

THE NAKED FIDUCIARY

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Business law is grounded in the common law of fiduciary duty. Courts and policymakers have been loath to abandon that principle. Yet, particularly in the contractual context of limited liability companies (“LLCs”), the fiduciary label is illusory and may undercut sound governance practices for those entities. This Article presents an in-depth empirical study about governance provisions included in LLC operating agreements and examines the implications of the data in the context of various types of businesses that might choose to organize as LLCs. The Article uses the data and related case studies to offer a new approach to LLC governance—the “coactive” LLC.

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INTRODUCTION

People form business relationships for a variety of reasons. The law, in turn, provides a variety of entity forms through which parties can do business. In many of these forms, the law assumes that one or more of the parties are entrusting

property or the operation of the business to others, with little ability to monitor or influence those in control.¹ That assumption not only is flawed in many instances but also may undermine the intrinsic value of the parties' original business relationship. Accordingly, using the "fiduciary" label in business law requires a thoughtful and nuanced approach.

A fiduciary generally is "someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence."² Although the scope of any fiduciary relationship often is context specific, fiduciaries typically owe separate duties of care and loyalty to their entrustors. The duty of care requires the fiduciary to pursue the interests of the entrustor in a non-negligent manner, whereas the duty of loyalty demands that the conduct of the fiduciary be free from conflict and self-dealing.³ A fiduciary also owes other duties to its entrustors, such as duties of good faith, disclosure (candor), and accounting; each of which may flow from the duties of care and loyalty or may be viewed independently.⁴

Commentators have considered the scope of fiduciary duties in the business context and debated their utility in light of protections afforded business managers, including the business judgment rule and exculpation provisions that shield certain parties from personal liability for breaches of the duty of care.⁵ Legislators likewise have grappled with waivers or modifications of traditional fiduciary duties in unincorporated business entities.⁶ For example, many state statutes governing LLCs permit the duties of care and loyalty to be modified to varying degrees, with some statutes prohibiting modifications that are "manifestly unreasonable" and others allowing the duties to be largely eliminated.⁷

1. See TAMAR FRANKEL, *FIDUCIARY LAW* 7–13 (2011).

2. ALASTAIR HUDSON, *EQUITY AND TRUSTS* 52 (6th ed. 2010).

3. See FRANKEL, *supra* note 1, at 101–07 (discussing fiduciaries' general duties).

4. *Id.*

5. See generally Kelli A. Alces, *Debunking the Corporate Fiduciary Myth*, 35 J. CORP. L. 239 (2009) (examining corporate fiduciary duties); Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997) (examining a debate concerning the role and nature of corporate fiduciary duties); Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 146–61 (explaining and contrasting the general contract approach to governance in the alternative entity context to that under corporate law); Celia R. Taylor, *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done About It*, 85 OR. L. REV. 993 (2006) (examining the role of fiduciary duties in the corporate context); see also *infra* Part I.B.2.

6. See, e.g., Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 35, 62–77 (2008) (explaining the development of and critiquing fiduciary duty provisions of the uniform act); see also *infra* Part I.A.2.

7. See generally Mark J. Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the "Manifestly Unreasonable" Standard*, 41 TULSA L. REV. 411 (2006) (discussing issues raised by fiduciary duty law in the alternative entity context); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565 (2007) (exploring the

This Article presents an in-depth empirical study (“OA Study”) of fiduciary duty and governance provisions in LLC operating agreements (“Operating Agreements”).⁸ The OA Study evaluates, among other things, whether Operating Agreements: (i) modify members’ or managers’ fiduciary duties; (ii) limit or eliminate the personal liability of members, managers, or others; (iii) permit members or managers to consider the interests of themselves or others in lieu of the LLC or its members generally; (iv) provide governance rights to parties who are not members or managers of the LLC; (v) indemnify or offer buy-out rights to parties; and (vi) require the consent of certain parties to amend or otherwise affect the rights of members and managers under the Operating Agreement. The data also include information about the LLCs’ states of organization, membership composition, and the industries to which the LLCs belong.⁹ Although there are limitations to the OA Study, the data offer insight not otherwise available regarding how and when parties are contracting around fiduciary duties. The data also support inferences regarding the policy implications of those practices.

The data and analyses presented in Part II show that Operating Agreements frequently modify the duties and personal liability of both member and non-member managers.¹⁰ Likewise, they are more likely to modify members’ duty of loyalty and allow members to compete with the LLC than they are to modify members’ duty of care.¹¹ Although these data may not be surprising, the data also suggest that some Operating Agreements go further and expressly permit members and managers to consider their own interests or the interests of certain other parties in lieu of the best interests of the LLC or its members generally. That type of duty variation is more typically found in Operating Agreements providing outside parties with governance rights (for example, voting or consent rights).¹²

Moreover, the data suggest that parties at the bargaining table can impact governance provisions and protect their own rights and interests. For example, agreements modifying members’ duty of loyalty are significantly more likely to require members’ unanimous consent to subsequently amend the Operating Agreement.¹³ Similarly, agreements eliminating members’ personal liability through an exculpation provision are significantly more likely to also indemnify members or members and their affiliates from liability relating to the LLC.¹⁴ These associations support an argument that members can obtain governance provisions

development of, and critiquing the trend in, state statutes permitting broad modifications to fiduciary duties); *see also infra* Part I.A.2.

8. See generally *infra* Part II.

9. See *infra* Part II.B.1.

10. See *infra* Part II.B.2.

11. See *infra* Part II.B.2.b.

12. See, e.g., Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655 (2004) (discussing third-party control in special purpose entity securitizations); *see also infra* Part II.B.3.

13. See *infra* Part II.B.2.c.

14. See *infra* Part II.B.2.c.

in their favor and have the ability to preserve those *ex ante* bargains over the life of the business relationship.

The data underscoring the importance of being at the bargaining table, however, also raise concerns regarding imbalances in bargaining power. For example, provisions modifying managers' duties and liability are significantly associated with (i) provisions indemnifying managers and their affiliates, and (ii) the absence of any buy-out rights for members.¹⁵ Although the potential member exposure associated with these provisions could be priced into the bargain, their inclusion also could be the result of parties' lack of information or representation in the negotiations. These factors are critical in evaluating the utility and desirability of lessening or even eliminating fiduciary duties in the LLC context.

Overall, the OA Study demonstrates that—regardless of any potential risk—parties are invoking state statutes that permit modifications to the traditional fiduciary duties owed by, and the personal liability of, members and managers in LLCs. The pervasive use of these provisions and the data associations highlighted by the OA Study inform the ongoing debate among policymakers, courts, and commentators regarding the fiduciary nature of LLC business relationships.

The fiduciary debate in the LLC context primarily concerns whether parties can negotiate the terms of their business relationship or remain subject to some level of fiduciary duty under statutory or common law. Business parties appear to approach the LLC form more as a contractual relationship, rather than a fiduciary relationship, and some commentators endorse that approach.¹⁶ Others believe that a threshold level of mandatory fiduciary duty is needed even in the LLC context.¹⁷ Courts appear willing to respect the parties' contractual arrangement, but some are just as willing to impose traditional fiduciary duties.¹⁸ Legislatures also are willing to recognize flexibility in the level of LLC fiduciary duties, but only two states permit a complete elimination of those duties.¹⁹

15. See *infra* Part II.B.4.

16. See Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 446 (1999) (arguing for the freedom of contract in unincorporated entities and suggesting that lawyers may echo this preference); see also *infra* Part I.B.2.

17. See, e.g., Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 918–76 (2005) (recognizing unequal bargaining power between majority and minority owners in LLCs and arguing for application of the minority oppression doctrine); see also *infra* Part I.B.2.

18. See, e.g., *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 62–65, 72 (Bankr. S.D.N.Y. 2009) (denying motion to dismiss a LLC bankruptcy case and finding that the LLC's operating agreement incorporated general corporate law principles and provided the independent director ability to act in accordance with corporate law duties); Kahn v. Portnoy, Civil Action No. 3515-CC, 2008 WL 5197164, at *13 (Del. Ch. Dec. 11, 2008) (denying motion to dismiss breach of fiduciary duty claims and finding that operating agreement was ambiguous on scope of duties); see also *infra* Part I.B.1.

19. DEL. CODE ANN. tit. 6, § 18-108 (2012); NEV. REV. STAT. ANN. § 86.286 (2012).

The divergent views about the fiduciary nature of LLCs create uncertainty and additional cost for parties electing to do business in the LLC form.²⁰ Parties bargaining *ex ante* for limited or no duties may *ex post* face court-imposed fiduciary duties and liability. That result often changes the economics and dynamics of the parties' original bargain. Simply imposing some level of mandatory fiduciary duties in all LLCs, however, does not provide a satisfactory answer from either a business or compliance perspective.²¹ Achieving maximum utility in the governance of LLCs requires a delicate balance that appreciates the different parties who may elect to do business as an LLC and the relationships among these parties.

An increasing number of scholars in a variety of disciplines are reassessing legal regulations under behavioral and cognitive theories, including the different types of trust relationships that exist in economic and other relationships.²² Trust theory is particularly relevant to LLCs because personal relationships often play a key role in those business entities. For example, parties forming LLCs frequently have preexisting relationships and may have motivations outside of any legal regulation to pursue the parties' collective interest. The trust underlying those relationships may differ significantly from parties using the LLC form as, for example, an impersonal investment vehicle. The latter situation likely is based primarily on cognitive or calculated trust, and the absence of any relational or affective trust may warrant some legal regulation to discourage self-dealing and other inappropriate conduct by managers.²³

Notably, the need for regulation in one situation does not justify or support the imposition of the same regulation in the other, more relational context. In fact, some commentators and studies posit that using such a one-size-fits-all approach could be counterproductive in situations involving blended or informed trust where parties have the relationship, information, and capacity to assess the trustworthiness of the counterparty.²⁴ External regulation—as opposed to the internal motivation and personal risk assessment present in an informed trust setting—may set a lower threshold of acceptable conduct. It also may cause parties

20. See generally Alex Y. Seita, *Uncertainty and Contract Law*, 46 U. PITTS. L. REV. 75 (1984) (discussing the impact of uncertainty on contract parties' expectations, bargains, and rights).

21. See *infra* Part III.C.

22. See, e.g., Claire A. Hill & Erin Ann O'Hara, *A Cognitive Theory of Trust*, 84 WASH. U. L. REV. 1717, 1718 (2006) ("A fast-growing legal literature can draw insights from trust scholars in several other fields, including sociology, psychology, political science, economics, neuroscience, medicine, and management to explore the effects of legal policy on the nature of trust in interpersonal relationships."); see also LYNN A. STOUT, CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE (2011).

23. Frank B. Cross, *Law and Trust*, 93 GEO. L.J. 1457, 1463–71 (2005) (explaining concepts of affective and cognitive trust and observing that "[a]ffective trust is akin to an emotion, while cognitive trust is more of a reasoned decision to trust another").

24. See, e.g., Ronald J. Colombo, *Trust and the Reform of Securities Regulation*, 35 DEL. J. CORP. L. 829, 849–52 (2010); Hill & O'Hara, *supra* note 22, at 1729–33.

to forego meaningful assessment and monitoring activities.²⁵ Consequently, mandating fiduciary duties in all scenarios may weaken the intrinsic value of LLC relationships built on informed trust.²⁶

Data presented in this Article, in addition to prior literature about LLCs and literature about trust, suggest a workable and balanced approach to LLC governance: so-called “coactive” LLCs.²⁷ This approach builds on existing default rules for LLCs, but also imposes traditional fiduciary duties on managing members and managers in all LLCs other than those qualifying as coactive LLCs. Coactive LLCs, in turn, involve three essential elements: (i) parties with all reasonably necessary information; (ii) parties who actively engage in negotiating the Operating Agreement (or have an opportunity to negotiate at the time of signing); and (iii) parties who have some control or meaningful influence over the future direction of the LLC. Each of these criteria is described more fully in Part III.A. The coactive LLC approach optimizes informed trust and respects bargained-for governance structures while protecting parties who have signed, but not really contracted for, the terms of the Operating Agreement.

Part I of this Article describes the origins of the LLC form and the characteristics that distinguish it from corporations and other unincorporated entities. This Part first considers the purpose and development of the LLC form. It then discusses legislative and judicial responses to LLC governance disputes and commentators’ perspectives on the appropriate approach to fiduciary duties in the LLC context.

Part II presents the data and key findings of the OA Study. This Part summarizes the methodology and scope of the study, as well as some basic descriptive data emerging from the study. It also explains the results of regression analyses and draws several inferences from the data. The characteristics and associations detailed in this Part lay the foundation for the policy analysis in Part III.

Part III considers the data through the lenses of trust theory, cultural norms, and general business policy. It examines the meaning of trust and the application of trust theory to the economic and business relationships typically present in the LLC context. It builds on trust literature to evaluate potential regulatory approaches to LLC governance. The discussion highlights the value of a policy that allows parties in coactive LLCs to freely tailor their governance

25. See, e.g., Colombo, *supra* note 24, at 850 (“[E]vidence suggests that law and regulation can ‘crowd out’ trust—a phenomenon whereby legal mechanisms and adherence to regulatory standards supplant social norms and the binds of trust.”).

26. See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1741 (2001) (noting flaw in “assum[ing] that it is the threat of the law that reins in misbehavior in all situations”).

27. See *infra* Part III.C.1 (“Coactive LLCs are identified by three key elements: (i) fully informed parties, (ii) active negotiation by the parties at the time the particular member signs the Operating Agreement, and (iii) some control or meaningful role in material transactions pursued by the LLC.”).

structures, but that also retains traditional standards of conduct in other LLC forms. The Article concludes by encouraging policymakers to adopt the coactive LLC approach and refrain from clothing parties with fiduciary duties where the fiduciary label is contrary to the parties' *ex ante* bargain, as well as the overall basis of their business relationship.

I. THE ORIGINS OF LLCs AND RELATED GOVERNANCE ISSUES

The LLC form is a relatively recent development.²⁸ It generally combines the limited liability protections of corporations with the tax treatment and flexibility of partnerships. LLC statutes are largely modeled after the default rules of partnership law, but LLC statutes in many states, and the parties invoking them, seek to push the concept of "doing business by contract" even further.²⁹ Some commentators view these efforts as positive innovations in governance and business law efficiency, whereas others are troubled by a perceived erosion of fiduciary duties.³⁰ This Part briefly outlines the key aspects of the LLC form, focusing on the contractual nature of the form and how fiduciary duty law governs this contractual relationship.

A. The Basic Parameters of the LLC Form

Parties historically used the corporate form to, among other things, obtain limited liability for owners and investors, facilitate centralized management, and expand financing options. Many incorporators perceive these advantages as outweighing the potential downsides associated with more formal regulation of corporations and the corporate tax structure. The proliferation of unincorporated business entity forms that offer limited liability, flexible management structures,

28. The Wyoming legislature passed the first LLC statute in 1975. See, e.g., LARRY E. RIBSTEIN, THE RISE OF THE UNINCORPORATION 119–20 (2010) (summarizing origins of LLC). See generally William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 855–60 (1995) (explaining the genesis of the Wyoming statute); Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 FORDHAM J. CORP. & FIN. L. 445 (2009) (explaining the development of LLCs).

29. See, e.g., Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 38 DEL. J. CORP. L. 789, 790–92 (2008) (discussing freedom of contract principle underlying Delaware's LLC statute); Miller, *supra* note 7, at 586–90 (discussing the progression of fiduciary duty waivers in the LLC context); see also J. William Callison & Allan W. Vestal, *Contractarianism and Its Discontents: Reflections on Unincorporated Business Organization Law Reform*, 42 SUFFOLK U. L. REV. 493, 501–05 (2009) (examining the development of the freedom of contract principle in partnership and LLC statutes).

30. Compare Ribstein, *supra* note 16, at 435, 446 (arguing for complete freedom of contract approach), with SANDRA K. MILLER, LIMITED LIABILITY COMPANIES: A COMMON CORE MODEL OF FIDUCIARY DUTIES §1:4 (2012), available at Westlaw LLCFID (arguing for some level of mandatory rules in LLC context).

and the option to be taxed as a partnership, however, challenge the common knee-jerk reaction that a corporation is the most favorable entity choice.³¹

1. Forming LLCs

The LLC has emerged as the preferred unincorporated alternative to the corporate form.³² Many state LLC statutes are based on freedom of contract principles and, consequently, allow parties wide latitude in negotiating many aspects of their business relationship.³³ For example, parties typically can elect to be member-managed or, alternatively, use a centralized form of management more akin to a corporation. Moreover, the active participation of members in the management of the LLC generally does not affect their limited liability rights. Parties also can define member qualifications, establish different classes of membership, and allocate voting and economic rights among members in a manner that best reflects the bargained-for terms of the relationship.³⁴

Although the LLC form does not necessarily foster the various financing options and free-transferability-of-ownership interests associated with corporations, parties can use the LLC form to implement staged financing and attract outside, passive investors with rights similar to those of corporate stockholders.³⁵ The challenge here lies in the absence of robust markets for most LLC interests and the limited exit strategies available to investors. These potential

31. See Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 459–60, 468–78, 483–85 (2010) (presenting empirical data to support statement that “[t]he limited liability company (LLC) is now undeniably the most popular form of new business entity in the United States”).

32. See *id.* at 460 (“[I]n Delaware and Colorado in 2007, over three new LLCs were formed for every one new corporation formed. Only four states had more new corporations formed than new LLCs in 2007; ten states and the District of Columbia had ratios of new LLCs to new corporations formed in excess of four to one; Connecticut came in with the highest, at a ratio of new LLCs to new corporations formed of 11.826 to 1.”).

33. DEL. CODE ANN. tit. 6, § 18-1101(b) (2012) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”); see also Conaway, *supra* note 29, at 801 (discussing the freedom of contract principle).

34. For general explanations about the flexibility available to parties under various states’ LLC statutes, see Barbara Ann Banoff, *Company Governance Under Florida’s Limited Liability Company Act*, 30 FLA. ST. U. L. REV. 53, 57–66 (2002) (discussing Florida law); Conaway, *supra* note 29, at 790–96 (discussing Delaware law); Elizabeth S. Miller, *Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, in ESSENTIALS OF BUSINESS LAW 1, 7–9 (State Bar of Tex. ed., 2010), available at http://www.texasbarcl.com/Materials/Events/9254/120692_01.pdf (discussing Texas law).

