own interests before the best interests of the company and may include a "systematic or sustained shirking of duty."[149] Because the business judgment rule presumes good faith, a shareholder must prove by a preponderance of the evidence that the director acted in bad faith.[150] The directors "did not act in bad faith, and were at most ordinarily negligent" when hiring Ovitz and approving his employment contract.[151] Because business judgment was exercised, ordinary negligence is insufficient to constitute a violation of the duty of care.[152]

On appeal, the Delaware Supreme Court affirmed the Chancery Court and determined the directors were not liable.[153] In so doing, the Delaware Supreme Court developed the conceptual range of good faith in some detail by delineating three

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144. *Id.*

145. *Id.* at *37 n. 470.

146. *Id.* at *35.

147. *Disney III*, 2005 WL 2056651 at *35.

148. *Id.* (citing *Guttman v. Huang*, 823 A.2d 492, 506 n. 34 (Del. Ch. 2003) ("The reason for the disloyalty (the faithlessness) is irrelevant, the underlying motive (be it venal, familial, collegial, or nihilistic) for conscious action not in the corporation's best interest does not make it faithful, as opposed to faithless."); *Nagy*, 770 A.2d at 48 n. 2 ("If it is useful at all as an independent concept, the good faith iteration's utility may rest in its constant reminder . . . that, regardless of his motive, a director who consciously disregards his duties to the corporation and its stockholders may suffer a personal judgment for monetary damages for any harm he causes.")).

149. *Id.* at *35.

150. *Id.* at *36. The same complaint nonetheless survived a motion to dismiss because the pleadings alleged the directors "*consciously and intentionally disregarded their responsibilities*, adopting a 'we don't care about the risks' attitude concerning a material corporate decision." *Id.* at *35 (quoting *Disney II*, 825 A.2d at 289) (emphasis in original). The evidence did not prove the allegation.

151. *Disney III*, 2005 WL 2056651 at *39.

152. *Id.* In its discussion of the business judgment rule, the court stated that it is widely believed that the standard of liability for a breach of duty of care, prior to the application of the exculpatory statute, is gross negligence. *Id.* at *32. However, the court noted ordinary negligence has been applied as a standard when the business judgment does not apply by reason of inaction. *Id.* at *32 n. 418 (citing *Rabkin v. Philip A. Hunt Chem. Corp.*, 1987 WL 28436 at *3 (Del. Ch. Dec. 17, 1987)). The same principle would apply when bad faith blocks reliance on the business judgment rule.

153. *Disney IV*, 2006 WL 1562466 at *34. The court remarked:

> It is notable that the appellants do *not* contend that the Disney defendants are directly liable as a consequence of those fiduciary duty breaches. Rather, appellants' core argument is indirect, *i.e.*, that those breaches of fiduciary duty deprive the Disney defendants of the protection of business judgment review, and require them to shoulder the burden of establishing that their acts were entirely fair to Disney.

Id. at *10 (emphasis in original).

categories of fiduciary behavior qualifying as bad faith:[154] "subjective bad faith" motivated by actual intent to harm the corporation ("Category I");[155] "gross negligence and without any malevolent intent" ("Category II");[156] and conscious and intentional dereliction or disregard of known duties ("Category III").[157]

The shareholders argued that Category II bad faith existed because the Disney directors were grossly negligent.[158] Even though the Chancery Court properly determined gross negligence did not exist, the Delaware Supreme Court clarified the appropriateness of treating mere gross negligence as bad faith.[159] The Court refused to conflate or infer bad faith from mere gross negligence (including the failure to be properly informed).[160] The Court justified its refusal by its interpretation of two Delaware statues that retain a separate and distinct role for gross negligence and good faith.[161] Therefore, conflation would specifically contravene statutory law and make the distinctions noted therein meaningless.

First, the exculpatory provisions of Delaware corporate law specifically adopt a rule and policy, by failing to state an exception for duty of care, that liability does not attach to a duty of care violation even if it involves gross negligence.[162] The statute was adopted to permit exculpation of even grossly negligent conduct. At the same time, one of the four express exceptions to permissive exculpation preserves liability for acts or omissions not in good faith.[163] Thus, as the argument goes, conflation ignores the reality that the statute requires retaining the distinction.[164] Bad faith may not be exculpated, but gross negligence may be exculpated.[165] Never mind the difficult task of defining the boundary between the two.

A second Delaware statutory pattern further requires separation of gross negligence and good faith. Delaware corporate law provides for permissive indemnification of any former or current officer, director, employee, or agent against all expenses, including judgments resulting from an unsuccessful defense, provided the person acted in good faith.[166] Accordingly, a person who acted with gross negligence could be indemnified whereas a person acting in bad faith may not. As a result, conflation of gross negligence and bad faith once again frustrates Delaware statutory law requiring the concepts to remain distinct.[167]

The problem, of course, with this approach is that at least the exculpation statute is a modern innovation and predicated upon distinctions in common law, including a

154. *Id.* at *25.
155. *Id.*
156. *Id.* at **25–26.
157. *Disney IV*, 2006 WL 1562466 at **26–27.
158. *Id.* at *25.
159. *Id.*
160. *Id.*
161. *Id.* at **25–26.
162. Del. Code Ann. tit. 8, § 102(b)(7).
163. *Id.* at § 102(b)(7)(ii).
164. *Disney IV*, 2006 WL 1562466 at *25.
165. *Id.*
166. Del. Code Ann. tit. 8, § 145(a)–(b).
167. *Disney IV*, 2006 WL 1562466 at *26.

manageable definition of good faith. It does little good after the statute is enacted to declare that we must retain the separateness of good faith because it is in the statute, at least when the statute was predicated on common law in the first place. Few argue that good faith does not have an independent role in corporate law. That question can be directed by statutory reference but, absent a statutory definition, common law must supply the answer to that puzzle.

Category III "loyalty" bad faith includes conscious abdication of a known duty. Once again, the Delaware Supreme Court determined that this category is important and independent in order to catch conduct between subjective bad faith and gross negligence.[168] First, the Court determined that if loyalty is classically defined to include the presence of personal benefit or a clear conflict of interest,[169] it would naturally exclude the positive notion of devotion and therefore good faith is necessary to fill that void.[170] Second, and again relying on Delaware statutes' use of the good faith concept, the Court argued it must remain a distinct duty precisely because the statute assigns it an independent role.[171] Specifically, through the use of the conjunctive "or," the Delaware exculpation statute distinguishes good faith from intentional misconduct and knowing violations of the law. Characterizing the latter two concepts as forms of Category I "subjective bad faith" and assuming an independent function of good faith separate from intentional misconduct (not exculpated) and gross negligence (exculpated), it therefore follows that unintentional but nonetheless culpable bad faith must exist. In short, statutory exculpation exists for gross negligence but not for known conduct or inferred conduct between gross negligence and intentional misconduct. This could certainly include serious abdication or dereliction failures.[172]

None of these categories is particularly helpful. First, except for cases involving provable subjective bad faith (the "smoking gun" memorandum), proof of such behavior is quite difficult, particularly when there are objective justifications for the behavior. Second, measures framed in terms of exceeding gross negligence but less than intentional misconduct are not particularly useful either. Gross negligence itself is an elusive concept. To suggest that unintentional bad faith must be worse than gross negligence is not a helpful standard.

