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By Joan MacLeod Heminway

Corporations and unincorporated entities exist to promote business by giving business venturers (entrepreneurs, promoters, and financial backers) standard, legally ordained structures to govern their business activities in a manner that is consonant with their reasonable expectations. A successful choice of entity involves gauging the reasonable expectations of the venturers and matching them as closely as possible to the operative rules and norms of a form of entity (as the same may be modified, of course, by valid agreements between or among the venturers). As Mark Loewenstein notes in his conclusion to Part I of this set of two entity rationalization articles, forms of entity have proliferated over the past 50 years, offering venturers more refined choices. At some point, one must wonder (as one of my students recently did) whether we now have too many forms of entity; whether the costs associated with choice of entity now exceed the benefits.

This pair of articles does not take on that argument directly. But the entity rationalization debate is borne of many of the same concerns, and thoughtful entity rationalization may lead to the conclusion that we are best off paring back the number of statutory entities to a more manageable number with more distinct rules grounded in policy objectives and relevant theory. As Mark observes, "the challenge of the 21st century will be to consider whether the legal differences among these [corporations and alternative] entities makes sense and, if not, how the law should be harmonized." I agree.

Yet, I think there is more to rationalizing than harmonization, and my reading of Mark's article leads me to believe that he does, too. For me, rationalization is a process – a consideration of parallel rules from the different forms of entity in light of underlying policy and applicable theory. My purpose in this article is to offer preliminary thoughts on that process by considering how corporate law and limited liability company (LLC) law address two key areas of entity law: freedom of contract and fiduciary duties. Like Mark, I will bring in partnership law when relevant or insightful.

Freedom of Contract

While entity laws do include immutable rules (e.g., those governing entity formation), much of corporate and unincorporated business association law consists of default rules – rules that the constituents can agree around (often, but not always, in ways specified in the statutes themselves). As a general matter, corporate law rules constrain private ordering more strictly than limited liability company rules, although the internal constituents in statutory close corporations – like those formed under Subchapter XIV of the Delaware General Corporation Law (DGCL) – and other closely held corporations often are given more leeway to agree around rules than those in other corporations. Under corporate law, modifications to statutory default rules often must be made in specified documents. Corporate statutes are replete with clauses like "unless the [the corporate charter – denominated articles of incorporation under the Model Business Corporation Act (MBCA) and a certificate of incorporation under the DGCL] [the bylaws] [a valid shareholder agreement] provide otherwise, . . ." For example, Section 7.21 of the MBCA states that ". . . unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each matter voted on at a shareholders' meeting." The parallel provision in the DGCL, Section 212, similarly states that "[u]nless otherwise provided in the certificate of incorporation . . . , each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder."

The relevant uniform LLC law in the United States, on which many state LLC statutes are based, originally came from the Revised Uniform Partnership Act (RUPA). The bias in partnership law (which originally was common law), as reflected in Section 103 of the RUPA, is to generally al-

low the partnership agreement to establish the rules that govern the partners' relations in and with the partnership. Consistent with this preference for self-determination, Section 110(a) of the Revised Uniform Limited Liability Company Act (RULLCA) gives effect to internal governance rules for the LLC contained in the operating agreement among the LLC members, except in certain limited respects expressly set forth in the statute. The RULLCA sets forth these limited exceptions in Section 110(c), some of which are immutable rules and some of which are rules allowing for tailored modification of statutory default rules in the operating agreement. It is significant to note in this context that operating agreements may be written or oral and, unlike corporate charters, have no specified structure or mandated contents. Although the RULLCA and its predecessor uniform acts flip the statutory presumption as to the location of the operative rules to the agreement among the venturers (from the corporate presumption that the statute includes the operative rules) and allow for a more open form of agreement, the net effect of the RULLCA is not measurably different from that of the corporate law: unless the parties agree otherwise, default rules in the statute govern their conduct.

There are several key areas, however, in which the RULLCA has begun to innovate away from both corporate and partnership law and toward a more pure freedom to contract for governance rules. This trend is exemplified by the absence in the RULLCA of any express apparent agency authority rule for members of a member-managed LLCs. Section 301 of the RULLCA provides that "[a] member is not an agent of a limited liability company solely by reason of being a member." By contrast, Section 301 of the 1995 version of the Uniform Limited Liability Company Act included a default rule providing that

> [e]ach member is an agent of the company for the purpose of its business, and an act of a member, including the signing of an instrument in the company's name, for apparently carrying on in the ordinary course the company's business or business of the kind carried on by the company binds the company, unless the member had no authority to act for the company in the particular matter and the person with whom the member was dealing knew or had notice that the member lacked authority.