35. See generally RIBSTEIN, *supra* note 28, at 193–222 (discussing utility of key features of LLC in large company context).

issues are among the reasons some investors continue to prefer the corporate form.³⁶

Consequently, whether parties elect to do business in the LLC form frequently depends on the identity of the parties and their business objectives.³⁷ For example, private equity funds may opt to form an LLC for tax or strategic management reasons, such as greater ease in aligning member distributions with firm profitability.³⁸ Parties also use LLCs to facilitate asset securitizations that protect intellectual property or financial investments from risks associated with the originating company.³⁹ Likewise, tax considerations or general flexibility in designing the internal governance of the firm may attract joint venturers, entrepreneurs, or others with pre-existing relationships to the LLC form.⁴⁰

Parties who have a specific reason for electing the LLC form likely will take the time and incur the cost of negotiating an Operating Agreement that maximizes the utility of the freedom of contract principle.⁴¹ Others may choose the LLC form, however, because it is recommended by counsel or friends and not necessarily for a particular business or strategic purpose. In those cases, less thought or care may be given to the terms of the business relationship, and the LLC statute's default rules may govern.⁴² Given the broad potential uses of the LLC form, any discussion of governance provisions must consider both the default rules and desirable modifications to those rules.

2. LLC Statutes and Fiduciary Duties

Parties motivated to negotiate an LLC Operating Agreement often address the fiduciary nature, if any, of the parties' business relationship. Parties may focus on fiduciary duties for a variety of legitimate reasons.⁴³ For example, one or more of the parties may hold or plan to obtain interests in other potentially

36. See generally Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUSINESS TAX STORIES 295, 310 (Steven A. Bank & Kirk J. Stark eds., 2005) (explaining the origins of LLCs and the impediments to the form supplanting the corporate form).

37. For a thoughtful empirical study of entity choice decisions, see Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79 (2001).

38. See, e.g., RIBSTEIN, *supra* note 28, at 225 (discussing use of LLC form by private equity firms).

39. See, e.g., John Bringardner, *Sears Finds Security*, IP L. & BUS., June 1, 2007, available at <http://www.law.com/jsp/article.jsp?id=1196280099819> (discussing securitization to protect intellectual property).

40. Victor Fleischer, *Taxing Blackstone*, 61 TAX L. REV. 89, 97 (2008) (discussing the use of LLC form and related tax consequences).

41. See, e.g., RIBSTEIN, *supra* note 28, at 6–9, 247–49 (observing flexibility in contractual nature of LLC).

42. See, e.g., Miller, *supra* note 7, at 585–86 (discussing empirical surveys suggesting lack of meaningful negotiation in LLC operating agreements).

43. See, e.g., RIBSTEIN, *supra* note 28, at 177–79 (discussing choice of fiduciary duties in LLC form).

related ventures. They may want flexibility to allocate time and resources among the LLC and other ventures. They may simply find it more efficient from an operations or cost perspective to rely on contract obligations, rather than fiduciary law, to achieve their objectives. Of course, parties also may seek lax fiduciary duties for illegitimate reasons, such as creating opportunities for self-dealing, and this potential must be part of any policy discussion.⁴⁴

Fiduciary duties are a basic component of general business law. A fiduciary relationship generally arises where “one party to a fiduciary relation (the *entrustor*) is dependent on the other (the *fiduciary*).”⁴⁵ Traditionally, fiduciaries were required to act solely in the best interests of their beneficiaries, even foregoing compensation for their services in some early scenarios.⁴⁶ That strict interpretation of a fiduciary relationship has eased over time, and a more relaxed approach now may apply so long as the fiduciary is required to act substantially for the benefit of others.⁴⁷ Fiduciaries commonly owe a variety of duties to beneficiaries, including duties of loyalty, care, and good faith.⁴⁸

Although fiduciary duty law largely developed outside of the business context,⁴⁹ most states have incorporated fiduciary concepts into their corporate, partnership, and other unincorporated laws, including LLC statutes.⁵⁰ The contractual nature of LLCs does not necessarily preclude a fiduciary relationship among parties to the Operating Agreement—the concept of entrustment underlying fiduciary law may apply to the negotiated relationship.⁵¹ Whether a fiduciary relationship is an essential element of LLCs, however, is subject to debate and is discussed further in Part I.B.2.

Most state LLC statutes address fiduciary duties among members and managers in some respect, typically by establishing the scope of fiduciary duties or by empowering parties to modify or eliminate duties. For example, the Illinois and South Dakota LLC statutes, which are two of the handful of state statutes patterned

44. See, e.g., Miller, *supra* note 7, at 595 (“The right to privately order LLC relationships is not a license to exploit, steal, or lie.”).

45. Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 800 (1983) (footnote omitted); see also ERNEST VINTER, A TREATISE ON THE HISTORY AND LAW OF FIDUCIARY RELATIONSHIP AND RESULTING TRUSTS: TOGETHER WITH A SELECTION OF SELECTED CASES 1 (3d ed. 1955) (explaining nature of fiduciary relationship).

46. See VINTER, *supra* note 45, at 34.

47. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1263–64 (2008).

48. See FRANKEL, *supra* note 1, at 101–07 (discussing general duties of fiduciaries).

49. Blair & Stout, *supra* note 26 (discussing trust and the development of fiduciary law in the corporate context).

50. FRANKEL, *supra* note 1, at 50–52, 96–99; see also D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1441–47, 1450–87 (2002) (suggesting that fiduciary duties are most apt, including in business context, where the duties protect a critical resource).

51. See *infra* Part I.B.2 (discussing contractarian and anti-contractarian perspectives).

after the 1995 Uniform Limited Liability Company Act (revised in 1996), offer guidance on both the duty of care and the duty of loyalty.⁵² These statutes typically provide that “[t]he only fiduciary duties a member [or manager] owes to a member-managed company and its other members are the duty of loyalty and the duty of care imposed by subsections (b) and (c).”⁵³ The duty of loyalty generally is defined as a duty to refrain from misappropriating the LLC’s property or opportunities, competing with the LLC, or otherwise engaging in self-dealing.⁵⁴ The duty of care generally is “limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.”⁵⁵ Members and managers also are expected to exercise their duties consistent with the obligations of good faith and fair dealing under these statutes.⁵⁶ With respect to altering these fiduciary duties, the Illinois and South Dakota statutes are slightly different,⁵⁷ but they generally follow the 1996 Uniform Act by prohibiting the complete elimination of fiduciary duties.⁵⁸ Notably, the 2006 Revised Uniform Limited Liability Act adopts a strikingly different approach to fiduciary duties by “uncabining” the duties owed by managing members and managers in LLCs.⁵⁹

Other states, such as Delaware and Massachusetts, and the American Bar Association’s Prototype LLC Act, do not specifically identify fiduciary duties by

52. See 805 ILL. COMP. STAT. 180/15-3 (2012); S.D. CODIFIED LAWS § 47-34A-409 (2012).

53. UNIF. LTD. LIAB. CO. ACT § 409(a), (h) (revised 1996), 6B U.L.A. 597 (2008).

54. *Id.* § 409(b), (h).

55. *Id.* § 409(c), (h).

56. *Id.* § 409(d), (h).

57. See 805 ILL. COMP. STAT. 180/15-3; S.D. CODIFIED LAWS § 47-34A-409.

58. Specifically, section 103 of the Uniform Limited Liability Company Act (“ULLCA”) provides in pertinent part:

The operating agreement may not:

....
(2) eliminate the duty of loyalty under Section 409(b) or 603(b)(3), but the agreement may:

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

(ii) 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;

(3) unreasonably reduce the duty of care under Section 409(c) or 603(b)(3);

(4) eliminate the obligation of good faith and fair dealing under Section 409(d), but the operating agreement may determine the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.

UNIF. LTD. LIAB. CO. ACT § 103(b), 6B U.L.A. 563 (2008).

59. REVISED UNIF. LTD. LIAB. CO. ACT §§ 110, 409 (revised 2006), 6B U.L.A. 443 (2008); see also Ribstein, *supra* note 6, at 62–63 (explaining the “uncabining” of duties under the revised statute).

or among members and managers.⁶⁰ Rather, these statutes address only the parties' ability to affect the scope of any fiduciary duties by contract under the Operating Agreement. For example, Delaware's LLC statute provides:

A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.⁶¹

Still, other state statutes do not specifically discuss fiduciary duties in any respect.⁶²

Courts and commentators have struggled with the fiduciary nature of the LLC form.⁶³ The long tradition of characterizing partners, directors, and certain managers as fiduciaries of the businesses with which they are associated creates a presumption—or at least a default rule—that LLC members and managers should be treated similarly. The following sections explore the potential tension between allowing parties to do business by contract in the LLC form and imposing fiduciary duties in that contractual relationship by decisional or statutory law.

B. Respecting the Contractual Nature of the LLC Form

LLC statutes typically include a few mandatory rules but largely provide default rules to govern the parties' relationship in the absence of an expressed agreement of the parties. The structure and substance of these statutes, including their approach to fiduciary duties, often is informed by the state's partnership and limited partnership statutes.⁶⁴ Moreover, in considering the fiduciary nature of LLCs, some courts look to traditional corporate governance law to fill gaps and ambiguity in the parties' agreement.⁶⁵ Courts and commentators debate whether

60. DEL. CODE ANN. tit. 6, §§ 18-1101 to -1109 (2005 & Supp. 2010) (Delaware Limited Liability Company Act); MASS. GEN. LAWS ch. 156C, §§ 1–72 (2005 & Supp. 2011) (Massachusetts Limited Liability Company Act); REVISED PROTOTYPE LTD. LIAB. CO. ACT (2011).

61. DEL. CODE ANN. tit. 6, § 18-1101(e).

62. See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 4A-101 (2012).

63. See *infra* Parts I.B.1–2.

64. See generally RIBSTEIN, *supra* note 28, at 131–32, 177–78 (discussing development of LLC statutes and fiduciary duty provisions).

65. Compare Feeley v. NHAOCG, LLC, C.A. No. 7304-VCL, 2012 WL 966944, at *6–8 (Del. Ch. Mar. 20, 2012) (choosing to fill gaps with corporate law), with JPMorgan Chase Bank, N.A. v. KB Home, 632 F. Supp. 2d 1013, 1024–27 (D. Nev. 2009) (refusing to fill default duties the Nevada legislature excluded), and *In re South Canaan Cellular Invs.*, LLC, 427 B.R. 85, 102–03 (E.D. Pa. 2010) (reaching same result and not imposing default duties). See also Michael K. Molitor, *Eat Your Vegetables (or at Least*

such gap-filling techniques are appropriate in the LLC context or whether the LLC form is different than its predecessor business entities. Particularly, the debate focuses on whether the LLC is truly intended to be purely contractual, rather than fiduciary, in nature. This Section considers the debate and identifies the related questions explored through the OA Study in Part II.

1. Gap-Filling Approaches Used by Courts

Courts have struggled with the treatment of LLCs since their inception. Commenting on this issue in the Delaware courts, Chief Justice Myron T. Steele of the Delaware Supreme Court posited that “courts should look to the parties’ agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance” when dealing with unincorporated business entities.⁶⁶ Although an easy principle to articulate, many courts vacillate between enforcing the parties’ Operating Agreements as written in accordance with general contract law and supplementing the parties’ agreements with traditional fiduciary law.⁶⁷

For the most part, courts enforce tailored limitations of traditional fiduciary duties among the members or among the LLC and the members in the Operating Agreement.⁶⁸ However, if conduct falls outside of the fiduciary limitations specifically contemplated by the Operating Agreement or if the contractual language is too broad or ambiguous, courts often default to traditional fiduciary law.⁶⁹ For example, a Kentucky court imposed a duty of loyalty where

Understand Why You Should): Can Better Warning and Education of Prospective Minority Owners Reduce Oppression in Closely Held Businesses?, 14 FORDHAM J. CORP. & FIN. L. 491, 494 (2009) (finding that LLC law is evolving to include traditional corporate remedies including dissolution and breach of fiduciary duty claims).

66. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 1, 25 (2007) (observing that Delaware cases “demonstrate a reluctance to come to grips with the reality that the contractual relationship between parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes—not the status relationship of the parties”).

67. See, e.g., Zimmerman v. Crothall, C.A. No. 6001-VCP, 2012 WL 707238, at *6–7 (Del. Ch. Mar. 5, 2012) (using traditional corporate governance principles rather than contract interpretation principles to analyze the meaning of “recklessness” in an operating agreement’s exculpation provision).

68. See CNL-AB LLC v. E. Prop. Fund I SPE (MS Ref) LLC, C.A. No. 6137-VCP, 2011 WL 353529, at *9 (Del. Ch. Jan. 28, 2011) (enforcing contractual limitation on fiduciary duties); Kelly v. Blum, No. 4516-VCP, 2010 WL 629850, at *10–17 (Del. Ch. Feb. 24, 2010) (enforcing the limitation that eliminated liability for all conduct except willful misconduct, but denying the motion to dismiss to determine whether the conduct fell within the express limitations).

69. See, e.g., Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 850–51 (Del. Ch. 2012) (holding that managers of an LLC are fiduciaries for the LLC and its members and also explaining that absent contractual modification, LLC managers owe traditional fiduciary duties under the law of equity). In *Gatz*, the Delaware Chancery Court explained, “Thus, because the LLC Act provides for principles of equity to apply, because

the Operating Agreement and LLC statute were silent and the managing member usurped corporate opportunities.⁷⁰

No one factor appears to trigger court-imposed fiduciary duties in the LLC context. The circumstances vary and produce fact-specific decisions. For example, in *General Growth Properties*, the United States Bankruptcy Court for the Southern District of New York interpreted certain LLC operating agreements in a manner that, according to the parties, failed to honor the contracting parties' intent to structure the LLCs as bankruptcy-remote entities.⁷¹ The relevant provision provided: "To the extent permitted by law . . . the Independent Managers shall consider only the interests of the Company, *including its respective creditors*, in acting . . ."⁷² The court read "to the extent permitted by law" as requiring the LLC managers to comply with Delaware corporation law and consider the interests of owners in exercising fiduciary duties.⁷³ Consequently, despite the bankruptcy-remote structure and the language arguably allowing managers to consider only the interests of the company and its creditors, the court directed the managers to consider the interests of the LLC's parent corporations.⁷⁴

LLC managers are clearly fiduciaries, and because fiduciaries owe the fiduciary duties of loyalty and care, the LLC Act starts with the default that managers of LLCs owe enforceable fiduciary duties." *Id.* at 851. Courts also appear willing to imply a duty of good faith into operating agreements, regardless of any contractual waivers. *Id.* at 851. Nevertheless, it is unclear whether good faith in this context is imposed under contract or fiduciary law. For an explanation of the different standards, see Smith, *supra* note 50, at 1488–89.

70. *Patmon v. Hobbs*, 280 S.W.3d 589, 593–96 (Ky. Ct. App. 2009).

71. *In re Gen. Growth Props., Inc.*, 409 B.R. 43, 63 (Bankr. S.D.N.Y. 2009). A bankruptcy-remote entity is "[a] business entity formed in a manner designed to minimize the risk of becoming a debtor in a bankruptcy case." BLACK'S LAW DICTIONARY (9th ed. 2009). General Growth Properties filed for chapter 11 bankruptcy in April 2009, representing the largest real estate bankruptcy case in U.S. history with approximately \$27 billion in debt. GENERAL GROWTH PROPERTIES, INC. (FORM 10-K), at F-7 (February 27, 2009), available at <http://www.sec.gov/Archives/edgar/data/895648/000095015209001871/c48762e10vk.htm#304>; Daniel Taub & Brian Louis, *General Growth Files Biggest U.S. Property Bankruptcy*, BLOOMBERG (Apr. 16, 2009, 2:18 PM), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=anaZwxRpYcTw> (last visited Sept. 28, 2012). Accordingly, the treatment of the LLC operating agreements in the *General Growth Properties* chapter 11 case significantly impacted the rights of the parties relying on those contracts. See generally *In re Gen. Growth Props., Inc.*, 409 B.R. 43.

72. *In re Gen. Growth Props., Inc.*, 409 B.R. at 63. Another example of a court interpretation that likely was not anticipated by the parties under the Operating Agreement is *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839 (Del. Ch. 2012). In *Gatz*, the Delaware Chancery Court construed two contractual provisions—an affiliate agreement clause and an exculpatory clause—narrowly and imposed monetary damages on the manager for breaches of common law fiduciary duties owed to minority investors. *Id.* at 857–59.

73. *In re Gen. Growth Props., Inc.*, 409 B.R. at 64.

74. Courts generally decline to recognize creditors as beneficiaries of an operating agreement absent express language in the agreement. See, e.g., *CML V, LLC v. Bax*, 28 A.3d 1037, 1041–43 (Del. 2011) (denying derivative standing to creditors of an

Another court implied common law fiduciary duties under language that said:

[W]henever a potential conflict of interest exists or arises between any Affiliate of the Company, on the one hand, and the Company or any Group Member, on the other, any resolution or course of action by the Board of Directors in respect of such conflict of interest shall be permitted and deemed approved by all Members, and shall not constitute a breach of this Agreement . . . or of any duty existing at law, in equity or otherwise, including any fiduciary duty . . .⁷⁵

The court noted that the relevant party was both an affiliate of the company and the company's controlling owner.⁷⁶ Therefore, if the LLC agreement did not explicitly address a controlling owner, that party as a controlling shareholder owed the "traditional fiduciary duties that controlling shareholders owe minority shareholders."⁷⁷

The tendency of courts to construe fiduciary limitations narrowly and to be suspicious of provisions purporting to eliminate all fiduciary duties is understandable given the long tradition of treating business partners and managers as fiduciaries.⁷⁸ Nevertheless, the courts' fluctuation between contract and fiduciary law in the LLC context creates uncertainty and additional costs for parties invoking the LLC form.⁷⁹ It also raises important policy considerations regarding the appropriate scope and content of LLC statutes. Do we want to allow parties to create business relationships in a purely contractual, rather than fiduciary, form? If yes, or even if maybe, do we want that contractual form to be available to all parties and businesses? The following Subsection summarizes the general thoughts of commentators on these issues. The remainder of the Article then considers them in light of the OA Study and trust theory.

2. The Ongoing Fiduciary Debate Among Commentators

Many commentators have discussed the fiduciary nature of business relationships and the policy concerns underlying waivers of fiduciary duties in

insolvent LLC). The impact of the "freedom of contract principle" on creditors of an LLC raises interesting issues that are beyond the scope of this Article.

75. *In re Atlas Energy Res., LLC*, C.A. No. 4589–VCN, 2010 WL 4273122, at *7 (Del. Ch. Oct. 28, 2010).

76. *Id.* In fact, the court distinguished this case from another LLC Agreement that read "*whenever a potential conflict of interest exists or arises between the General Partner or any of its Affiliates, on the one hand.*" *Id.* at *8 (quoting *Brickell Partners v. Wise*, 794 A.2d 1, 2 (Del. Ch. 2001)).

