THE DELAWARE JOURNAL OF CORPORATE LAW

MEMORIAL TO PROFESSOR DONALD E. PEASE

ARTICLES

Volume 30 **2005** **Number 2**

THE DUTY OF FINEST LOYALTY AND REASONABLE DECISIONS: THE BUSINESS JUDGMENT RULE IN UNINCORPORATED BUSINESS ORGANIZATIONS?

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ABSTRACT

The business judgment rule, a cornerstone of the jurisprudence of the duty of care in the corporate context, holds a less defined role in the contractually driven realm of unincorporated business organizations such as the partnership, limited partnership, and limited liability company. This uncertainty has in recent years been exacerbated by rapid developments in statutory schemes. This article examines (1) the business judgment rule as applied in the corporate context, (2) the recent developments in the laws of unincorporated business organizations, and (3) the interplay of the business judgment rule and the often contractually defined (but at default fiduciary) models of the various unincorporated business organizations.

I. INTRODUCTION

Compare, if you will, the following rather unambiguous rulings on the application of the business judgment rule in the context of an unincorporated business organization: "We have determined the business judgment rule may apply to partnerships, thus eliminating judicial review of business decisions in the best interest of the partnership if they are made in good faith and with the care of an ordinarily prudent person."[1] "[T]he business judgment rule also is inapposite in the partnership context because it is a function of the unique corporate setting."[2] "We hold that in a limited

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[1]Kuznik v. Bees Ferry Assocs., 538 S.E.2d 15, 28 (S.C. Ct. App. 2000).

[2]Henkels & McCoy, Inc. v. Adochio, 138 F.3d 491, 502 (3d Cir. 1998) (citing 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1036-37 (perm. ed. rev. vol. 1994)). *Cf.* Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n, 980 P.2d 940, 946-50 (Cal. 1999) (stating corporate business

partnership the duty of the general partner to the limited partners is a duty to discharge his responsibilities according to the business judgment rule."[3]

If a mark of insanity is the ability to simultaneously maintain two irreconcilable thoughts, then we must conclude that the law is schizophrenic on the question of whether and how the business judgment rule applies in the context of unincorporated business organizations.[4] The business judgment rule is not a rule of conduct, but, rather, a principle of judicial review under which the decisions of corporate directors are afforded great deference when those decisions are challenged as violating the standard of care. The conundrum to be addressed may be stated as follows:

> If all fiduciary relationships in business organizations include a duty of care, regardless of the statutory or common law formulation of that duty, is there any reason the same judicial standard of review should not apply to every challenge asserting a violation of the duty of care, or are the standards of care of the different organizational forms of such a different nature that a single principle of review is inappropriate?

Part I of this article reviews the business judgment rule as it has developed in the corporate context, the effect of its application, and the requirements for avoiding the application of the rule. Furthermore, Part I distinguishes the rule from a simple gross negligence standard of liability. Part II reviews some of the recent developments in unincorporated business organization laws, focusing on structural changes that have altered the relationship of owners among themselves and to the entity. Part II also focuses on the degree to which the business judgment rule has (or has not) been incorporated into the fiduciary provisions of unincorporated business organization laws. Part III reviews the limited case law addressing the

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judgment rule did not directly apply to action taken by unincorporated homeowners' association, but holding deference to decision of board of such association was appropriate where board "acted upon reasonable investigation, in good faith, and in a manner the [b]oard believed was in the best interest of the [a]ssociation and its members").

[3]Jackson v. Marshall, 537 S.E.2d 232, 236 (N.C. App. 2000).

[4]In this article, the term "unincorporated business organizations" encompasses only the partnership, limited partnership, limited liability company, limited liability partnership, and limited liability limited partnership. Because of the novel application of trust law to the business trust, it is not considered herein, and no effort to review the law of other unincorporated organizations, such as the cooperative, has been undertaken. We note, however, that the business judgment rule has been applied in the context of a donative trust. *See, e.g.*, Wood Prince v. Lynch, No. 03-1975, 2005 R.I. Super. LEXIS 24, at *11-*17(R.I. Super. Ct. Feb. 8, 2005).

application or rejection of the business judgment rule in unincorporated business organizations. Part IV considers the uneasy interplay of the business judgment rule in the contractual environment of unincorporated business organizations, positing that in most instances the business judgment rule is inapplicable in this environment.

II. THE BUSINESS JUDGMENT RULE

A. *The Corporate Standard of Care and the Business Judgment Rule*

The business judgment rule, which originally existed as a common law standard,[5] but is now codified in part,[6] is a standard of judicial review that protects the broad discretion conferred on a corporate board of directors from excessive judicial interference.[7] If a board has exercised a minimum level of care,[8] typically satisfied by reference to the procedures utilized in arriving at its decision, then courts will not second-guess the merits of that decision.[9] As applied by the Delaware Supreme Court in *Aronson v. Lewis*,[10] the business judgment rule:

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[5]Gries Sports Enters., Inc. v. Cleveland Browns Football Co., 496 N.E.2d 959, 963 (Ohio 1986) (noting that the business judgment rule has a history of at least 150 years as part of the common law); MODEL BUS. CORP. ACT § 8.31, cmt. note on the Business Judgment Rule (1984) [hereinafter MBCA]; *see* Resolution Trust Corp. v. Dean, 854 F. Supp. 626, 636 (D. Ariz. 1994); FDIC. v. Stahl, 854 F. Supp. 1565, 1571 (S.D. Fla. 1994); Paramount Communications v. QVC Network, 637 A.2d 34, 46 (Del. 1993).

[6]*See infra* notes 20-24 and accompanying text.

[7]As with most legal principles, there are cases in which the business judgment rule has been entirely misapplied. For example, in *Baker v. 16 Sutton Place Apartment Corp.*, 768 N.Y.S.2d 198 (N.Y. App. Div. 2003), decisions by a landlord to forego certain maintenance work, purportedly in violation of lease covenants, were held to be protected by the business judgment rule.

[8]As noted in *Cede & Co. v. Technicolor, Inc.*, under Delaware law directors are "charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of the shareholders." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (subsequent history omitted). The broader application of the business judgment rule to questions of loyalty or of good faith, as discussed in *Cede*, is beyond the scope of this article.

[9]*See, e.g.*, FDIC v. Castetter, 184 F.3d 1040, 1046 (9th Cir. 1999); Smith *ex rel.* Boston Chicken, Inc. v. Arthur Andersen, LLP, 175 F. Supp. 2d 1180 (D. Ariz. 2001); Kahn v. Roberts, 679 A.2d 460, 467 (Del. 1996); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985); Solomon v. Armstrong, 747 A.2d 1098, 1111-13 (Del. Ch. 1999); Weiss v. Samsonite, 741 A.2d 366, 371-72 (Del. Ch. 1999); Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1140 (Del. Ch. 1994); Potter v. Pohlad, 560 N.W.2d 389, 392 (Minn. App. 1997); Green Party of N.J. v. Hartz Mountain Indus., Inc., 752 A.2d 315, 326 (N.J. 2000); Koos v. Cent. Ohio Cellular, Inc., 641 N.E.2d 265, 274 (Ohio 1994). In Delaware jurisprudence, the duty of due care first appears in *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

[10]473 A.2d 805 (Del. 1984).

> (c) A director or officer who makes a business judgment in good faith fulfills the duty under this Section if the director or officer:
>
> > (1) is not interested [§ 1.23] in the subject of the business judgment;
> >
> > (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
> >
> > (3) rationally believes that the business judgment is in the best interests of the corporation.[21]

The Delaware and ALI-PCG formulations differ. The former model is a presumption, while the latter is a safe harbor.[22] This distinction, however, is not relevant to this analysis. The MBCA contains a somewhat detailed provision that recognizes the business judgment rule and provides guidance as to its application.[23] The MBCA comment states that the provision "does

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[21]*Id.* § 4.01(c). The standard of care to which this business judgment rule applies, set forth in ALI-PCG § 4.01(a), provides in part:

> A director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.

For a discussion of the business judgment rule as embodied in the ALI-PCG, see generally Charles Hansen, *The Duty of Care, the Business Judgment Rule, and The American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355 (1993).

[22]Douglas M. Branson, *The Rule That Isn't a Rule—The Business Judgment Rule*, 36 VAL. U. L. REV. 631, 635-36 (2002).

[23]Section 8.31 of the MBCA provides:

> (a) A director shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action, as a director, unless the party asserting liability in a proceeding establishes that:
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> (1) any provision in the articles of incorporation authorized by section 2.02(b)(4) or the protection afforded by section 8.61 for action taken in compliance with section 8.62 or 8.63, if interposed as a bar to the proceeding by the director, does not preclude liability; and
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> (2) the challenged conduct consisted or was the result of:
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> (i) action not in good faith; or
>
> (ii) a decision
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> (A) which the director did not reasonably believe to be in the best interests of the corporation, or
>
> (B) as to which the director was not informed to an extent the director reasonably believed appropriate in the circumstances;

not codify the business judgment rule . . . . Because the elements of the business judgment rule and the circumstances for its application are continuing to be developed by the courts, it would not be desirable to freeze the concept in a statute."[24]

It has been suggested that a distinction between the business judgment *rule* and business judgment *doctrine* may exist. The rule shields directors from personal liability for damages stemming from decisions that are protected by the business judgment rule, while the business judgment doctrine serves to protect from judicial scrutiny the decisions rendered by those directors.[25] As used herein, the business judgment rule is interpreted

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> or
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> (iii) a lack of objectivity due to the director's familial, financial or business relationship with, or a lack of independence due to the director's domination or control by, another person having a material interest in the challenged conduct
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> (A) which relationship or which domination or control could reasonably be expected to have affected the director's judgment respecting the challenged conduct in a manner adverse to the corporation, and
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> (B) after a reasonable expectation to such effect has been established, the director shall not have established that the challenged conduct was reasonably believed by the director to be in the best interests of the corporation; or
>
> (iv) a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention, by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefor; or
>
> (v) receipt of a financial benefit to which the director was not entitled or any other breach of the director's duties to deal fairly with the corporation and its shareholders that is actionable under applicable law.

MBCA § 8.31.

[24]MBCA 8.31, cmt., Note on the Business Judgment Rule.

[25]*See, e.g.*, 1 DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE—FIDUCIARY DUTIES OF CORPORATE DIRECTORS 6 (5th ed. 1998), quoting:

> Some have suggested that, within the business judgment standard's broad ambit, a distinction might usefully be drawn between that part which protects directors from personal liability for the decision they make and the part which protects the decision itself from attack. While these two objects of the business judgment standard's protection are different, and judicial review might result in the decision being enjoined but no personal liability (or vice versa), their operative elements are identical (*i.e.*, good faith, disinterest, informed judgment and "best interests"). As a consequence, the courts have not observed any distinction in terminology and have generally followed the practice of referring only to the business judgment rule, whether dealing with personal liability issues or transactional justification matters.

Id. (quoting MBCA § 8.31, cmt., note on the Business Judgment Rule).

as equally applicable to both the decision and any resulting liability. The rule versus doctrine dichotomy, therefore, does not apply.

B. *Justifications for the Business Judgment Rule*

At least five justifications have been provided for the business judgment rule:[26]

(1) Recognition of the possibility of error and the need to apply a relaxed standard before imposing liability so as to maintain the pool of potential directors;[27]
(2) The need to encourage the efficient acceptance of risk;[28]
(3) Protection of the courts from enmeshment in corporate decision-making;[29]

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[26]*See* BLOCK ET AL., *supra* note 25, at 12-18. *See also* 3A FLETCHER ET AL., *supra* note 2, § 1037 (providing similar justifications).

[27]*See, e.g.*, Washington Bancorp v. Said, 812 F. Supp. 1256, 1267-68 (D.D.C. 1993) ("Courts recognize that even disinterested, well-intentioned, informed directors can make decisions that, in hindsight, [are] improvident."); Air Line Pilots Ass'n v. UAL Corp., 717 F. Supp. 575, 582 (N.D. Ill. 1989), *aff'd*, 897 F.2d 1394 (7th Cir. 1990) (stating that the business judgment rule "encourages competent individuals to become directors who otherwise might decline for fear of personal liability"); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 97 (1979) ("[P]ersons of reason, intellect and integrity would not serve as directors if the law exacted from them a degree of prescience not possessed by people of ordinary knowledge.").

[28]*See, e.g.*, Resolution Trust Corp. v. Blasdell, 930 F. Supp. 2d 417, 423 (D. Ariz. 1994), stating:

> Directors . . . regularly make complex decisions involving risk, and many such decisions may appear in hindsight to have been made improvidently. . . . [O]ur country's corporate system depends to a degree on the willingness of corporations to take risk. With large sums of money at stake—and the threat of litigation in the event of failure correspondingly high—few directors would recommend ventures involving more than minimal risk.

Id. (citations omitted). *See also Air Line Pilots Ass'n*, 717 F. Supp. at 582.

> The business judgment rule encourages directors to engage in ventures which have potential for great profit but which may entail some risk. Commonly cited support for this proposition is the speculation that if stricter liability were imposed on directors, the founders of McDonald's Corporation who put $3 million at risk to patent a novel hamburger manufacturing technique might never have made this profitable decision.

Id. (citations omitted). *See also* Herzel & Katz, *supra* note 12, at 1189 ("Another thing the court failed to appreciate is the need to help directors be bold. The threat of crushing legal liability will make them too cautious.").

[29]*See, e.g.*, FDIC v. Stahl, 89 F.3d 1510, 1517 (11th Cir. 1996) (quoting Int'l Ins. Co. v. Johns, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989)) ("[D]irectors are, in most cases, more qualified to make business decisions than are judges."); Dodge v. Ford Motor Co., 170 N.W. 668, 684

(4) Protection of the board of directors' franchise to direct the management of the corporation;[30] and
(5) The remedy available to the shareholders in the ability to replace the directors.[31]

When the business judgment rule is not available, the directors bear the heavy burden of proving the entire fairness of the transaction.[32] For

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(Mich. 1919); *In re* J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780 (Del. Ch. 1988).

> Because businessmen and women are correctly perceived as possessing skills, information and judgment not possessed by reviewing courts and because there is great social utility in encouraging the allocation of assets and the evaluation and assumption of economic risk by those with such skill and information, courts have long been reluctant to second-guess such decisions when they appear to have been made in good faith.