Arguably, a more plausible role for good faith is not to make it an actionable independent standard but to relegate it to a status that simply defeats the privilege of asserting various statutory and judicial referents that work in various ways to shield behavior from liability. The net effect would then be to eliminate the business judgment rule presumption, eliminate statutory exculpation, and eliminate permissive indemnification. This alone does not create liability. As evidenced by the Delaware Supreme Court, it is not adequate to plead bad faith to deconstruct the business judgment

168. *Id.* at **26–27.

169. Chancellor Chandler determined that an expanded version of loyalty embracing elements of positive devotion could fill the gap currently filled by good faith. *Disney III*, 2005 WL 2056651 at *40 n. 487 (discussing Johnson, *After* Enron, *supra* n. 45).

170. *Disney IV*, 2006 WL 1562466 at *26.

171. *Id.* at *27.

172. *Id.*

rule and create liability if the directors cannot prove entire fairness. More is needed. Absent a claim of personal benefit, liability will only follow upon a showing of breach of duty, corporate harm, and causation. Absent personal benefit, the duty breach is more likely to be in terms of the duty of care. However, bad faith eliminates reliance upon both the business judgment presumption as well as statutory exculpation. Once these protections are stripped away by bad faith, the standard of care conduct should be ordinary care.

In *In re the Walt Disney Co. Derivative Litigation* ("*Disney III*"), the Chancery Court determined that at most the directors exhibited ordinary negligence, but because the business judgment rule presumed good faith and that presumption was not rebutted in this case, ordinary negligence was not adequate to create liability.[173] If the business judgment rule had not applied because no decision had been made, what standard would apply? Gross negligence can hardly be the standard because the business judgment rule does not apply. Although the presence of a decision makes proving bad faith more problematic because the business judgment rule presumes good faith, bad faith should have no role beyond determining the appropriate liability standard—ordinary negligence. If bad faith is present, neither the business judgment rule nor statutory exculpation is available. Is the bad faith itself then independently actionable as a positive duty? If so, is it strict liability or is there a separate duty? Treating bad faith as a method to disarm statutory and judicial favoritism seems appropriate as no policy can be advanced to justify presumptions and exoneration for intentional or near-intentional bad behavior. Stripping away these favors then leaves a base duty of ordinary care with a showing of breach, harm, and causation, and shifts the burden to the directors to establish the transaction or conduct that nonetheless did not impede an otherwise fair result to the corporation. Fairness is arguably not a correct defense at this instance. Hopefully, in an appropriate case the Delaware courts will strip away the *Cede II* analysis that applies entire fairness to a duty of care breach. Indeed, this explains the curious passage and the approach of the shareholders in the *Disney* litigation—or at least the plaintiff's confusion.

III. UNINCORPORATED ORGANIZATION FIDUCIARY DUTY

Unlike the fiduciary duty of loyalty,[174] the scope of a partner's fiduciary duty of care to other partners in general and limited partnerships has received scant attention in partnership case law or scholarly commentary.[175] The advent of the hybrid entity limited liability company has done little to garner further attention.[176] However, the extraordinary parallel development of the duty of care of corporate officers and directors provides a rich universe of judicial decisions and scholarship.[177] In the crucible of

173. 2005 WL 2056651 at *39 (Del. Ch. Aug. 9, 2005).

174. Until the end of the twentieth century, corporate law arguably preferred duty of loyalty cases to duty of care cases. Allen, Jacobs & Strine, *Function over Form*, *supra* n. 41, at 871–72.

175. 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, 359 (2005).

176. *Id.* at 370.

177. Some argue that early Massachusetts close corporation cases imported partner-styled fiduciary duties of loyalty and improperly applied them to shareholders in close corporations. *E.g. Donahue v. Rodd*

corporate law, the duty of care owed by corporate officers and directors to the corporation and its shareholders has attracted far more attention, especially with the extended recent litigation concluding with *Disney IV*.[178] In particular, corporate law has more carefully explored the critical link between fiduciary duties and the obligation of good faith.[179] In fact, perhaps the only extraordinary question is why duty of care and good faith have generated so much attention in corporate law and so little attention in unincorporated entity law.[180]

One explanation might be that after a quick rise to stardom in the celebrated case of *Van Gorkom*,[181] the corporate duty of care was quickly buried by state legislatures authoring articles of incorporation to eliminate director monetary liability for breaches of the duty of care.[182] Barring a more rare case involving a duty of loyalty breach, the race was on to define the proper scope, measure, and role of good faith in director accountability. Arguably, *Disney IV*[183] is the apex of that strategic struggle leaving nearly as many questions unanswered as answered. Except for a few limited liability company state statutes, such exculpatory laws remain the domain of the corporate law.[184] As a result, care and good faith have been tested alternatively as the only liability prongs.

Another related reason may be that most unincorporated business organizations have only a few owners. Like closely-held corporations, serious problems tend to cluster

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Electrotype Co., 328 N.E.2d 505 (Mass. 1975). Unlike partners in early general partnerships, close corporation shareholders are not personally liable for corporate obligations, are not agents of the corporation *qua* shareholder status, and do not possess the power to dissolve the entity at will. Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 Del. J. Corp. L. 377, 390 (2004). This article proposes a reverse export from non-close corporate law to partnerships and limited liability companies. The fiduciary duty at issue is that of care, not loyalty, and the positions involved are those of directors and officers, not the shareholders. Unlike the duty of loyalty, the fiduciary duty of care is more likely to be consistent from entity to entity. However, even to the basic point, modern partnership-styled entities tend to be very similar to corporations. Agency, personal liability, and at-will dissolution are no longer a *sine qua non* of unincorporated entity owner status. *See* Re-ULLCA §§ 301 (no agency status), 304 (no personal liability), 701 (member dissociation does not dissolve entity). Consequently, the similarities between corporations and limited liability companies on these important categories are gradually disappearing. Moreover, especially in the context of the duty of loyalty, it is important to distinguish between officers and directors because the former are agents *qua* status while the latter are not.

178. 2006 WL 1562466.

179. Scholarly literature has also explored far more extensively the role of good faith to corporate fiduciary duties. *See e.g.* Berry, *supra* n. 126; Dickerson, *supra* n. 126; Dunn, *supra* n. 126; Griffith, *supra* n. 126; Janssen, *supra* n. 126; Keenan, *supra* n. 126; Reed & Niederman, *supra* n. 126; Rivers, *supra* n. 126; Rosenberg, *supra* n. 126; Sale, *supra* n. 126; Steves, *supra* n. 126.