77. *Id.* at *9 (quoting *Kelly v. Blum*, Civil Action No. 4516–VCP, 2010 WL 629850, at *12 (Del. Ch. Feb. 24, 2010)).

78. This approach also is consistent with the general drafting principle that limitations on fiduciary duties are strictly construed. See, e.g., *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 171–72 (Del. 2002); RESTATEMENT (THIRD) OF AGENCY § 8.06 (2006).

79. See Seita, *supra* note 20.

unincorporated business forms, such as the LLC.⁸⁰ This Article does not seek to rehash the fiduciary debate. Rather, it offers new and meaningful data and perspective on the relevant issues and proposes a workable solution for policymakers.⁸¹ Nevertheless, this Subsection summarizes the fiduciary debate and prior empirical surveys concerning LLC governance to provide necessary background and context for the remainder of the Article.

Whether characterized as contractual or common law, fiduciary duties generally apply to partners and managers in most business relationships.⁸² The scope of duties is not, however, identical or consistent among business entities. Partners generally can define the scope of their duties to the partnership and each other through their partnership agreement.⁸³ This tailored approach to duties finds support in common law agency principles.⁸⁴ Consequently, partners may contract for something less than the “utmost duty of loyalty” traditionally expected of fiduciaries, particularly in the common law trust context.⁸⁵

Directors and officers of corporations tend to fall between the strict fiduciary standards applied to trustees in the trust context and the more malleable standards applicable to partners and even the common law agency relationship.⁸⁶ A key difference between the corporate and partnership standards is the inability of most parties to negotiate in any meaningful way regarding the scope of fiduciary duties in the corporate setting. Accordingly, although the close corporation may warrant separate analysis, fiduciary duties in the corporate context generally are not subject to waiver *ex ante* by the parties.⁸⁷

80. See Sandra K. Miller, *Legal Realism, the LLC, and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing*, 45 WAKE FOREST L. REV. 729, 732–33 (2010) (summarizing four approaches to fiduciary duties in the LLC context: mandatory duties of care and loyalty, duties of care and loyalty subject to modification, duties of care and loyalty subject to elimination, and no fiduciary duties).

81. See *infra* Part II.

82. See Blair & Stout, *supra* note 26, at 1781–82 (summarizing contractarian and anti-contractarian views about fiduciary duties). See generally FRANKEL, *supra* note 1, at 229–42 (describing debate and endorsing fiduciary law concept); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (endorsing contract approach); Larry E. Ribstein, *Fencing Fiduciary Duties*, 91 B.U. L. REV. 899, 901–03 (2011) (describing the debate and endorsing the contract approach).

83. UNIF. P’SHIP ACT § 103 (amended 1997), 6 Pt. 1 U.L.A. 73 (2001) (allowing certain modifications to fiduciary duties).

84. See Ribstein, *supra* note 82, at 902–04.

85. See *id.*

86. See, e.g., *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 366–70 (Del. 2006) (explaining directors’ fiduciary duties); FRANKEL, *supra* note 1, at 50–52 (same).

87. See, e.g., *In re CLK Energy Partners, LLC*, Bankruptcy No. 09-50616, Adversary No. 09-5042, 2010 WL 1930065, at *8 (Bankr. W.D. La. May 12, 2010) (“[T]he application of fiduciary duties in the case of a Delaware LLC differs from the application of those duties in the corporate context. Fiduciary obligations in the corporate context are based on the ‘status’ of the parties, while the duties owed by an individual who manages or controls an LLC is governed by contract.”). Notably, in unincorporated business forms, the

As described above, many LLC statutes allow parties to modify or even eliminate fiduciary duties in the LLC form.⁸⁸ Supporters of this approach emphasize the contractual nature of the relationship and the ability of parties to bargain over the scope of, among other things, the parties' fiduciary duties.⁸⁹ Critics highlight limitations on bargaining power and the inability of some members to protect or extract themselves from an abusive situation.⁹⁰ As with most good debates, each side raises valid points, making it difficult for policymakers to determine the optimal default rule.

Surprisingly few commentators have evaluated the issues at the core of the fiduciary debate empirically. The dearth of empirical studies likely is due to the challenges in obtaining relevant data and designing meaningful studies, as discussed in Part II. Accordingly, the existing empirical studies focus primarily on survey data collected from lawyers forming LLCs and the number of LLCs organized in various states.⁹¹

duty of loyalty typically garners the most attention, as parties frequently share ownership and management functions and have interests in other, similar ventures. *See supra* Part I.B.1; *infra* Part II.B.3.

88. *See supra* Part I.A.2.

89. *See, e.g.*, Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 124–30 (2006) (arguing that the Delaware courts' understanding of contractual good faith is appropriate in the context of LLCs); Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 222–25 (2009) (arguing in favor of complete freedom of contract); Ribstein, *supra* note 16 (same).

90. *See, e.g.*, Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company*, 38 HARV. J. ON LEGIS. 413, 435–37 (2001) [hereinafter Miller, *Remedies*] (arguing for preservation of default rules allowing investors to exit in LLC context); Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243, 244–46 (2009) [hereinafter Miller, *Fiduciary Duties*] (recommending mandatory fiduciary duties); Douglas K. Moll, *supra* note 17, at 958–59 (raising minority oppression concerns similar to those in close corporations); *see also* Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701, 702–03 (2011) (arguing that Delaware's statute allowing parties to waive fiduciary duties is unconstitutional).

91. For an example of an empirical study of LLC filings, see Chrisman, *supra* note 31, at 462 (observing a strong dominance of the LLC form in all areas other than "publicly traded companies, companies that plan to become publicly traded companies, and non-profit entities"). *See also* Ribstein & Kobayashi, *supra* note 37, at 121–28 (empirical study of entity choice decisions). In addition, an empirical study of publicly traded LLCs conducted while the OA Study was ongoing presents interesting and, in some respects, very similar findings despite the different nature of the LLCs included in the database and analyzed in that study. *See* Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 558 (2012) ("[N]otwithstanding the ongoing academic debate, as a practical matter, fiduciary traditionalists have lost the battle to protect fiduciary duties from contract—at least in the publicly traded sphere.").

Professor Sandra Miller conducted two empirical surveys on LLC governance issues.⁹² Her surveys targeted lawyers in various states who represented clients in business-entity-choice and -formation matters. A greater percentage of lawyers in both studies reported representing majority or controlling holders in LLCs on a fairly regular basis.⁹³ As Miller subsequently observed, “[b]oth studies challenge the notion that most LLC owners retain attorneys who thoughtfully draft LLC operating agreements tailored to the specifics of their business arrangements.”⁹⁴ Among other things, her studies suggest that many lawyers forming LLCs think of the Operating Agreement as a form document, fail to appreciate the nuances of fiduciary law, and do not necessarily understand applicable LLC law in their respective jurisdictions.⁹⁵

The OA Study and the subsequent discussion of trust theory build on the extant LLC literature to offer a multi-factor test for assessing the desirability of fiduciary waivers in the LLC form.

II. AN EMPIRICAL STUDY OF LLC GOVERNANCE PROVISIONS

LLCs are governed largely by privately negotiated contracts. Although the private contractual nature of the LLC form provides parties with flexibility in designing governance structures, it makes analyzing the use and impact of LLCs challenging. LLCs generally are not required to file their Operating Agreements with state or federal agencies, and only the parties to the Operating Agreement know the terms, unless or until litigation ensues. Accordingly, very little objective information about LLCs in practice exists.

This Article fills that void and presents an in-depth empirical study of actual Operating Agreements. The OA Study focuses on the governance provisions of Operating Agreements but also provides other basic information about the LLCs, including state of organization, membership structure, and industry to which the LLC belongs. As explained below, the OA Study is limited by, among other things, the pool of publicly available Operating Agreements. Nevertheless, the OA Study contributes new and meaningful information to the LLC debate and complements the thoughtful theoretical and survey work previously done by others in the field.⁹⁶

92. See 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*]; Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609 (2006) [hereinafter Miller, *An Empirical Glimpse*].

93. In the 2003 study, 56% of respondents reported representing majority investors while 20% reported representing minority investors. Miller, *New Direction*, *supra* note 92, at 388. In the 2006 study, 84% of respondents reported representing controlling investors while 67% reported representing minority investors. Miller et al., *An Empirical Glimpse*, *supra* note 92, at 627.

94. Miller, *supra* note 80, at 739.

95. See *id.* at 738–40 (describing general findings in two surveys).

96. See *supra* Part I.B.2.

This Part first describes the methodology and scope of the OA Study. It then presents the key data and findings. In discussing the data, this Part draws on prior literature to add context and develop meaningful inferences. This discussion informs the policy analysis that follows in Part III.

A. Study Methodology

The Authors devoted substantial time to designing the parameters of the database and the scope of the OA Study. Among other issues, the Authors had to identify a reliable source to access Operating Agreements and then tailor the study's design to the available information. Given the limited availability of Operating Agreements and the Authors' desire to perform a thorough study with broad application, the Authors conducted an extensive review of all 150 Operating Agreements ultimately included in the database created for this study.

1. Creating the Database

Operating Agreements typically are not filed with the Secretary of State or other appropriate agencies in the state of the LLC's organization.⁹⁷ As a result, no single, readily available source of Operating Agreements exists. Rather, Operating Agreements generally are available only through indirect means, such as by making specific requests to the LLC, searching public dockets to identify litigation in which Operating Agreements have been filed as exhibits, or identifying public companies that have filed Operating Agreements with the Securities and Exchange Commission ("SEC").

The Authors decided to use filings with the SEC to populate the database. They based this decision on a number of factors, including the ability to search and identify relevant Operating Agreements electronically through the EDGAR Pro Online service. The primary drawback to this approach is that it limited the types of Operating Agreements included in the database. Operating Agreements typically are filed with the SEC if one or more of the signatories to the agreement are public companies.⁹⁸ Accordingly, the database does not necessarily represent Operating Agreements negotiated or executed in small business LLCs or LLCs organized primarily by individuals as opposed to entities. This limitation and the utility of the OA Study in light of it are discussed in Part II.B.1.

97. While the formation of the LLC generally requires a formal, filed document with the state, it is not required that the operating agreement complementing the articles of organization be made public. *See, e.g.*, 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 4:16 (2012).

98. *See, e.g.*, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC, <http://www.sec.gov/about/whatwedo.shtml> (last modified July 30, 2012) ("[T]he SEC requires public companies to disclose meaningful financial and other information to the public. . . . [S]equities sold in the U.S. must be registered. . . . These [registration] statements and the accompanying prospectuses become public shortly after filing, and investors can access them using EDGAR.").

The Authors used a number of searches and techniques to identify references to Operating Agreements in SEC filings and then to locate copies of the actual agreements.⁹⁹ These searches yielded 446 documents that referenced the search terms in some manner. The Authors and one of their two coders combed through each of these references and eliminated duplicates and irrelevant agreements. The Authors then endeavored to locate copies of the Operating Agreements in the remaining references, creating a database containing 150 Operating Agreements.¹⁰⁰

Given the relatively small pool of Operating Agreements and the inherent limitations on the nature of the parties involved with these LLCs, the Authors opted not to limit the pool further through a random selection process. Rather, the Authors reviewed and coded all 150 Operating Agreements to maximize the data available for analysis.

2. The Study's Design and Scope

The Authors also devoted significant time to defining, testing, revising, and finalizing all variable names and labels that, together, comprise the project codebook. The Authors developed an initial codebook and tested it on three Operating Agreements. The Authors then distributed the codebook to two other coders, reviewed it with them, and revised it based on their feedback. The Authors and coders tested the codebook by coding Operating Agreements not included in the database. After this exercise, the Authors and coders met to review the test coding results. The Authors revised the codebook based on the results and follow-up conversations with the coders. Next, the Authors repeated this process three times, resulting in a final codebook consisting of 58 primary variables and an acceptable level of inter-coder reliability.¹⁰¹

The primary variables included in the codebook cover the following general categories: background information, management structure, fiduciary duties and any exculpation of members or managers, third-party governance rights, indemnification provisions, and transferability of membership interests. The variables within each category then identified specific information. For example, coders identified whether the Operating Agreements addressed fiduciary duties and, if so, how they were addressed. Coders considered whether third parties held any veto, consent, or other rights with respect to the governance or operations of

99. Specifically, the Authors searched targeted portions of EDGAR Pro Online's "Annual Report Sections" and "Current Event (8-K) Sections" libraries for the ten-year period of 2001–2011.

100. The majority of Operating Agreements were executed after 2004, likely because of the prevalence of paper filings prior to that time. The percentage of agreements by year are as follows: 1995 (0.7%), 1996 (0.7%), 1997 (2.7%), 1998 (2%), 1999 (0.7%), 2000 (2.7%), 2001 (4%), 2002 (4.7%), 2003 (2%), 2004 (4.7%), 2005 (8.7%), 2006 (19.3%), 2007 (16%), 2008 (8.7%), 2009 (7.3%), 2010 (9.3%), unknown (6.0%).

101. The primary variables were broken down further into sub-variables to remove subjective judgment from the coding process. In addition, the Authors designed and monitored a Web-based entry system to reduce coder error throughout the process. Coders also double-coded cases to insure inter-coder reliability during the actual study.

the LLC. They also analyzed the scope of any indemnification, buy-out, and right-of-first-refusal provisions. Coders thoroughly reviewed each Operating Agreement randomly assigned to them. Moreover, Operating Agreements were double-coded throughout the process to maintain an acceptable level of inter-coder reliability.

Upon completion of the coding process, the Authors reviewed and reconciled any inconsistencies in the database. This process required only minor changes throughout the database. The Authors then commenced their analysis of the data. The following discussion presents the key data and findings, as well as a contextual analysis of particular Operating Agreement provisions, to facilitate a deeper exploration of the data.

B. Key Data and Findings

Several assumptions underlie the perceived value of the LLC form: Parties will actively negotiate the terms governing their business relationship; parties will be fully informed and frequently represented by counsel in these negotiations; and parties can adequately assess, allocate, and price risk *ex ante* without the intervention of legislators or judges.¹⁰² Under these assumptions, private ordering of LLC business relationships is more conducive to cooperation and profitability than alternatives. As discussed in Part I.B.2, however, commentators have questioned whether this theory holds in practice. Indeed, Miller's research suggests that it does not.¹⁰³

The question then becomes whether the assumptions underlying the LLC form are flawed for all business relationships or only some. If the latter possibility is correct, policymakers may need to reevaluate the types of businesses eligible for the LLC or other business entity forms. It may be time to rationalize business entity law by promoting private ordering in varying degrees depending on the nature of the underlying business relationship. The Authors designed the OA Study to help inform responses to these important questions.

The data show that parties electing to form LLCs are invoking the flexibility in structuring firm governance permitted under many state statutes. Notably, however, these governance modifications are not uniform. Rather, they suggest intentional decisions—for example, modifying the duty of loyalty but not the duty of care or modifying managers' duties but preserving members' ability to modify or amend the Operating Agreement. Similarly, many of the provisions suggest negotiated language, as opposed to language simply opting out of the statutory default rules. Although it is impossible to determine the level of active negotiation or the parties' knowledge base from the Operating Agreements, the data do demonstrate certain inferences. As discussed in Part II.C, these inferences allow consideration of the value of private ordering in the LLC context and the

102. See RIBSTEIN, *supra* note 28, at 2–8; Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More than a Decade of Experimentation?*, 32 J. CORP. L. 565, 580 (2007) (describing these factors as the contractarian theory of LLCs).

103. See *supra* notes 92–95 and accompanying text.

potential cost of allowing certain parties or courts to unilaterally change the bargain *ex post*.

1. Background Data

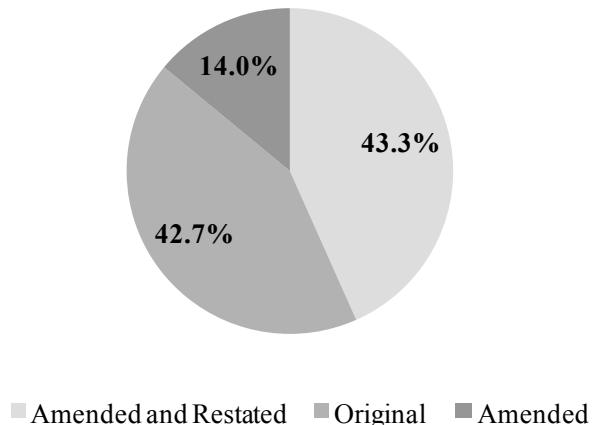
The majority of LLCs in the database are organized under the laws of the state of Delaware (56.7%), with California (12%) and Nevada (7.3%) representing the state of organization for most of the remaining LLCs (see Table 1).¹⁰⁴ In identifying the 150 agreements included in the database, the Authors eliminated duplicates. Nevertheless, the Authors retained Operating Agreements amended either in full or in part to allow a substantive review of these agreements.

Table 1: State of LLC Organization

State	Original Sample (n=150)		Analytic Sample (n=129)	
	n	%	n	%
Delaware	85	56.7	76	58.9
California	18	12.0	16	12.4
Nevada	11	7.3	11	8.5
Maryland	6	4.0	3	2.3
Arizona	3	2.0	3	2.3
Iowa	3	2.0	3	2.3
Colorado	2	1.3	2	1.6
Indiana	2	1.3	2	1.6
New York	2	1.3	2	1.6
Ohio	2	1.3	2	1.6
Texas	2	1.3	2	1.6
Florida	1	0.7	1	0.8
Illinois	1	0.7	1	0.8
Michigan	1	0.7	1	0.8
Missouri	1	0.7	1	0.8
Virginia	1	0.7	1	0.8
Wisconsin	1	0.7	1	0.8
Unknown	8	5.3	1	0.8

Accordingly, the database includes 64 (42.7%) original Operating Agreements, 65 (43.3%) amended and restated Operating Agreements, and 21 (14%) amended Operating Agreements (see Figure 1). After reviewing and coding all 150 Operating Agreements, the Authors determined that the 21 amended Operating Agreements lacked meaningful substantive data, and they excluded these 21 agreements from the data analysis presented below.

104. As explained *infra*, most of the data analysis is performed only on original Operating Agreements or amended and restated Operating Agreements (amendments only were excluded). The distribution of the states of organization for the 129 Operating Agreements is similar to that for all 150 agreements: Delaware (58.9%); California (12.4%); Nevada (8.5%).