Id. (quoting Solash v. Telex Corp., Nos. 9518, 9528 & 9525, 1988 Del. Ch. LEXIS 7, at *21 (Del. Ch. Jan. 19, 1988), *reprinted in* 13 DEL. J. CORP. L. 1250, 1262 (1988)). *See also* Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991), which states: "Managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism 'selects out' judges who try to make business decisions. In the long run firms are better off when business decisions are made by business specialists, even granting the inevitable errors." A corollary of this rationale is that it preserves judicial resources, a benefit not to the corporation, but to the legal system as a whole.

[30]*See, e.g.*, Michael P. Dooley & E. Norman Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 BUS. LAW. 503, 522 (1989), stating:

> The power to hold to account is the power to interfere and, ultimately, the power to decide. If stockholders are given too easy access to courts, the effect is to transfer decisionmaking power from the board to the stockholders or, more realistically, to one or a few stockholders whose interests may not coincide with those of the larger body of stockholders. By limiting judicial review of board decisions, the business judgment rule preserves the statutory scheme of centralizing authority in the board of directors. In doing so, it also preserves the value of centralized decisionmaking for the stockholders and protects them against unwarranted interference in that process by one of their number. Although it is customary to think of the business judgment rule as protecting directors from stockholders, it ultimately serves the more important function of protecting stockholders from themselves.

See also In re Consumers Power Co. Derivative Litig., 132 F.R.D. 455, 464 (E.D. Mich. 1990) (stating that the business judgment rule "protect[s] the corporation and its stockholders from other stockholders where only the 'duty of care' and not the 'duty of loyalty' is at issue") (citation omitted).

[31]*See, e.g.*, Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1351 (D. Nev. 1997) ("'[O]ne of the justifications for the business judgment rule[] . . . is that unhappy shareholders can always vote the directors out of office.'") (quoting Shoen v. Amerco, 885 F. Supp. 1332, 1340 (D. Nev. 1994)).

[32]*See, e.g.*, Van de Walle v. Unimation, Inc., [1990-1991 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,834, at 99,030-31 (Del. Ch. Mar. 6, 1991), stating: "[W]here corporate fiduciaries, because of a conflict, are disabled from safeguarding the interests of the stockholders to whom they owe a duty, the Court will furnish compensatory procedural safeguards by imposing

instance, the business judgment rule does not apply when directors are interested in the challenged transaction or cannot demonstrate satisfaction of the procedures that would indicate due investigation.

C. *Differentiating the Business Judgment Rule from the Standard of Care*

It is important to note the difference between the standard of care, which is the standard of conduct expected of directors in their decision making, and the business judgment rule, which is the standard of review that determines whether directors will be held liable for a poor decision.[33]

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upon the fiduciaries an exacting burden of establishing the utmost propriety and fairness of their actions."

[33]*See* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1295-96 (2001), *reprinted in* 26 DEL. J. CORP. LAW 859, 867-69 (2001), which states:

> A judicial standard of review is a value-laden analytical instrument that reflects fundamental policy judgments. In corporate law, a judicial standard of review is a verbal expression that describes the task a court performs in determining whether action by corporate directors violated their fiduciary duty. Thus, in essential respects, the standard of review defines the freedom of action (or, if you will, deference in the form of freedom from intrusion) that will be accorded the persons who are subject to its reach.
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> There exists a close, but not perfect, relationship, between the standard by which courts measure director liability (the "standard of review") and the standard of behavior that we normatively expect of directors (the "standard of conduct"). As Professor Melvin Eisenberg expressed this idea in his thoughtful article on corporate standards of review, "[a] *standard of conduct* states how an actor should conduct a given activity or play a given role. A *standard of review* states the test a court should apply when it reviews an actor's conduct to determine whether to impose liability or grant injunctive relief." Standards of conduct are sometimes referred to as "conduct rules" that are addressed to corporate directors and officers, whereas standards of review are "decision rules" that are addressed to judges.
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> In most areas of law, standards of conduct and standards of review tend to conflate and become one and the same, but in corporate law the two standards often diverge. The reasons are rooted in policy interests. First, directors must make decisions in an environment of imperfect information. Second, given the limited investment in publicly held firms that typical corporate directors are able or willing to make, any risk of liability would likely dwarf the incentives for assuming the role. Third, courts are ill-equipped to determine after-the-fact whether a particular business decision was reasonable in the circumstances confronting the corporation.
>
> The interplay of these considerations can be illustrated by considering how judges review board decisions under the business judgment standard. Where the business judgment standard applies, a director will not be held liable for a decision–even one that is unreasonable–that results in a loss to the corporation, so long as the decision is rational. In this review context, the business judgment standard ("rationality") diverges from, and becomes more lenient than, the

Where the business judgment rule applies, a director will not be held liable for a decision, "even one that is unreasonable"[34] and results in a loss to the corporation, so long as the director was not grossly negligent in reaching the decision.[35] Furthermore, while the plaintiff is required to show gross negligence in order to overcome the presumption of the business judgment rule, proof of a grossly negligent decision alone is not sufficient to set aside the decision or yield an award of damages. Liability may be avoided in the absence of causation or damages,[36] or where the directors can establish the fairness of the challenged transaction.[37] The decision, in such instances, will be respected,[38] and the directors will not be exposed to personal liability.

D. *Exoneration from Liability Does Not Define the Standard of Care*

It also must be noted that provisions limiting the personal liability of directors[39] or partners are generally not viewed as defining the applicable fiduciary duty. Rather:

> [t]he liability of a general partner to a limited partnership and to other partners does not define the scope of the fiduciary duty of the general partner. Instead, it merely deals with the consequences, i.e., liabilities, which flow from a breach of duty. A similar view has been articulated in connection with Section 102(b)(7) of the Delaware General Corporation Law

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> normative standard of expected conduct ("reasonableness"). The justifications for this divergence have been thoroughly stated elsewhere, and will not be repeated here. Suffice it to say that we endorse a corporate law regime which affords substantial freedom of action to disinterested, well-motivated directors.

Id. (citations omitted).

[34] *Id.* at 1296, *reprinted in* 26 DEL. J. CORP. L. at 868.

[35] *Aronson*, 473 A.2d at 812.

[36] *See* MBCA § 8.31(b)(1) (imposing on a party seeking to hold a director liable for money damages the burden of establishing that the corporation has suffered harm proximately caused by the director's conduct).

[37] *Id.* § 8.31, cmt. 1.h.

> Under case law, personal liability as well as transactional justification issues will be subject to a fairness standard of judicial review if the plaintiff makes out a credible claim of breach of the duty of loyalty or if the presumptions of the business judgment standard (*e.g.*, an informed judgment) are overcome, with the burden of proof shifting from the plaintiff to the defendant.

[38] *See supra* note 25.

[39] Examples of such provisions include DEL. CODE ANN. tit. 8 § 102(b)(7) (2001); MBCA §§ 2.02(b)(4), 8.31; KY. REV. STAT. ANN. § 271B.8-300(5)(b) (Banks-Baldwin 2003).

> (the "GCL") .... Commentators generally agree that Section 102(b)(7) of the GCL is not a modification or elimination of the fiduciary duty owed to stockholders. Rather, it is viewed as a modification of the remedies available for breaches of such fiduciary duty.[40]

III. THE EVOLVING STRUCTURE OF UNINCORPORATED BUSINESS ORGANIZATIONS

It is necessary to consider the current state of unincorporated business organizations law in order to fully appreciate how and why certain courts have applied the business judgment rule in that context. Since 1988, the law of unincorporated business organizations has undergone monumental, and at times bewildering, changes. These developments include new unincorporated business forms and increased detail in the organizational statutes, as well as modification, alteration, and sometimes

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[40]MARTIN I. LUBAROFF & PAUL M. ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS § 11.2.4 (2005). *See also* S. 533, 133d D. Gen. Assembly 2, 5 Del. Laws, ch. 289, §§ 1-2 (1986) (commentary to Section 102(b)(7)) ("This provision would have no effect on the availability of equitable remedies, such as injunction or rescission, for breach of fiduciary duty."); WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 7.04, at 217 (4th ed. 1988) ("The commentators agree that the new section [102(b)(7)] does not eliminate or alter a director's fiduciary duty of care."); E. Norman Veasey et al., *Delaware Supports Directors With a Three-Legged Stool of Limited Liability, Indemnification, and Insurance,* 42 BUS. LAW. 399, 403 (1987), which states:

> [S]ection 102(b)(7) does not eliminate the duty of care that is properly imposed upon directors. Directors continue to be charged under Delaware law with a duty of care in the decisionmaking process and in their oversight responsibilities. The duty of care continues to have vitality in remedial contexts as opposed to actions for personal monetary damages against directors as individuals. For example, it will continue to be vitally important in injunction and rescission cases and may well be relevant in elections, proxy contests, resignations, and removal contexts.

Id. Because the provisions in a partnership agreement addressing the liability of a general partner and the indemnification of a general partner are generally provisions that protect a general partner, the question is frequently raised whether or not these provisions are relevant to the fiduciary duty of a general partner. An argument can be made that limitations on a general partner's liability define the scope of the fiduciary duty of the general partner. Where, for example, a partnership agreement provides that a general partner has no liability to a limited partnership or to other partners except with respect to its gross negligence or willful misconduct, it could be argued that the fiduciary duty of the general partner is to act without gross negligence or willful misconduct. To the extent the fiduciary duty of a general partner is defined by such provisions, it is important to make certain that the provisions of a partnership agreement, which arguably relate to a general partner's fiduciary duty, are consistent throughout the partnership agreement. For instance, if one provision in a partnership agreement states or implies that a general partner has a duty to act without negligence, a provision exonerating a general partner from liability for negligence would be inconsistent. The creation of such ambiguities should be avoided.

reversal of prior statutes and/or common law rules. One consequence of these changes is that much of the common law predating these developments is of little, if any, continuing authority. These changes have also altered the frame of reference for the interpretation of the organic documents of the unincorporated business organization.

A. *The Evolving Partnership (and the Limited Liability Partnership)*

The venerable partnership and the Uniform Partnership Act (1914)[41] were revised and repackaged in the Uniform Partnership Act (1997).[42] In the process, issues and treatments once understood as central to the partnership were revised, leaving in place a structure with the same name, but a different look.

One of the most striking changes was the wholesale modification of the rule of limited liability. First, while UPA provided for joint liability for certain claims and joint and several liability for other claims,[43] RUPA substituted a single rule of joint and several liability.[44] RUPA also provided a mechanism for eliminating all vicarious liability of the partners, thereby introducing the feature of limited liability to the general partnership context. In response to concerns among professionals about the rules of personal liability incorporated in UPA Section 15, the limited liability partnership emerged as an elective status for a partnership under which the

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[41]UNIF. P'SHP ACT (1914) [hereinafter UPA], 6 Pt. I U.L.A. 373 (2001).

[42]UNIF. P'SHP ACT (1997) [hereinafter RUPA], 6 Pt. I U.L.A. 58 (2001). In response to a proposal for updating set forth in UPA Revision Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, *Should the Uniform Partnership be Revised?*, 43 BUS. LAW. 121 (1987), the UPA was revised and initially released in 1992. The 1992 version was subsequently revised in 1993 and again in 1994. Limited liability partnership provisions were added in 1996, and additional amendments were added in 1997. Through much of its consideration by the National Conference of Commissioners on Uniform State Laws (NCCUSL), it was referred to as the Revised Uniform Partnership Act. In 1994, the "Revised" was dropped. Nonetheless, "Revised Uniform Partnership Act" and "RUPA" have become firmly fixed as the colloquial name of the act, and "RUPA" is in fact used in NCCUSL's prefatory note to the act. All references herein to "RUPA" are to the Uniform Partnership Act (1997).

[43]UPA § 15 provides:

All partners are liable

(a) Jointly and severally for everything chargeable to the partnership under sections 13 and 14.

(b) Jointly for all other debts and obligations of the partnership; but any partner may enter into a separate obligation to perform a partnership contract.

6 Pt. I U.L.A. 613 (2001).

[44]RUPA § 306(a), 6 Pt. I U.L.A. 117 (2001).

partners would be afforded limited liability.[45] While this elimination of vicarious liability to third parties was the most discussed aspect of the limited liability partnership, for purposes of this article the more important feature is the modification of the intra-partnership obligations that arise out of limited liability partnership status. The election of limited liability partnership status, as provided in RUPA Section 306(c), not only eliminates vicarious liability among the partners, but also voids pre-election

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[45]The limited liability partnership (LLP) was devised in Texas in 1991 in an effort to address the vicarious liability among partners for the errors of any individual partner by providing a limited exception to the liability provision of UPA § 15. *See, e.g.*, ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM LIMITED PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT (2001) § 1.01(a) (2002 ed.), which states in part:

> The limited liability partnership (LLP) originated in Texas in 1991 to protect against a limited list of torts. It was inspired by the government suits against law and accounting firms that had done work for the freewheeling savings and loan and thrift associations that failed in large and costly numbers in the 1980s along with the collapse of real estate values they had helped to inflate. The suits alleged joint and several liability claims under U.P.A. § 15 for various kinds of malpractice or other tortious misconduct. The claims were against all partners including many who had nothing to do with the failed associations. The suits highlighted the vicarious liability of partners for each other's conduct, a liability that did not exist in other forms of professional organization.

Adoption of similar statutes proceeded with Louisiana in 1992 and Delaware, the District of Columbia and North Carolina in 1993. *Id.* § 1.01(b). As these further state adoptions advanced, Texas was revising its LLP provisions to address circumstances not anticipated in the admittedly rushed effort to adopt the first statute in 1991. *Id.* § 1.01(a).

