

THE PITFALLS OF FIDUCIARY DUTY WAIVERS IN DO-IT-YOURSELF LLC FORMATION

Derek Terry*

In his article, Professor Fershee illuminates concerns about the elimination of the duty of loyalty in limited liability companies (“LLCs”) organized under and governed by Delaware law.¹ His article focuses on decisions about tailoring fiduciary duties after formation planning, such as amendments to the LLC operating agreement effected by a majority of members entitled to vote that reduce or eliminate the fiduciary duties of members and the consequences of those amendments to members holding a minority interest.² This comment aims to highlight issues occurring at the formation of an LLC, a time at which less sophisticated small business founders risk blindly waiving the consequences of a breach of fiduciary duty. Further, I suggest a remedial alternative to better inform the unwary entrepreneur seeking to organize business operations through an LLC using online formation service platforms.

The Delaware Limited Liability Company Act permits all fiduciary duties to be eliminated by contract among the members of the LLC.³ This approach comports with Delaware’s stated policy of ultimate contractual freedom⁴ and is likely desirable for sophisticated co-venturers arranging

* 2019 Juris Doctor Candidate, The University of Tennessee College of Law; 2016 B.S., *summa cum laude*, The University of Tennessee’s Haslam College of Business. The author will join the Corporate, M&A, and Securities practice of Husch Blackwell, LLP in September 2019. The author was asked to provide comment in response to Professor Joshua P. Fershee’s CLE presentation, “An Overt Disclosure Requirement for Eliminating the Duty of Loyalty.” The author would like to thank Rick Rose Distinguished Professor of Law Joan M. Heminway for her assistance in crafting this comment.

¹ See Joshua P. Fershee, *An Overt Disclosure Requirement for Eliminating the Duty of Loyalty*, 20 TENN. J. BUS. L. 979 (2019).

² See *id.* at 980.

³ DEL. CODE ANN. tit. 6, § 18-1101(e) (2013).

⁴ DEL. CODE ANN. tit. 6, § 18-1101(b) (2013).

their business affairs.⁵ Nevada has taken a similar approach, allowing fiduciary duties to be wholly waived in an LLC operating agreement.⁶ However, not every LLC investor is sophisticated. The emergence of online entity formation services like LegalZoom and RocketLawyer pose a heightened risk to the uncounseled entrepreneur⁷ who may be prompted, without knowledge, to waive certain prohibitions on conduct that otherwise may represent breaches of fiduciary duty, such as competing with the LLC. Delaware and states with similar business entity statutes have opened the door for fiduciary duty waivers to become the standard, rather than the exception, in LLC agreements and operating agreements.

Small business start-ups are increasingly common in the information age, and the LLC form is one of the most popular entity choices for start-up founders.⁸ Simply googling “LLC operating agreement” reveals myriad fill-in-the-blank websites and ready-made forms for designing an entity structure on your own. Today, you can form a legal entity with the same amount of time and effort expended in ordering shoes on Amazon. LegalZoom boasts that it has helped launch over one million businesses since its inception in the early 2000s, and a user can form an LLC in five to ten minutes using its services.⁹ Similarly, RocketLawyer offers free LLC operating agreements online.¹⁰ Both

⁵ See Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. 2129, 2131 (2018) (noting the economic efficiency provided sophisticated LLC parties in tailoring governance provisions to meet their specific needs).

⁶ NEV. REV. STAT. § 86.286(5) (2015).

⁷ The term “entrepreneur” used in this article refers generally to a person or persons starting a business operation for profit.

⁸ See Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207, 208 (2015) (noting that more than one-third of all firms in the United States are LLCs); see also *Our Business Products*, LEGALZOOM, <https://www.legalzoom.com/business/> (last visited Jan. 3, 2019) (noting the popularity of LLCs among small business owners).

⁹ *Our Business Products*, LEGALZOOM, <https://www.legalzoom.com/business/business-formation/llc-overview.html> (last visited Jan. 3, 2019).