Figure 1. Type of Operating Agreement (n=150)

For the remaining 129 Operating Agreements, the overwhelming majority (89.9%) were executed among five or fewer parties.¹⁰⁵ Although many of these agreements had procedures for admitting additional members, all but nine of the agreements indicated that they identified all current members in the LLC.¹⁰⁶ Only 16 of the LLCs included individual members and only 32 of the LLCs included some type of financial institution as a member. The majority (83.7%) of LLCs instead had some type of for-profit business entity as a member, with 69 LLCs having a corporate member, 62 having an LLC member, and 12 having a limited partnership member.¹⁰⁷

The LLCs in the database operate in a variety of industries. For example, 22.5% involve businesses in the transportation, electric, gas, oil, or utility industries; 19.4% involve real estate ventures; 17.1% involve finance or financial investment vehicles; and 11.6% involve communication, entertainment, and gambling ventures. In addition, the database includes several LLCs operating in the manufacturing, mining, retailing, and services industries (see Figure 2).¹⁰⁸

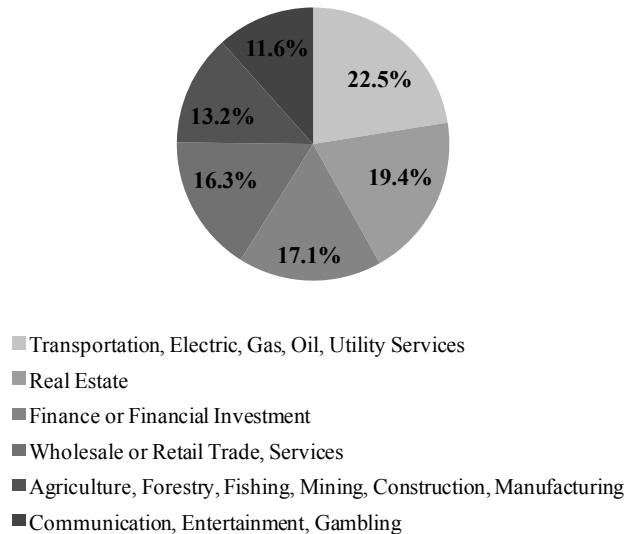
105. Most LLCs reported two members (61.2%), with 12 (9.3%) reporting one member, 12 (9.3%) reporting three members, seven (5.4%) reporting four members, six (4.7%) reporting five members, and the remaining four (3.2%) reporting six or more members. For this variable, seven agreements did not provide the relevant information.

106. Specifically, 90.7% of the Operating Agreements purported to identify all current members. For this variable, three agreements did not provide the relevant information.

107. For this variable, five agreements did not provide the relevant information. Note also that some agreements indicated having more than one type of for-profit business entity as a member.

108. Specifically, the database includes 5.4% in manufacturing, 5.4% in mining, and 16.3% in retail or services. Additional industries in the database are agriculture, forestry, and fishing which constitute 1.6%.

Figure 2. LLC Industry (n=129)



As acknowledged earlier, the LLCs included in the database do not represent all types of parties or businesses that might elect to organize as an LLC. That limitation actually might lend additional value to the OA Study, however, in that the study population should more closely mirror parties who satisfy the assumptions underlying the purported value of private ordering in the LLC context (for example that LLCs are organized by represented, sophisticated, and fully informed parties).¹⁰⁹ To the extent the OA Study highlights potential weaknesses in those underlying assumptions, it is reasonable to infer an even greater weakness in the types of small or start-up businesses not necessarily represented in the database. The resulting implications of the OA Study are discussed in Part II.C.

2. Management and Fiduciary Duty Data

In many states, parties organizing an LLC can elect to be managed by the members themselves or by third-party managers.¹¹⁰ The parties can further tailor their management structures so that members in a member-managed structure have either unequal-management rights or a centralized-management form that includes non-member managers.¹¹¹ This flexibility is grounded in the freedom of contract

109. See *supra* note 102 and accompanying text.

110. See, e.g., 1 RIBSTEIN & KEATINGE, *supra* note 97, § 8:2 (explaining statutory default rules for centralized (designated managers) or decentralized (member management) management and stating that “decentralized management is the general rule in LLCs and centralized management the exception”).

111. *Id.* § 8:3 (“[T]he parties also can agree to delegate management authority to a single member, or to an outside manager even in a member-managed firm.” (footnotes omitted)); *id.* § 8:4 (“[When there is centralized management] LLC statutes should and

principle underlying the LLC form. But it also may be expressed in a state's statute or recognized by applicable common law. Unless a specific management structure is expressly prohibited by applicable law, the parties to the Operating Agreement can consent to any variety of management structures.

Moreover, as described in Part I.A, parties also have some ability to define the scope and nature of any fiduciary duties owed among the parties. The extent of permissible modifications depends largely on applicable state law. This subsection considers both the governance structures and level of fiduciary duties selected by parties to the database Operating Agreements. It further considers any association among these seemingly related factors.

a. Management Structures

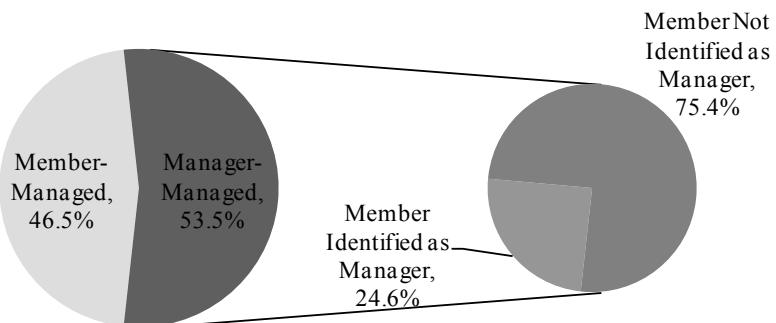
The OA Study set "member-managed" and "manager-managed" as the two primary governance structures for coding purposes. It then further dissected each LLC's governance structure by asking particular questions about the involvement of members in the management and operation of the LLC. This multi-level approach allowed coders to capture variations in the two basic management structures.

The LLCs in the database were fairly evenly divided between member-managed (46.5%) and manager-managed (53.5%) governance structures (see Figure 3). Only 31.7% of the member-managed LLCs included all members in the management authority allocated under the agreement. The remaining 68.3% vested management rights in one or a few of the LLC members. Likewise, only 24.6% of the manager-managed LLCs involved one or more members in management decisions.¹¹² The remaining 75.4% of the manager-managed LLCs were managed primarily by third parties. In 91.3% of the manager-managed LLCs, the Operating Agreement allocated all management decisions to the managers (as opposed to only decisions on day-to-day or operational matters or some other defined or limited authority).¹¹³

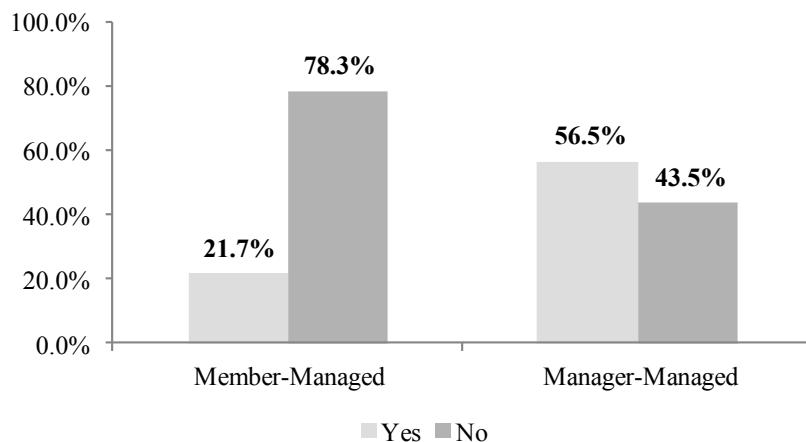
often do require member approval of at least some manager actions in the absence of contrary agreement.").

112. Moreover, 14 of the 17 LLCs involving a member in a manager-managed governance structure identified a for-profit business entity as the active member. The other three LLCs involved either an individual or a financial institution as the active member.

113. For this variable, one agreement did not provide the relevant information.

Figure 3. Management Type (n=129)

Coders also identified whether the Operating Agreement appointed a formal board or committee of managers to assist in the management of the LLC. Parties invoked this type of centralized governing body in 40.3% of the Operating Agreements. In most instances (75%), the board or committee was similar in identity or duties to the managers of the LLC. The remaining LLCs in this category (23.1%) frequently used the board or committee to review decisions of the managers and members.¹¹⁴ Manager-managed agreements were significantly more likely than member-managed agreements to appoint a governing body (56.5% versus 21.7%, respectively; p<.001) (see Figure 4).

Figure 4. Whether Governing Body Appointed per Operating Agreement by Management Type

^{114.} For this variable, one agreement appointing a governing body did not provide the relevant information.

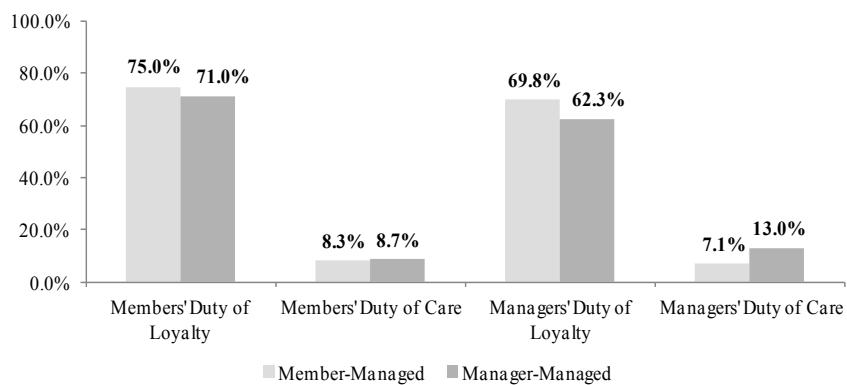
b. General Fiduciary Duties

A large majority of the database Operating Agreements (72.9%) modified or purported to eliminate any fiduciary duty of loyalty owed by members. In addition, 68.2% of the agreements expressly authorized members to compete in some manner with the LLC or other members. Nevertheless, only 8.5% of the agreements purported to modify or eliminate any fiduciary duty of care owing among members.

The data are very similar with respect to the fiduciary duties of managers. Operating Agreements in the database modified or purported to eliminate managers' duty of loyalty in 56.6% of the agreements and managers' duty of care in only 9.3% of the agreements. These data include fiduciary duty provisions for both member-managed and manager-managed LLCs. If an Operating Agreement governing a member-managed LLC included a fiduciary duty provision applicable only to members involved in the management of the LLC, those provisions were coded as manager-specific.

To isolate any effects from the management structure, the Authors performed a variety of regression analyses to identify variables that influenced whether the LLC was member-managed or manager-managed and the scope of any fiduciary duty provisions in the Operating Agreement. The LLC's management structure did not significantly affect whether the LLC purported to modify or eliminate fiduciary duties for members or managers (see Figure 5).¹¹⁵

Figure 5. Fiduciary Modifications by Management Type



115. Member-managed LLCs modified members' duty of loyalty in 75% of the agreements, and manager-managed LLCs modified members' duty of loyalty in 71% of the agreements ($p=.218$). Member-managed LLCs modified members' duty of care in 8.3% of the agreements, while manager-managed LLCs modified members' duty of care in 8.7% of the agreements ($p=.598$). Member-managed LLCs modified managers' duty of loyalty in 69.8% of the agreements, and manager-managed LLCs modified managers' duty of loyalty in 62.3% of the agreements ($p=.305$). Member-managed LLCs modified managers' duty of care in 7.1% of the agreements, and manager-managed LLCs modified managers' duty of care in 13% of the agreements ($p=.578$).

c. Exculpation and Indemnification of Members and Managers

Most state statutes recognize the concept of “limited liability” for LLC members and managers.¹¹⁶ Limited liability for members or managers typically speaks only to their potential personal liability for the debts or other obligations of the LLC to third parties. These statutory limited liability provisions typically state:

[N]o member of a limited liability company shall be personally liable . . . for any debt, obligation, or liability of the limited liability company, whether that liability or obligation arises in contract, tort, or otherwise, solely by reason of being a member of the limited liability company.¹¹⁷

Notably, limited liability in many instances does not protect members and managers from personal liability to the LLC, members, or other beneficiaries of the Operating Agreement. Members and managers might still be exposed to liability for breaches of any fiduciary duties, breaches of contract, or other causes of action that might exist among the parties and relate to the LLC.

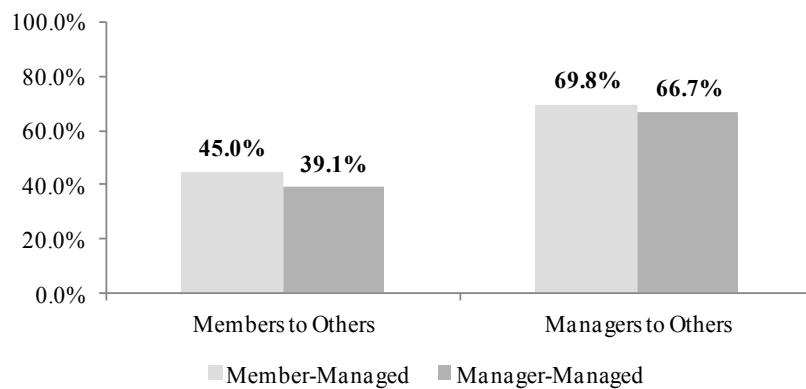
Accordingly, coders also analyzed provisions in the database Operating Agreements that purported to eliminate any personal liability of members or managers to the LLC, members, or other beneficiaries of the Operating Agreement. These provisions typically resemble an exculpatory provision included for directors in a corporation’s charter.¹¹⁸ Both member-managed and manager-managed LLCs were more likely than not to eliminate personal liability of managers (69.8% and 66.7%, respectively) and less likely to eliminate personal liability of members (45% and 39.1%, respectively). Again, the type of management structure did not significantly affect whether the Operating Agreement included this type of exculpation provision for either members or managers ($p=.733$ and $p=.500$, respectively) (see Figure 6).

116. See, e.g., 1 RIBSTEIN & KEATINGE, *supra* note 97, § 12:2.

117. CAL. CORP. CODE § 17101(a) (2012).

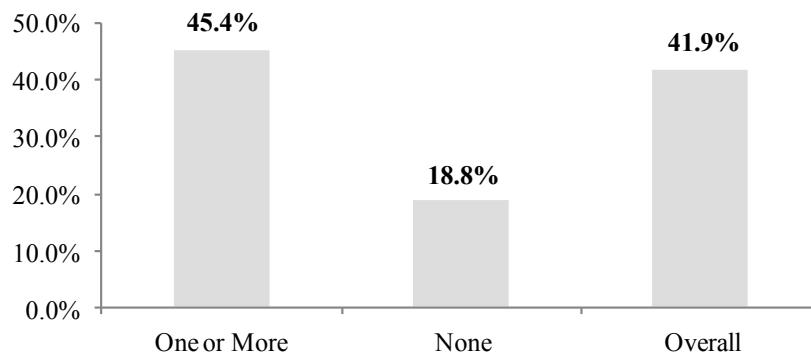
118. For an example of a provision from an Operating Agreement, see LIMITED LIABILITY COMPANY OPERATING AGREEMENT OF MT. HAMILTON LLC § 5.5, at 26 (Dec. 22, 2010) [hereinafter MT. HAMILTON], available at <http://www.sec.gov/Archives/edgar/data/917225/000091722510000022/exh992.htm> (“[T]he Manager shall not be liable or responsible to the Company or any Member and shall not be in breach or default of its duties under this Agreement for any act or omission (a) that is not caused by or attributable to the Manager’s willful misconduct or gross negligence . . .”). For an example of a corporate exculpation provision, see DEL. CODE ANN. tit. 8, § 102(b)(7) (2012).

Figure 6. Limitation or Elimination of Personal Liability by Management Type



Even though neither the number nor type of members involved with the LLC significantly impacted the governance structure or scope of any fiduciary duty provisions, the type of member did influence exculpation clauses. Specifically, LLCs with at least one for-profit member were significantly more likely to eliminate the personal liability of members to others (including the LLC, other members, or other beneficiaries) than were LLCs without a for-profit member (45.4% vs. 18.8%, respectively; $p=.044$) (see Figure 7). This finding is striking considering that, in the overall analysis, a majority of the Operating Agreements did not include this type of protection for members (see Figure 7).¹¹⁹

Figure 7. Percent of Operating Agreements Limiting or Eliminating Personal Liability of Members to Others by Number of For-Profit Members and Overall



119. In the total population of 129 Operating Agreements, 41.9% purported to eliminate the personal liability of members, while 58.1% did not.

A similar finding emerged with respect to indemnification rights. A majority of the database Operating Agreements (94.6%) included some form of mandatory indemnification.¹²⁰ The differences in indemnification related primarily to who was covered by the provision. For example, 24% of the agreements covered only members or members and their affiliates; 28.7% of the agreements covered only managers or managers and their affiliates; and 34.9% of the agreements covered some combination of members, managers, and their respective affiliates.¹²¹

Further analysis of the indemnification data produced two interesting findings. First, Operating Agreements eliminating members' personal liability through some type of exculpatory provision were significantly more likely than agreements not eliminating that personal liability to also indemnify members or members and their affiliates from liability relating to the LLC (40.7% versus 12%, respectively; $p<.001$) (see Figure 8).¹²² Second, Operating Agreements modifying or eliminating managers' duty of loyalty were significantly more likely than agreements not eliminating that duty to also indemnify managers or managers and their affiliates from liability relating to the LLC (39.7% versus 12.8%, respectively; $p=.003$) (see Figure 9).¹²³

120. The majority (78.3%) of the Operating Agreements included indemnification clauses basically covering any potential or actual claims, litigation, or liability. For this variable, six agreements did not provide the relevant information. Also, although the majority of the Operating Agreements contained very broad indemnification language (for example, indemnification for any potential, threatened or actual claims, litigation, or other liability relating to the LLC), 80.6% of the agreements also contained some type of exclusions. These exclusions typically provided that the LLC would not provide indemnification for conduct that was in bad faith, illegal, constituted gross negligence, reckless conduct or fraud, a breach of fiduciary duty, a breach of the Operating Agreement, or some combination of these factors.

121. For this variable, six agreements did not provide the relevant information and 7.8% of the agreements contained indemnification provisions that covered other parties.

122. In addition, the Operating Agreement is more likely to require the unanimous consent of members to amend the agreement when the Operating Agreement modifies or eliminates members' duty of loyalty than when it does not ($p=.049$). Specifically, the unanimous consent of members is required in 48.9% of the agreements modifying or eliminating members' duty of loyalty and 29.4% of the agreements not including such a modification or elimination.