180. Scholarly literature exploring fiduciary duty of care and good faith in the partnership law context has been more limited. *See e.g.* Norwood P. Beveridge, Jr., *Duty of Care: The Partnership Cases*, 15 Okla. City U. L. Rev. 753 (1990); Dickerson, *supra* n. 1; Elisa Feldman, Student Author, *Your Partner's Keeper: The Duty of Good Faith and Fair Dealing under the Revised Uniform Partnership Act*, 48 SMU L. Rev. 1931 (1995); *Fiduciary Duties of Partners*, 48 Iowa L. Rev. 902 (1963); Gregory, *supra* n. 29; Michael L. Keeley, Student Author, *Whose Partnership Is It Anyway?: Revising the Revised Uniform Partnership Act's Duty-of-Care Term*, 63 Fordham L. Rev. 609 (1994); Gerard C. Martin, Student Author, *Duties of Care under the Revised Uniform Partnership Act*, 65 U. Chi. L. Rev. 1307 (1998); Jean H. Toal & W. Bratton Riley, *Fiduciary Duties of Partners and Limited Liability Company Members under South Carolina Law: A Perspective from the Bench*, 56 S.C. L. Rev. 275 (2004).

181. 488 A.2d 858.

182. *See e.g.* Del. Code Ann. tit. 8, § 102(b)(7).

183. 2006 WL 1562466.

184. *See e.g.* Del. Code Ann. tit. 6, § 18-1101(e); Ga. Code Ann. § 14-11-305(4) (2003); N.Y. L.L.C. L. § 417(a) (McKinney Supp. 2006); Va. Code Ann. § 13.1-1025(B) (2006).

around the opportunistic self-interested behavior of any unincorporated controlling owners. Duty of care is rarely implicated because such self-interested behavior is better suited to the duty of loyalty. Because early partnerships could be dissolved at-will, early partnership law avoided many of the close corporation lack-of-liquidity and marketability problems unique to corporate law. As a result, close corporation law tested the limits of fiduciary duty law because minority shareholders had no way out of the oppressive situation—no market for shares and no way to dissolve the entity to sell the business and distribute proceeds.[185] However, modern unincorporated entity law is moving toward entity stability and away from entity dissolution power. This trend promises to introduce corporate lock-in problems to unincorporated entities. With the confluence of close corporation and unincorporated entity law, contractual remedies may ultimately take center stage. How vigorously courts enforce contracts related to such matters will ultimately determine owners' rights.[186]

A. *Duty of Care and the Business Judgment Rule*

Fiduciary duties are highly contextual. As a result, the standard of care depends upon the nature and function of the duties of the fiduciary.[187] UPA did not specifically state a duty of care owed by a partner to the other partners.[188] Since every state adopted UPA, common law filled the gap through case law that developed the duty of care of partners by reference to the "relationships" of a UPA partner to the partnership and other partners. UPA § 9(1) provides that "[e]very partner is an agent of the partnership for the purpose of its business," and UPA § 21(1) provides that "[e]very partner must account to the partnership for any benefit, and hold as trustee for it any profits derived . . . from any transaction connected with the formation, conduct, or liquidation of the partnership." Because both agents and trustees are types of fiduciaries, partners owe fiduciary duties to

185. *See e.g.* Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. Corp. L. 285 (1990); Adam Chernichaw, Student Author, *Oppressed Shareholders in Close Corporations: A Market-Oriented Statutory Remedy*, 16 Cardozo L. Rev. 501 (1994); Sandra K. Miller, *Minority Shareholder Oppression in the Private Company in the European Community: A Comparative Analysis of the German, United Kingdom, and French "Close Corporation Problem,"* 30 Cornell Intl. L.J. 381 (1997); Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 Vand. L. Rev. 749 (2000); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. Corp. L. 913 (1999); Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 Bus. Law. 699 (1993); James M. Van Vliet, Jr. & Mark D. Snider, *The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap*, 18 N. Ill. U. L. Rev. 239 (1998).

186. *See e.g.* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618 (1989); 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) [hereinafter Miller, *Role of the Court*]; Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. Cal. L. Rev. 351 (2003) [hereinafter Miller, *New Direction*]; Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership*, 70 Wash. U. L.Q. 417 (1992); Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. Corp. L. 377 (1990).

187. DeMott, *supra* n. 10, at 882.

188. Like corporate law, most early partnership law cases focused on duty of loyalty and not duty of care. Allen, Jacobs & Strine, *Function over Form*, *supra* n. 41, at 872 (corporate care); Miller & Rutledge, *supra* n. 175, at 358; Michele Healy Ubelaker, Student Author, *Director Liability under the Business Judgment Rule: Fact or Fiction?* 35 Sw. L.J. 775, 789 (1981) (corporate care).

the partnership and the other partners.[189] The hallmark of a fiduciary duty is the duty of loyalty,[190] and both partners[191] and directors[192] have been described as fiduciaries. Unlike the duty of loyalty, the duty of care is not uniquely fiduciary in character and thus while some courts and statutes refer to the duty of care as a fiduciary duty, that characterization is both inaccurate[193] and unfortunate.[194] Conflation of duty of care with duty of loyalty obscures the unique nature of loyalty that, unlike care, does not require proof of negligence under either tort or contract principles.[195]

There is little debate that as a fiduciary a partner owes a duty of care to other partners under UPA defined by agency or trustee contexts. The nature and scope of that duty is an entirely different matter. A paid agent owes a duty of care measured by an ordinary duty of care negligence standard.[196]

> Tort law imposes duties of care on an agent because the agent undertakes to act on behalf of the principal, because the principal's reliance on that undertaking is foreseeable by the agent, and because it is often socially useful that an agent fulfill the agent's undertaking to the principal.[197]

Subject to limitations naturally inherent in contract law, the contract between the principal and agent can raise or lower the standard of care.[198] Statutory provisions may also raise or lower the standard, but, in their absence, the common law agency rules are imposed.

Likewise, trust law imposes a duty upon a trustee "to exercise such care and skill as [persons] of ordinary prudence would exercise in dealing with [their] own property."[199] The terms of the trust may likewise lower or otherwise modify the duty of care, but such provisions are strictly construed.[200] An exculpatory provision in the trust terms may relieve the trustee for a breach of trust unless the act was "committed in bad faith or intentionally or with reckless indifference to the interest of the beneficiary."[201] Thus, the terms of the trust may relieve the trustee of liability for ordinary negligence but may not relieve the trustee for liability arising from willful intentional default, gross negligence, or acts or omissions done with reckless indifference to the beneficiary's interest.[202]

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189. Likewise, corporate fiduciary duty law emerged from agency and trust law. Rock & Wachter, *supra* n. 22, at 651.