As originally conceived, the LLP would be the entity of choice for professional firms unable to make use of the limited liability company and the limited liability protections afforded thereby. In place thereof, the first LLP statutes provided "partial shield" liability protection. Under these formulations, the partners would be protected from vicarious liability by a modification to the state's adoption of UPA § 15 through a proviso that the partners would not have vicarious liability for claims arising out of some statutory formulation intended to address claims arising in malpractice, malfeasance, or other professional negligence. *See, e.g.*, KY. REV. STAT. ANN. § 362.220(2) (Banks-Baldwin 2003) (stating that a partner in an LLP organized in Kentucky was not liable for partnership debts "arising from negligence, malpractice, wrongful acts, or misconduct"). By providing limited liability from such professional claims, the partners were not shielded from claims arising in the ordinary course of business. In effect, vicarious liability was retained with respect to voluntary creditors of the partnership, while vicarious liability was eliminated with respect to involuntary creditors. The scope of the limited liability afforded by the LLP was first expanded in 1994 with Minnesota's adoption of a "full shield" liability shield statute (MINN. STAT. ANN. § 323.14(subd.2) (West 1995) (repealed 1997)), which eliminated vicarious liability regardless of the nature of the claim. The full-shield approach was eventually adopted in RUPA. As of this date, all states have adopted LLP legislation in either a partial shield or full shield format. *See* Elizabeth G. Hester & Thomas E. Rutledge, *Practical Guide to Limited Liability Partnerships*, *in* 5 STATE LIMITED LIABILITY COMPANY AND PARTNERSHIP LAWS §§ 10.1, 10.2, PGLLP-1 (Elizabeth S. Miller & Arthur J. Jacobson eds., Supp. 2004).

obligations of indemnification and/or contribution.[46]

Though the development of the LLP and the abolition of vicarious liability for partnership debts were certainly revolutionary aspects of RUPA, a change of equal if not greater significance took place with respect to fiduciary duties. UPA relied almost entirely upon a common law formulation of the fiduciary duties[47] among the partners, most famously expressed as:

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[46]RUPA § 306(c), 6 Pt. I U.L.A. 117, provides:

> An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner. This subsection applies notwithstanding anything inconsistent in the partnership agreement that existed immediately before the vote required to become a limited liability partnership under Section 1001(b).

See also Elizabeth S. Miller, *Highlights of the Uniform LLP Amendments*, PUBOGRAM NEWSLETTER (ABA Section of Business Law), Dec. 1996, *available at* http://www.abanet.org/buslaw/partners/pubogram/1996_98/11-1highlights.html, *reprinted in* Prototype LLP Agreement Subcommittee of the Committee on Partnerships and Unincorporated Business Organizations, *Prototype Partnership Agreement for a Limited Liability Partnership Formed Under the Uniform Partnership Act (1997)*, 58 BUS. LAW. 689 (2003).

> To counter the erosion of the liability shield that would take place if a partner were required to contribute to satisfy partnership obligations, RUPA section 306(c) provides that a partner in an LLP will not be liable, "directly or indirectly, by way of contribution of otherwise," for a partnership obligation solely by reasons of being a partner. RUPA section 306(c) goes on to provide that inconsistent provisions of the partnership agreement in effect immediately before the vote to become an LLP are not effective with respect to partnership obligations incurred after the partnership becomes an LLP. Thus, previously negotiated contribution provisions that would otherwise require a partner to contribute towards obligations of the partnership arising after the partnership becomes an LLP are "trumped" by the election to become an LLP.

Id. at 690 (footnotes omitted).

[47]*See* UPA §§ 19-21 (setting forth the statutory underpinnings of the fiduciary nature of the partner relationship). *See also* UPA §§ 4(3), 9(1); RESTATEMENT (SECOND) OF AGENCY § 13 (1958). UPA § 21, oft cited as the statutory formulation of the fiduciary duties amongst the partners, does not use the term "fiduciary" in its text, but only in its title, stating at subsection (1):

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

UPA § 21(1), 6 Pt. II U.L.A. 194 (2001).

As noted in Official Comment 1 to RUPA § 404, this provision "is structurally different from the UPA which touches only sparingly on a partner's duty of loyalty and leaves any further development of the fiduciary duties of partners to the common law of agency." RUPA § 404, cmt. 1, 6 Pt. I U.L.A. 143 (2001).

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions.[48]

This formulation, while addressing the standard of loyalty imposed upon partners, failed to address the standard of care that may apply, and the standard of care in partnerships has generally received far less attention than the standard of loyalty.[49] When courts have addressed the standard of

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[48]Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928). This language, however, has been criticized as overstating partner obligations. *See, e.g.*, Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425 (1987), which states:

> Although colorful, the judicial rhetoric inevitably overstates the standard of conduct the law actually imposes on partners. If partners truly are fiduciaries, they are a unique species of this group and cannot be subjected to traditional standards applicable to other types of fiduciaries. . . . Partners . . . are always joint owners. . . . Partners are not disinterested trustees, and the likelihood that most partners operate under a "punctilio of an honor the most sensitive" standard is remote.

Id. at 458 (footnotes omitted). Perhaps the better description of the fiduciary duties of the partners in a UPA partnership is that set forth in *Latta v. Kilbourn*, 150 U.S. 524 (1893), which observed:

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

Id. at 541.

[49]The emphasis on the duty of loyalty rather than the duty of care is, of course, in no way unique to the partnership context. Until relatively recently, the corporate law on the fiduciary duties of corporate directors was focused almost entirely upon the duty of loyalty, it being assumed that the duty of care was itself not separately enforceable. *See* Allen et al., *supra* note 33, at 1299, *reprinted in* 26 DEL. J. CORP. LAW at 872 ("Only toward the end of the twentieth

care applicable to partners in the direction and operation of the partnership, there has been a tendency to eschew holding a partner liable for mere mismanagement or simple negligence.[50]

Whether the UPA standard of care was that of an ordinarily prudent person,[51] a more relaxed standard than ordinary care,[52] or merely good faith,[53] has long been the subject of debate.[54] Indeed, one may conclude that the relative paucity of case law and the varying language employed by the courts have not yielded the necessary critical mass of decisional law required to derive and impose a consistent standard. In addition, regardless of the standard of care employed, the question of whether such standard could be prospectively modified by the partnership agreement has also been the subject of some debate.[55]

RUPA has supplanted the common law of fiduciary obligations and replaced it with an exclusive statutory formulation.[56] RUPA states that "[a] partner's duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining

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century did Delaware's corporation law first accord 'bite' to the duty of care."); Michele Healy Ubelaker, *Director Liability Under the Business Judgment Rule: Fact or Fiction?*, 35 SW. L. J. 775, 789 (1981) ("The modern view [of a corporate director's fiduciary duty] definitely stresses the duty of loyalty, and avoids specific discussion of the parameters of due care.").

[50] *See* 2 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 6.07(f) (2005) (footnote omitted). *See also infra* notes 119-36 and accompanying text.

[51] Norwood P. Beveridge, Jr., *Duty of Care: The Partnership Cases*, 15 OKLA. CITY U. L. REV. 753, 754 (1990).

[52] BROMBERG & RIBSTEIN, *supra* note 50, § 6.07(f).

[53] J. WILLIAM CALLISON & MAUREEN A. SULLIVAN, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 12.02, at 2-6 to 12-10 (2004).

[54] *See also* Gerard C. Martin, *Duties of Care Under the Revised Uniform Partnership Act*, 65 U. CHI. L. REV. 1307, 1309-10 (1998), which states, "While most courts and scholars agree that partners owe each other some duty of care under the UPA, there are some who argue the partners owe each other no duty of care whatsoever. Additionally, others disagree strongly about what that duty is."

[55] *See, e.g.*, Claire Moore Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111 (1993):

> The most fundamental duty owed by partners to one another is a fiduciary duty. Partners may, however, believe that by mutual consent they can restrict or virtually eliminate these mutual obligations. Under current partnership law, this belief is probably mistaken; under most present judicial interpretations of the Uniform Partnership Act (UPA), fiduciary duties are mandatory provisions waivable only with informed consent, on a case-by-case basis.

Id. (footnotes omitted)

[56] *See* RUPA § 404, 6 Pt. 1 U.L.A. 143 (2001). Section 404 specifies a partner's duty of loyalty and duty of care and states that these duties are the "only" fiduciary duties that partners owe to the partnership or other partners.

from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[57] Furthermore, this standard of care may be reduced by an agreement of the partners unless the reduced standard is unreasonable.[58]

During the drafting process, language expressly addressing "errors in judgment" was considered for inclusion in RUPA.[59] The final version of RUPA, however, does not contain an express articulation of the business judgment rule.[60] Thus, it may be argued that a court should not apply the business judgment rule when considering alleged violations of the duty of care under RUPA. The Official Comment to RUPA Section 404(c), however, references *Rosenthal v. Rosenthal*,[61] a case that applied the business judgment rule in the partnership context.[62] It may be argued, therefore, that RUPA does incorporate a business judgment rule. Either argument, in fact, may correctly state the rule depending upon what is

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[57]*Id.* § 404(c), 6 Pt. I U.L.A 143 (2001). In addition, RUPA § 404(d) provides: "A partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing."

[58]*See id.* §§ 103(a), 103(b)(4), 6 Pt. I U.L.A. 73 (2001) (providing that the relations among the partners and between the partners and the partnership are governed by the partnership agreement, but that the partnership agreement may not unreasonably reduce the duty of care otherwise applicable under Section 404(c) or 603(b)(3)).

[59]RUPA § 404(d) (1991 Draft) provided: "A partner has a duty to act in the conduct of the business of the partnership in a manner which does not constitute gross negligence or willful misconduct. An error in judgment or a failure to use ordinary skill and care does not constitute gross negligence." *See also* Donald J. Weidner, *Three Policy Decisions Animate Revisions of Uniform Partnership Act*, 46 BUS. LAW. 427, 468 (1991).

[60]Contrast the Texas Revised Partnership Act, which states the duty of care in terms of ordinary care and incorporates a business judgment rule as follows:

> (c) Care. A partner's duty of care to the partnership and the other partners is to act in the conduct and winding up of the partnership business with the care an ordinarily prudent person would exercise in similar circumstances. An error in judgment does not by itself constitute a breach of this duty of care. A partner is presumed to satisfy this duty if the partner acts on an informed basis and in compliance with Subsection (d).

TEX. REV. CIV. STAT. ANN. art. 6132b-4.04(c) (Vernon Supp. 2003).

Subsection (d) provides:

> (d) Method of Discharge. A partner shall discharge the partner's duties to the partnership and the other partners under this Act or under the partnership agreement, and exercise any rights and powers in the conduct or winding up of the partnership business:
>
> (1) in good faith; and
>
> (2) in a manner the partner reasonably believes to be in the best interest of the partnership.

Id. art. 6132b-4.04(d).

[61]543 A.2d 348 (Me. 1988).

[62]*See infra* notes 119-21 and accompanying text.

meant by the "business judgment rule." To the extent that the business judgment rule results in a gross negligence standard of liability,[63] the RUPA provision can fairly be characterized as embodying the business judgment rule. On the other hand, to the extent the business judgment rule connotes a relaxed standard of review (and accordingly a relaxed standard of liability) when measuring conduct against a stated standard of care, it is inappropriate to apply the business judgment rule under RUPA because the apparent intent behind the statute is to impose a duty of care that defines both the standard of conduct and standard of liability in terms of gross negligence.

B. *The Evolving Limited Partnership (and the Limited Liability Limited Partnership)*

Following the revision of UPA,[64] NCCUSL undertook a similar effort to modernize and update its limited partnership statute. The result was the Uniform Limited Partnership Act (2001), commonly referred to as "ReRULPA."[65] Building upon the lessons learned in the course of drafting RUPA, ReRULPA modified long accepted rules of liability within the limited partnership and adopted a statutory formula of fiduciary duties and obligations.[66]

ReRULPA expressly provides for the limited liability limited partnership. This new format, analogous to the limited liability partnership, allows a limited partnership to elect a status in which limited liability is enjoyed by not only the limited partners, but the general partners as well.[67] At the same time, ReRULPA provides greater liability protection to the limited partners in that, unlike the RULPA formulation, protection is not

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[63] *Cf.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

[64] *See generally* Allan W. Vestal, *A Comprehensive Uniform Limited Partnership Act? The Time Has Come*, 28 U.C. DAVIS L. REV. 1195 (1995) (commenting on the desirability of revising the law of limited partnerships and its separation from the law of general partnerships).

[65] The Uniform Limited Partnership Act (2001) is the successor to the Uniform Limited Partnership Act (1976) with 1985 Amendments. The Uniform Limited Partnership Act (1976) was the successor to the Uniform Limited Partnership Act (1916), often referred to as ULPA. With the 1985 Amendments, the 1976 Uniform Limited Partnership Act is commonly referred to as the Revised Uniform Limited Partnership Act, or RULPA. *See* ReRULPA Prefatory Note, 6A U.L.A. 2-3 (2003). The uniform act approved in 2001, a comprehensively re-written limited partnership law as contrasted with a mere revision and supplementation, was commonly referred to throughout the drafting process as ReRULPA (the "Revision" of RULPA), and that unofficial acronym is used herein.

[66] ReRULPA §§ 303, 408(c), 6A U.L.A. 46, 62 (2003); *see infra* notes 75-77 and accompanying text.

[67] ReRULPA § 404(c), 6A U.L.A. 57 (2001).

subject to forfeiture as a consequence of "excessive" involvement in the management and operation of the partnership.[68]

RULPA, like its predecessor, the Uniform Limited Partnership Act of 1916,[69] does not address partner fiduciary duties and relies on "linkage" to the law of general partnerships to supply the rules for this area.[70] While partner fiduciary duties are only vaguely addressed in UPA,[71] RUPA explicitly defines a partner's fiduciary duties and delineates the extent to which partners may contractually modify those duties.[72] How well the concept of linkage to UPA or RUPA works has been the subject of some debate.[73] Illustrating their doubt about the success of linkage, the drafters of ReRULPA determined that ReRULPA should not be linked to UPA or RUPA, and the new act was drafted as a stand-alone statute.[74] Thus, under ReRULPA, the fiduciary duties of both the general and limited partners are determined solely by the terms of ReRULPA.

Under ReRULPA, "[a] general partner's duty of care to the limited partnership and the other partners in the conduct and winding up of the limited partnership's activities is limited to refraining from engaging in

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[68] *Compare* RULPA § 303, 6A U.L.A. 324 (2003) *with* ReRULPA § 303, 6A U.L.A. 46 (2003).

[69] UNIF. LTD. P'SHIP ACT (1916), 6A U.L.A. 312 (1995).

[70] RULPA § 403 (amended 1985) provides:

> (a) Except as provided in this [Act] or the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.
>
> (b) Except as provided in this [Act], a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and the other partners. Except as provided in this [Act] or in the partnership agreement, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

RULPA § 403 (amended 1985), 6A U.L.A. 365 (2003).