123. In addition, the Operating Agreement is more likely to require the consent of certain managers to amend the agreement when the Operating Agreement modifies or eliminates managers' duty of loyalty ($p=.002$) or personal liability ($p=.027$) than when it does not.

Figure 8. Target of Indemnification by Limitation or Elimination of Member Duty of Loyalty

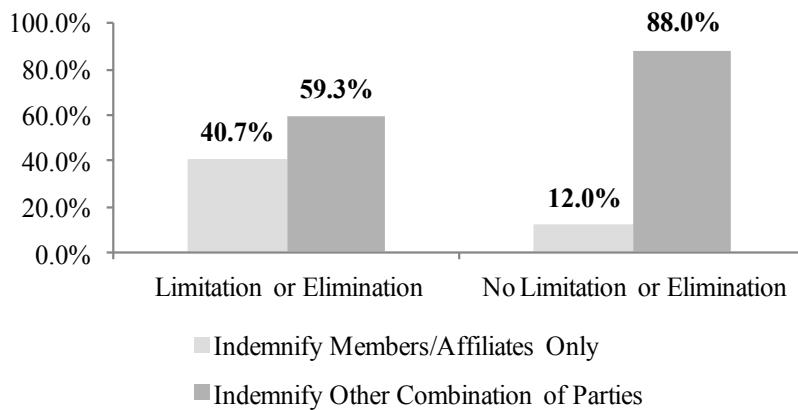
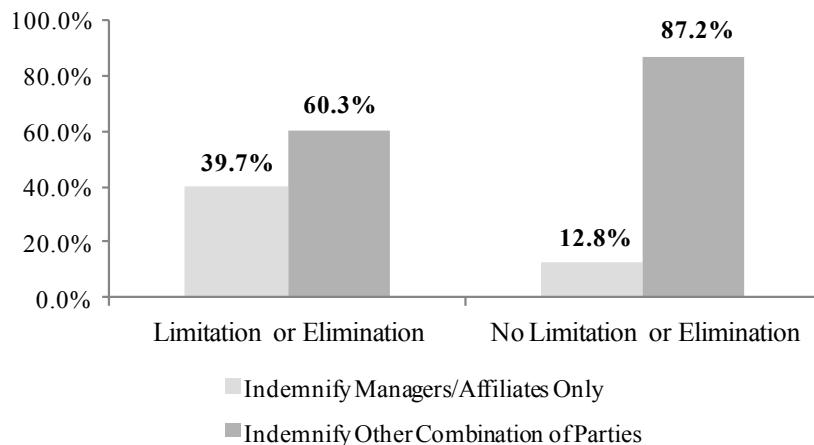


Figure 9. Target of Indemnification by Limitation or Elimination of Manager Duty of Loyalty



3. Self-Dealing and Third-Party Governance Rights

As noted above, a majority of the database Operating Agreements modified or purported to eliminate the duty of loyalty of members and managers. In addition, a majority of the agreements expressly permitted members to compete with the LLC or other members. These types of modifications might be expected given the language of some LLC statutes that permit modifications of the duty of loyalty that are not manifestly unreasonable.¹²⁴ Several courts also have recognized

124. See *supra* Part I.A.2.

the ability of members to eliminate anti-competition provisions in modifying the duty of loyalty in appropriate cases.¹²⁵

Some of the database Operating Agreements, however, further extended modifications of the duty of loyalty by expressly *permitting* self-dealing conduct. These provisions typically recognized the ability of members or managers to consider their own interests or the interests of certain identified parties in managing the affairs of the LLC. For example, the Operating Agreement might provide: “[E]ach Member will be entitled to consider only such factors and interests as it desires, including its own interests, and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Company or any other Person.”¹²⁶

The language and scope of these self-dealing provisions varied among the Operating Agreements. Nevertheless, 40.3% of the Operating Agreements included some variation that gave the members or managers the discretion to consider their own interests or other specified interests in lieu of the best interests of the LLC or other members. Moreover, 13.2% of the Operating Agreements not only gave members or managers such discretion, but also directed that their votes be cast in a specified manner.

In addition, the more questionable category of self-dealing provisions that directed members or managers to consider their own interests or the interests of others as paramount were associated with Operating Agreements that gave identified third-parties some form of limited governance rights. For example, the Operating Agreement might give a lender or other third party veto or consent rights with respect to certain aspects of the LLC’s affairs.¹²⁷ Operating Agreements granting these third-party governance rights were significantly more likely than agreements not granting these rights to identify specific factors to be considered by members or managers in managing the LLC (33.3% versus 11.2%, respectively; p=.032) (see Figure 10). These LLCs also were significantly more likely than those

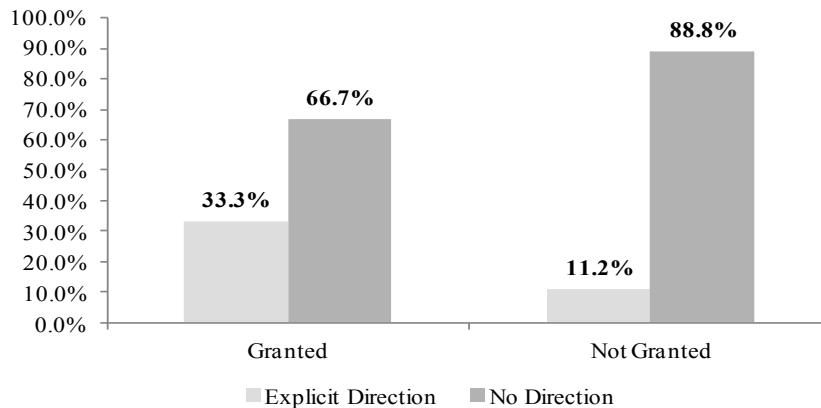
125. See, e.g., *Vila v. BVWebTies LLC*, C.A. No. 4308-VCS, 2010 WL 3866098, at *12 (Del. Ch. Oct. 1, 2010) (explaining that a breach of fiduciary duty counterclaim was lacking merit because “the LLC Agreement explicitly allowed [member] to engage in other business activities” and was “an improper attempt to supplant the primacy of the LLC Agreement in the alternative entity context”); *Pointer v. Castellani*, 918 N.E.2d 805, 819 (Mass. 2009) (affirming that president-member was not liable for breach of fiduciary duty of loyalty by usurping a corporate opportunity because “operating agreement directly enumerat[ed] a limited business purpose and explicitly allow[ed] any member the right ‘to conduct any other business or activity whatsoever’” (citations omitted)).

126. OPERATING AGREEMENT OF ATLAS PIPELINE MID-CONTINENT WESTOK, LLC at 40 § 6.4 (July 27, 2007), available at <http://www.sec.gov/Archives/edgar/data/1092914/000119312507165488/dex105.htm>.

127. The database included only a small number of these agreements, with 9.3% of the Operating Agreements granting some type of third-party governance rights. Accordingly, the statistical significance of these associations may be affected by the small sample size. If a third-party received governance rights under the Operating Agreement, it also was significantly more likely to have access to the LLC’s confidential information than third-parties without such governance rights (p=.049).

not granting third-party governance rights to be structured as a single-purpose or special-purpose vehicle ($p < .001$).

Figure 10. Direction to Consider Other Interests by Granting Third-Party Governance Rights



4. Transferability and Exit Rights

The law treats LLC membership interests similar to partnership interests. Accordingly, LLC membership interests generally are not transferable without the consent of the other members.¹²⁸ LLC members often can transfer their economic interests but not their non-economic interests (typically akin to their control rights) in the LLC.¹²⁹ This feature reflects the close relationship that typically exists among members to an LLC: Members want some control over the parties involved with the business. It also may make financing and growth challenging, depending on the LLC's objectives.

Despite the potential downside, the majority (81.4%) of database Operating Agreements included general restrictions on the transfer of membership interests.¹³⁰ Only 10.1% of the agreements permitted free transferability, and 4.7% allowed free transferability after compliance with a formal notice procedure. The lack of a meaningful exit strategy for members raises concerns regarding potential minority oppression, particularly under Operating Agreements that also modify or eliminate one or more traditional fiduciary duties.

Minority oppression—or “squeeze-out” or “freeze-out”—commonly is defined as oppressive conduct in a business enterprise by controlling

128. J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE § 4:4 (2012).

129. *Id.*

130. In addition, 3.1% of the database Operating Agreements included not only a general restriction on transfer but also a prohibition on transferring the membership interest to a competitor or person affiliated with a competitor of the LLC. For this variable, one agreement did not provide the relevant information.

stakeholders.¹³¹ Similar to shareholders in closely held corporations, the lack of a robust secondary market and the presence of transferability restrictions may expose LLC members to oppression. Commentators have thoughtfully explored the consequences of oppression, which may include exclusion from profits or economic gain, denial of business information, exclusion from decision-making, termination of employment or removal from management, and limitations on exit or withdrawal.¹³² The discussion of minority oppression in the LLC context also must consider whether the risk exposure inherent in accepting a minority or passive interest in an LLC was priced into or negotiated as part of the parties' *ex ante* bargain.

To inform this discussion, coders analyzed any buy-out provisions or rights of first refusal included in the database Operating Agreements. Buy-out agreements create an opportunity for minority holders and other members to change the composition of the LLC ownership structure when, for example, the parties' objectives have changed or a member breaches the agreement. Likewise, rights of first refusal facilitate membership changes by allowing parties to exit after first offering their interests to the LLC or other members.¹³³

Only 16 of the database Operating Agreements included some form of a buy-out provision. All of the buy-out provisions were permissive in nature, allowing the company or non-defaulting members to purchase other members' interests at a fair or predetermined price. The buy-out provisions were triggered by a variety of factors, including the default of a member, failure of a member to

131. See 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 1:1 (2012) ("[T]he term 'squeeze-out' [means] the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.").

132. See, e.g., *id.* § 1:3; Miller, *Remedies*, *supra* note 90, at 416 (criticizing the "movement to eliminate buy-out rights of limited liability company members in order to achieve estate tax-related objectives"); Moll, *supra* note 17 (arguing that the problems of minority oppression in the close corporation setting are applicable to the limited liability company form of business organization).

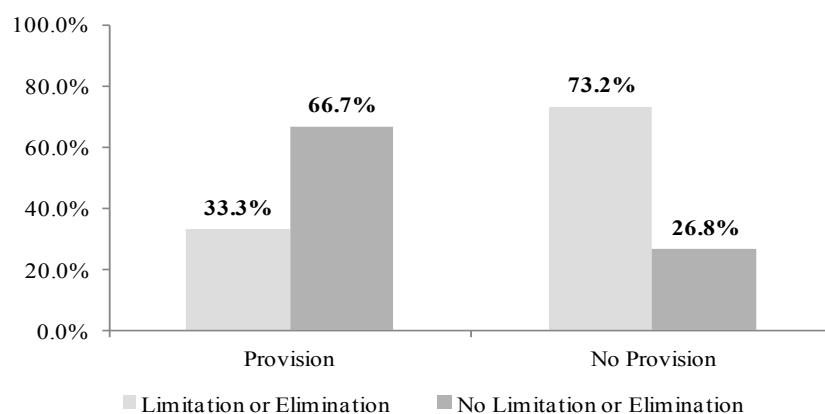
133. See, e.g., 1 O'NEAL & THOMPSON, *supra* note 131 § 6:16 ("Properly drawn [buy-out provisions or rights of first refusal] can be a protection against squeeze out[s]"); Miller, *Remedies*, *supra* note 90, at 454 (arguing that "[c]onsidering the relative imbalance of power between majority and minority LLC owners, and the uncertain prospects for litigation concerning a breach of fiduciary duty and duty of care, LLC statutes should retain a default buy-out rule to protect minority LLC owners who may have lacked the bargaining power or the foresight to obtain reasonable buy-out protection in an operating agreement"); Moll, *supra* note 17, at 896 ("Exit rights for the owners of any business enterprise are useful in two major respects. First, an exit allows an owner to liquidate its investment and to recover the value of its invested capital. Second, the threat of exit in large numbers tends to restrain managers from taking action that harms the interests of owners.").

comply with transfer restrictions on the interests, deadlock among the parties, and the bankruptcy or death of a member or similar change in control feature.¹³⁴

Some of the database Operating Agreements also included mandatory rights of first refusal.¹³⁵ These rights were allocated to either the company, the company and some or all of the other members, all of the other members, or specified members. In most agreements (97%), the right of first refusal provision was only one of several restrictions on transfer.

The data did not show any significant association among the modification of either members' or managers' fiduciary duties and either buy-out agreements or rights of first refusal. Nevertheless, a significant association did emerge between provisions eliminating the personal liability of managers and buy-out provisions. Specifically, Operating Agreements were significantly more likely to limit or eliminate the personal liability of managers to the LLC, members, or other beneficiaries when the agreements did not include a buy-out provision (73.2% versus 33.3%, respectively; p=.002) (see Figure 11). In addition, 77 (59.7%) of the Operating Agreements included in this analysis identified one or more members as managers.¹³⁶

Figure 11. Limitation or Elimination of Personal Liability of Managers to Others by Existence of Buy-Out Provision



134. Of the 16 Operating Agreements with buy-out provisions, five granted rights to members upon another member attempting to transfer interests in violation of the agreement; four were triggered by another member's default under the agreement; one was based on deadlock among members; one was based on financial insolvency of another member; and five were some combination of factors.

135. Thirty-three (25.6%) of the Operating Agreements included rights of first refusal. All of these rights were mandatory in nature. Approximately half (n=16) of the rights of first refusal were granted to the LLC and other members, with the majority of remaining (n=12) rights being granted just to the other members.

136. As described in Part II.B.2.a-b, these data include members with management responsibilities in both member-managed and manager-managed LLCs.

The association between managers' personal liability and buy-out provisions—similar to that between managers' personal liability and indemnification—requires further analysis.¹³⁷ One conceivable explanation is that members are less concerned about minority oppression issues in the context of managers versus members and, accordingly, less likely to negotiate over buy-out provisions or indemnification.¹³⁸ If the LLC employs a completely independent, third-party manager, that explanation might ease concerns. Nevertheless, many managers also are members. Notably, 92.2% of the Operating Agreements with members acting as managers do not include buy-out provisions.¹³⁹ The implications of these data are considered further below in the context of specific database Operating Agreements.

C. Synthesizing the Data and Findings

The data provide several meaningful insights into the LLC organization process among a population that is likely to critically analyze and negotiate the terms of an Operating Agreement.¹⁴⁰ The data show that these parties frequently modify the duty of loyalty and preserve members' ability to operate other ventures and compete with the LLC but do not necessarily invoke blanket waivers of fiduciary duties or personal liability. Some of the data, however, raise interesting issues about the extent of duty waivers and the allocation of power at the negotiating table. Although it is difficult to perform a quantitative analysis of these issues using the data, the language of the Operating Agreements and the associations in the data permit several meaningful inferences. This section explores these inferences and builds the foundation for the application of trust theory to LLC law discussed in Part III.

1. The Language of the Agreements

The Authors reviewed each of the 150 database Operating Agreements in detail. This Article does not seek to perform a contextual analysis of each agreement; rather, it summarizes certain common governance provisions that contribute to the overall analysis. This Subsection highlights provisions from Operating Agreements that represent member-managed, manager-managed, and third-party governance situations and supplements these examples with related provisions from other database Operating Agreements.

137. See *infra* Part II.C.2.

138. The Authors acknowledge that the parties also might negotiate a separate Buy-Out Agreement that is not incorporated into the Operating Agreement. The data do not capture any separate, independent agreements.

139. A significant trend emerged showing an association between Operating Agreements with members acting as managers and the absence of buy-out provisions ($p=.053$).

140. See *supra* Part II.B.1.

a. Member-Managed LLCs

The governance structures used in member-managed LLCs ranged from all members having some control over management decisions to only one or a few members being designated as managers. Although the latter structure appeared more frequently among the member-managed database Operating Agreements (68.3%), the remaining member-managed database Operating Agreements (31.7%) contemplated a management role for all members. The Operating Agreements often implemented an all-member management structure through a board or committee of managers: Each member appoints one or an equal number of representatives to the board and maintains some control over those representatives. In addition, the Operating Agreements specifically recognized the control over, and relationship between, the member and the member's appointee.

Hybrid member-managed LLCs frequently invoke both a centralized-management feature and a member-specific allocation of management rights and duties. For example, Laurel Mountain Midstream, LLC ("Laurel Mountain"), is a joint venture between a subsidiary of the Williams Company, Inc., and Atlas Pipeline Partners, L.P., that owns and operates a significant natural gas gathering system active in the Marcellus Shale in western Pennsylvania.¹⁴¹ The Operating Agreement generally provides:

The business and affairs of the Company shall be managed under the direction of the Members acting through the Management Committee, subject to (a) the delegation of powers and duties to the Operating Member pursuant to Article 7 and to officers of the Company and other Persons as provided for by resolution of the Management Committee and (b) the special rights of the Preferred Interest Member set forth in Section 5.8.¹⁴²

To retain the desired level of member control, each member of Laurel Mountain appoints one representative and one alternate representative to the Management Committee.¹⁴³ A majority vote of representatives on the Management Committee is sufficient to conduct most business, with certain events triggering a different percentage vote.¹⁴⁴ The Laurel Mountain Operating Agreement uses this committee structure in lieu of authorizing each member to act as an agent for the LLC, which is the default rule under many LLC statutes.¹⁴⁵ On this point, the agreement provides: "No Member, solely by reason of its status as such, has any right to transact any business for the Company or any authority or power to sign

141. *Laurel Mountain Midstream LLC*, WIKIMARCELLUS, http://waytogo.com/wiki/index.php/Laurel_Mountain_Midstream_LLC (last visited Sept. 21, 2012).

142. AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT OF LAUREL MOUNTAIN MIDSTREAM, LLC § 5.1, at 29 (June 1, 2009) [hereinafter LAUREL MOUNTAIN] (emphasis removed), available at <http://www.sec.gov/Archives/edgar/data/1092914/000119312509126234/dex102.htm>.

143. *Id.* § 5.2, at 29.

144. *Id.* § 5.4, at 29–30.