The RULLCA implemented a similar change with respect to the apparent authority of managers in a manager-managed LLC (omitting express agency authority for managers that was included in Section 301 of the predecessor ULLCA). The lack of a statutory default rule in the RULLCA defining the apparent authority of members or managers allows LLC members to contract for the authority rules they desire in their operating agreement. In the absence of valid authority provisions in the operating agreement, the common law of agency provides the necessary rules.

Delaware LLC law offers business venturers the most flexibility as to the rules that govern their relations with each other and the LLC. The Delaware Limited Liability Company Act (DLLCA) does not distinguish between member-managed and manager-managed LLCs and is silent as to the apparent authority of any members or managers that may be provided for in the operating agreement. This silence exemplifies Delaware's strong policy favoring the freedom of constituents in LLCs to contract for their own governance rules. This policy is drafted right into the DLLCA. Section 18-1101(b) of the DLLCA provides that "[i]t 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." This general provision summarizes and guides interpretation of the DLLCA.

It is a "given" that freedom to contract is more significant in LLCs than corporations. LLCs were created as a more highly contractual alternative to the standardized, statutory corporate form, while still offering business participants structural and governance norms. In a world of rules that balances contractual freedom against black letter rules and foreseeable outcomes, the LLC form favors freedom to contract over certainty and predictability. Thus, harmonization regarding freedom of contract would contradict a key rationale for the existence of corporations and LLCs as two distinct forms of entity and undermine the freedom of choice of entrepreneurs who desire to form an entity rather than conduct their business using contracts. We can justify the general differences between corporate and LLC law with respect to the freedom to contract on this basis.

Is it possible that the freedom to contract in the LLC form may reach a point of maximum utility? Although the idea may be a bit far-fetched, there may be a time at which LLC law extends freedom of contract to such a great degree that there is no longer any measurable benefit to organizing a business under the LLC form. Said another way, as LLC law edges toward forcing or strongly encouraging governance rulemaking through contracts among business venture participants and away from statutory default rules, there may be less of a need for LLC law. Business venturers certainly are able to conduct business through contracts among themselves and with third parties without the benefit of LLC law. Admittedly, however, as long as limited liability status is only obtainable through entity formation, the LLC form will continue to have substantial value for participants in firms that do not want to organize as corporations.

Fiduciary Duties

To codify, or not to codify? That is the main question, when it comes to fiduciary duty principles in entity law. Corporate law has eschewed codifying fiduciary duties in any great detail, preferring instead, at most, to rely on a general concept (expressed in, e.g., Sections 8.30(a) and 8.30(b) of the MBCA) that corporate directors and officers are charged with acting in good faith, in the best interest of the corporation, and with due care. The DGCL does not even express this general notion, leaving the whole of fiduciary duty law to judicial review. Modern unincorporated entity laws, starting with the RUPA, have, however, codified

exclusive or non-exclusive fiduciary duties of loyalty and care, and provide for an obligation of good faith and fair dealing among the constituents. Examples include Section 404 of the RUPA (providing that the only two fiduciary duties of partners to each other and the partnership are care and loyalty, as expressly defined) and Section 409 of the RULLCA (providing for nonexclusive duties of care and loyalty, as expressly defined).

The trend in LLC law has been toward broader fiduciary duties, less codification of fiduciary duties, and more freedom of contract in tailoring fiduciary duties. The RULLCA, for instance, defines the duty of care in Section 409(c) more broadly than the predecessor ULLCA. The RULLCA definition encompasses a negligence standard of care in addition to the previous standard's inclusion of gross negligence, willful misconduct, and knowing violation of the law. In a bolder move, both the DLLCA and the American Bar Association's Revised Prototype Limited Liability Company Act decline to codify fiduciary duties. Instead, both allow members to freely provide for, define, and delimit fiduciary duties in the LLC's operating agreement (now denominated in the DLLCA as a limited liability company agreement).

The freedom of contract with respect to LLC fiduciary duties in Delaware has fostered an interesting debate that has been played out in the judiciary in Delaware in the past few years – perhaps most notably in *Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012), and *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012). The debate concerns whether members or managers of an LLC have any fiduciary duties if none are provided for in the limited liability company agreement. A recent amendment to the DLLCA clarified that a court may continue to find that fiduciary duties are applicable to LLC participants when no fiduciary duties are provided for in the LLC agreement. Section 18-1104 of the DLLCA, effective August 1, 2013, provides that "[i]n any case not provided for in this chapter, the rules of law and equity, *including the rules of law and equity relating to fiduciary duties and the law merchant*, shall govern." (emphasis added). Accordingly, although a limited liability company agreement may limit or eliminate fiduciary duties under Delaware law, if the agreement remains silent as to fiduciary duties, common law fiduciary duties apply.

LLC fiduciary duty law is evolving toward freedom of contract. The rationalization of entity law rules governing fiduciary duties, like those described above relating to freedom of contract, involves considering both the value and the nature of certainty and predictability in business planning and enforcement. This debate will naturally influence the separation of corporate law from LLC law and, perhaps, the continued need for and existence of LLC law.