RULPA § 1105 provides: "In any case not provided for in this [Act] the provisions of the Uniform Partnership Act govern." RULPA (amended 1985), 6A U.L.A. 547 (2003).

[71] *See supra* note 47 and accompanying text.

[72] *See supra* notes 56-58 and accompanying text.

[73] *See generally* Elizabeth S. Miller, *Linkage and Delinkage: A Funny Thing Happened to Limited Partnerships When The Revised Uniform Partnership Act Came Along*, 37 SUFFOLK U. L. REV. 891 (2004) (discussing the "linkage" debate); Larry E. Ribstein, *Linking Statutory Forms*, 58 LAW & CONTEMP. PROBS. 187, 187 (1995) (finding that "[a]lthough linkage has long been an accepted feature of the law of business associations, it creates confusion about the applicable law . . . [and] may cause application of inappropriate rules to linked business forms"); Vestal, *supra* note 64, at 1196 (stating that "[t]he nexus [between general partnership law and limited partnership law] is no longer clear, the substance is no longer appropriate, and the uniformity (and the associated benefit of stability for limited partnerships) is fast disappearing").

[74] *See* ReRULPA Prefatory Note, 6A U.L.A. 2-3 (2003) (discussing the drafting committee's rationale for rejecting linkage and drafting a stand-alone statute).

grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[75] The general partner's duty of care under ReRULPA, therefore, is articulated in language identical to that used in RUPA[76] and does not include an express articulation of the business judgment rule. ReRULPA also follows the RUPA model with respect to contractual modification of a general partner's duty of care by precluding the partnership agreement from unreasonably reducing a general partner's duty of care.[77]

ReRULPA specifies that "[a] limited partner does not have any fiduciary duty to the limited partnership or to any other partner solely by reason of being a limited partner."[78] Any duty of care on the part of a limited partner would arise only as a result of provisions in the partnership agreement expressly imposing such a duty or creating a role for a limited partner, which gives rise to such a duty under other law (e.g., the law of agency).[79]

These changes have moved the limited partnership model closer to the corporate model in some significant respects, just as the changes to RUPA had the same effect on the general partnership model. It is possible to view the gross negligence standard of care in RUPA and ReRULPA as encompassing the business judgment rule to the extent that it has been interpreted to result in a gross negligence standard of liability.[80] As is the case under RUPA, however, it is inappropriate to apply the business judgment rule under ReRULPA to the extent that the business judgment rule connotes a relaxed standard of review (and thus, a relaxed standard of liability) when measuring conduct against a stated standard of care. The apparent intent behind ReRULPA, like RUPA, is to specify both the standard of conduct and standard of liability involved in the duty of care in terms of gross negligence.

C. *The Rise of the Limited Liability Company*

The 1990s also saw the rise and rapid development of a new form of unincorporated business organization, the limited liability company

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[75]ReRULPA § 408(c), 6A U.L.A. 62 (2003). In addition, ReRULPA § 408(d) provides: "A general partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing." *Id.*

[76]*See* RUPA § 404(c), 6 Pt. I U.L.A. 143 (2001).

[77]ReRULPA § 110(b)(6), 6A U.L.A. 24 (2003).

[78]*Id.* § 305(a), 6A U.L.A. 51.

[79]*See id.* § 305, cmt., 6A U.L.A. 51.

[80]*See supra* notes 59-63 and accompanying text.

(LLC).[81] The LLC combined for the first time limited liability for all participants with maximum freedom of contract to structure the enterprise in accordance with the desires of the participants.[82] An anomaly in 1988 (existing under only Wyoming and Florida law), the LLC was by 1996 a form of organization authorized by the laws of all fifty states, the District of Columbia, and the Virgin Islands.[83]

LLC statutes vary widely. A number of state statutes drew heavily from the Prototype Limited Liability Company Act, which was a product of a working group organized under the American Bar Association, Section of Business Law, Committee on Partnerships and Unincorporated Business Organizations.[84] Relatively few states have adopted the Uniform Limited Liability Company Act[85] promulgated by NCCUSL.

The duty of care imposed on managing members and managers under ULLCA is based on the RUPA definition of a partner's duty of care and

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[81]*See generally* Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375 (1992) (discussing the LLC as an emerging entity); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1 (1995) (discussing the rapid growth and acceptance of LLCs).

[82]*See* UNIF. LTD. LIAB. CO. ACT (1996), Prefatory Note, 6A U.L.A. 554 (2003) [hereinafter ULLCA] ("The allure of the limited liability company is its unique ability to bring together in a single business organization the best features of all other business forms—properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership."). The very first LLC statutes are generally characterized as "bulletproof," in that these statutes provided for minimal flexibility with respect to certain entity characteristics pertinent to the federal tax classification of the LLC and, as those tax classifications regulations were generally interpreted, these statutes would assure partnership classification. There arose a second generation of LLC acts, characterized as "flexible," which provided default rules with respect to those tax classification items that would provide for partnership classification. With the flexibility to modify those default rules, however, came the risk of inadvertent failure to meet the requirements for partnership tax classification of an LLC. The third generation of LLC statutes arose after the adoption of the check-the-box classification regulations effective January 1, 1997. These post-check-the-box statutes have largely eliminated those aspects of the prior statutes that were crafted to meet the pre-check-the-box tax classification test.

[83]*See generally* 1 CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY—TAX AND BUSINESS LAW § 1.01(3) (2003) (describing the evolution of the LLC from Wyoming to all fifty states, the District of Columbia, and the Virgin Islands); 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 1:02, 1-7 to 1-10 (2003) (citing the historical development of LLC in all fifty states); Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW. 499, 499 (2001) (stating "Limited Liability Companies . . . are now authorized by statute in all states").

[84]AM. BAR ASS'N PROTOTYPE LTD. LIAB. CO. ACT (1992) (ABA Prototype). The ABA PROTOTYPE was completed in late 1992, and is reproduced at RIBSTEIN & KEATINGE, *supra* note 83, at App. B.

[85]ULLCA (1996), 6A U.L.A. 553 (2003). ULLCA was completed in 1994, and was revised by 1996 in response to the check-the-box federal income tax classification regulations. *See infra* note 91 (listing states that have adopted ULLCA).

does not contain an express articulation of the business judgment rule. Section 409(c) of ULLCA provides: "A member's duty of care to a member-managed company and its other members in the conduct and winding up of the company's business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law."[86] Similarly, in a manager-managed LLC, a manager is held to the same standard of care prescribed for a member in a member-managed company.[87] ULLCA also follows the RUPA model regarding contractual modification of the duty of care in the operating agreement; the operating agreement may not unreasonably reduce the duty of care defined in the statute.[88]

The ABA PROTOTYPE addresses the duty of care of a member or manager as follows:

> A member or manager shall not be liable, responsible or accountable in damages or otherwise to the limited liability company or to the members of the limited liability company for any action taken or failure to act on behalf of the limited liability company unless the act or omission constitutes gross negligence or willful misconduct.[89]

The commentary to this provision of the ABA PROTOTYPE likens this standard to the model commonly applied to corporate directors, managing partners, or general partners of limited partnerships and implies that the standard embodies the protection of the business judgment rule.[90]

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[86]ULLCA § 409(c), 6A U.L.A. 600 (2003). This language is essentially identical to that set forth in RUPA § 404(c) and ReRULPA § 408(c). ULLCA § 409(d) provides: "A member shall discharge the duties to a member-managed company and the other members under this [Act] or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing." 6A U.L.A. 600.

[87]ULLCA § 409(h)(2), 6A U.L.A. 601 (2003).

[88]ULLCA § 103(b)(3), 6A U.L.A. 567 (2003).

[89]ABA Prototype § 402(A). *See also* KY. REV. STAT. ANN. § 275.170(1) (Michie 2003) (adopting ABA PROTOTYPE § 402(A)).

[90]The commentary to Section 402(A) of the ABA PROTOTYPE states:

> Subsection (A) sets forth the gross negligence standard of care for those participating in management. This is similar to the standard commonly applied to corporate directors, managing partners, or general partners of limited partnerships. In general, as long as managers avoid self-interested and grossly negligent conduct, their actions are protected by ***the business judgment rule***. With respect to general partnerships, *see* RUPA §404(d).
>
> Although the duty of care has been formulated in similar terms for managers of all types of firms, as noted above there are important differences among firms that may result in variations in applying the general standard. The duty of care

State LLC acts reflect various approaches to the duty of care of managers and managing members. Eight states have adopted ULLCA.[91] Seven of the eight retained the RUPA-based ULLCA formulation of the duty of care, which limits the duty of care to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.[92] Several non-ULLCA states have adopted a duty of care standard like that found in ULLCA,[93] while the Wisconsin act merely prohibits criminal violations and willful misconduct.[94]

Approximately eighteen state LLC statutes parallel language formerly used in the MBCA[95] and require managers and managing members

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> may be lower in a general partnership because the partners' individual liability makes it likely not only that managing partners will manage carefully, but that non-managing partners will at least take an active interest in management. At the other end of the spectrum, limited partners or shareholders in a publicly-traded corporation may not participate in management and may rely more heavily on the fiduciary duties of the general partners or directors. LLCs have members with limited liability, but can be expected to be closely held because management rights are not freely transferable, and therefore may lie between the two extremes. Moreover, there will be differences among LLCs. It is likely that the precise boundaries of the duty will be left to develop by case law and operating agreement rather than by statutory provision.

Id. (emphasis added).

[91]Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont, and West Virginia have adopted ULLCA along with the Virgin Islands. ULLCA Table of Jurisdictions Wherein Act Has Been Adopted, 6A U.L.A. 553 (2003).

[92]ALA. CODE § 10-12-21(g), (k)(2) (2003); HAW. REV. STAT. ANN. § 428-409(c) (Michie 2004); 805 ILL. COMP. STAT. ANN. 180/15-3(c) (West 2002); MONT. CODE. ANN. § 35-8-310(3) (2003); S.C. CODE ANN. § 33-44-409(c) (Law. Co-op. Supp. 2003); S.D. CODIFIED LAWS § 47-34A-409(c) (Michie 2000); W. VA. CODE ANN. § 31B-4-409(c) (Michie 2003). Vermont substituted an MBCA-based formulation of the duty of care. VT. STAT. ANN. tit. 11, § 3059(c) (2003).

[93]*See* FLA. STAT. ANN. § 608.4225(b) (West Supp. 2004); OR. REV. STAT. § 63.155(3) (2003). The Colorado LLC act was recently amended to adopt the ULLCA formulation of the duty of care. COLO. REV. STAT. § 7-80-404(2) (as amended effective July 1, 2004). Prior to July 1, 2004, Colorado followed the MBCA model. *See* COLO. REV. STAT. § 7-80-406(1) (2003). The California LLC act provides that LLC managers and managing members have the same fiduciary duties as general partners. CAL. CORP. CODE § 17153 (West Supp. 2004). Since California has adopted RUPA, the result is a duty of care like that found in ULLCA.

[94]WIS. STAT. ANN. § 183.0402(b), (d) (West 2002). Even a criminal violation would not violate the standard of conduct set by the statute if the member or manager had "no reasonable cause to believe the conduct was unlawful." *Id.* § 183.0402(b).

[95]MBCA § 8.30(a) (1984). Section 8.30(a) formerly read as follows:

> (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
> (1) in good faith;
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
> (3) in a manner he reasonably believes to be in the best interests of the

to act in good faith and exercise the care of an ordinarily prudent person in a like position under similar circumstances.[96] Most of these states also specify that managers and managing members must act in a manner reasonably believed to be in the best interests of the company.[97] Virginia

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corporation.

Former Section 8.30(a) of the MBCA has been rewritten and divided into subsections (a) and (b). The current provisions read as follows:

> (a) Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation.
>
> (b) The members of the board of directors or a committee of the board, when becoming informed in connection with their decisionmaking function or devoting attention to their oversight function, shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances.

MBCA § 8.30(a)-(b).

[96] ALASKA STAT. § 10.50.135(a) (Michie 2004); CONN. GEN. STAT. ANN. § 34-141(a) (West 2002); GA. CODE ANN. § 14-11-305(1) (2003); IOWA CODE ANN. § 490A.706(1) (West 2003); LA. REV. STAT. ANN. § 12:1314(A)(1) (West 2003); ME. REV. STAT. ANN. tit. 31, § 652(1) (West 2003); MICH. COMP. LAWS ANN. § 450.4404(1) (West 2003); MINN. STAT. ANN. §§ 322B.663(1), 322B.69 (West 2004); MISS. CODE ANN. § 79-29-402(1) (2003); MO. ANN. STAT. § 347.088.1 (West 2001); N.Y. LTD. LIAB. CO. LAW § 409(a) (McKinney 2005); N.C. GEN. STAT. § 57C-3-22(b) (2003); N.D. CENT. CODE § 10-32-86(1) (Supp. 2003); OHIO REV. CODE ANN. § 1705.29(B) (West 2003); OKLA. STAT. ANN. tit. 18, § 2016(1) (West 1999); R.I. GEN. LAWS § 7-16-17(a) (2002); TENN. CODE ANN. §§ 48-239-115(a), 48-240-102(b), 48-241-111(a) (2003); VT. STAT. ANN tit. 11, § 3059(c) (1997). All of these statutes also include provisions entitling managers and managing members to rely on specified types of information and reports. ALASKA STAT. § 10.50.135(a) (Michie 2004); CONN. GEN. STAT. ANN. § 34-141(b) (West 2002); GA. CODE ANN. § 14-11-305(2) (2003); IOWA CODE ANN. § 490A.706(2) (West 2003); LA. REV. STAT. ANN. § 12:1314(A)(2) (West 2003); ME. REV. STAT. ANN. tit. 31, § 657 (West 2003); MICH. COMP. LAWS ANN. § 450.4404(2) (West 2003); MINN. STAT. ANN. § 322B.663(2) (West 2004); MISS. CODE ANN. § 79-29-402 (2) (2003); MO. ANN. STAT. § 347.090 (West 2001); N.Y. LTD. LIAB. CO. LAW § 409(b) (McKinney 2005); N.C. GEN. STAT. § 57C-3-22(b) (2003); N.D. CENT. CODE § 10-32-86(2) (2003); OHIO REV. CODE ANN. § 1705.30 (West 2003); OKLA. STAT. ANN. tit. 18, § 2016(2) (West 1999); R.I. GEN. LAWS § 7-16-17(b) (2002); TENN. CODE ANN. §§ 48-239-115(b), 48-240-102(c), 48-241-111(b) (2003); VT. STAT. ANN. tit. 11, § 3059(i) (1999). The Louisiana statute goes on to provide that, notwithstanding the statutory duty of care imposed, a member or manager shall not be personally liable to the limited liability company or its members for monetary damages unless the member or manager acted in a grossly negligent manner or engaged in conduct demonstrating a greater disregard for the duty of care than gross negligence, including intentional tortious conduct or intentional breach of the duty of loyalty. LA. REV. STAT. ANN. § 12:1314(B) (West 2003). "Gross negligence" is defined in the statute as "reckless disregard of or carelessness amounting to indifference to the best interests of the limited liability company or the members thereof." *Id.* § 12:1314(C).