145. *See id.* § 5.1, at 29.

for or bind the Company unless such power or authority has been expressly delegated to such Member in accordance with this Agreement¹⁴⁶

In a corporate setting, this type of committee structure typically weakens owners' oversight and control because, among other things, directors must exercise their fiduciary duties for the benefit of the corporation and shareholders generally. The Laurel Mountain Operating Agreement, among others, alters this outcome by contract. Specifically, it states:

- (a) Each Member acknowledges its express intent, and agrees with the other Member, for the benefit of the Representatives, that to the fullest extent permitted by applicable Law: (i) the only fiduciary or other duties or obligations, if any, that any Representative will owe in their capacity as a Representative will be to the Member that appointed such Representative to serve in that capacity, and the nature and extent of those duties and obligations and the liabilities resulting from any breach thereof constitute an internal governance affair of Member; and (ii) no Representative will, under this Agreement, the Delaware Act or otherwise, owe in his capacity as a Representative, or be personally liable for monetary damages for any breach of, any fiduciary or other duties or obligations, including any obligation of good faith and fair dealing, to the Company, any other Member or any of their respective Affiliates or any other Representative.¹⁴⁷

Nevertheless, the Operating Agreement does impose some traditional fiduciary duties on the one member identified as the "Operating Member."¹⁴⁸

In addition, the Laurel Mountain Operating Agreement includes detailed provisions that permit members to compete with the business of the LLC and other members, subject to identified projects committed to the LLC itself.¹⁴⁹ It also

146. *Id.* § 5.7, at 31.

147. *Id.* § 6.5, at 33.

148. *Id.* § 7.4, at 37.

The Operating Member shall exercise the Operating Member's powers and rights, and discharge the Operating Member's duties under this Agreement in accordance with the following: (a) the requirements of this Agreement; (b) in accordance with practices generally acceptable for an experienced and prudent operator engaged in a similar activity under similar circumstances of the natural gas gathering industry; (c) all applicable Laws and regulations, including environmental standards in effect from time to time, and any other applicable rules and requirements of Governmental Authorities; (d) the contractual obligations and undertakings of the Company, as the same may be amended from time to time; and (e) honestly, in good faith and in the reasonable interests of the Company

Id.

149. *Id.* § 2.8, at 17.

Except as otherwise provided in this Section . . . with respect to the Area of Interest, the Members and their Affiliates may at any time, and from time to time, directly or indirectly, engage in, and possess interests in,

includes a broad exculpation of member liability for any alleged usurpations of LLC opportunities:

[N]o Member who (directly or though [sic] an Affiliate) acquires knowledge of a potential transaction, agreement, arrangement or other matter that may be an opportunity for the Member shall have any duty to communicate or offer such opportunity to the Company, and such Member (and its officers and Representatives on the Management Committee) shall not be liable to the Company, any Member or any other Person for breach of any fiduciary or other duty by reason of the fact that such Member pursues or acquires such opportunity for itself or its Affiliate, directs such opportunity to another Person or does not communicate such opportunity or information to the Company.¹⁵⁰

Modifications of members' duty of loyalty and exculpation of members' personal liability to the LLC, members, or other beneficiaries were common provisions in member-managed Operating Agreements. Many were tailored to the circumstances of the parties' particular deal, as in Laurel Mountain. Others, however, contained much broader language.¹⁵¹ In addition, several member-managed Operating Agreements—with only one or a few members granted management authority—included broad purported waivers of fiduciary duties of those managers.¹⁵²

without the consent of the Company or the other Member, other business ventures and activities of any and every type and description, independently or with others, regardless of whether such ventures are competitive with the Company or any other Member, and regardless of whether such business ventures and activities are located inside or outside the Area of Interest, or otherwise.

Id.

150. *Id.*

151. For example, the Mt. Hamilton Operating Agreement, which is managed in part by a member-appointed management committee, provides:

There are no implied covenants contained in this Agreement other than the contractual duty of good faith and fair dealing. The Members, the Manager and the Representatives shall not have any fiduciary or other duties to the Company or the other Members except as specifically provided by this Agreement, and the Members', the Representatives', and the Manager's duties and liabilities otherwise existing at law or in equity are restricted and eliminated by the provisions of this Agreement to those duties and liabilities specifically set forth in this Agreement.

MT. HAMILTON, *supra* note 118, § 4.10, at 20. The Mt. Hamilton Operating Agreement allocates certain management responsibilities to one member but reserves "major decisions" to the management committee as direct member control. See *id.* § 5.2(a), at 21 ("Representatives shall not be considered managers under the Act, but derive all of their right, power and authority from the Members.").

152. See, e.g., NATIONAL CINEMEDIA, LLC THIRD AMENDED AND RESTATED LIMITED LIABILITY COMPANY OPERATING AGREEMENT § 4.14, at 31 (Feb. 13, 2007), available at <http://www.sec.gov/Archives/edgar/data/1377630/000119312507034062/dex101.htm> ("[W]henever in this Agreement a Manager . . . is permitted or required to

b. Manager-Managed LLCs

Manager-managed LLCs in the database Operating Agreements ranged from companies with only independent third-party managers to third-party managers appointed by or affiliated with members to combinations of both structures. In some cases, members retained voting or veto rights over specified actions or amendments to the agreements. In others, managers retained complete discretion over most decisions, and are subject only to removal for cause. As noted above, strong manager liability protections did not always correlate with strong member protections.¹⁵³

NC² Global, LLC (“NC² Global”), is a joint venture between Caterpillar, Inc., and Navistar, Inc., that “combines truck manufacturing and transportation expertise with worldwide distribution.”¹⁵⁴ The NC² Global Operating Agreement is a manager-managed structure that expressly acknowledges that, subject to certain exceptions, “the Members shall not have any vote or take any part in the control or management of the Business or have any authority or power to act for or on behalf of the Company in any manner whatsoever.”¹⁵⁵ Rather, similar to the Laurel Mountain Operating Agreement, each member of NC² Global is entitled to appoint four representatives to the board. One distinction between the two structures, however, is that the NC² Global members’ representatives may not be “an officer or employee of the Company or an employee of [the member] or one of its Affiliates who is seconded to the Company . . .”¹⁵⁶

Interestingly, the lack of formal affiliation between a member and its representative in a manager-managed LLC may not be a meaningful distinction in every case. For example, similar to the Laurel Mountain Operating Agreement, the NC² Global Operating Agreement also limits the fiduciary duties of the board of representatives, stating: “No Representatives shall owe a fiduciary duty to the Company or to a Member not appointing such Representative, except for the

make a decision . . . in its ‘sole discretion’ or ‘discretion,’ with ‘complete discretion’ or under a grant of similar authority or latitude, such Manager . . . shall be entitled to consider only such interests and factors as it desires, including its own interests, and shall, to the fullest extent permitted by applicable law, have no duty or obligation to give any consideration to any interest of or factors affecting the Company or the Members . . .”); LIMITED LIABILITY COMPANY AGREEMENT OF RIDGEWOOD ENERGY K FUND, LLC § 12.11, at A-30 (April 1, 2004), *available at* <http://www.sec.gov/Archives/edgar/data/1285480/000121465905001256/ex101.txt> (“There are potential conflicts of interest involved in the operation of the Fund. . . . In determining a course of action or deciding among various alternatives that potentially conflict, the Manager will consider these and other conflicts that may exist and exercise reasonable business judgment when determining such action or choosing among various alternatives.”).

153. See *supra* Part II.B.

154. Who We Are, NC², <http://www.nc2.com/overview> (last visited Sept. 28, 2012).

155. AMENDED AND RESTATED JOINT VENTURE OPERATING AGREEMENT § 4.1 (Sept. 9, 2009) [hereinafter NC2 GLOBAL], *available at* http://www.sec.gov//edgar/data/18230/000001823009000375/ex_10-1.htm.

156. *Id.* § 5.1.

implied contractual covenant of good faith and fair dealing provided for under the [Delaware] Act.”¹⁵⁷ In addition, the NC² Global Operating Agreement requires unanimous member consent for a variety of conduct, such as admission of new members, changes to board composition, and amendments of the Operating Agreement.¹⁵⁸ These member-retained voting rights coupled with the directed duties owed by board representatives give members significant control even in this type of manager-managed structure.

The NC² Global Operating Agreement does not specifically address members’ fiduciary duties or exculpation of members’ liability, other than through an extremely detailed covenant not to compete and limited indemnification provisions. As discussed above, many courts interpret silence as preserving traditional fiduciary duties for managers and controlling members.¹⁵⁹ Accordingly, unless addressed in a separate agreement, members in an LLC like NC² Global may continue to owe certain fiduciary duties. This conclusion likely is supported by the limitation of liability provision included in the NC² Global Operating Agreement. That provision invokes traditional notions of owners’ limited liability for a company’s debt and provides that owners are not liable for that debt solely by reason of being a member of an LLC.¹⁶⁰

157. *Id.* § 5.12.

158. *Id.* § 4.8 (listing a number of actions or decisions requiring unanimous member consent).

159. See, e.g., *In re CLK Energy Partners, LLC*, Bankruptcy No. 09-50616, 2010 WL 1930065, at *8 (Bankr. W.D. La. May 12, 2010) (“Delaware’s LLC Act provides that an LLC agreement may modify or even eliminate the fiduciary duties of an LLC’s managers. The only duty that cannot be eliminated is the duty of good faith and fair dealing. If the LLC agreement is silent as to those duties, Delaware courts will generally default to the fiduciary duties applicable to a corporation. Accordingly, the scope of a manager’s duties in the LLC context turns on the applicable LLC agreement.” (citations omitted)); *Coventry Real Estate Advisors, L.L.C. v. Developers Diversified Realty Corp.*, 923 N.Y.S.2d 476, 477 (N.Y. App. Div. 2011) (“Under Delaware law . . . , absent a provision to the contrary in the governing LLC agreement, an LLC’s ‘managers and controlling members owe the traditional fiduciary duties that directors and controlling shareholders in a corporation would’” (citations omitted)); *Kelly v. Blum*, Civil Action No. 4516-VCP, 2010 WL 629850, at *10–14 (Del. Ch. Feb. 24, 2010).

160. NC2 GLOBAL, *supra* note 155, § 4.2.

No Member shall be obligated or liable to the Company, any creditor of the Company, or any other Person, for any Liabilities or debts of the Company, whether arising in contract, tort, or otherwise, solely by reason of being a Member, except as specifically set forth herein or as otherwise agreed to in writing by such Member. Except as required by law, no Member shall be liable to the Company, any other Member, any creditor of the Company, or any other Person for the repayment of amounts received from the Company. The failure of the Company to observe any formalities or requirements relating to the exercise of its powers or management of its Business or affairs under this Agreement or the Act shall not be grounds for imposing personal liability on the Members or the Representatives for Liabilities or debts of the Company,

The majority of manager-managed Operating Agreements contained waivers of managers' duties and limitations of managers' personal liability. These agreements included manager-managed structures that did not directly link a manager's duties to the member appointing or hiring the manager. For example, in Raft River Energy, LLC ("Raft River"), which is essentially a financing arrangement between U.S. Geothermal, Inc., and The Goldman Sachs Group for owning and operating a geothermal energy plant in Idaho, the members are entitled to vote for members of the management committee in a more traditional owner/shareholder format.¹⁶¹ The Raft River Operating Agreement does not direct managers to vote in a particular manner, but it does contain very broad exculpation provisions for both managers and members:

Notwithstanding any provision to the contrary elsewhere in this agreement, to the extent that, at law or in equity, the Management Committee or any member has any duties (fiduciary or otherwise) and liabilities relating thereto to the company or another member of the company, (A) neither the management committee nor any member shall be liable to the company or the other members for actions taken by the management committee, any member or any of their affiliates in reliance upon the provisions of this agreement, (B) each manager is expressly permitted to serve as a manager or director of any other entity, including other entities in the same or similar industries, (C) each member and each manager is permitted to explore and develop business opportunities outside of the company, even if such opportunities may compete with the activities of the company, (D) no manager or member is required, by virtue of their position as a manager or member, to present business opportunities in the geothermal industry or utilizing geothermal resources to the management committee or the company before pursuing such opportunities in any capacity or on behalf of any other entity, and (E) the duties (fiduciary or otherwise) of the management committee, each manager and each member are intended to be modified and limited to those expressly set forth in this agreement, and no implied covenants, functions, responsibilities, duties, obligations or liabilities shall be read into

whether arising in contract, tort, or otherwise, solely by reason of being a Member or Representative.

Id.

161. The Raft River Operating Agreement allocates members' voting rights for the management committee based on units held by the member and the financing nature of the agreement—e.g., in the first year, the financing member is allocated more seats on the committee than it receives in the second year, and so forth. AMENDED AND RESTATED OPERATING AGREEMENT OF RAFT RIVER ENERGY I LLC § 5.2 (Aug. 9, 2006), available at <http://www.sec.gov/Archives/edgar/data/1172136/000106299306002569/exhibit10-2.htm>.

this agreement, or otherwise exist against the management committee or any member.¹⁶²

Nevertheless, some member-managed and manager-managed Operating Agreements—including the single-purpose entities discussed below—do recognize basic fiduciary duties for managers and often reconcile any exculpatation provisions with the scope of those duties.¹⁶³

c. Third-Party Governance Rights in Operating Agreements

The majority of database Operating Agreements allocated management and control rights solely to members and managers. Nevertheless, a handful of agreements also granted some type of governance right—e.g., a vote, consent, or veto right—to non-members and non-managers. These third-party governance rights typically were associated with financing arrangements underlying the formation and operations of the LLC and frequently were coupled with access to information rights.¹⁶⁴

It is possible for an LLC to have a provision in their Operating Agreement that requires lenders to consent to some LLC actions. For example, G&E HC REIT II Pocatello MOB JV, LLC (“G&E”), is an LLC formed by Grubb & Ellis Healthcare REIT II Holdings, LP, and Pocatello Medical Office Partners, LLC, for purposes of certain real estate development activities.¹⁶⁵ Article X of the G&E Operating Agreement identifies the LLC as a “single purpose entity” and requires the lender’s consent to a variety of actions relating to the LLC’s operations.¹⁶⁶ These actions include: amendments to the agreement; any liquidation, dissolution, or similar transaction involving the LLC; and any changes to the LLC’s business model.¹⁶⁷

162. *Id.* § 5.14 (original in all caps). Similarly, the Ruby Newco LLC Operating Agreement, which permits election of managers to a board by a majority vote of the combined class A and class B units, provides:

Neither Ruby nor any of its Affiliates (other than the Company and the Company Subsidiaries), nor any of their respective officers, directors and/or employees shall have any duty to refrain from engaging, directly or indirectly, in the same or similar business activities or lines of business as the Company or the Company Subsidiaries.

FORM OF AMENDED AND RESTATED OPERATING AGREEMENT OF RUBY NEWCO LLC § 4.8(b), at D-13 (2007), available at <http://www.sec.gov/Archives/edgar/data/1308161/000119312507197546/ds4.htm>.

163. See *infra* Part II.C.1.c.

164. Operating Agreements granting third-party governance rights were significantly more likely to organize as a single purpose or special purpose entity ($p < .001$) and to receive access to information ($p = .049$).

165. See AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT OF G&E HC REIT I POCATELLO MOB JV, LLC § 2.5 (July 27, 2010), available at <http://www.sec.gov/Archives/edgar/data/1455271/000129993310002918/exhibit2.htm>.

166. *Id.* § 10.2.

167. *Id.* § 10.2(a).

In addition, Operating Agreements implementing a financing arrangement—particularly where one or more lenders are not members—recognize some form of traditional fiduciary duties for managers. For example, the G&E Operating Agreement states: “The Manager shall discharge its duties in good faith and in the best interests of the Company in accordance with this Agreement.”¹⁶⁸ Similarly, these agreements might align any exculpation of manager liability with traditional fiduciary duties, such as:

The Managing Member shall not be liable to the LLC or to the Members for any act performed or omitted to be performed by it on behalf of the LLC, provided such act or omission was taken in good faith, was reasonably believed by the Managing Member to be in the interests of the LLC and within the scope of authority granted or reserved to the Managing Member under this Agreement, and did not constitute fraud or willful misconduct.¹⁶⁹

Regardless of form, Operating Agreements incorporating third-party governance rights typically contained at least a basic level of accountability for members or managers. This observation corresponds with the regression analysis that shows a significant association between third-party governance rights and provisions limiting the discretion of members and managers.¹⁷⁰ Next, this Article will discuss additional associations among contractual provisions and data.

2. Analyzing the Data in Context

The database Operating Agreements are substantively rich and diverse. Despite the manifest variations, however, several common themes emerge. LLCs that foster joint ventures between parties in the same or similar industries include duty waivers frequently tailored to the parties’ relationship or industry. LLCs managed by one or more members generally include strong manager protections. Generally, Operating Agreements tend to favor waivers of the duty of loyalty for both members and managers that permit those parties to compete with or take opportunities from the LLC. And perhaps not surprisingly, LLCs used as financing vehicles grant strong protections to third-parties and restrain managers’ discretion in various respects.¹⁷¹

The contractual language also enhances the quantitative data analysis. For example, regression analysis suggests a significant association among modifications to members’ duty of loyalty and a requirement of unanimous member consent to amend the Operating Agreement.¹⁷² It also suggests a significant association between elimination of members’ personal liability to the

168. *Id.* § 4.1(b).

169. AMENDED AND RESTATED OPERATING AGREEMENT OF 919 JV LLC, § 7.01(c), at 34 (Dec. 21, 2001), available at http://www.sec.gov/Archives/edgar/data/930548/000090514802000032/efc2-0004_ex101.txt.

170. *See supra* Part II.B.3.

171. Operating Agreements with third-party governance rights were significantly more likely to direct interests to be considered by members or managers ($p=.032$).

172. *See supra* note 122.

LLC, members, or other beneficiaries and indemnification for members and their affiliates.¹⁷³ These associations suggest active negotiation by members who have built in some voting control and economic protection.

This type of active negotiation is reflected in the Laurel Mountain Operating Agreement. Consistent with its detailed waivers of liability and indemnification, the agreement also requires the unanimous consent of members to amend the agreement and provides specific consequences for a member who defaults under the agreement, including a forfeiture provision.¹⁷⁴ The Mt. Hamilton Operating Agreement likewise requires unanimous consent for all but certain identified amendments and incorporates a separate standard of liability and limited exculpation for the member who is allocated additional management rights under the agreement.¹⁷⁵ The ability to preserve the contract as negotiated *ex ante* without expressed consent gives parties some control over contractual abuses of their interests in the LLC. It also encourages discussion among members about new or unanticipated developments. Admittedly, it does not protect members from breaches of the contract, but they at least have some continuing control over what does or should constitute a breach.