¹⁰ *Make Your Free LLC Operating Agreement*, ROCKETLAWYER, https://www.rocketlawyer.com/sem/llc-operatingagreement.rlp?id=1375&partnerid=103&cid=245637905&adgid=19301475905&loc_int=&loc_phys=9013451&mt=b&ntwk=g&dv=c&adid=282259056390&kw=%2Boperating%20%2Bagreement&adpos=1t1&plc=&trgt=&trgtid=kwd23054676785&gclid=EAIaIQobChMIhJWgnr643QIVhY2zCh1HgQIbEAAAYASAAEgK7dfD_BwE#/ (last visited Jan. 3, 2019).

platforms offer a fill-in-the-blank format where the do-it-yourself entrepreneur selects the state of organization,¹¹ voting method, and other important matters for crafting a certificate of organization and operating agreement. Neither business formation service provider prompts the entity creator to select whether they agree to waive fiduciary duties for members or managers of the LLC in the fill-in-the-blank process and, instead, waives those duties by default.¹² Further, neither site offers any information about fiduciary duties in their respective entity formation processes. In an article on LegalZoom's website titled, "How to Draft an LLC Operating Agreement," the author lists various important terms of a typical operating agreement and describes their consequence.¹³ While disclaimed as a non-exhaustive overview, the article makes no mention of fiduciary duties or the ability to modify or eliminate them.¹⁴

Perhaps most troubling is that RocketLawyer's form LLC operating agreement waives fiduciary duties of members regardless of the

¹¹ Both LegalZoom and RocketLawyer offer the ability to choose your state of organization. However, LegalZoom does instruct the do-it-yourself entrepreneur that "most customers form their LLC in their local state." See *Our Business Products, LLC*, LEGALZOOM.COM, <https://www.legalzoom.com/llc/name/state?/> (last visited Jan. 3, 2019).

¹² RocketLawyer's form LLC operating agreement waives the consequences of a breach of fiduciary duty by members acting in their capacity as a member, but maintains fiduciary duties for managers or officers, as applicable. See *Make Your Free LLC Operating Agreement, Limited Liability Company Agreement*, at p. 4 ¶ III(H), ROCKETLAWYER.COM, https://www.rocketlawyer.com/sem/llc-operatingagreement.rlp?id=1375&partnered=103&cid=245637905&adgid=19301475905&doc_int=&doc_phys=9013451&mt=b&ntwk=g&dv=c&adid=282259056390&kw=%2Boperating%20%2Bagreement&adpos=1t1&plc=&trgt=&trgtid=kwd23054676785&gclid=EAIaIQobChMIhJWgnr643QIVhY2zCh1HgQIbEAAAYASAAEgK7dfD_BwE#/ (select state of organization, follow "Make Document" and tab to page 4 of the form agreement) ("The Members shall have no fiduciary duties whatsoever, whether to each other or to the Company, unless that Member is a Manager or an Officer of the Company, in which instance they shall owe only the respective fiduciary duties of a Manager or Officer, as applicable.").

¹³ Edward A. Haman, *How to Draft an LLC Operating Agreement*, LEGALZOOM.COM (June 2015), <https://www.legalzoom.com/articles/how-to-draft-an-llc-operating-agreement>.

¹⁴ Edward A. Haman, *How to Draft an LLC Operating Agreement*, LEGALZOOM.COM (June 2015), <https://www.legalzoom.com/articles/how-to-draft-an-llc-operating-agreement>.

state the entity creator selects as the state of organization.¹⁵ Some states, such as Tennessee, do not allow a blanket waiver of the duty of loyalty for members of an LLC.¹⁶ The risk of an unintended or invalid waiver of fiduciary duties posed to a RocketLawyer entity creator wishing to form an LLC in Tennessee may be minimal since the waiver term will almost assuredly be held unenforceable if challenged in court. Nonetheless, the lack of transparency provided to the unwary, inexperienced, unsophisticated do-it-yourself entrepreneur could result in small business owners agreeing to business arrangements that are invalid or that were not desired or bargained for.