[97] The Georgia statute merely requires that the belief be "in good faith" rather than "reasonable." GA. CODE ANN. § 14-11-305(1) (2003). The Maine statute requires only that managers and members act "with a view to the interests of the limited liability company." ME. REV. STAT. ANN. tit. 31, § 652(1) (West 2003). The Iowa statute simply states that duties must be discharged "in a manner the manager believes to be in the best interests of the limited liability company." IOWA CODE ANN. § 490A.706(1) (West 2003). The New York statute does not

simply requires that managers act in accordance with their good faith business judgment of the best interests of the limited liability company.[98]

Approximately nine states do not specify a standard of care, but provide immunity from liability in the absence of gross negligence, willful misconduct, or similar culpable conduct.[99] The LLC statutes of approximately eleven other states specify neither a standard of conduct nor a threshold of liability,[100] albeit some of these statutes imply that there are fiduciary duties and associated liability for breach.[101]

Many state LLC statutes explicitly give members the flexibility to define duties or liabilities of managers and managing members, at least to some extent, in the LLC's operating agreement or articles of organization. These statutes, however, address this issue in a variety of ways.[102] The ULLCA approach permits the operating agreement to define the duty of care, but the default gross negligence standard may not be unreasonably reduced.[103] Some statutes have provisions similar to the types found in corporate statutes permitting director exculpation in the articles of incorporation.[104] A number of jurisdictions permit the operating agreement

include any language along these lines.

[98]VA. CODE ANN. § 13.1-1024.1 (Michie 1999).

[99]*See* ARK. CODE ANN. § 4-32-402(1) (Michie 2001); IDAHO CODE § 53-622(1) (Michie 2000); IND. CODE ANN. §§ 23-18-4-2(a) to -4-10 (Michie 1999); KY. REV. STAT. ANN. § 275.170(1) (Michie 2003); N.H. REV. STAT. ANN. § 304-C:31(IV), (V) (1995); N.J. STAT. ANN. §§ 42:2B-26, 42:2B-30 (West. Supp. 2003); N.M. STAT. ANN. § 53-19-16(B) (Michie 2003); UTAH CODE ANN. 48-2c-807(1) (2002); WASH. REV. CODE ANN. § 25.15.155(1) (West Supp. 2004). A number of these provisions are modeled quite closely or verbatim after the ABA PROTOTYPE.

[100]These states are Arizona, Delaware, District of Columbia, Kansas, Maryland, Massachusetts, Nebraska, Nevada, Pennsylvania, Texas, and Wyoming. *See* RIBSTEIN & KEATINGE, *supra* note 83, app. 9-4, at 9-62 to 9-63 (charting the duty of care in LLC statutes).

[101]For example, some of these state statutes include provisions protecting members and managers who rely in good faith on reports and information. *See* DEL. CODE ANN. tit. 6, § 18-406 (2001); KAN. STAT. ANN. § 17-7697 (2003); MASS. GEN. LAWS ANN. ch. 156C, § 11 (West 2002). In addition, provisions authorizing the expansion or restriction of duties, or the limitation or elimination of liability for breach of a duty, imply the existence of traditional fiduciary duties. *See* DEL. CODE ANN. tit. 6, § 18-1101(c) (2003); D.C. CODE ANN. § 29-1020(a) (2004); MASS. GEN. LAWS ANN. ch. 156C, §§ 8(b), 63(b) (West 2002); TEX. REV. CIV. STAT. ANN. art. 1528n-2.20(B) (Vernon 2002).

[102]*See* RIBSTEIN & KEATINGE, *supra* note 83, app. 9-6, at 9-68 to 9-69 (categorizing the approaches toward waiver of fiduciary duties in the state LLC statutes).

[103]ULLCA § 103(b)(3), 6A U.L.A. 567. *See also* FLA. STAT. ANN. §§ 608.423(1), (2)(c) (West 2002); HAW. REV. STAT. §§ 428-103(a)-(b) (2004); S.C. CODE ANN. § 33-44-103(a)-(b) (Law. Co-op. Supp. 2003).

[104]*E.g.*, IOWA CODE ANN. § 490A.707 (West 1999); MICH. COMP. LAWS ANN. § 450.4407 (West 2001); N.Y. LTD. LIAB. CO. LAW § 417 (McKinney 2005); N.D. CENT. CODE § 10-32-86(5) (Supp. 2003); R.I. GEN. LAWS § 7-16-18 (1999); VA. CODE ANN. § 13.1-1025 (Michie 1999).

to modify duties and/or liabilities without expressly limiting such power.[105] In perhaps the ultimate expression of freedom of contract, the recently amended Delaware statute states that the fiduciary duties of a member or manager "may be expanded or restricted or *eliminated* by provisions in the limited liability company agreement."[106]

Although LLC statutes currently reflect a variety of approaches to the duty of care, the end result for the standard of liability is similar under the various statutes. To the extent that the statutes reflect a corporate approach towards the duty of care, the courts can be expected to apply the corporate business judgment rule. The ULLCA model sets a gross negligence standard of care, and, presumably, a gross negligence standard of liability,[107] which results in a standard of liability similar to that resulting from application of the business judgment rule.[108] Likewise, the ABA PROTOTYPE model addresses the duty of care in terms of a standard of liability, rather than a standard of care, which results in a standard of liability consistent with application of the business judgment rule.[109] In states where the statute is silent, the courts will likely apply standards

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[105] *See, e.g.*, CONN. GEN. STAT. ANN. § 34-143(1) (West 2002); DEL. CODE ANN tit. 6, § 18-1101(c), (e) (2003); KY. REV. STAT. ANN. § 275.180(1) (Michie 2003); MASS. GEN. LAWS ANN. ch. 156C, § 63(b) (West 2002); TEX. REV. CIV. STAT. ANN. art. 1528n-2.20(B) (Vernon 2002).

[106] DEL. CODE ANN. tit. 6, § 18-1101(c) (2004) (emphasis added). The limited liability company agreement may not, however, eliminate the implied contractual covenant of good faith and fair dealing. *Id.* Prior to August 1, 2004, this provision stated that the fiduciary duties of a member or manager could be "expanded or restricted" by the operating agreement. The Delaware Supreme Court had indicated in dicta that similar language in the Delaware limited partnership statute did not authorize the elimination of a general partner's fiduciary duties, pointing to the absence of such express authorization in the statute. Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 167-68 (Del. 2002). In response to this opinion, the Delaware legislature amended both the limited partnership and limited liability company acts to expressly permit elimination of fiduciary duties. 2004 Del. Laws ch. 275 (H.B. 411) (eff. Aug. 1, 2004). *See also* DEL. CODE ANN. tit. 6, § 18-1101(e) (2004) (providing that a limited liability company agreement may limit or eliminate any and all liabilities of a member of manager for breach of contract and breach of fiduciary duty, except that a "limited liability company agreement may not limit or eliminate liability for an act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing"). *See also* Allan G. Donn, *Contractual Modification of Fiduciary Duties for Delaware Unincorporated Business Entities*, 7 J. PASSTHROUGH ENTITIES 21 (Nov./Dec. 2004); Paul M. Altman et al., *Contractually Defining Duties of General Partners in Delaware Limited Partnerships*, 19 PUBOGRAM NEWSLETTER (ABA Section of Business Law) 8 (July 2002).

[107] ULLCA § 409(c), 6A U.L.A. 600 (2003); *see also supra* notes 85-89 and accompanying text.

[108] As in the case of RUPA, it does not appear appropriate to further relax the standard of liability under the auspices of the business judgment rule since the statute appears to align the standard of care and the standard of liability. *See supra* notes 59-63 and accompanying text.

[109] *Supra* notes 89-90 and accompanying text.

similar to those traditionally applied in the corporate or partnership context, which ultimately protect managing persons from liability for mere negligent mismanagement. Thus far, there is little case law dealing with the duty of care in the limited liability company context. As is the case with the corporate and partnership case law, the duty of loyalty has received more attention than the duty of care.[110]

D. *The Changed Landscape of Unincorporated Business Entity Law and the Diminution of Co-Venturer Oversight*

As unincorporated business organization law has adopted certain features that have traditionally been the hallmark of the corporate model, i.e., limited liability, the degree to which venturers expect and need to engage in extensive oversight of one another has been diminished.[111] Once

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[110]*See, e.g., generally* Credentials Plus, LLC v. Claderone, 230 F. Supp. 2d 890 (N.D. Ind. 2002) (stating members of LLCs owe a duty of loyalty and finding the duty was breached by an individual's competition with the LLC); Blackmore Partners, L.P. v. Link Energy LLC, 864 A.2d 80 (Del. Ch. 2004) (holding pleadings were sufficient to support an inference of disloyal conduct on the part of LLC managers who approved a sale of the LLC's assets that rendered the equity units worthless); Metro Communications Corp., BVI v. Advanced Mobilecomm Techs., Inc., 854 A.2d 121 (Del. Ch. 2004) (finding pleadings were sufficient to state claims against LLC managers for common law fraud and breach of fiduciary duties of loyalty and disclosure in connection with a bribery scheme leading to the collapse of the LLC); Solar Cells, Inc. v. True North Partners, LLC, No. 19,477, 2002 Del. Ch. LEXIS 38 (Del. Ch. Apr. 25, 2002) (granting injunctive relief based on reasonable probability the plaintiff member would prevail on its breach of duty of loyalty claim against the other member in connection with a squeeze-down merger); VGS, Inc. v. Castiel, No. 17,995, 2000 Del. Ch. LEXIS 122 (Del. Ch. Aug. 31, 2000), *aff'd*, 781 A.2d 696 (Del. 2001) (finding LLC managers breached their duty of loyalty by secretly orchestrating a squeeze-down merger of the LLC); Anest v. Audino, 773 N.E.2d 202 (Ill. App. 2002) (holding an LLC member breached his fiduciary duty to the other member by diverting a business opportunity of the LLC); Bio-Septic Sys., LLC v. Weiss, 60 P.3d 943 (Mont. 2002) (finding no breach of fiduciary duty where an LLC member received compensation as an independent contractor); TIC Holdings, LLC v. HR Software Acquisitions Group, Inc., 750 N.Y.S.2d 425 (N.Y. Sup. 2002), *aff'd*, 755 N.Y.S.2d 19 (N.Y. A.D. 1 Dept. 2003) (finding LLC manager was not entitled to summary judgment based on release provisions in the LLC operating agreement because the alleged breaches of fiduciary duty involved misconduct that cannot be released by such provisions); Jundt v. Jurassic Res. Dev., N. Am., L.L.C., 656 N.W.2d 15 (N.D. 2003) (holding that defendant LLC members did not violate their fiduciary duties by allegedly diverting business opportunities); McConnell v. Hunt Sport Enters., 725 N.E.2d 1193 (Ohio App. 1999) (concluding LLC members did not breach their duty of loyalty by competing with the LLC because the LLC operating agreement permitted members to compete); Flippo v. CSC Assocs. III, L.L.C., 547 S.E.2d 216 (Va. 2001) (finding LLC member breached his fiduciary duties by acting in his own interest and the statutory business judgment rule was inapplicable).

[111]In a typical partnership, where partners participate in management and have equal liability for partnership obligations, the partners have the incentive and the power to monitor the partnership business, and a *good faith* standard is appropriate. *See* Susan Saab Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Law Partnerships*, 39 S. TEX. L. REV. 399, 419-22 (1998); Susan Saab Fortney, *Seeking Shelter in the Minefield of*

the corporation was the structure of choice for most ventures in which passive capital was sought. The limited partnership was used when taxation under Subchapter K was a material aspect of the transaction, such as real estate syndications. Common to both of these structures was the provision of limited liability to passive investors. The investors, in these situations, could accept a passive role, being one in which they engaged in little if any oversight of the managers because their exposure to the venture in question was limited to the amount invested.[112] The UPA partnership, conversely, was seldom used for ventures of significant magnitude because the rule of personal liability for partnership obligations imposed extensive oversight responsibilities among the partners and the high costs of maintaining and distributing the information necessary to respond to those demands.[113]

Today, the menu of available business structures is such that limited liability is no longer restricted to corporate shareholders and limited partners. Limited liability is now available for all venturers by utilizing a limited liability partnership, limited liability limited partnership, or limited liability company. The practical limitations upon the availability of capital from passive investors that previously limited the size of most partnerships

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Unintended Consequences—The Traps of Limited Liability Law Firms, 54 WASH. & LEE L. REV. 717, 751-52 (1997).

[112]Stephen B. Presser, *Thwarting the Killing of the Corporation: Limited Liability, Democracy, and Economics*, 87 NW. U.L. REV. 148, 158 (1992):

> First [Easterbrook and Fischel] observe that if there were unlimited shareholder liability, shareholders would find it necessary to monitor closely the activities of their corporations in order to escape liability, and that the high cost of this monitoring would itself discourage investment. Further, they argue, the need for increased monitoring would render uneconomic their favored strategy of diversified investing, which now seems to attract risk-averse capital. Limited liability decreases the need for shareholder monitoring, since less is at risk, they claim, and thereby "makes diversification and passivity a more rational strategy and so potentially reduces the costs of operating the corporation."

Id. (quoting FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 42 (1991) (footnotes omitted)).