Several of the database Operating Agreements also reflect meaningful manager protections. For example, regression analysis shows significant associations between modifications of managers' duty of loyalty and various provisions, including limited personal liability, required consent for amendments to the Operating Agreement, and indemnification of managers and their affiliates.¹⁷⁶ In addition, the data show a significant trend between modifications to managers' duty of loyalty and very broad indemnification provisions covering any and all claims or liability.¹⁷⁷

These associations among waivers of managers' duty of loyalty and other manager protections like indemnification and veto rights over amendments indicate that managers may hold substantial leverage in negotiating the Operating Agreements. They also suggest that managers may have extremely broad discretion in operating the LLC and very little accountability to members or the LLC. This inference must be considered in light of the significant association between elimination of managers' personal liability and the absence of buy-out rights,¹⁷⁸ and the large number of members serving as managers in these cases.

173. See *supra* Part II.B.2.c.

174. LAUREL MOUNTAIN, *supra* note 142, §§ 6.1–6.5, at 32–33 (liability and indemnification); *id.* § 13.2, at 53 (amendment); *id.* § 9.2(a), at 43 (default and forfeiture of rights).

175. MT. HAMILTON, *supra* note 118, § 12.6, at 45–46 (amendment); *id.* § 5.5, at 26 (exculpation).

176. See *supra* Part II.B.2.c.

177. Operating Agreements are more likely to modify or eliminate managers' duty of loyalty when "any and all liability" is indemnified than when indemnification is limited to "actual litigation or proceedings only" (p=.053). See *supra* Part II.B.2.c.

178. See *supra* Part II.B.4.

Although broad waivers of managers' duties and personal liability certainly can be considered and included in the risk allocation desired by the parties, they also may reflect overreaching by one or more parties, particularly when the manager is affiliated with one or more members. The challenge for policymakers in this context is two-fold. The first consideration is whether to condone bargained-for "overreaching." The second is whether instances of overreaching and unequal or no bargaining among affected parties can or should be controlled. Similarly, related considerations exist as to the scope of permissible waivers and limitations and whether, as in the Laurel Mountain Operating Agreements, contractual provisions can protect members from liability to "persons" other than parties to the Operating Agreement.¹⁷⁹

Overall, the data and contextual analysis suggest that the assumptions (for example, that LLCs are organized by represented, sophisticated, and fully informed parties) underlying the purported value of LLCs might prove accurate in some instances.¹⁸⁰ In other instances, however, these assumptions are weak or inapplicable. The question then becomes how policymakers should allocate discretion to contract around governance default rules given the variance in the knowledge and sophistication of parties who are eligible to organize LLCs. Part III considers this question and proposes some factors for policymakers to balance in creating any bright-line rules.

III. USING THE DATA IN CONJUNCTION WITH TRUST THEORY TO STRIKE AN APPROPRIATE POLICY BALANCE

The database of Operating Agreements reflect a spectrum of possibilities. The data suggest that parties can and do negotiate contract provisions tailored to their specific needs and risk tolerance. Even in what appear to be heavily negotiated contracts (based on deal terms and contract length), however, regression analysis shows that parties with management functions often had more bargaining power in the negotiation and often tipped the scales in their favor. Consequently, depending on the parties' relationship and *ex ante* bargain, non-managing members may be significantly disadvantaged in efforts to protect their own interests. That potential and the issues highlighted by Miller's empirical surveys¹⁸¹ cannot be overlooked in assessing LLC governance policy and regulation.

This Part draws on trust theory to further explore the potential implications of the OA Study and prior LLC literature. It not only considers the foundations of trust—i.e., affective or cognitive—and related behavioral studies, but it also explores the growing interdisciplinary dialogue regarding trust and regulation. This dialogue involves both whether law can foster individual trust and whether trust can guide the need for and scope of any particular regulation. The

179. The Laurel Mountain Operating Agreement defines "person" as "any individual, corporation, partnership, joint venture, association, joint stock company, limited liability company, trust, estate, unincorporated organization or Governmental Authority." LAUREL MOUNTAIN, *supra* note 142, § 1.1, at 12.

180. See *supra* note 102 and accompanying text.

181. See *supra* notes 92–95 and accompanying text.

application of trust theory to LLC formation enriches the analysis of LLC governance policy and regulation.

A. An Overview of Trust Theory

Concepts of trust permeate individuals' personal and economic decisions on a daily basis.¹⁸² Many of these decisions involve an assessment of the individual's exposure or vulnerability to risk, and trust often plays a critical role in whether the individual accepts or rejects potential risk.¹⁸³ The type of trust invoked by an individual may differ, however, depending on the nature of the decision at hand. Accordingly, a basic understanding of trust concepts is necessary to consider the utility of trust theory in formulating law.

1. Affective and Cognitive Trust

The term "trust" means different things to different people. Some commentators focus on the truster's vulnerability in the trust relationship.¹⁸⁴ Others focus on a mutual trust among parties to the relationship built on shared "values, principles, and standards of behavior."¹⁸⁵ Still others emphasize the relationship between trust "and one's perception of another's trustworthiness."¹⁸⁶ No one definition of trust covers all situations, and some level of vulnerability or exposure (even if just economic exposure) likely underlies all definitions of the term.¹⁸⁷ Accordingly, this Article does not adopt one specific definition of trust. Rather, it focuses on the act of trusting and assumes that the truster undertakes some assessment of the trustee based on internal or external factors.

This assumption permits an evaluation of the general types of trust—*affective* and *cognitive*—that might inform any regulatory analysis. *Affective trust*

182. TAMAR FRANKEL, TRUST AND HONESTY: AMERICA'S BUSINESS CULTURE AT A CROSSROAD 49–55 (2006).

183. For a discussion of trust theory and economic decisions generally, see FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY (1995) and ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY (2000).

184. Blair & Stout, *supra* note 26, at 1739–40 (including as a key component of trust concept, "a willingness to make oneself vulnerable to another, based on the belief that the trusted person will choose not to exploit one's vulnerability").

185. Larry E. Ribstein, *Law v. Trust*, 81 B.U. L. REV. 553, 557 (2001).

186. Angela L. Coletti et al., *The Effect of Control Systems on Trust and Cooperation in Collaborative Environments*, 80 ACCT. REV. 477, 481 (2005). Notably, several studies show an association between an individual's willingness to trust and her own trustworthiness. See, e.g., Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 BUFFALO L. REV. 1361, 1379–80 (2009) (explaining study that "tended to show . . . the extent to which one says one trusts others may, in fact, be a reflection of that person's trustworthiness"); Hill & O'Hara, *supra* note 22, at 1742 ("Because trustworthy people also tend to be more trusting, they are more likely themselves to seek out opportunities for reaping cooperative gains.").

187. See, e.g., Colombo, *supra* note 24, at 834; Cross, *supra* note 23, at 1461; Hill & O'Hara, *supra* note 22, at 1723–24 ("Despite its importance, scholars from the various disciplines relevant to trust have failed to converge on a single definition.").

is based on emotion and commonly associated with “‘true’ or ‘real’ or ‘moralistic’ trust.”¹⁸⁸ Individuals invoking affective trust rarely analyze the potential consequences of trusting another. Their decision to trust another stems from “an attitude of optimism about [that person’s] goodwill and . . . the confident expectation that, when the need arises, the one trusted will be directly and favorably moved by the thought that [the truster is] counting on her.”¹⁸⁹

Cognitive trust is a more calculated approach to the trust decision. “In its strictest form, cognitive trust is based upon a cost-benefit analysis” of the benefits of trust versus the associated risks.¹⁹⁰ It is a considered analysis of the potential advantages and disadvantages to trusting another grounded in relevant information, risk exposure, and mitigation opportunities. Business and economic decisions are commonly associated with cognitive trust but, as discussed below, that generalization does not mean that those decisions are never the result of affective trust or that other decisions are never the result of cognitive trust.¹⁹¹

To the contrary, many decisions likely include elements of both affective and cognitive trust.¹⁹² In fact, some commentators emphasize the value of encouraging trust that involves active assessment by the truster of all available information, including prior experiences that inform emotional assessments of the trustee (both trusting and distrusting), social norms, and external regulations.¹⁹³ This Article refers to this blended type of trust as “informed trust” but recognizes the various gradations of informed trust that might exist. Admittedly, informed trust is only as good as the available information and the truster’s assessment skills. Fully informed but inaccurate assessments may still result.

The limitations of even informed trust decisions have led commentators to consider when and how trust theory should inform legal regulations.¹⁹⁴ Although some commentators debate the extent to which regulations should try to

188. See Cross, *supra* note 23, at 1464–65 (explaining affective trust).

189. *Id.* at 1464 (citation omitted).

190. *Id.* at 1465.

191. See Colombo, *supra* note 24, at 836 (explaining economic foundation often attributed to cognitive trust and the perspective of some commentators that such an economic calculation is not trust at all).

192. See, e.g., Cross, *supra* note 23, at 1468 (explaining the blending of affective and cognitive trust and noting that “[a]ffective trust may itself be fundamentally cognitive and strategic if our trusting nature is the product of experience or hardwired by evolution into our brains”); see also Brescia, *supra* note 186, at 1370 (observing that “separating out each instance where one is applying affective or cognitive trust can be difficult”). The concept of “authentic trust” blends certain elements of cognitive and affective trust, but it does not embrace considered analysis or calculation in the trust decision. See, e.g., Cross, *supra* note 23, at 1470–71 (describing the concept of authentic trust and its limitations).

193. See, e.g., Cross, *supra* note 23, at 1530 (“Optimal trust has been defined as ‘prudence with a bias toward trust’” (citation omitted)); Hill & O’Hara, *supra* note 22, at 1721 (“We argue that trust is a nuanced cognitive assessment of another’s trustworthiness, and that it is made using both conscious and subconscious processes.”).

194. See, e.g., Colombo, *supra* note 24, at 853–57; Hill & O’Hara, *supra* note 22, at 1729–33.

maximize individual trust,¹⁹⁵ this Article assumes that, at least in the LLC context, basic default rules are necessary to provide some certainty to parties organizing LLCs and to those doing business with LLCs. The Article focuses on the role of trust in creating or refining regulations.

Legal rules typically mandate how people should act and the consequences of their failure to act.¹⁹⁶ As mentioned above, this basic framework can provide much needed certainty, particularly in the areas of business and finance. Neither policymakers nor commentators can agree, however, regarding the optimal level of regulation, with both sides arguing the dire consequences of either too little or too much regulation.¹⁹⁷ In this regard, some commentators argue that too much regulation “crowds out” trust-based decisions.¹⁹⁸ With most significant details of a transaction subject to regulation, individuals do not need to assess the trustworthiness of the trustee or the value of the transaction to them based on that assessment. Likewise, too little regulation may subject individuals to significant risk because they may inaccurately assess the trustworthiness of the trustee.¹⁹⁹ The role of policymakers is to strike an appropriate balance between these two extremes.

2. The Interrelatedness of Trust and Regulation

Relationships built on informed trust generally are more efficient and durable than pure arm’s-length transactions.²⁰⁰ For example, informed trust

195. Compare Ribstein, *supra* note 185, with Tamar Frankel, *Trusting and Non-Trusting on the Internet*, 81 B.U. L. REV. 457 (2001). For a discussion about empirical data concerning the relation between trust and law, see Cross, *supra* note 23, at 1523–27.

196. Indeed, legal rules work primarily by “promising rewards and threatening punishments,” which may undervalue trust relationships. See Blair & Stout, *supra* note 26, at 1739.

197. See, e.g., CHRISTOPHER HOOD ET AL., THE GOVERNMENT OF RISK: UNDERSTANDING RISK REGULATION REGIMES (2001); Thomas M. Arnold & Jerry L. Stevens, *Mixed Agendas and Government Regulation of Business: Can We Clean Up the Mess?*, 45 U. RICH. L. REV. 1059 (2011).

198. See, e.g., Colombo, *supra* note 24, at 850 (explaining “crowd out” theory); Sim B. Sitkin & Nancy L. Roth, *Explaining the Limited Effectiveness of Legalistic “Remedies” for Trust/Distrust*, 4 ORG. SCI. 367, 369 (1993) (“The adoption of legalistic ‘remedies’ . . . imposes a psychological and/or an interactional barrier between the two parties that stimulates an escalating spiral of formality and distance and leads to a need for more rules.”) (citations omitted)).

199. See Blair & Stout, *supra* note 26, at 1802 (noting, in exploring roles of interpersonal trust and fiduciary duties, that “[t]rust only works, however, when one knows that one’s fellow shareholders in the firm are indeed trustworthy”); Hill & O’Hara, *supra* note 22, at 1729–33 (describing limitations of trust); see also generally Carol M. Rose, *Trust in the Mirror of Betrayal*, 75 B.U. L. REV. 531 (1995) (discussing the role of law in trust relationships).

200. See, e.g., Blair & Stout, *supra* note 26, at 1757 (“Where trust can be harnessed, it can substantially reduce the inefficiencies associated with both agency and team production relationships.”).

relationships can reduce monitoring, implementation, and enforcement costs.²⁰¹ Not all informed trust relationships, however, produce optimal results in the absence of regulation. To that end, some commentators posit that legal regulation is most appropriate “where people are inclined to systematically trust one another too much or too little and are systematically inclined to process trust information heuristically.”²⁰² The objective then is to identify circumstances that foster more accurately informed trust assessments, as well as those that do not.

Prior literature and cooperation studies generally indicate increased levels of cooperation and trust sentiments when the parties know each other and engage in repeated dealings.²⁰³ Parties who know each other likely share the same values, friends, or business industry; are personally invested in the transaction; and face reputational or other retribution for misconduct.²⁰⁴ If the parties engage in multiple transactions or a sustained relationship, they may be motivated to continue the relationship or at least have an opportunity to acquire positive or negative information concerning the other party to more accurately assess their trustworthiness.²⁰⁵ In these instances, lower levels of regulation may produce optimal results.²⁰⁶

On the other hand, increased regulation may be necessary if the parties do not know each other or if there is a preexisting relationship that biases any trust assessment.²⁰⁷ In these instances, the parties’ lack of information or inaccurate assessments cause misguided trust and create potentially significant costs and

201. See Brescia, *supra* note 186, at 1372 (“[T]rust reduces transaction costs because economic actors have to spend less time and money searching for legitimate economic partners and monitoring the behavior of such partners.”).

202. Hill & O’Hara, *supra* note 22, at 1733; see also Colombo, *supra* note 24, at 875 (arguing for nominal regulation where affective trust is strong and more regulation in purely cognitive trust settings).

203. See, e.g., Blair & Stout, *supra* note 26, at 1760–62 (explaining social dilemma experiments supporting human tendencies of trust and cooperative behavior); Brescia, *supra* note 186, at 1378–89 (describing a study that, among other things, showed “when the parties did not know one another, it was less likely that they engaged in conduct likely to optimize the outcome for both”); see also Colombo, *supra* note 24, at 842–43 (explaining psychology of trust and concept that “[a]ll trust, whatever its originating wellspring, ‘grows with use’” (quoting Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 600 (2001))).

204. See, e.g., Blair & Stout, *supra* note 26, at 1750–55 (explaining incentives driven by internalized trust); Hill & O’Hara, *supra* note 22, at 1794 (“[I]ncreased reputational consequences of lax monitoring [by corporate directors] may . . . be able to do what law cannot . . .”).

205. See, e.g., Colombo, *supra* note 24, at 842 (explaining the development of trust over time).

206. See Hill & O’Hara, *supra* note 22, at 1749–50 (“To the extent that relationships are formed and maintained in a manner consistent with this paradigmatic relationship [e.g., built gradually over time], the role for law in promoting an optimal level of trust is presumably minimal.”).

207. See *id.* at 1734–40 (discussing trust biases and decision-making errors related to trust).

unjust results.²⁰⁸ Although the law arguably should not protect individuals from bad business decisions, a trustee's lack of accurate information may warrant some regulatory restraints on the trustee's conduct. Legal regulation substitutes for the moral or relational restraints otherwise imposed in an informed trust relationship.²⁰⁹

This broad interplay between trust and regulation informs the LLC fiduciary debate.²¹⁰ The contractual nature of the LLC form inherently draws on the knowledge, experiences, and relationship among the contracting parties. These characteristics lend themselves nicely to a trust theory analysis, which in turn may help guide LLC governance regulations.

B. The Role of Trust in LLCs

Parties use the LLC form to support a variety of business endeavors.²¹¹ State law generally does not restrict the identity of members or business purposes of LLCs.²¹² As such, no one trust relationship likely describes every LLC.²¹³ Nevertheless, the informed trust characteristics described above provide a solid foundation for applying trust theory to LLCs.

LLCs with only a few members who know each other *and* operate in the same or related industries present the strongest case for informed trust relationships.²¹⁴ The business origins of most of these relationships weaken the negative trust biases often introduced by familial or friendship ties. Additionally, the common industry or shared business acquaintances may lend stability to the

208. See Colombo, *supra* note 24, at 851–52 (explaining role of law in reducing “cost of vulnerability” in instances of pure cognitive trust).

209. See Hill & O’Hara, *supra* note 22, at 1752–54 (discussing role of law in encouraging specific trust (akin to cognitive/calculating trust) where trust biases, such as in-group bias, might cause non-optimal or misguided trust).

210. Trust literature considers the role of law and trust in various fiduciary relationships and provides insightful guidance to the LLC analysis. See, e.g., Blair & Stout, *supra* note 26, at 1781–90 (discussing trust in corporate fiduciary context but noting that analysis for unincorporated entities—such as LLCs—might be different); Hill & O’Hara, *supra* note 22, at 1762–95 (discussing trust theory in context of doctor-patient and corporate directors).

211. See, e.g., Chrisman, *supra* note 31, at 459–62 (“The limited liability company (LLC) is now undeniably the most popular form of new business entity in the United States. . . . The only areas that have not been dominated by the LLC are those of publicly traded companies, companies that plan to become publicly traded companies, and non-profit entities.”).

212. See *supra* Part I.A.1.

213. The application of trust theory to governance structures admittedly is complex and nuanced. See, e.g., Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 513 (2009) (discussing complexities inherent in analyzing corporate governance principles under trust theory). Nevertheless, the principles underlying trust theory can help inform the parameters of governance regulations. See *id.* (using trust theory to evaluate and propose methods to enhance corporate directors’ duty of loyalty).

214. These relationships generally fit the “paradigmatic” trust relationship that develops gradually and warrants less regulatory intervention. See *supra* Part III.A.2.

relationship, even if it is in the early stages.²¹⁵ Moreover, parties typically perform due diligence and insist on information necessary to accurately assess the risk profile of the transaction. Although these characteristics will not hold for every joint-venture type LLC, they are likely present in many.