190. *See supra* n. 25 and accompanying text.

191. *Meinhard*, 164 N.E. at 546; *see supra* n. 26 and accompanying text.

192. *Pepper*, 308 U.S. at 306–07; *see supra* n. 27 and accompanying text.

193. *Compare Restatement (Third) of Agency* § 8.01 *with id.* at § 8.08; *see id.* at § 8.08 rptr. n. cmt. b; *supra* n. 28 and accompanying text.

194. Gregory, *supra* n. 29, at 183.

195. *Id.* at 184–88.

196. *Restatement (Third) of Agency* § 8.08.

197. *Id.* at § 8.08 cmt. b; *see Restatement (Third) of Torts* § 43 (4th tent. draft 2004); *Restatement (Second) of Torts* § 323 (1965).

198. *Restatement (Third) of Agency* § 8.08 cmt. b.

199. *Restatement (Second) of Trusts* § 174.

200. *Id.* at § 174 cmt. d.

201. *Id.* at § 222.

202. *Id.* at § 222 cmt. a.

Notwithstanding the clear agency and trust rule preferring an ordinary negligence standard, an early partnership authority suggested the standard of care for a partner was measured by gross negligence and not by ordinary negligence.[203] Under this standard, a partner would not be liable for mere negligent management. However, the 1968 version of that authority cites cases that appear to justify only a more narrow inference that a partner is not liable for mere "errors of judgment,"[204] a standard contemplating ordinary negligence subject perhaps to a modern corporate-styled business judgment rule.[205] When the business judgment rule is applicable, gross negligence is ordinarily assumed as necessary to overcome the application of the rule.[206] In refusing to hold a partner responsible for losses caused by a bookkeeping department improperly supervised, one court stated the rule as follows:

> There is no general principle of partnership which renders one partner liable to his copartners for his honest mistakes. So far as losses result to a firm from errors of judgment of one partner not amounting to fraud, bad faith, or reckless disregard of his obligations, they must be borne by the partnership. Each partner owes to the firm the duty of faithful service according to the best of his ability. But, in the absence of special agreement, no partner guarantees his own capacity.[207]

Similarly, other cited cases determined that a partner was not liable absent "culpable negligence."[208] Rather than suggesting a gross negligence standard of care generally applicable to a business judgment rule, references to "errors in judgment" and "culpable negligence" merely suggest divergence between the actual duty of care and the actual liability standard. This is not novel and has existed in the corporate world for some time.[209] Several authors agree with this formulation and thoroughly discuss the early cases upon which a partner is held to a standard of ordinary care but nonetheless not liable for honest mistakes of judgment.[210]

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203. Judson A. Crane, *Handbook of the Law of Partnership and Other Unincorporated Associations* 301 (West 1938). Similar treatment was carried forward in subsequent related works. Alan R. Bromberg & Larry E. Ribstein, *Bromberg and Ribstein on Partnership* § 6.07(f) (Aspen 2000) ("A partner may be held accountable not only for deliberately appropriating an unauthorized benefit, but also for poor management. Partners, however, are not subject to the ordinary care standard applicable to a paid agent. Thus, the partner is not liable to the partnership for the whole burden of losses caused by mere errors of judgment . . . . The courts have sometimes applied a business judgment rule in both general partnerships and limited partnerships. This rule has not been applied where the defendant partner acted contrary to specific or general parts of the partnership agreement." (footnotes omitted)); Alan R. Bromberg, *Crane and Bromberg on Partnership* 395 (West 1968) ("Although a partner owes a duty of faithful services to the best of his ability, he is not held to possess the degree of knowledge and skill of a paid agent. In the absence of special agreement, no partner guarantees his own capacity. He is not liable to his partnership for the whole burden of losses caused by errors of judgment and failure to use ordinary skill and care in the supervision and transaction of business." (footnotes omitted)).

204. Bromberg, *supra* n. 203, at 395.

205. *See supra* pt. II.A.

206. *Id.*

207. *Hurter v. Larrabee*, 112 N.E. 613, 614 (Mass. 1916).

208. *Northen v. Tatum*, 51 So. 17, 19 (Ala. 1909) ("[L]osses occasioned by conduct or omission of a managing partner will not be charged against him, unless he has been guilty, in the conduct or omission, of fraud, bad faith, or culpable negligence." (citations omitted)).

209. Allen, Jacobs & Strine, *Critique*, *supra* n. 41, at 450; Allen, Jacobs & Strine, *Function over Form*, *supra* n. 41, at 867–68; Eisenberg, *supra* n. 41, at 437–38.

210. Beveridge, *supra* n. 180, at 756–60; Keeley, *supra* n. 180, at 622–23; Martin, *supra* n. 180, at 1311.

Is this a standard of ordinary care duty with a protective business judgment rule layer imposing liability only upon business decisions involving a grossly negligent decision-making process[211] or a pure gross negligence duty standard? Arguably, so little case law developed on the point that it is difficult to argue that there is any definitive standard.

Regardless of the outcome of that question, RUPA resolved the question by articulating the fiduciary duty of care in the statute. Relative to the fiduciary duty of care, RUPA provides that a partner's duty of care "is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[212] Accordingly, grossly negligent conduct becomes the duty and not simply the liability standard. The partnership agreement may reduce the duty of care to something less than gross negligence[213] but cannot "unreasonably reduce the duty."[214] The comments state that "absolving partners of intentional misconduct is probably unreasonable."[215] This is consistent with corporate exculpation for gross negligence but with an exception for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[216]

In both cases, liability for violations of gross negligence can be eliminated. The partnership provisions do so by way of eliminating the front-end duty while the corporate provisions do so by eliminating back-end liability. Some states allow more flexibility to the partnership agreement. For example, Delaware prefers freedom of contract[217] and therefore allows the partnership agreement to eliminate all fiduciary duties except the agreement may not limit or eliminate the contractual obligation of good faith and fair dealing.[218] Some argue that such contractual freedom with regard to fiduciary duties is inappropriate,[219] while others support the approach.[220]

A partnership is required to indemnify a partner for liabilities incurred in the "ordinary course of the business . . . or for the preservation of its business or property."[221] The ordinary-course standard modifies common law agency[222] and allows

211. *See supra* pt. II.A.

212. RUPA § 404(c). An early draft also clarified that errors in judgment did not constitute gross negligence. Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 Bus. Law. 427, 468 (1991).

213. RUPA § 103(a).

214. *Id.* at § 103(b)(4).

215. *Id.* at § 103 cmt. 6.

216. Del. Code Ann. tit. 8, § 102(b)(7)(ii).

217. *Id.* at tit. 6, § 15-103(d). A partner may also rely on the terms of the partnership agreement. *Id.* at tit. 6, § 15-103(e).