[113]The exceptions to this rule were the large accounting and legal partnerships that continued to operate in that format for a variety of reasons, including long held prejudices against the practice of the learned professions other than through the general partnership form, tax disincentives to practicing as a professional service corporation after that form became available in the 1960s, and rules of professional regulation that precluded or eliminated many of the benefits of other business forms. Recent years have seen the adoption of the limited liability partnership and the limited liability company as an alternative to the traditional partnership. *See generally* Robert W. Hillman, *Organizational Choices of Professional Service Firms: An Empirical Study*, 58 BUS.LAW. 1387, 1389-95 (2003) (discussing various different business entities available to professional services firms and the benefits associated with the newer entities such as LLCs and LLPs); Thomas E. Rutledge, *The Place (If Any) of the Professional Structure in Entity Rationalization*, 58 BUS. LAW. 1413, 1419-23 (Aug. 2003) (same).

have now been largely eliminated.[114] While the corporation is generally the vehicle of choice for publicly held companies, publicly held limited partnerships and limited liability companies are not unheard of. Thus, the unincorporated business organization, which was previously restricted to the closely-held and closely-managed realm, is now available for the largest, as well as the smallest, of ventures.

As unincorporated business organizations take on aspects and characteristics traditionally enjoyed by the corporate form, there is a danger that corporate jurisprudence may be indiscriminately applied to unincorporated organizations. Wholesale application of corporate case law would do great violence to the differing default obligations undertaken by, and the contractual flexibility afforded to, the participants of those ventures. Rather, any application of corporate principles to unincorporated organizations must take place only after a careful review of the appropriateness of doing so.[115]

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[114]Note, however, that this limitation is not complete. RUPA § 301, which vests in each partner apparent agency authority on behalf of the partnership in its ordinary course of business, will continue to limit the size of general partnerships as promoters seek to limit (control) agency.

[115]For example, to date courts have shown a general reluctance to pierce the veil of the limited liability company (*see* cases collected in Elizabeth S. Miller, *The First Decade of LLC and LLP Case Law: A Survey of Cases Dealing with Registered Limited Liability Partnerships and Limited Liability Companies*, which appears in the program materials for "Partnerships and LLCs—Important Case Law Developments 2004" (American Bar Association, August 2004)), a reluctance that appropriately parallels the reluctance of courts to pierce the corporate veil. There are any number of other areas where the courts may be invited to analogize or borrow from the corporate context when an LLC statute fails to provide guidance. For example, absent statutory authorization, courts have differed as to whether LLC members may bring a derivative action. *See generally* Weber v. King, 110 F. Supp. 2d 124 (E.D. N.Y. 2000) (recognizing common law right to bring derivative action even though the New York LLC statute does not expressly permit such actions); Schindler v. Niche Media Holdings, LLC, 772 N.Y.S.2d 781 (N.Y. Sup. Ct. 2003) (holding that the New York LLC statute does not permit derivative actions because it contains no provision authorizing such actions).

An example of a questionable application of corporate norms in the LLC context appears in *Geresy v. Dommert*, No. 243,468, 2004 Mich. App. LEXIS 1397 (Mich. App. June 3, 2004) (unpublished decision), where the operating agreement provided that each of the members agreed to be personally liable for one-fifth of certain obligations and to sign guarantees. *Id.* at *5-*6. One of the members signed the operating agreement on behalf of the LLC, and all five members signed the operating agreement under the heading "members." *Id.* at *15. The court held that the members could not be held liable because "they had signed the operating agreement only once, rather than twice, which indicated that they had signed only as members and not as individuals." *Id.* The court relied upon the general rule that "'an individual stockholder or officer is not liable for his corporation's engagements unless he signs individually, and where individual responsibility is demanded the nearly universal practice is that an officer signs twice—once as an officer and again as an individual.'" *Id.* (citation omitted).

IV. THE MIXED HISTORY OF THE BUSINESS JUDGMENT RULE IN UNINCORPORATED BUSINESS ORGANIZATION LAW

As noted in the introduction, there are conflicting decisions on whether the business judgment rule applies in the realm of unincorporated business organizations.[116] A number of facts may have given rise to these disagreements, including uncertainty as to the applicable formulation of the standard of care, less than exacting appreciation of the purpose and effect of the business judgment rule, and the indiscriminate application of corporate law rules to an unincorporated law question.

A. *General and Limited Partnerships*

Courts have yet to apply the duty of care as articulated in either RUPA[117] or ReRULPA,[118] but a number of cases have applied a business judgment rule in the partnership context. For example, in *Rosenthal v. Rosenthal*,[119] the Maine Supreme Court pronounced that partners are subject to the same fiduciary duties of care and loyalty owed by a corporate director under Maine law.[120] After describing the duty of care as requiring that degree of diligence, care, and skill which ordinarily prudent persons would exercise under similar circumstances, the court provided a lengthy explanation of how and why the business judgment rule insulates partners from liability for informed decisions so long as the partners were not

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[116] *See supra* notes 1-3 and accompanying text.

[117] RUPA § 404(c), 6 Pt. I U.L.A. 143 (2001).

[118] ReRULPA § 408(c), 6A U.L.A. 62 (2003).

[119] 543 A.2d 348 (Me. 1988).

[120] The Maine Supreme Court stated that the trial court's delineation of fiduciary obligations accurately described the duties of care and loyalty owed under Maine law by the corporate director to the corporation and its shareholders, as well as the duties of a partner to the partnership and his fellow partners. Those duties were described as follows:

> (1) To act with that degree of diligence, care and skill which ordinarily prudent persons would exercise under similar circumstances in like positions;
>
> (2) To discharge the duties affecting their relationship in good faith with a view to furthering the interests of one another as to the matters within the scope of the relationship;
>
> (3) To disclose and not withhold from one another relevant information affecting the status and affairs of the relationship;
>
> (4) To not use their position, influence or knowledge respecting the affairs and organization that are subject to the relationship to gain any special privilege or advantage over the other person or persons involved in the relationship.

Id. at 352.

motivated by fraud or bad faith.[121]

Various articulations of the business judgment rule have appeared in other partnership cases that have insulated partners from liability for decisions involving carelessness,[122] failure to use ordinary skill and care,[123] poor business judgment,[124] simple negligence,[125] unwise investment

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[121]The Maine Supreme Court concluded that the trial court incorrectly instructed the jury by misstating the business judgment rule. *Id.* at 353. In doing so, the court stated:

> Having already stated that defendants owed [their co-partner] four specific fiduciary duties, including the duty of due care, the presiding justice told the jury that the business judgment rule would come into play *only* if the defendants had not otherwise violated the duty of due care. Thus the justice left open to the jury to find a breach of fiduciary duty by defendants on a showing merely that they had failed "[t]o act with that degree of diligence, care and skill which ordinarily prudent persons would exercise under similar circumstances in like positions." That is not the law.
>
> Many courts, including our own, have long recognized that it falls outside the proper judicial domain to inquire into and second-guess the prudence of particular business decisions honestly reached by those entrusted with the authority to determine what course of action best advances the well-being of the enterprise. . . .
>
> Thus the business judgment rule will insulate from a finding of liability the informed business decisions made by [the acting partners] unless [the other partners] [are] able to show that their allegedly harmful conduct was primarily motivated by fraud or bad faith. . . .
>
> The jury instruction in this case did not give [the acting partners] the benefit of the business judgment rule to which by law they are entitled. It erroneously permitted the jury to assess the ordinary prudence of defendants' business decisions, a function denied to judicial tribunals. The jury should have been told that for it to conclude that defendants in fact violated their fiduciary obligations . . ., it must find that the predominating motive for their conduct was fraud or bad faith.

Id. at 353-54 (citations omitted).

[122]Bane v. Ferguson, 890 F.2d 11, 14 (7th Cir. 1989) (finding no precedent in Illinois or elsewhere for imposing tort liability on careless managers for the financial consequences of the collapse of the firm).

[123]Wirum & Cash Architects v. Cash, 837 P.2d 692, 702 (Alaska 1992) (stating that partners are not generally liable to the partnership for "failure to use ordinary skill and care in the supervision and management of business because harm to the partnership is frequently outweighed by the need to give the partner sufficient leeway to exercise discretion on behalf of the partnership") (quoting ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 6.07(f), at 6.85-.86 (1992)).

[124]ARTRA Group Inc. v. Salomon Bros. Holding Co., 680 N.E.2d 769, 773 (Ill. App. 1997) (stating that the "exercise of poor business judgment does not [alone] constitute a breach of a fiduciary duty" and indicating that some type of intentional or willful disregard of duty would be required to impose liability) (citations omitted).

[125]Borys v. Rudd, 566 N.E.2d 310, 316 (Ill. App. 1990) (stating that "partnership losses occasioned by a partner's poor judgment or mistakes of judgment will be borne by the partnership so long as the decision does not involve fraud, illegality, or conflict of interest").

schemes,[126] negligence with no breach of trust,[127] or an abuse of discretion.[128] Other courts have stated the rule more abstractly, finding there was no liability where there was no fraud or misconduct,[129] the *Aronson v. Lewis* standard was satisfied,[130] there was no allegation of interestedness,[131] there was good faith and reasonable diligence,[132] or the care rendered was that of an ordinary prudent person.[133] Some courts appear to apply the business judgment rule as a substantive rule without specifying a standard of liability or review.[134] On the other hand, at least

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[126]Stuart Silver Assocs. Inc. v. Baco Dev. Corp., 665 N.Y.S.2d 415, 418 (N.Y. App. Div. 1997) (stating that the business judgment rule shielded the general partners from liability for an unwise investment scheme in the absence of bad faith, a conflict of interest, or personal bias).

[127]Duffy v. Piazza Constr. Inc., 815 P.2d 267, 268-69 (Wash. App. 1991) (stating that there is generally no liability on the part of a partner for negligence in the management of the partnership and that it is only actionable when there is a breach of trust).

[128]Grider v. Boston Co., 773 S.W.2d 338, 342 (Tex. App. 1989) (stating that the judgment used in making business decisions will be respected by the courts in the absence of a clear abuse of discretion).

[129]Cates v. Int'l Tel. & Tel. Corp., 756 F.2d 1161, 1178-79 (5th Cir. 1985) (stating that there were no grounds to interfere with the majority partner's decision not to bring suit on behalf of the partnership where there was no allegation that the majority partner was guilty of any fraud or misconduct or that he was even unwise in refusing to consent to the suit).

[130]*In re* Boston Celtics Ltd. P'ship S'holders Litig., No. 16,511, 1999 Del. Ch. LEXIS 166, at *12 (Del. Ch. Aug. 6, 1999). *See also* Seaford Funding Ltd. P'ship v. M&M Assocs. II, L.P., 672 A.2d 66, 70 (Del. Ch. 1995) ("When limited partners make demand and the general partner refuses to pursue the action after informed consideration and in good faith, the business judgment rule comes into play.") (citation omitted).

[131]Dean v. Dick, No. 16,566, 1999 Del. Ch. LEXIS 121, at *15 (Del. Ch. June 10, 1999).

[132]Shlomchik v. Richmond 103 Equities Co., 662 F. Supp. 365, 373-74 (S.D.N.Y. 1986) (finding no failure on the part of the general partners to fulfill their obligation to make a business judgment in the exercise of good faith and reasonable diligence under the existing circumstances); *Seaford Funding Ltd. P'ship*, 672 A.2d at 70.

[133]Wyler v. Feuer, 149 Cal. Rptr. 626, 633 (Cal. Ct. App. 1979) (stating that the good faith business judgment and management of a general partner need only satisfy the standard of care demanded of an ordinarily prudent person and will not be scrutinized by the courts with the "cold clarity of hindsight").

[134]Master Garage Inc. v. Bugdanowitz, 690 P.2d 879, 882 (Colo. Ct. App. 1984) (dismissing claim for breach of fiduciary duty because partner's action constituted a business judgment); Lehrberg v. Felopulos, 248 N.E.2d 648, 653 (Mass. 1969) (finding that the general partners' decision was made in the exercise of business judgment as to what was best for the partnership and was a decision that could reasonably be made by a partner with the power to act); Jackson v. Marshall, 537 S.E.2d 232, 236 (N.C. App. 2000) (holding that the duties of a general partner are similar to the duties of a corporate director and that the general partner's duty to the limited partners is to discharge his responsibilities according to the business judgment rule); *See also* Opus Corp. v. Int'l Bus. Mach. Corp., 141 F.3d 1261, 1267-68 (8th Cir. 1998) (applying business judgment rule standard articulated by the partners in the limited partnership agreement). The business judgment rule has not been applied when the court determined that the partner breached the partnership agreement. *See generally* Fisher v. Hampton, 118 Cal. Rptr. 811 (Cal. Ct. App. 1975) (holding that the general partner breached the partnership agreement by refusing

one court has stated that the business judgment rule is not applicable in the partnership context at all.[135] One commentator has summed up the state of the case law as follows:

> Partners have a duty to use appropriate care in managing the partnership business, and they can be held accountable for poor business management which violates the requisite duty. Traditionally, the courts have held partners to a *reasonable care* standard or a *good faith* standard with respect to partnership business. Under a *reasonable care* standard, a partner is liable to the partnership or the other partners if his or her conduct was unreasonable. The reasonable care standard has fallen into general disuse, and the good faith standard has become the accepted method for determining partner liability for a breach of his or her duty of care. Under a *good faith* standard of care, a partner is not liable to the partnership or his or her co-partners for acts which are not fraudulent or wanton and which are undertaken in good faith. When the good faith standard is applied, there is no need to consider whether a partner used ordinary care in managing the partnership business, and a partner will not be liable if his or her conduct results from a mistake or an honest error in judgment. Partners have been held liable for mismanagement when they were grossly negligent or acted in reckless disregard for the affairs of the partnership.[136]

Consequently, whether the jurisdiction applies the reasonable care or the good faith standard determines whether a relaxed standard of review is appropriate. Insomuch as RUPA applies a gross negligence standard of care, equal to the standard of review under the business judgment rule, it would appear that a court applying both the RUPA standard and the business judgment rule would either be duplicating its efforts or providing excessive deference to the actions under challenge.

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to comply with an express provision contained therein); Wallner v. Parry Prof'l Bldg., Ltd., 27 Cal. Rptr. 2d 834, 839 (Cal. Ct. App. 1994) (holding that limited partner may bring a derivative suit on the grounds of an alleged breach of the partnership agreement); Roper v. Thomas, 298 S.E.2d 424 (N.C. Ct. App. 1982), *rev. denied*, 302 S.E.2d 244 (N.C. 1983) (holding that the business judgment rule did not protect the general partner where the general partner breached the partnership agreement); Shinn v. Thrust IV, Inc., 786 P.2d 285 (Wash. Ct. App. 1990) (same).