In this type of business venture, the trust relationship may provide even stronger incentives than are provided by regulations for parties to act in the LLC's best interests—or at least not to the detriment of the LLC and its other members. These incentives flow from the parties' relationship, shared values, common acquaintances, and the terms of the contract itself. For example, in several of the database Operating Agreements, the language suggests that the parties had a general sense (affective trust) that the other members would pursue joint interests but also recognized the unique position of many parties with ventures outside of the LLC.²¹⁶ In these cases, the parties crafted detailed provisions to ease restrictions on self-dealing and conflicts of interest, likely based on an assessment of parties' needs and each member's own desire to protect against downside risk.²¹⁷ Parties engaging in this type of considered, informed trust (even if an imperfect risk assessment) are reaching a deal that establishes the parties' desired risk allocation, prices that allocation into deal terms, and likely approaches an optimal result and level of trust. Legal regulation—unlike informed trust—cannot be tailored to the parties' particular transaction and, accordingly, must be carefully tailored not to dampen the effects of informed trust.

Notably, an LLC having only a few members does not necessarily lead to an informed trust relationship. The parties may not know each other (either directly or indirectly through business or industry sources) or they may know each other very well, being family members or long-time friends.²¹⁸ As discussed above, these situations are more susceptible to trust biases and misguided trust. The circumstances that lead to over- or under-trusting also may arise in LLCs with a significant number of members. For example, in LLCs formed as investment vehicles members may be passive investors who lack the information and the relationships necessary to make an accurate trust assessment.²¹⁹ Moreover, the structure of the LLC membership and the underlying trust relationships may vary not only among LLCs but also within LLC membership classes.²²⁰ Accordingly, some types of LLCs may require legal regulation in lieu of any trust relationship.

215. See Colombo, *supra* note 24, at 870 (arguing that the minimal regulation of hedge funds comports with trust theory given that “the hedge fund industry is marked by repeat players, generally drawn from a similar social milieu”).

216. See *supra* Part II.C.1.

217. See *supra* Part II.C.1.

218. See Hill & O’Hara, *supra* note 22, at 1750 (discussing role of emotion in various relationships that may “amplif[y] the potential for systematic overtrust and undertrust”).

219. See *supra* Part III.A.2.

220. See *supra* Part III.A.2.

The diversity in LLC forms complicates the trust theory analysis. Unlike corporate management structures,²²¹ doctor-patient settings,²²² or specific investment firms,²²³ it is difficult to generalize about the relationships underlying LLCs. Nevertheless, trust theory still informs the analysis. The remainder of the Article uses trust theory, prior LLC literature, and the OA Study to develop specific policy recommendations.

C. Tailoring LLC Laws to Maximize Trust and Utility

Developing a brightline legal standard is difficult, but certainty adds significant value in the business context.²²⁴ Parties doing business together need to understand *ex ante* the parameters in which they can work without incurring additional transactional or litigation costs *ex post*. Any such costs can dramatically change the value of the deal and saddle parties with results for which they never bargained. Parties forming LLCs under existing statutory and decisional law face this type of uncertainty, often despite their best efforts to comply with the law.²²⁵

The task of adding certainty to the laws governing LLCs, however, requires a delicate balancing of multiple competing interests and policy concerns. The simple fixes of mandating a minimal level of fiduciary duty and management standards of conduct, or alternatively allowing all terms to be fixed solely by the parties' contract, would be easy to design yet likely unsatisfactory in implementation and result.²²⁶ Not all LLC relationships are suited for governance primarily by contract.²²⁷ In those that are, parties likely would incur significant costs trying to find work-arounds or forego valuable opportunities if required to operate under mandatory regulations that worked against their best interests. Parties also may try—either consciously or unconsciously—to offset increased costs by relaxing their trust assessment of their counterparties.

LLC governance standards require a more nuanced, but definitive, approach that (i) maintains a strong set of default rules for parties not wanting or needing to incur the expense of bargaining a deal-specific contract, (ii) protects

221. See, e.g., Blair & Stout, *supra* note 26, at 1781–90.

222. See, e.g., Hill & O'Hara, *supra* note 22, at 1762–79.

223. See, e.g., Colombo, *supra* note 24, at 857–74.

224. See, e.g., Jack B. Jacobs, *The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 15 (2005) (“Equity will always be with us, but why not develop a bright line rule that would make the application of equity more predictable?”).

225. See Seita, *supra* note 20, at 101 (“Although case decisions may seek to encourage efficient behavior, the uncertainties of litigation together with differing risk attitudes of the contract parties may encourage inefficient breaches . . .”); see also *supra* Part I.B.1.

226. For deficiencies in a contract model, see *supra* note 90 and accompanying text. For deficiencies in a model of a mandatory minimum level of duties and conduct, see Professor Miller's work, which argues for mandatory fiduciary duties while noting the limitations as expressed by Professor Ribstein. MILLER, *supra* note 30 § 4:14.

227. See generally Larry E. Ribstein, *The Uncorporation's Domain*, 55 VILL. L. REV. 125 (2010) (discussing utility of uncorporate forms).

investors lacking the information or trust relationship to meaningfully assess and allocate risk in the governance context, and (iii) allows parties actively involved in the negotiation of the contract to set their own governance terms. The coactive LLC concept implements this approach.

1. The Coactive LLC

The coactive LLC approach emerges from the OA Study, prior LLC literature, and trust theory. The OA Study shows that some parties can and do negotiate thoughtfully about the terms of their relationship—from the economics to governance to the consequences of misconduct—creating a coactive LLC.²²⁸ Although these agreements cannot cover every potential contingency, traditional contract law is well-suited to enforce these bargains.²²⁹ Nevertheless, the OA Study also suggests trends of unequal bargaining power that allow those with management rights to obtain lax standards of conduct and significant liability protection.²³⁰ These trends may be less troublesome if considered by the parties and priced into the overall deal terms, but Miller’s empirical surveys suggest that some LLC relationships lack this type of thoughtful negotiation. Miller’s surveys also raise questions about the knowledge of and information available to parties forming some LLCs.²³¹

Trust theory complements the OA Study and prior literature by explaining when parties are more likely to assess the trustworthiness of counterparties and therefore more accurately allocate and price risk.²³² Performing the type of fact-specific analysis required under trust theory on a case-by-case basis, however, does not produce a cohesive and generally applicable legal standard. Something more is needed—a standard based on objective criteria informed by trust theory.

This Article proposes a standard based on the existing default rules structure of LLC statutes with the clarification that some level of traditional fiduciary duties are mandated for managing members and managers in all LLCs other than coactive LLCs.²³³ Coactive LLCs are identified by three key elements: (i) fully informed parties, (ii) active negotiation by the parties at the time the particular member signs the Operating Agreement, and (iii) some control or

228. See generally *supra* Part II.

229. See, e.g., Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1410 (1989) (explaining that an efficient legal standard is hypothetical contracting where “[r]ational and fully informed parties would agree ex ante on the value-maximizing arrangement”).

230. See *supra* Part II.B.2.

231. See *supra* note 95 and accompanying text.

232. See *supra* Part III.A.2.

233. The level of duties owed by managing members and managers in non-coactive LLCs should provide accountability to owners akin to that owed among partners under most state’s partnership statutes. See UNIF. P’SHIP ACT § 103(b)(3), (4) (amended 1997), 6 U.L.A. 73 (2001) (specifying that the partnership agreement may not “eliminate the duty of loyalty [except if not manifestly unreasonable or if ratified by all or a percentage of partners specified in the agreement or] unreasonably reduce the duty of care”).

meaningful role in material transactions pursued by the LLC. Parties could opt into the coactive LLC form by certifying qualification based on these elements.²³⁴

2. Fully Informed Parties

Parties to coactive LLCs must have access to all information reasonably necessary for the parties to assess the proposed LLC and, in turn, the trustworthiness of the other members. Although many potential business partners perform significant due diligence before doing business together, many do not. This requirement would encourage more thoughtful diligence by parties wanting complete freedom of contract.²³⁵ Admittedly, there is a cost associated with this diligence that parties could avoid by following default rules. As such, parties must consider this cost in forming coactive LLCs and factor it into the value of the overall transaction.

3. Active Negotiation

The active negotiation requirement ensures that parties to coactive LLCs have a seat at the bargaining table. This seat does not ensure equal bargaining power, but it gives parties an opportunity to discuss and understand the deal terms.²³⁶ A party at the bargaining table can decide whether the ultimate deal satisfies its needs and risk appetite. If it does not, the party can walk away.²³⁷ If it elects to sign the Operating Agreement, the party should not be able to upset the expectations of other parties at the bargaining table after the fact, absent fraud or misrepresentation.

Situations with the earmarks of informed, active bargaining are in stark contrast to a party being presented a form or a completed Operating Agreement with only the option to sign or not sign.²³⁸ A “take it or leave it” approach to

234. Parties forming coactive LLCs would certify in the LLC’s articles of organization that the members satisfied the three key elements and that the LLC qualified as a coactive LLC. Contract law—for example, fraud in the inducement or misrepresentation—is well suited to address any challenges to this representation by members *ex post*.

235. Although some have suggested increasing diligence by parties through increased regulation, the coactive LLC approach proposes incentivizing parties to collect and assess relevant information by allowing those parties who do it (and meet the other requirements of coactive LLCs) to opt out of otherwise mandatory regulations. See Hill & O’Hara, *supra* note 22, at 1756–57.

236. For a general discussion of contractual bargaining power, see Daniel D. Barnhizer, *Inequality of Bargaining Power*, 76 U. COLO. L. REV. 139 (2005).

237. *Id.* at 180 (“[E]very party theoretically has the power to walk away from the proposed bargain and satisfy its needs or wants elsewhere.”); see also Herman B. Leonard & Richard J. Zeckhauser, *Financial Risk and the Burdens of Contracts*, 75 AM. ECON. REV. 375, 375, 379 (1985) (“Risk perceptions, risk preferences, and the chosen allocation of risk between the parties are three elements of the collection [of information and incentive burdens, but] full optimality [of contracts] is difficult to achieve.” (citations omitted)).

238. For a general discussion of the limitations of form documents, see Kirsten K. Davis, *Legal Forms as Rhetorical Transaction: Competency in the Context of Information and Efficiency*, 79 UMKC L. REV. 667 (2011).

Operating Agreements should not garner the freedom of contract privilege. In those situations, the efficiency of the process and the potential for undue influence also come at a price: governance by mandatory fiduciary duties.

4. Retained Control

Finally, the last element of the coercive LLC—the requirement that members have control or a meaningful role in material transactions—eliminates passive investments in this type of LLC. Although parties may still allocate and price risk in these situations, those allocations have a high probability of being inaccurate given the significant opportunity for abuse by managers with complete discretion.²³⁹ These situations are akin to those described as “overtrusting” under trust theory and closely resemble traditional fiduciary relationships.²⁴⁰ Indeed, the passive member is entrusting things of value to the complete discretion of the managing member or manager.²⁴¹ Accordingly, lack of control or meaningful influence warrants the protection of traditional fiduciary duties.

Notably, this last element does not mean that manager-managed LLCs are excluded from qualifying as coercive LLCs. As demonstrated by the OA Study, many manager-managed LLCs reserve significant voting rights to the members, including major business decisions; admission of new members; economic contributions and distributions; and dissolution, liquidation, or bankruptcy of the LLC.²⁴² If members ultimately retain control over these or similar matters—whether in a member-managed or manager-managed LLC—they also should retain the discretion to contract for governance terms.

The concept of control or influence over a business entity is not new, and decisional law exists to guide the determination. In the coercive LLC context, the four-prong test endorsed by the U.S. Supreme Court in *SEC v. Howey* is particularly apt.²⁴³ This test considers whether an “investment contract” is a “security” for purposes of the 1933 Securities Act. The test commonly is articulated as: (i) a monetary investment (ii) with an expectation of profits from (iii) a common enterprise that (iv) depends solely or substantially on the efforts of third parties.²⁴⁴ If an investment meets the test, the investment contract—which

239. Larry T. Garvin, *Small Business and the False Dichotomies of Contract Law*, 40 WAKE FOREST L. REV. 295, 308–09 (2005) (explaining—based upon the psychological idea of “bounded rationality”—that if information is scarce, decisions are based on cognitive shortcuts which “increas[e] the likelihood and magnitude of error”).

240. See Hill & O’Hara, *supra* note 22, at 1723 (describing “overtrust” between board members and corporate officers and patients and doctors whereby “trust-relevant information” is not accurately processed).

241. *See supra* Part I.A.2.

242. *See supra* Part II.C.1.b.

243. 328 U.S. 293, 301 (1946).

244. *Id.* at 298–301. With respect to the last element of the *Howey* test, this Article adopts the slightly relaxed iteration suggested by the Supreme Court and used by various lower courts. *See United Hous. Found. v. Foreman*, 421 U.S. 837, 839, 852 (1975) (focusing on whether profits were “derived from the entrepreneurial or managerial efforts of others”).

may be an LLC ownership or economic interest—is a security and federal securities laws apply accordingly.²⁴⁵

The *Howey* test is extremely useful in analyzing the last element of coercive LLCs. The fact that a member investing in an LLC relies solely or substantially on the managers or other members to manage and grow that investment indicates a lack of meaningful control by the member itself. That investing member has little ability to affect the course of the LLC or protect his monetary investment; that member closely resembles the shareholder beneficiary of traditional fiduciary duties in the business context. Moreover, if a member's LLC interest is a security, traditional fiduciary duties complement the disclosure and investor protection objectives of federal securities laws.²⁴⁶

5. Implementation of the Coercive LLC

In sum, LLC statutes and decisional law applying them should impose traditional fiduciary duties unless the LLC qualifies as a coercive LLC. Although this approach strikes an appropriate balance in the fiduciary debate, it likely will not appease some commentators on either side of the debate. For example, those who support mandatory fiduciary duties will likely argue that minority members in coercive LLCs are still subject to oppression by managers or the majority.²⁴⁷ This position, however, fails to recognize and respect the intentional business decision made by parties to coercive LLCs. The law should not substitute its concept of a good or fair business deal for that negotiated by the parties, absent flaws or weaknesses in the bargaining process.²⁴⁸

Likewise, those who support no fiduciary duties or the ability to modify or eliminate fiduciary duties in all LLCs will likely argue that parties should be able to contract for the terms of their business relationship, regardless of the process or knowledge of the parties.²⁴⁹ Admittedly, even passive investors or ill-informed investors can choose to forego the LLC opportunity and invest their money elsewhere. Nevertheless, the limited ability of these investors to accurately assess the trustworthiness of the counterparties and the efficiency of default rules in these situations support a compromise that preserves complete freedom of contract for some, but not all, types of LLCs.

245. *Howey*, 328 U.S. at 299; *see also* 15 U.S.C. §§ 77b(a)(1), 78c(10) (2012) (defining “security” for purposes of federal securities laws).

246. For a discussion of publicly-traded LLCs, see Ribstein, *supra* note 227.

247. *See supra* Part I.B.2.

248. *See, e.g.*, Barnhizer, *supra* note 236, at 141 (“[C]ourts must identify those situations in which bargaining power should have legal consequences and develop more sophisticated and realistic analyses of that phenomenon.”); Steele, *supra* note 89, at 238 (“[A] court may strike terms to an agreement if it finds some indicia of fraud, undue influence, or adhesion [but s]imply because, on occasion, parties may ineffectively bargain, *ex ante*, does not require the courts to swoop in as a protector for ill-advised contract makers.”).

249. *See supra* note 89 and accompanying text.

The coactive LLC concept provides a framework for legislatures and courts to implement freedom of contract principles while protecting truly vulnerable parties. This balance should ease courts' concerns regarding fairness and promote legislatures' intent to grant flexibility in business formation decisions.²⁵⁰ A solution that addresses the perspectives of both courts and legislatures has a greater chance of being enforced consistently, thereby creating certainty for the business community. A solution that provides complete freedom of contract for parties satisfying objective criteria also permits parties to elect the LLC form that best serves their business and economic goals. The coactive LLC is a well-balanced compromise that promotes the underlying purpose of the LLC form in a fair and consistent manner.

CONCLUSION

The LLC form allows parties to craft an entity that facilitates their business objectives and reflects their desired governance structure. The freedom of contract principle underlying the LLC form, however, raises concerns among policymakers and commentators.²⁵¹ The potential for information asymmetry and unequal bargaining power exists and may expose parties—particularly minority or passive investors—to increased risk of loss. Policymakers and commentators also have raised questions regarding the need for and utility of the LLC form.

The OA Study presents an in-depth empirical study of actual Operating Agreements. The study dissects the substance of these agreements and uses the data to draw meaningful inferences regarding parties' governance and other preferences in the LLC form. The data suggest that many parties intensely negotiate Operating Agreements, and the overwhelming majority of agreements modify traditional fiduciary duties in some respect.²⁵² These modifications are not necessarily blanket waivers, but they often reflect particular parameters likely reached through negotiation. Nevertheless, regression analysis also suggests that some parties—in particular, managing members and managers—may possess greater influence at the bargaining table, allowing these parties to achieve substantial discretion and liability protection.²⁵³ Accordingly, even in a population of Operating Agreements among arguably sophisticated parties in developed industries, the potential for information asymmetry and unequal bargaining power may exist. It also may be an appropriate allocation of risk based on the parties' pricing of the contract and their respective appetites for risk.

The challenge then is to determine when parties in the LLC context are truly vulnerable versus when they knowingly negotiated what in hindsight is a bad business deal. The OA Study, interpreted in light of the prior LLC literature and trust theory, suggests returning to the assumptions underlying the LLC form (for example that LLCs are organized by represented, sophisticated, and fully informed parties) in striking an appropriate balance in LLC fiduciary policy. These

250. *See supra* Part I.

251. *See supra* Part I.

252. *See supra* Part II.C.

253. *See supra* Part II.C.2.

assumptions generally align with the required elements of informed trust, which considers when parties have the capacity to accurately assess the trustworthiness of the counterparty and likely risk exposure.²⁵⁴ Any standard governing deference to the parties' contractual governance structure should seek to optimize informed trust and establish limitations in circumstances potentially leading to misguided trust or trust abuses.

An approach that retains default rules for governing LLCs and imposes mandatory fiduciary duties in all LLCs other than coactive LLCs strikes an appropriate policy balance. This approach continues the freedom of contract principle for parties who intentionally choose the terms of the Operating Agreement through active negotiation, informed decision-making, and some control over the direction of the LLC—i.e., parties to coactive LLCs. Parties who do not satisfy these criteria really are not doing business by contract, and the law should not pretend that they are. Imposing fiduciary duties on managers or managing members in LLCs other than coactive LLCs encourages parties to engage in meaningful negotiations about their business relationship or comply with the traditional standards of conduct in the business community. In either scenario, it provides appropriate incentives for parties to do the right thing and an appropriate role for regulation in the parties' business relationship.

254. *See supra* Part III.A.1.