Fiduciary duty waivers in Delaware LLC agreements are the new norm. Professor Mohsen Manesh conducted a study of 85 publicly traded Delaware alternative entity firms (which included both LLCs and limited partnerships) in 2012, finding that 75 of the firms either waived all fiduciary duties of managers or exculpated managers from liability for a breach of their fiduciary duties.¹⁷ The result is unsurprising considering the policy underlying Delaware's LLC Act and the general purpose for states' adoption of the LLC form beginning in the 1990s. Contractual freedom and the ability to shirk liability may be a sound goal and appropriate policy for well-informed business co-venturers; however, small business founders may not appreciate the nature or implications of fiduciary duties and the effect of waiving them in their LLC operating agreement. LegalZoom's "LLC in ten minutes" model does not impart to the start-up owner the importance of considering and negotiating an operating agreement.

Duty of loyalty waivers lie at the heart of the debate between the pure contractarian, freedom of contract view of the LLC form and the more traditional view of the LLC as a fiduciary relationship between members of a business association. An important premise underlying the freedom of contract view is market efficiency premised on the availability

¹⁵ See *Make Your Free LLC Operating Agreement, Limited Liability Company Agreement*, at p. 4 ¶III(H), ROCKETLAWYER.COM, <https://www.rocketlawyer.com/secure/interview/questions.aspx?document=77376671&cid=1375#q3> (last visited Jan. 3, 2019).

¹⁶ See TENN. CODE ANN. § 48-249-205(b)(13). However, a LLC operating agreement may "identify specific types or categories of activities that do not violate the duty of loyalty under § 48-249-403(b)(1) or (b)(2), if not manifestly unreasonable . . ." TENN. CODE ANN. § 48-249-205(b)(13)(A).

¹⁷ Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 33 J. CORP. L. 555, 558 (2012).

of adequate information and the ability to exercise equitable bargaining power. Basic principles of contract formation require a meeting of the minds founded on the parties' understanding of the terms of the agreement and a mutual commitment to be bound by them. The consequences of the absence or presence of fiduciary duties imposed upon members and managers of LLCs are not readily apparent to unsophisticated individuals. In the case of an entrepreneur organizing a business association without the assistance of an attorney, the risk that the organizing owners are not properly informed about the risks and rewards associated with fiduciary duties, or waivers of them, is especially great. The contractarian policy of Delaware and similar states' LLC regimes is undermined by the implementation of automatic modification of default rules and duties, without the end-user's consent, by these online LLC formation service providers.

In the case of the start-up founder looking to RocketLawyer for business formation assistance, the informational asymmetry arises between the trusted service provider and the company founders, in addition to potential asymmetry between the parties seeking to form an LLC to conduct their business operations. Sophisticated investors or entrepreneurs are unlikely to be customers of LegalZoom and RocketLawyer. Free or low-cost online business formation services are most attractive to the quintessential small business founder, who may not have the resources to retain or an appreciation of the need for legal counsel in the creation of an LLC. The default rule imposing fiduciary duties on members of an LLC is most appropriate to protect uninformed and uncounseled individuals. The automatic elimination of that default rule for customers of LegalZoom and RocketLawyer inserts what ought to be a negotiated term of the operating agreement that may have unintended consequences.