218. *Id.* at tit. 6, § 15-103(f); *see* Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing under Delaware Law*, 60 Bus. Law. 1469, 1469 (2005).

219. *E.g.* Miller, *Role of the Court*, *supra* n. 186, at 1610–11; Miller, *New Direction*, *supra* n. 186, at 357.

220. *E.g.* Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 Wake Forest L. Rev. 123, 123 (2006).

221. RUPA § 401(c). Commentary indicates this standard was continued from UPA § 18(b). *Id.* at § 401 cmt. 4.

222. *Moren v. JAX Rest.*, 679 N.W.2d 165, 168 (Minn. App. 2004).

conduct to be in the ordinary course of the partnership even though it is motivated by both personal and business reasons.[223]

ULPA 2001 adopted the RUPA duty of care paradigm with the modification that only general partners are generally subject to the duty.[224] Limited partners were not subject to a fiduciary duty of care.[225] However, unlike the Uniform Limited Partnership Act of 1985, ULPA 2001 abandoned the so-called "control rule" and thereby permits a limited partner to "[participate] in the management and control of the limited partnership" without becoming personally liable as a general partner.[226] As a result, limited partners are encouraged to so participate.[227] While the duty of care does not attach to a limited partner solely by reason of that status, participation in management may subject the limited partner to a duty of care at least in cases where the role served is fiduciary in nature.[228] Moreover, for the most part, the scope and power of the partnership agreement relative to the duty of care remained the same as with RUPA.[229]

ULLCA made no changes to the basic duty of care paradigm thereby continuing the gross negligence duty standard,[230] empowering the partnership agreement to reduce the duty[231] but not unreasonably so,[232] and permitting mandatory indemnification for conduct in the ordinary course of business.[233] In order to impose the statutory duty only upon those members fairly charged with management on behalf of other owners, the location of the duty of care depended upon the management structure of the limited liability company.[234] Management by all the members was the default rule,[235] and in that case the duty of care was imposed equally upon all members[236] who had an equal right to participate in management[237] and who were all statutory agents of the

223. *Id.* (citing *Wolfe v. Harms*, 413 S.W.2d 204, 215–16 (Mo. 1967); *Grotelueschen v. Am. Fam. Mut. Ins. Co.*, 492 N.W.2d 131, 137 (Wis. 1992)).

224. ULPA 2001 § 408(c). Importantly, unlike the Uniform Limited Partnership Act of 1985 ("ULPA 1985"), which was linked to UPA in all cases not covered by the Act, ULPA 2001 became a "free-standing" act without any linkage. *See* ULPA 1985 § 1105; Daniel S. Kleinberger, *A User's Guide to the New Uniform Limited Partnership Act*, 37 Suffolk U. L. Rev. 583, 593–94 (2004); Elizabeth S. Miller, *Linkage and Delinkage: A Funny Thing Happened to Limited Partnerships When the Revised Uniform Partnership Act Came Along*, 37 Suffolk U. L. Rev. 891, 891–92 (2004).

225. ULPA 2001 § 305(a).

226. *Id.* at § 303.

227. *See generally* Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?* 37 Suffolk U. L. Rev. 667 (2004); Daniel S. Kleinberger, *The Reporter's Rejoinder*, 37 Suffolk U. L. Rev. 967 (2004).

228. ULPA 2001 § 305(a) cmt.

229. *Id.* at § 110(a)–(b); *see also* Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 Suffolk U. L. Rev. 927, 929 (2004).

230. ULLCA § 409(c).

231. *Id.* at § 103(a).

232. *Id.* at § 103(b)(3).

233. *Id.* at § 403(a).

234. Carter G. Bishop, *The Uniform Limited Liability Company Act: Summary and Analysis*, 51 Bus. Law. 51, 69–70 (1995).

235. ULLCA §§ 101(12) (definition of member-managed company), 203(a)(6) (member management is default rule unless specified otherwise in articles of organization).

236. *Id.* at § 409(c).

237. *Id.* at § 404(a)(1).

company.[238] In a manager-managed company,[239] the duty of care is imposed on the managers,[240] no member has a duty of care[241] unless exercising the responsibilities of a manager,[242] and the managers but not the members are the statutory agents of the company.[243]

The gross negligence standard in the context of a limited liability company was not uniformly adopted by states as an expression of the base duty of care.[244] Many states adopted an ordinary duty of care standard.[245] As a result of these trends, divisions and attitudes altered by various corporate scandals in the Enron era, the drafters of Re-ULLCA[246] altered the approach of the duty of care to concurrently increase the duty standard from gross negligence to ordinary negligence while at the same time granting the operating agreement more flexibility.[247] The duty of care was thus restated from gross negligence to one requiring the "care that a person in a like position would reasonably exercise under similar circumstances and in a manner the member reasonably believes to be in the best interests of the company."[248] The duty of care is "subject to the business judgment rule,"[249] meaning that a state adopting Re-ULLCA can apply its own version of that rule.[250] Nonetheless, while not altering the base duty of care, the application of any version of the business judgment rule will normally presume that all decisions were made with ordinary care. Therefore, whenever a decision-making process is involved, this presumption can only be overcome by proving gross negligence. Consequently, while Re-ULLCA raises the duty of care, it likewise returns the liability standard to something similar to gross negligence as a default rule.

The base duty of care has two other important features. Unlike a RUPA partnership agreement or a ULLCA operating agreement, but similar to corporate articles exculpation rules,[251] a Re-ULLCA operating agreement may specifically eliminate monetary "liability" of a member or manager to the limited liability company or other

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238. *Id.* at § 301(a)(1).

239. *Id.* at §§ 101(11), 203(a)(6) (must be specified as such in articles of organization).

240. ULLCA § 409(h)(2).

241. *Id.* at § 409(h)(1).

242. *Id.* at § 409(h)(3). A manager was relieved of any duty delegated to a member by the operating agreement. *Id.* at § 409(h)(4).

243. *Id.* at § 301(b)(1).

244. Miller & Rutledge, *supra* n. 175, at 366–70.

245. *Id.* at 366–67.

246. Adopted by vote of the National Conference of Commissioners on Uniform State Laws on July 13, 2006, at its Annual Meeting in Hilton Head, South Carolina.

247. Re-ULLCA § 408(a) modifies the standard for mandatory indemnification. Rather than refer to "ordinary course" as did ULLCA § 403(a), Re-ULLCA § 408(a) refers to a "liability incurred in the course of the member's or manager's activities on behalf of the company" provided the liability was not incurred in a breach of fiduciary duties stated in Re-ULLCA § 409. This means that the right to required indemnification will increase as the duty standard is lowered in the operating agreement. Members in a manager-managed company who are not also managers but incur an obligation on behalf of the company would be entitled to permissive indemnification. Re-ULLCA § 408(9). Also, if agency law requires indemnification, then that law would apply through the supplemental law principles. *Id.* at § 107.