[135]Henkels & McCoy, Inc. v. Adochio, 138 F.3d 491, 502 (3d Cir. 1998).

[136]CALLISON & SULLIVAN, *supra* note 53, § 12.02, at 12-5 to 12-6 (footnotes omitted).

B. *Limited Liability Companies*

Because no widely accepted approach to the duty of care has emerged in the limited liability company statutes, it is difficult to draw broadly applicable principles from those statutes. Further, because there is little case law focusing on the duty of care of a member or manager of a limited liability company, there is a dearth of judicial guidance on whether liability for breach of the standard of care will be determined under a relaxed standard of culpability.

The first LLC cases addressing the duty of care and business judgment rule were decided in the context of statutes that did not specify a duty of care or standard of liability. In the Maryland case of *Froelich v. Erickson*, the court applied the corporate business judgment rule because the LLC operating agreement specified that the LLC's directors were subject to the duties of a corporate fiduciary as defined by Maryland law.[137] In *VGS, Inc. v. Castiel*,[138] the Delaware Court of Chancery implied that the business judgment rule is applicable in the LLC context, but rejected the defendant managers' argument that the business judgment rule protected them in that case.[139] The court found that the defendant managers breached their duty of loyalty by secretly orchestrating a squeeze-down merger; therefore, the court concluded the business judgment rule did not protect the managers even though they may have conscientiously believed the plan was in the best interest of the LLC.[140] In *Carson v. Lynch Multimedia Corp.*, a breach of fiduciary case involving a Kansas LLC, a federal district

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[137]Froelich v. Erickson, 96 F. Supp. 2d 507, 520 (D. Md. 2000), *aff'd sub nom.*, Froelich v. Senior Campus Living LLC, 5 Fed. Appx. 287 (4th Cir. 2001). The limited liability company was structured with corporate features such as a "board of directors" and classes of "preferred" and "common" interests. The Fourth Circuit Court of Appeals further addressed the application of the business judgment rule in this case in *Froelich v. Senior Campus Living, LLC*, 355 F.3d 802 (4th Cir. 2004). Stretching the rule beyond recognition was the Maryland case of *LGB Group, LLC v. Booty*, in which the business judgment rule was held to protect the decision of an LLC's members to amend the operating agreement. LGB Group, LLC v. Booty, Nos. CAL 03-00088, CAE 02-00408 & CAL 03-08305, 2004 WL 1058958, at *11-*12 (Md. Cir. Ct. Jan. 28, 2004).

[138]No. 17,995, 2000 Del. Ch. LEXIS 122 (Del. Ch. Aug. 31, 2000), *aff'd*, 781 A.2d 696 (Del. 2001).

[139]*Id.* at *15-*16. See also the cursory opinion in the Delaware case of *Stern v. LF Capital Partners, LLC* that implies, but does not clearly state, that the business judgment rule would protect decisions made by what may have been the LLC's managers. Stern v. LF Capital Partners, LLC, No. 19,218, 2003 Del. Ch. LEXIS 30, at *3 (Del. Ch. Mar. 12, 2003). In *Blackmore Partners, L.P. v. Link Energy LLC*, the Delaware Court of Chancery held that *Revlon* duties apply in the LLC context and that a provision in the LLC operating agreement eliminating liability for breach of the duty of care would not protect the managers from disloyal or intentional misconduct. Blackmore Partners, L.P. v. Link Energy LLC, 864 A.2d 80 (Del. Ch. 2004).

[140]*VGS, Inc.*, 2000 Del. Ch. LEXIS 122, at *15-*16.

court in Kansas assumed that Kansas courts would follow the corporate business judgment rule as articulated in Delaware.[141] The court, however, concluded the alleged conduct would not be protected because it involved actions that were taken for reasons "wholly unrelated to the business" of the LLC.[142]

A few cases addressing statutory formulations of the duty of care have appeared, but these cases generally yield little more than recitation of the statutory provisions followed by a conclusion that the duty was or was not breached.[143] *Shell v. King*, a mismanagement case in which the

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[141]123 F. Supp. 2d 1254, 1260 (D. Kan. 2000) (stating that Kansas courts have a long history of looking to Delaware decisions involving corporation law).

[142]*Id.* (characterizing the Delaware business judgment rule as presupposing "that the 'directors act on an informed basis and in the honest belief [that] they acted in the best interest of the corporation'") (quoting Krim v. ProNet, Inc., 744 A.2d 523, 527 (Del. Ch. 1999)).

[143]*See* DeBold v. Case (*In re* Tri-River Trading LLC), 317 B.R. 65, 74 (Bankr. E.D. Mo. 2004) (noting that the Missouri LLC statute requires that "'[a]n authorized person shall discharge his duty . . . in good faith, with the care a corporate officer would exercise under similar circumstances, in the manner he reasonably believes to be in the best interests of the limited liability company,'" and concluding that an LLC member's withdrawal of financial support, which led the LLC to experience significant financial losses, breached the statutory fiduciary duty) (quoting MO. REV. STAT. § 347.088 (2003)); *In re* Provenza, 316 B.R. 225, 230 (Bankr. E.D. La. 2003) (reciting the statutory fiduciary duties and standard of liability under the Louisiana LLC act, and commenting that courts employ "at minimum, a gross negligence standard and the business judgment rule" under the Louisiana LLC statute, in reaching its conclusion that an LLC member/manager's alleged failure to disclose certain financial difficulties did not amount to a breach of fiduciary duty and that an exculpatory provision in the articles of organization relieved the member of liability even if the action amounted to a breach of fiduciary duty to the LLC or its members). In an unpublished California case, the California Court of Appeal concluded that a managing member's failure to seek additional capital (which was needed in order to close the purchase of property sought by the LLC) constituted gross negligence, noting parenthetically that the business judgment rule defense was unavailable. Denevi v. Green Valley Corp., Nos. H024089, H024292, H024293, H024374 & H025206, 2005 Cal. App. Unpub. LEXIS 578, at *24-*25 (Cal. App. 6 Dist. Jan. 21, 2005). The operating agreement in that case absolved the managing member from liability for any loss or damage unless it resulted from "'fraud, deceit, gross negligence, reckless or intentional misconduct, or a knowing violation of law.'" *Id.* at *9. The standard in the operating agreement was thus similar to the default standard under the California LLC statute, which incorporates by reference the standard of care specified in the California Revised Uniform Partnership Act. *See supra* note 93. That standard limits the duty of care to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. CAL. CORP. CODE § 16404 (West Supp. 2004). In *Flippo v. CSC Associates III, LLC*, the Virginia Supreme Court stated that an LLC "manager, like a corporate director, is required to discharge his duties in accordance with his 'good faith business judgment . . . [in] the best interests of the . . . [LLC].'" Flippo v. CSC Assocs. III, LLC, 547 S.E.2d 216, 221 (Va. 2001). The court acknowledged that the Virginia LLC statute protects managers "from liability in the exercise of that . . . judgment under certain circumstances." *Id.* The court concluded, however, that the manager was not protected in relying on advice of counsel in connection with the transaction in question because the advice was sought in the member's personal capacity for his own personal interests. *Id.* at 222. In essence, the transaction in question breached the manager's duty of loyalty. *Id.* Thus, the court did not need to discuss the

Tennessee Court of Appeals interpreted Tennessee's MBCA-based articulation of a manager's duty of care in the context of allegations against an LLC's "Chief Manager,"[144] could have been a vehicle for exploring the relationship between the statutorily prescribed standard of conduct and the standard of liability, but the court did not do so. Although the manager argued he was protected by provisions permitting delegation of duties and reliance on financial information prepared by others, the court concluded that the chief manager's wholesale delegation of financial matters to another individual, without taking any steps to verify whether the individual was correctly performing these responsibilities, was negligent and a breach of the manager's fiduciary obligations to the LLC.[145] The court spoke in terms of mere negligence and did not discuss the business judgment rule or make any distinction between the standard of conduct articulated by the statute and the standard of liability imposed by the court.

V. THE BUSINESS JUDGMENT RULE IN A CONTRACT LAW ENVIRONMENT

To the extent that any definitive statements can be made in this realm, the business judgment rule has no application in a duty of care analysis under the formulation of RUPA, ReRULPA, or ULLCA.[146] In each of these instances, the organic acts provide a standard of care of gross negligence. Conduct that does not rise to the level of gross negligence does not give rise to liability—there has been no violation of the standard. On the other hand, where gross negligence is present, liability and culpability should attach (assuming such other requisites as damages, causation, etc.). There is no place for a relaxed standard of review when gross negligence is already applied by the standard of care.[147] A relaxed standard of review would serve no purpose—unless the desire is to avoid culpability—until there is behavior such as willful misconduct that is more egregious than

standard of care and the standard of liability under the statutory duty of care provisions. *Id.* at 221-22.

[144]No. E2003-02124-COA-R3-CV, 2004 Tenn. App. LEXIS 507, at *4 (Tenn. Ct. App. Aug. 5, 2004).

[145]*Id.* at *19-*21.

[146]This statement is made subject to the discussion below regarding contractual modification of the duty of care. The partners or members are, of course, generally free to agree regarding the standard of conduct and standard of liability that will apply in their relationship under these statutes.

[147]*See, e.g.*, Martin, *supra* note 54, at 1329-30 (explaining that adoption of the gross negligence standard of care in RUPA applies to both the standard of conduct and the standard of review, eliminating any necessity for the application of a separate business judgment rule).

mere gross negligence. Dropping the standard of review below the gross negligence threshold would result in a more relaxed standard of review than typically applied under the business judgment rule. This further relaxed standard would not reflect the business judgment rule as heretofore generally understood.

Unincorporated business organizations, as contrasted with corporations, are uniquely creatures of contract in which the participants have broad discretion to craft the agreement amongst themselves, including matters of fiduciary duties. The primacy of the organic documents organizing an LLC was addressed in *In re Lake Country Investments,*[148] where the court observed:

> Limited liability companies are neither general corporations nor general or limited partnerships. They are a specially recognized form of entity . . . . The case law applicable to partnerships and construing partnership law, which has been briefed and discussed at length, is of limited utility. The specific written agreements must be given effect, and even the statute relied upon by [defendants] recognizes the primacy of the structural and organizational documents in the context of limited liability companies.[149]

This overlap of contract and fiduciary law gives rise to a new challenge, one requiring a mechanism for assessing which frame of reference will be applied when considering a question.[150] Courts could apply a contract analysis, assessing the action to determine if it is permitted or forbidden by the terms of the agreement entered into between the parties.[151] Alternatively, the question may be assessed under a fiduciary model wherein the limitations imposed serve to protect the non-managerial investors from overreaching by those in management. This problem can

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[148]Nos. 99-20287 & 00-6064, 2001 Bankr. LEXIS 1033 (Bankr. D. Idaho Mar. 19, 2001).

[149]*Id.* at *34 (footnotes omitted).

[150]*See generally* Jack B. Jacobs, *Entity Rationalization: A Judge's Perspective*, 58 BUS. LAW. 1043 (2003) (presented at Entity Rationalization Symposium, University of Maryland College of Law, Nov. 1, 2002) (describing the Delaware Court of Chancery's growing challenges in dealing with governance issues for alternative business entities).

[151]*See id.* at 1044-45, which states:

> [T]hose entity forms [LP, LLP, LLC or Business Trust] are, by statute, to be governed by contract rules, customized in the organizational instrument of the entity in question and limited only by the express prohibitions of the entity enabling statute. Indeed, the alternative entity statutes contemplate that fiduciary duty principles may be displaced, to a greater or lesser degree, by contract.

exist regardless of entity form.[152] A decision, nevertheless, needs to be made as to which frame of reference will control.[153] May an action that is sanctioned by the agreement be permitted to stand where it clearly implicates and indeed violates general fiduciary standards?

The interplay of the contract and fiduciary duty models of analysis in unincorporated business organizations yields multiple scenarios for answering this question. Specifically, there are at least six viable scenarios:

- The underlying statute expressly provides for a fiduciary duty of care and permits it to be waived or modified in the agreement,[154] and the parties have, by agreement, waived or modified the duty;
- The underlying statute expressly provides for a fiduciary duty of care, but is silent regarding waiver or modification, and the parties have, by agreement, waived or modified the duty;
- The underlying statute expressly provides a fiduciary duty of care, and the agreement is otherwise silent;
- The underlying statute is silent as to a fiduciary duty of care, but permits modification or waiver of duties, and the parties have incorporated a standard into the agreement;
- The underlying statute is silent as to a fiduciary duty of care and as to modification or waiver of duties, and the parties have incorporated a standard into the agreement;[155]
- The underlying statute is silent as to a fiduciary duty of care (and either does or does not permit modification or waiver of duties), and the parties have not incorporated a standard into the agreement.[156]

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[152]*Id.* at 1045.

[153]*Id.*

[154]*See, e.g.*, RUPA § 103(b)(4), 6 Pt. I U.L.A. 73 (2001) (permitting a reasonable reduction in the standards of care set forth in RUPA §§ 404(c) and 603(b)(3)).

[155]This fact situation was faced in UPA partnerships, and by means of linkage in RULPA limited partnerships, which sought to incorporate a contractually defined (and limited) standard of care.

[156]These scenarios in graphic form are:

In the first scenario, the parties have provided by agreement the appropriate standard of care, and exceptions thereto, for their intended relationship. This contractual provision was made in accordance with the express statutory authority to do so.[157] As the waiver or modification of the standard is permitted by the underlying statute, the agreement of the parties should be given its full effect,[158] and the interpretation of the waiver or modification should be on the basis of contract law. A fiduciary analysis should not apply to determine whether the waiver or modification was fair

Scenario	Statutory Standard of Care	Modification of Standard Expressly Allowed	Agreement Provides Modified Standard of Care
1	✓	✓	✓
2	✓		✓
3	✓		
4		✓	✓
5			✓
6		[✓]	

[157] *See, e.g.*, RUPA §§ 103(b)(4), 404(c)

[158] This is not to say, however, that it is either simple or appropriate to modify statutory or common law fiduciary duties. As observed in Murdock:

> In order to draft an adequate shareholders' agreement in the corporate context, or operating agreement in the LLC context, which would provide the types of protection that fiduciary duties provide on a default basis, one could expect an attorney's fee in the range of $10,000 or more, at least in the Chicagoland area. One of the reasons for this high cost is the difficulty in drafting such an agreement. Because we are dealing with a relationship, we need to anticipate problems that may not arise until years down the line. If one were to examine the litigated cases, one would find that many of the cases involve problems that have arisen a decade or more after the organization of the business. This is because, over time, situations change. Personality differences may arise, someone may go through an ego shattering divorce, a spoiled child may enter the business, or the financial misfortunes of one member may lead him or her to make demands that are unacceptable to other members.