An example may best illustrate the potential adverse effects of unsophisticated entrepreneurs unknowingly or unadvisedly waiving member fiduciary duties. Suppose two friends, Joe and Sue, set out to operate a coffee shop in a small town. Joe, the coffee guy, has worked tirelessly to create a recipe for a great cup of coffee. Sue, the successful contractor, is interested in helping her friend fund the small operation and offers to purchase equipment and inventory and pay the first few months' rent. The two friends opt to form a Delaware LLC on LegalZoom, because Sue has read online that Delaware is "pro-business" state and both have heard that most new businesses are formed as LLCs. They form Small Town Coffee, LLC in ten minutes online, purchasing an operating

agreement in which their fiduciary duties to each other are automatically waived. Business operations begin, and Sue soon realizes that while Joe is great at making a cup of coffee, his managerial skills are lacking. Another friend of Sue approaches her with the idea of starting a coffee shop in the same town, selling a better cup of coffee at prices similar to Small Town Coffee. Sue decides to invest in the new coffee shop, which directly competes with Small Town Coffee, and discontinues funding Small Town Coffee. Joe is understandably upset and believes he must have legal recourse. However, where the operating agreement explicitly and clearly waives Sue's fiduciary duty of loyalty, Sue is free to compete against Small Town Coffee without liability. The contractarian argues that this result is precisely what Joe and Sue bargained for. But is that true?

The current *caveat emptor*-like policy of “entrepreneur beware,” holding a start-up founder responsible for due diligence and research before signing an operating agreement, seems reasonable enough to the sophisticated reader. Starting a business with others is certainly an important transaction that should be undertaken thoughtfully and with the assistance of an experienced businessperson or an attorney. The adage “you get what you paid for” rings true for the scorned co-venturer who decided to use or accede to the use of a free RocketLawyer LLC operating agreement. The fact is that many small business founders do not seek counsel, and with the emergence of cost-effective online resources, entrepreneurs often do not appreciate the value of legal advice in structuring their LLC. Where the uncounseled entrepreneur enters the stage, the default rules of fiduciary duties seem most appropriate.

Borrowing from Professor Fershee's proposal for required disclosure,¹⁸ the informational asymmetry problem may be alleviated by statutory disclosure requirements imposed on online business formation service providers. Sites like RocketLawyer and LegalZoom could be required to briefly explain the concept of fiduciary duties of loyalty and care and the consequences of their breach. Business formation document providers could further be required to seek the customer's consent to a waiver of fiduciary duties in the form documents they provide. However, this proposal raises the familiar problem states have encountered with regulating “document provider” sites like LegalZoom as lawyers in the

¹⁸ See *supra* note 1, at 980–81.

past decade.¹⁹ States prohibit the provision of legal services without a license to practice law within the state, often imposing criminal liability for violations.²⁰ Regulating business formation service providers legislatively, as opposed to through attacks from the state bar for the unauthorized practice of law,²¹ would avoid this issue. Forcing these providers to explain the consequence of fiduciary duties through disclosure, however, may very well bring them into the ambit of the practice of law. The remedy to the issue of uninformed LLC organizers is less than clear, but the problem is neither nominal nor inconsequential.

The promotion of better-informed start-up organizers bolsters the viability of the LLC form for small businesses and the policy of contractual freedom underlying most LLC statutory schemes. The consequences of an unintentional waiver of some or all applicable fiduciary duties may be great, while the burden of providing the unsophisticated entrepreneur the information and opportunity to agree to waive those duties would be minimal. No matter the size of the enterprise or legal and business acumen of the entrepreneurs, the opportunity to weigh the consequences of the terms of their entity structure on an informed basis is paramount to the value of the principles of contractual freedom that lie at the root of the LLC form.

¹⁹ See Robert Ambrogi, *Latest Legal Victory has LegalZoom Poised for Growth*, ABA JOURNAL (Aug. 2014), http://www.abajournal.com/magazine/article/latest_legal_victory_has_legalzoom_poised_for_growth/ (last visited Jan. 3, 2019).

²⁰ See, e.g., TENN. CODE ANN. § 23-3-103.

²¹ See, e.g., TENN. CODE ANN. § 23-3-103(d)(1) (providing that “any organized statewide bar association . . . may bring a civil action . . . seeking relief . . .” against a person violating the prohibition against the unauthorized practice of law).