248. *Id.* at § 409(c).

249. *Id.*

250. *See supra* pt. II.A.

251. *See e.g.* Del. Code Ann. tit. 8, § 102(b)(7).

members for a breach of duty of care[252] not including a breach of duty of loyalty,[253] receipt of an improper financial benefit,[254] liability for an improper distribution,[255] an "intentional infliction of harm on the company,"[256] or "an intentional violation of criminal law."[257] Like RUPA and ULLCA but providing further guidance, the Re-ULLCA operating agreement further permits the duty of care itself to be altered "except to authorize intentional misconduct or knowing violation of law."[258] This generally means that both the duty of care and liability for breach can sanction even grossly negligent conduct.

Like ULLCA, Re-ULLCA assigns the duty of care according to the management structure but therein ends the similarity. Like ULLCA, the default management architecture is management by the members and not by managers.[259] Managers of a manager-managed company are subject to a duty of care[260] but members are not.[261] Members in a member-managed company are subject to a duty of care.[262] This will continue to place an emphasis on selection of manager-management in those cases where members, who do not intend to participate in management, do not wish to be subject to a duty of care. The method to select a manager-managed company[263] over a member-managed company[264] is different. Rather than shifting through the public articles,[265] management by managers is selected by the members in the operating agreement.[266] Specifically, the operating agreement must "expressly" provide that the "company is 'manager-managed,'"[267] the "company is or will be 'managed by managers,'"[268] or that management "is or will be vested in managers."[269] A "manager" is defined as a "person who under the operating agreement . . . is responsible, alone or in concert with others, for performing . . . management functions."[270] Since the operating agreement may be oral,[271] the requirement that the agreement must "expressly" refer to the management style is designed to require specific agreement on this specific topic.

Unlike ULLCA, where every member of a member-managed company and every manager of a manager-managed company was a statutory agent,[272] Re-ULLCA severs

252. Re-ULLCA § 110(g).
253. *Id.* at § 110(g)(1).
254. *Id.* at § 110(g)(2).
255. *Id.* at § 110(g)(3).
256. *Id.* at § 110(g)(4).
257. Re-ULLCA § 110(g)(5).
258. *Id.* at § 110(d)(3). The agreement provision must not be "manifestly unreasonable." *Id.* at § 110(d).
259. *Id.* at § 407(a).
260. *Id.* at § 409(g)(1).
261. Re-ULLCA § 409(g)(5).
262. *Id.* at § 409(c).
263. *Id.* at § 102(10).
264. *Id.* at § 102(12).
265. ULLCA § 203(a)(6).
266. Re-ULLCA § 102(10).
267. *Id.* at § 102(10)(A).
268. *Id.* at § 102(10)(B).
269. *Id.* at § 102(10)(C).
270. *Id.* at § 102(9). Management functions are further described in Re-ULLCA § 407(b).
271. Re-ULLCA § 102(13).
272. ULLCA §§ 301(a)(1) (member-management), 301(b)(1) (manager-management).

statutory agency entirely. As a result, no member or manager of a limited liability company is a statutory agent.[273] Therefore, agency will be determined by reference to common law agency principles.[274] It is therefore no longer necessary, as under ULLCA, to select management by managers in order to negate the apparent statutory authority of a member.[275] Since creditors, particularly trade creditors, seldom if ever routinely check filed documents to determine the agency status of a member, this switch was designed to facilitate practice and minimize the efforts of the members to negate statutory apparent authority.[276] Filed statements of authority are therefore more likely to be used to grant authority under Re-ULLCA[277] than to limit authority under ULLCA.[278]

B. Duty of Loyalty

While UPA did not express a duty of care,[279] it did express early contours of a duty of loyalty, at least in the sense that a partner must act in the best interests of the partnership to the exclusion of personal interests. UPA provided that a partner was broadly accountable as a fiduciary in 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.[280]

Also, a partner was an agent.[281] As a result, a partner was generally subject to the fiduciary duties applicable to an agent.[282] These provisions gave rise to one of the most venerable statements of fiduciary accountability by Justice Cardozo:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[283]

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273. Re-ULLCA § 301(a) (no member an agent *qua* membership). No other statute specifically states a manager is a statutory agent.

274. *Id.* at § 107.

275. ULLCA § 301(b)(1).

276. ULLCA permitted filing statements of authority to limit the authority of a statutory member agent, but with the exception of real estate, these limitations did not bind third parties without specific notice or knowledge of the limitation. *Id.* at § 301(c).

277. Re-ULLCA § 302.

278. ULLCA § 301(c).

279. *See supra* nn. 187–189 and accompanying text.

280. UPA § 21(1).

281. *Id.* at § 9(1).

282. *Id.* at § 4(3).

283. *Meinhard*, 164 N.E. at 546 (citation omitted).

RUPA recognized the loyalty aspects of UPA but nonetheless adopted the position that lawyers needed defined boundaries and that fiduciary duty law, particularly loyalty, was unbounded as evidenced by Cardozo's famous opinion. As a result, RUPA approached fiduciary duties in several ways. First, RUPA provided that the "only" fiduciary duties owed by a partner are the duty of loyalty and the duty of care[284] specifically stated.[285] The intended effect of placing borders around fiduciary duties was to preclude courts from creating or expanding those duties.[286] Some states did not adopt the term "only," thus freeing fiduciary duties to roam.[287] Next, the duties of care[288] and loyalty[289] were explicitly expressed. The duty of loyalty was stated to be "limited to" three elements: (i) "to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity";[290] (ii) "to refrain from dealing with the partnership . . . as or on behalf of a party having an interest adverse to the partnership";[291] and (iii) "to refrain from competing with the partnership" before its dissolution.[292]

As with the duty of care, the partnership agreement could alter the duty of loyalty, but the power of the agreement was carefully circumscribed. First, the partnership agreement could not eliminate the duty of loyalty.[293] However, short of elimination, the agreement was empowered to "identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable"[294] and to specify the number or percentage of partners that could "authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty."[295] Some states allow more flexibility to the partnership agreement. For example, Delaware prefers freedom of contract[296] and therefore allows the partnership agreement to eliminate all fiduciary duties except the agreement may not limit or eliminate the contractual obligation of good faith and fair dealing.[297]

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284. *See supra* nn. 212–223 and accompanying text.

285. RUPA § 404(a).

286. *Id.* at § 404 cmt. 1.

287. *See e.g. Enea v. Super. Ct. of Monterey County*, 34 Cal. Rptr. 3d 513, 517–18 (Cal. App. 6th Dist. 2005).

288. RUPA § 404(c).

289. *Id.* at § 404(b).

290. *Id.* at § 404(b)(1). This provision was designed to replicate UPA § 21(1) except that the duty did not apply to the formation of the partnership and a partnership opportunity was added as an example. *Id.* at § 404 cmt. 2.