Murdock, *supra* note 83, at 528-29 & n.161 (citing Battaglia v. Battaglia, 596 N.E.2d 712, 719 (Ill. App. Ct. 1992), *appeal denied*, 602 N.E.2d 446 (Ill. 1992) (involving brothers that had worked together for forty years); *In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1176 (N.Y. 1984) (involving plaintiffs that had worked for the business for thirty-five and forty-two years, respectively); Pedro v. Pedro, 489 N.W.2d 798, 803 (Minn. Ct. App. 1992) (involving a plaintiff that had been employed for forty-five years and the defendant brothers employed for thirty-four and fifty years, respectively)).

to the participants or whether it permits overreaching by those in control.[159] Only if the waiver or modification exceeds the scope permitted by the statute should a fiduciary analysis be applied, which presents another question. As the parties sought to modify the fiduciary duty of care to a degree not permitted, should the managers' actions be assessed based upon the default standard of care, or rather against the standard of care as it may be modified without violation of the underlying statute? It can be debated whether the courts do more violence to the agreement of the parties by adopting one outcome or the other.

The second scenario should result in the enforcement of the contractual standard of care that was accepted by the parties. This enforcement should apply notwithstanding the absence of statutory authority for the modification of the standard. It would be the height of paternalism for the courts to determine that a negotiated standard should be rejected and the statutory standard applied simply because the legislature did not address contractual modification of duties.[160] The absence of an express right of modification should not be interpreted as equivalent to an express legislative statement barring modification. While it may be unwise for investors to participate in a venture in which those in control are not bound by a standard of care, or in which the care demanded of them is minimal, courts should be reluctant to prohibit the parties from entering into such an agreement absent a clear manifestation of legislative intent that the standard is not subject to waiver or modification.[161]

The third scenario is the most related to the corporate law situation, namely that there is a statutorily defined standard of care which must be applied by the courts, unmodified by any agreement of the parties. If there is an appropriate situation in the realm of unincorporated business organization law for the application of the business judgment rule, this would be it. As has been set forth above, however, the applicable standard of care under RUPA, ReRULPA, and ULLCA is already one of gross negligence. As previously noted, additional deference to the conduct of those managing the organization would seem inappropriate and excessively

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[159]We assume for this discussion that the contractual modification is within the limits set by the statute. *See, e.g.*, RUPA § 103(b)(4); ReRULPA § 110(b)(6).

[160]Note that some LLC acts do not provide for a standard of care, but do recognize the primacy of the operating agreement as controlling the relationship among the members. *See, e.g.*, KY. REV. STAT. ANN. § 275.003 (Michie 2002) ("It shall be the policy of the General Assembly through this chapter to give maximum effect to the principles of freedom of contract and the enforceability of operating agreements.").

[161]Egregious abuses may be addressed by resort to principles of good faith and fair dealing and, in the face of a modification of the standard of care, a judicial determination that the modification lacked the specificity necessary to sanction the subject conduct.

lenient.[162]

Scenarios four and five involve the question of whether the parties may by contract modify the otherwise applicable common law. The answer is clear if the statute expressly permits such modification. Even in the absence of such express authorization, the parties should be able to do so. There is case law stating that they may,[163] and there is no patent rationale for rejecting the standard that the parties might adopt.[164] As discussed below, there is no justification in either scenario for applying a reduced standard of review to the standard of care defined by the participants. In these cases, we simply assume that the parties said what they meant to say[165] and that if they intended a relaxed standard of review, they would have so provided in the document. As with any universal statement, however, there is at least one exception: if the agreement in question incorporates a corporate standard of care (either by reciting the corporate formulation in the document or by a statement to the effect that those in control of the unincorporated business are subject to the standards of a corporate director), and the state law applies the business judgment rule,[166] it would be appropriate to apply the rule to the actions of those acting on behalf of the unincorporated organization. While doing so involves an assumption that the drafter meant to incorporate the business judgment rule, it is a greater assumption to determine that the drafter sought to reject the standard of review applied to that standard of care.

The final scenario is the most troubling because the participants have provided no contemporaneous description of their expectations. One view would be that the parties sought to have their agreement interpreted by the common law fiduciary duty of care.[167] An alternate and equally valid view would be that the parties drafted the agreement pursuant to what they thought was necessary for their relationship. While they did accept common law rules of contract interpretation and enforcement, including

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[162]*See supra* notes 146-47 and accompanying text.

[163]*See* McLendon v. McLendon, 862 S.W.2d 662, 676-77 (Tex. App.1993) (holding the parties' agreement to modify the general partners' duties enforceable); Grider v. Boston Co., 773 S.W.2d 338, 342-43 (Tex. App. 1989) (same); *see also* R.S.M., Inc. v. Alliance Capital Mgmt. Holdings, L.P., 790 A.2d 478, 499 & n.33 (Del. Ch. 2001) (discussing the extent of contractual modification of fiduciary duties in the partnership agreement); Sonet v. Timber Co., L.P., 722 A.2d 319, 324 & n.12 (Del. Ch. 1998) (same).

[164]*See supra* note 160.

[165]We should always make this assumption in all cases in which the parties define an applicable standard of care.

[166]*See, e.g.*, Froelich v. Erickson, 96 F. Supp. 2d 507, 520 (D. Md. 2000), *aff'd sub nom.*, Froelich v. Senior Campus Living LLC, 5 Fed. Appx. 287 (4th Cir. 2001).

[167]Whether the participants had a common understanding of that standard of care is open to dispute.

good faith and fair dealing, they did not contract on the basis of the importation of fiduciary rules. There is little, if any, justification for either of these views, and even less justification for accepting one over the other. Perhaps a fiduciary analysis is not required, as the parties have addressed all of the issues they deem important and have retained the information and oversight rights sufficient to protect against abuse.[168]

Important for our purposes is that in five of the six scenarios the contracting parties have specified the standard of care they deem necessary and appropriate to their dealings. The contracting parties, in such a situation, reasonably expect the terms of their agreement to be enforced. What they do not expect is that the terms of their agreement will be enforced not as they have written, but to a degree deemed necessary to preserve the flexibility of management. That is, however, exactly what the application of the business judgment rule (i.e., additional deference) does when applied to these situations. The differentiation in the standards of care and review will result in the court enforcing a more lenient standard of conduct that is contiguous with the standard of review, which is not the parties' contracted standard. If contracting parties are not able to expect that the limitations they impose on the care of the managers will be enforced as written, then they must draft the modifications not to the limit of what is permitted, but rather to some unknown limitation that is more restrictive than the actual agreement. Then, in an action for enforcement, the court's deference to the manager will grant additional flexibility, which, when combined with the contractual grant, will equal the standard of care actually intended by the parties.

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[168]As Professor Ribstein described:

> Fiduciary duties are a specific type of contractual term, namely a duty of unselfishness, which applies in the absence of contrary agreement in the particular case where an "owner" who controls and derives the residual benefit from property delegates open-ended management power over property to a "manager." . . . In such a relationship the fiduciary has the incentive to use control to enrich herself rather than the owner, and the owner's most effective protection is to subject the manager to a limited ex post duty focusing on whether the manager has engaged in self-dealing.
>
> Although others have described fiduciary duties along similar lines, they usually do not clarify *why* the property manager needs to be constrained by the strong fiduciary duty. In other words, while it is apparent that the property owner would not delegate control over his property without demanding some protection, it is not clear why the benefits of the particular protection provided for in fiduciary law outweigh the costs. The short answer is that the fiduciary's discretion cannot readily be constrained by devices other than fiduciary duties without undermining the owner's objectives in delegating control.

Larry E. Ribstein, *The Structure of the Fiduciary Relationship*, *at* http://home.law.uiuc.edu/~ribstein/structureofthefiduciaryrelationship9.doc, at 8-9 (Nov. 23, 2003 Draft) (footnotes omitted)

Clearly, this situation is unworkable. It would not be possible for contracting parties to properly assess the degree to which they must draw back the contractual standard of care so that, when combined with the effective grant of authority resulting from the application of the business judgment rule, the intentions of the parties are actually achieved. As such, the business judgment rule should not be applied in unincorporated business organizations that utilize a gross negligence standard of care or culpability.

Admittedly, a determination not to apply the business judgment rule where the parties, by agreement, have adopted a particular formulation for the standard of care fails to provide any guidance with respect to the application of the business judgment rule where the parties have made no express (or clearly implicit) decision regarding the standard of care. Such organizations will fall into one of three categories: (1) inadvertent partnerships, in which no thought has been given to the standard of care; (2) minimally lawyered entities, where little if any thought has been given to the standard of care and the advisors may be unaware that the standard of care is subject to modification or lack the sophistication necessary to confidently modify the standard; or (3) organizations lawyered by sophisticated advisors who do not deem any modification of the default standard of care necessary.

In this situation, there exist at least two rationales for not applying the business judgment rule in the context of unincorporated business organizations. The first is the need to ensure consistency on review among both lawyered and unlawyered organizations. Extensively lawyered organizations, with sophisticated organic documents specifying a standard of care, are entitled to the enforcement of a specified standard without application of the business judgment rule. Arguably, they should not be subject to a standard of review that differs from that applied to the unlawyered or where the default statutory or common law standard has been adopted.

Secondly, the business judgment rule should not be applied to the new unincorporated business forms because it generally does not appear in the organizational statutes.[169] The business judgment rule was well

[169]Of course, where the business judgment rule has been expressly incorporated in a statute, this statement is inapposite, and the business judgment rule should be applied unless the parties have expressly elected out of it in the organic documents. In addition, in those instances where the statutory formulation of the duty of care in an LLC or partnership statute is based on the former MBCA model (i.e., an MBCA-based standard of care without explicit provisions embodying the business judgment rule), courts will likely view the business judgment rule as an implicit feature of the formulation, and application of the business judgment rule arguably best reflects the intent underlying adoption of such a corporate model. *See supra* notes 95-96 and

developed by the time that RUPA, ReRULPA, ULLCA, and the ABA PROTOTYPE were drafted and at the time the various state legislatures crafted their own statutes based upon these acts. The drafters of the statutes, by and large national and regional experts in unincorporated business organization law, typically did not incorporate the business judgment rule into the fiduciary duty formulations set forth in the statute. While it is always somewhat problematic to draw conclusions from the absence of a provision from a statute, the absence of such an important concept as the business judgment rule is worthy of note and indicative of legislative intent. This argument by absence is even stronger in the case of RUPA and ReRULPA where the business judgment rule was expressly considered and in the end not incorporated into the uniform act.[170]

VI. CONCLUSION

The business judgment rule has proved to be an ever-evolving legal concept,[171] and its contour and application have proved exceptionally difficult to reduce to a precise formulation.[172] At the same time, statutory formulations of the duty of care have only recently been adopted in the context of the unincorporated business organizations reviewed in this

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accompanying text; *see* TEX. REV. CIV. STAT. ANN. art. 6132b-4.04(c) (quoted in *supra* note 60). In the case of those statutes that are silent with respect to the duty of care, the courts might follow any of several courses, all of which can be found in prior case law: articulation of a standard of care and a standard of review/liability that are contiguous; articulation of a standard of care subject to a relaxed standard of review/liability (as reflected in the business judgment rule); or articulation of a standard of review/liability without specifying the standard of care itself. Inasmuch as each of these approaches may well (as they have in the past) ultimately reflect a reluctance to impose liability short of gross negligence or similarly culpable conduct, the difference in approaches may be more theoretical than practical.

[170] *See supra* note 57.

[171] *See* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 (1985) ("The day-to-day evolution of the business judgment rule in the Delaware court continues to be the best law game in town.").

[172] *See* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984).

> A while back, the solonic custodians of the Model Business Corporation Act (MBCA), the ABA's Committee on Corporate Laws, struggled through three years of debate to arrive at a formulation of the director's duty of care. . . . Over the past three years, this same ABA committee has been engaged in an overall revamping of the entire Model Act. In the course of that exercise, the committee tried again to grapple with the elements of the business judgment rule in a new section 8.30. After no less than ten drafts and literally hundreds of man-hours of struggle, the effort was again abandoned, and it was decided, *faute de mieux*, to retain old section 35 and not seek to go further. Substantially all of the battle raged over the subject traditionally called the directors' duty of care.

Id. at 1478-79 (footnotes omitted).

article. These statutory formulations largely divorce current law from the limited, and occasionally contradictory, prior case law regarding the standards of care and review. What, if any, role a relaxed standard of review (as reflected in the corporate business judgment rule) should play in the context of unincorporated business organizations has never been clearly and consistently articulated by the courts. The introduction of the new statutory schemes has further complicated the analysis. What is presently clear is that under those unincorporated business organizations statutes that have adopted a gross negligence standard of care, there exists no room for a further reduced standard of review.

Furthermore, as a matter of contractual construction, where the participants in an unincorporated business organization seek to specifically define a standard of care, that standard should be enforced as written. It would do violence to the agreement to apply a more relaxed standard of review (and, ultimately culpability) than applied by the contract. While there will be particularized exceptions to this principle, the application of the written standards should be the first rule. Some may fear that this rule of construction will signal a departure from the fiduciary realm of unincorporated business organizations. Such concern, however, is misplaced. Legislatures remain fully capable of defining the fiduciary standards that will apply in unincorporated business organizations and the limits on departures from those statutorily defined standards. This is what we have seen in the last decade in RUPA, ReRULPA, and ULLCA. Fiduciary principles will likewise continue to be applicable in those situations in which the underlying statute does not express a standard of care and the parties to the agreement have not sought to craft one to govern their relationship.

Just as the last decade has seen significant developments in the area of unincorporated business organization law, we can expect that the next decade will see development in the case law on how these new formulas should be applied and, in the case of partnerships and limited partnerships, how they will differ from their predecessors. It will be the sum of those developments in the law that will determine, in the unincorporated business organization realm, whether or not a relaxed standard of review will apply to alleged violations of the standard of care.