Policies underlying fiduciary duties are different, however, from those underlying other governance rules. Fiduciary duties promote trust in co-venturers in entering into business relationships with each other. They arose at common law to enforce implicit promises in the relations between legal actors. Accordingly, the failure to provide for default fiduciary duties in an LLC statute should not necessarily mean, as it may in the context of other statutorily constructed entity law rules, that no rule exists – i.e., that business entity participants have no fiduciary duties to each other.

Apart from the freedom to contract, there is no support in existing policy or theory for different fiduciary duties for participants in different forms of legal entity. Although courts and legislatures categorize fiduciary duties in an effort to clarify their meaning and provide certainty and predictability in business planning and enforcement, fiduciary duty doctrine is, at its core, interstitial. It fills gaps in the more express principles that govern the structure of business entities and the manner in which their operations are governed. The existence of statutory or common law fiduciary duties in the absence of the clear, express limitation or elimination of them supplies a foundational trust that incentivizes entrepreneurs, promoters, and financial backers to efficiently form and operate businesses. This is common to all relationships in business firms and dictates harmonization of legal rules across entities. The content of default fiduciary duties should be the same across all forms of entity.

Having said that, freedom of contract in the LLC form should still be able to operate in much the way that the DLLCA now provides (if not otherwise, as provided in, e.g., the RULLCA). Informed venturers with legal capacity should be able to enter into valid and binding contracts that vary statutory or common law fiduciary duties. They may have other ways of supplying the trust needed to engage in business together. It is only where the contracts on fiduciary duties are invalid or unenforceable, or where no contractual provision on fiduciary duties is made, that common law would or should step in to fill gaps in the rules that govern the relations among business entity participants.

Conclusion

The issues raised in this article provide some food for thought on entity rationalization for legislators, practitioners, and the judiciary through two examples. The article does not address, however, several important issues that exist in the overall entity rationalization debate. In particular, the article does not address the notion that state policy goals may differ in justifiable ways, meaning that state judgments about the need to harmonize entity law (which is, of course, state law) may be, and are, in fact, different. The many variations in the ways that states handle aspects of fundamental change transactions in their entity law rules (including variations in the availability of shareholder-initiated dissolutions and the availability of dissenters' rights for charter amendments and in business combination transactions) illustrates these policy differences. This means that forms of entity are not the same in each state. State law differences offer venturers more choice in constructing their businesses but make the task of rationalization more complex.

Other elements of complexity also confound the entity rationalization process. Both federal corporate governance rules applicable to public entities (enacted through

the federal securities laws and implemented by Securities and Exchange Commission regulation) and stock exchange rules applicable to listed companies further complicate entity rationalization. Moreover, none of the analysis in this article takes into account whether the focus of the norms of entity law match the evolving requirements and preferences of participants in business ventures.

Despite the complexity of the entity rationalization process, there is much to be gained from a careful comparative analysis of entities within any individual state in light of policy and theory – an analysis that may not always be occurring when legal rules are debated in the legislature, in judicial proceedings, and in the public at-large. New entity laws have continued to proliferate in the 21st century, with social enterprise entity legislation – including the enactment of laws providing for low-profit limited liability companies, commonly known as L3Cs, benefit corporations, and other similar forms of entity – being a large player in the current legislative adoption game. Some of these laws represent only minor adjustments to existing entity laws, and the cost of their adoption may not result in palpable benefits for business venturers or the state. In some instances, the articulated benefits of these statutes may not be benefits at all. In many (if not most) cases, existing entity law can accomplish the same objectives with – and sometimes even without – small enhancements allowing for additional freedom of contract. In those cases, a whole new entity law is not needed. Legislative time is precious, and we should not be squandering it on unnecessary statutes.

The accumulation of the information in Mark Loewenstein's *Part I* article and this article suggest that entity rationalization should be part of ongoing debates regarding the adoption of new forms of entity and the amendment and interpretation of existing entity law statutes. Similarities and differences among rules for different forms of entity should make sense in light of policy and theory. Ultimately, if done properly, the entity rationalization process should generate a limited set of distinct business entities that well serve the needs of those who wish to use them. That would be a desirable result.

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ADDITIONAL RESOURCES

For other materials on this topic, please refer to the following.

Business Law Today

Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in elaware LLC Agreements
By Paul M. Altman, Elisa Erlenbach Maas, and Michael P. Maxwell
February 2013

Fiduciary Duties of Managers of LLCs: The Status of the Debate in Delaware
By Lewis H. Lazarus and Jason C. Jowers
February 2012

Delaware LLC's and the Implied Covenant of Good Faith and Fair Dealing
By Lewis H. Lazarus and Jason C. Jowers
November 2011