291. *Id.* at § 404(b)(2). However, a partner did not violate this provision "merely because the partner's conduct furthers the partner's own interest." RUPA § 404(e).

292. *Id.* at § 404(b)(3).

293. *Id.* at § 103(b)(3).

294. *Id.* at § 103(b)(3)(i).

295. *Id.* at § 103(b)(3)(ii).

296. Del. Code Ann. tit. 6, § 15-103(d). A partner may also rely on the terms of the partnership agreement. *Id.* at tit. 6, § 15-103(e).

297. *Id.* at tit. 6, § 15-103(f), *see* Altman & Raju, *supra* n. 218, at 1469.

Some argue that such contractual freedom with regard to fiduciary duties is inappropriate,[298] while others support the approach.[299]

As with the duty of care, ULPA 2001 followed RUPA precisely with regard to the duty of loyalty paradigm except the duties applied only to general partners[300] and not to limited partners.[301] The RUPA limitation features were expressly retained. Thus, the "only" fiduciary duties were care and loyalty,[302] and care and loyalty were likewise "limited" to the expressions therein.[303] The power of the partnership agreement was likewise circumscribed. First, the partnership agreement could not eliminate the duty of loyalty.[304] However, short of elimination, the agreement was empowered to "identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable"[305] and to "specify the number or percentage of partners which may authorize or ratify, after full disclosure to all partners of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty."[306] Again, some states allow more flexibility in the partnership agreement. For example, Delaware prefers freedom of contract[307] and, therefore, allows the partnership agreement to eliminate all fiduciary duties except the agreement may not limit or eliminate the contractual obligation of good faith and fair dealing.[308] Some argue that such contractual freedom with regard to fiduciary duties is inappropriate,[309] while others support the approach.[310]

As with duty of care, ULLCA followed the RUPA duty of loyalty paradigm precisely, except that duties applied to members in a member-managed company[311] and to managers in a manager-managed company.[312] The RUPA limitation features were expressly retained. Thus, the "only" fiduciary duties were care and loyalty,[313] and care and loyalty were likewise "limited" to the expressions therein.[314] The power of the partnership agreement was likewise circumscribed. First, the partnership agreement could not eliminate the duty of loyalty.[315] However, short of elimination, the agreement was empowered to "identify specific types or categories of activities that do not violate

298. *E.g.* Miller, *Role of the Court*, *supra* n. 186, at 1610–11; Miller, *New Direction*, *supra* n. 186, at 357.
299. Gold, *supra* n. 220, at 123.
300. ULPA 2001 § 408.
301. *Id.* at § 305(a).
302. *Id.* at § 408(a).
303. *Id.* at §§ 408(b) (loyalty), 408(c) (care).
304. *Id.* at § 110(b)(5).
305. ULPA 2001 § 110(b)(5)(A).
306. *Id.* at § 110(b)(5)(B).
307. Del. Code Ann. tit. 6, § 17-1101(c). A partner may also rely on the terms of the partnership agreement. *Id.* at tit. 6, § 17-1101(e).
308. *Id.* at tit. 6, § 17-1101(d); *see* Altman & Raju, *supra* n. 218, at 1469.
309. *E.g.* Miller, *Role of the Court*, *supra* n. 186, at 1610–11; Miller, *New Direction*, *supra* n. 186, at 357.
310. Gold, *supra* n. 220, at 123.
311. ULLCA § 409(a).
312. *Id.* at § 409(h).
313. *Id.* at § 409(a).
314. *Id.* at §§ 409(b) (loyalty), 409(c) (care).
315. *Id.* at § 103(b)(2).

the duty of loyalty, if not manifestly unreasonable,"[316] and to "specify the number or percentage of members or disinterested managers that may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty."[317] Some states allow more flexibility in the partnership agreement. For example, Delaware prefers freedom of contract[318] and, therefore, allows the partnership agreement to eliminate all fiduciary duties except the agreement may not limit or eliminate the contractual obligation of good faith and fair dealing.[319] Some argue that such contractual freedom with regard to fiduciary duties is inappropriate,[320] while others support the approach.[321]

Also as with the duty of care,[322] the Re-ULLCA approach deviated from the RUPA pattern repeated in ULLCA and ULPA 2001. However, most of the deviation is in the freedom of the operating agreement and less in the expression of the duty itself. First, the expressed duties of care and loyalty are not the "only" fiduciary duties and thus become examples but not exclusive expressions.[323] Next, the duty of loyalty is not limited to the expression in the statute, again freeing the duty to roam according to circumstances.[324] The duty of loyalty is expressed as "including" the duty to account and hold as trustee any property, profit, or benefit derived "in the conduct or winding up of the company's activities,"[325] "from a use by the member of the company's property,"[326] or "from the appropriation of a . . . company opportunity."[327] The duty also includes the duty "to refrain from dealing with the company . . . as or on behalf of a party having an interest adverse to the company."[328] Unlike ULLCA, Re-ULLCA provides that it is a defense to a claim for a breach of this conflict of interest that the transaction was "fair" to the company.[329] Also, the duty includes a duty "to refrain from competing with the company."[330]

Unlike with the duty of care,[331] the operating agreement may not eliminate liability for a breach of the duty of loyalty.[332] However, unlike ULLCA, the operating agreement may eliminate the duty of loyalty "if not manifestly unreasonable."[333] Re-ULLCA includes a specific definition of the phrase "manifestly unreasonable." First,

316. ULLCA § 103(b)(2)(i).
317. *Id.* at § 103(b)(2)(ii).
318. Del. Code Ann. tit. 6, § 18-1101(b). A member or manager may also rely on the terms of the limited liability company agreement. *Id.* at tit. 6, § 18-1101(d).
319. *Id.* at tit. 6, § 18-1101(c); *see* Altman & Raju, *supra* n. 218, at 1469.
320. *E.g.* Miller, *Role of the Court*, *supra* n. 186, at 1610–11; Miller, *New Direction*, *supra* n. 186, at 357.
321. Gold, *supra* n. 220, at 123.
322. *See supra* pt. II.A.
323. Re-ULLCA § 409(a).
324. *Id.* at § 409(b).
325. *Id.* at § 409(b)(1)(A).
326. *Id.* at § 409(b)(1)(B).
327. *Id.* at § 409(b)(1)(C).
328. Re-ULLCA § 409(b)(2).
329. *Id.* at § 409(e); *compare id. with* ULLCA § 409(e) (A member does not violate the duty of care or loyalty "merely because the member's conduct furthers the member's own interest.").
330. Re-ULLCA § 409(b)(3).
331. *Id.* at § 110(g).
332. *Id.* at § 110(g)(1).
333. *Id.* at § 110(d)(1).

a court must determine whether a term of the operating agreement is manifestly unreasonable.[334] The determination is to be made by reference to the time the term "became part of the operating agreement and by considering only circumstances existing at that time."[335] The term may then be invalidated "only if, in light of the purposes and activities of the limited liability company, it is readily apparent that: (A) the objective of the provision is unreasonable; or (B) the provision is an unreasonable means to achieve the provision's objective."[336]

C. *Good Faith*

UPA did not state an express obligation of good faith and fair dealing. As a result, good faith and fair dealing arose by implication of law. RUPA altered that approach by expressly stating that "[a] partner shall discharge the duties . . . under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing."[337] ULPA 2001 and ULLCA stated a similar obligation.[338]

RUPA's comments stated that the purpose of this obligation was to make an explicit statutory expression of the duty.[339] While contractual good faith is implied in all contracts and thus arguably would have applied to the partnership agreement, the statute makes clear that the obligation applies to duties created by statute or the partnership agreement as well as to rights to be exercised under RUPA. Indeed, the commentary states that good faith and fair dealing is a contractual concept.[340] While acknowledging the subjective elements of good faith and the objective elements of fair dealing,[341] the commentary prefers an "excluder" role as opposed to a direct positive law definition.[342] The Uniform Commercial Code ("UCC") defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[343]

Good faith cannot be eliminated by the partnership agreement.[344] However, "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."[345] The

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334. *Id.* at § 110(h).
335. Re-ULLCA § 110(h)(1).
336. *Id.* at § 110(h)(2).
337. RUPA § 404(d).
338. ULPA 2001 § 408(d); ULLCA § 409(d).
339. RUPA § 404 cmt. 4.
340. *Id.* (citing *Restatement (Second) of Contracts* § 205 (1981)).
341. *Id.*
342. *See* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195, 262 (1968).
343. Rev. U.C.C. § 1-201(20), 1 U.L.A. 5 (2004).
344. RUPA § 103(b)(5).
345. *Id.*

elimination restriction was borrowed from the UCC.[346] The immutable characteristics of good faith were mimicked by ULPA 2001[347] and ULLCA.[348]

Re-ULLCA adopts a few changes. First, the statutory language makes clear that the good faith referent is "contractual" good faith.[349] This aspect continues the RUPA aspect but makes clearer the contractual roots. In most cases, contractual good faith is a performance obligation operating to better define the proper contours of the other duties created by the parties in the agreement itself. In this case, the same idea pertains. As a result, the proper referent and boundary for good faith is the intent of the parties expressed in the operating agreement as supplemented by the duties created by the Act. The purpose of good faith is therefore to protect the agreed obligations of the members, not to generate new obligations rooted in statutory origin.[350] Second, as previously discussed,[351] Re-ULLCA makes a genuine attempt to define the scope of the phrase "manifestly unreasonable." Without such a definition, the scope of that phrase only adds to the ambiguity already present in the concept of good faith itself. Other states have also adopted an immutable role for good faith as the minimum duty that cannot be eliminated by the parties.[352]

IV. CONCLUSION

The scope, relationship, and role of the core fiduciary duties of care and loyalty are undergoing radical change in business entity law. Almost all states define the duty of care for all business organizations in either ordinary negligence or gross negligence terms and in any event apply some version of a business judgment rule to require gross negligence in some form. While the expression may be somewhat different, the outcome is mostly harmonized. At a minimum, liability for a breach of duty of care depends heavily upon proving gross negligence.

Even then, nearly all corporate statutes and a growing trend of unincorporated entity statutes permit total exculpation for liability based even on gross negligence. Those exculpation statutes rather uniformly make exception for violations of loyalty or good faith and do not sanction intentional misconduct. As a result of that policy decision, duty of care as historically defined is all but disappearing even though the policy rationales are different for directors of a public corporation and the owner-managers of a closely-held business. Exculpation originated as a reaction to the enormous liability exposure for a director of a public corporation that accrues through a more vigorous duty of care standard. Small mistakes can have catastrophic economic

346. Prior U.C.C. § 1-102(3), 1 U.L.A. 68 (2004) ("The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable."); *see also* U.C.C. § 1-302.

347. ULPA 2001 § 110(b)(7).

348. ULLCA § 103(b)(4).

349. Re-ULLCA § 409(d).

350. *Id.* at § 409 cmt.

351. *See supra* nn. 334–336 and accompanying text.

352. *See e.g.* Del. Code Ann. tit. 6, §§ 15-103(f) (general partnership), 17-1101(d) (limited partnership), 18-1101(c) (limited liability company).

consequences. Missing a per share fair value of a public company by a single dollar will have enormous consequences when multiplied by millions of shares. The same tension does not exist in closely-held constructs, thus arguing that a more reasonable and robust care standard should apply where all the owners are involved in management. In the end, the question becomes one of presumed intent expressed in a default rule. Do the owners of a closely-held business intend to share losses equally that arise from a particular member's gross negligence, or do they intend the actor bear the full responsibility of such conduct?

Regardless of the answer to the duty of care issue, the presence of statutory exculpation for care with loyalty and bad faith exceptions places enormous pressure on the conceptual definition of that triad. Managers will argue for a broader care definition, whereas owners will argue for broader loyalty and good faith definitions. If loyalty is narrowly defined to require the actor only to refrain from receiving an improper personal benefit or engaging in a conflict of interest transaction without disclosure, then the good faith exception will gradually expand. Together, loyalty and good faith must require some element of positive devotion and attention to the best interests of the entity. Systematic oversight and participation failures will not suffice and eventually will be subsumed in either loyalty, good faith, or both. Reinvigorating loyalty has some advantages because of its intuitive contours, while bad faith remains a more elusive category.

In most states, the question remains concerning the procedural role for bad faith. This article argues that the presence of bad faith at once dismisses both the business judgment rule presumption as well as the application of statutory exculpation. What remains? In cases not involving a duty of loyalty, however defined, what remains is a duty of care standard requiring proof of only ordinary negligence, entity harm, and causation. It could be argued that statutory exculpation will then simply be expanded to remove the bad faith exception since liability, at least in a publicly traded corporation, once again becomes enormous. That answer misses the mark. Of course, mistakes in such an environment will have catastrophic consequences. But there is little policy justification for sanctioning bad faith conduct under any reasonable definition as it borders or often overlaps intentional misconduct. It is one thing to exculpate liability for conduct constituting a mere negligent tort; it is another to exculpate conduct constituting an intentional tort. In most if not all cases, such conduct is not even insurable.

As a result, when bad faith is proven, even when such conduct does not accrue a personal benefit to the actor, this article has argued that the duty and liability standards should conflate into a single unified ordinary care standard. Moreover, upon proof of breach of that duty, harm, and causation, the actor should be personally liable without the possibility of indemnification. Of course, this means that the actor should not have yet another bite at the apple by asserting meaningless proof that the bad faith harm was otherwise "entirely fair" to the entity.