

Spring 3-1-1997

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### Recommended Citation

Donald J. Weidner, *Foreword to Freedom of Contract and Fiduciary Duty: Organizing the Internal Relations of the Unincorporated Firm*, 54 Wash. & Lee L. Rev. 389 (1997), <https://scholarlycommons.law.wlu.edu/wlulr/vol54/iss2/2>

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# Foreword to Freedom of Contract and Fiduciary Duty: Organizing the Internal Relations of the Unincorporated Firm

Donald J. Weidner\*

This symposium begins with five extraordinary papers on fiduciary duties in unincorporated business associations. It is my pleasure to offer a glimpse of what they contain, and I do so in order of their presentation last November at the Washington and Lee University School of Law in Lexington, Virginia.

## *Professor Claire Moore Dickerson*

Professor Dickerson explains that the standard of performance applicable in the business community has been a norm that lies on a continuum stretching from contract-law good faith to trust-law fiduciary duty. Precise location on the spectrum has been determined by the actor's conflict of interest and dominance. As the power of a transactor becomes greater relative to the other party, and especially as the transactor's conflict of interest increases, the standard of performance for the transactor moves along the continuum toward fiduciary duty. A corollary is that parties should not normally be able to opt out of a higher level of good faith identified by the levels of conflict and dominance. At a minimum, the level of good faith for opting out should be determined by conflict and dominance, and because that can be determined with relevance only at the time of the subject transaction, opting out should be — as it is now for classic fiduciary duty — only on an ad hoc basis and not at formation.

Norm entrepreneurs, positing a level playing field among co-owners of a business, have led an astonishingly successful effort to modify norms applicable to unincorporated businesses. They have directed their efforts

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\* Dean and Professor, Florida State University College of Law. Dean Weidner was the Reporter for the Revised Uniform Partnership Act (1994). This Foreword relates to *The Future of the Unincorporated Firm* Symposium presented at the Washington and Lee University School of Law on November 15, 1996.

toward changing the good faith norm so that the actor's dominance and conflict no longer determine the standard's place on the good faith spectrum. The Revised Uniform Partnership Act (RUPA) and limited liability company (LLC) statutes attempt to move the standard of performance away from the fiduciary duty end of the spectrum and toward the good faith end of the spectrum. The lowering of the standard mandatory minimum of performance adopts by statute the lawyer-economists' contractarian perspective that evolved in the world of incorporated businesses. Success has also been reflected in the adoption of waiver provisions in RUPA and in LLC statutes, some of which track RUPA, some of which provide for waivers in other terms, and some of which make no mention of fiduciary duties.

Where the lawyer-economists see a level playing field, Professor Dickerson sees uneven, hilly terrain. The standard of performance should reflect that terrain, as should the waiver rules. It is appropriate for the law to influence the standard of performance because good faith performance is a nonrenewable resource, and its destruction harms all participants in the business area. The standard of performance on the good faith spectrum is a reservoir of good will and trust that is the commons of the business area. Norm defectors use a supply of good will and trust when they act below the good faith standard. A person who violates a norm — in even the most isolated contract between two willing participants — adversely affects the community at large. People who act in less than good faith pollute the commons by affecting the good faith norm. They increase the agency costs and the transaction costs generally for the entire community. The law can increase the incentive to cooperate by penalizing defection, thus increasing the relative benefit of cooperation. A law that supports the good faith norm thus reduces agency costs because it reduces the need for monitoring.

As norms come close to a point of equilibrium, or tipping point, between change and not, a tiny incremental effort will have a dramatic effect. Game theory suggests that in a multiparty environment, a sufficiently determined and sufficiently large group of objectors can successfully invade a territory. Once defection begins, others may have incentive to defect as well, in an accelerating pattern. This is what has been occurring with respect to the good faith norm in unincorporated business relationships. It is time to reverse the process.

*Professor J. Dennis Hynes*

Professor Hynes argues that the law of agency provides a compelling analogy for the use of the bargain principle to define fiduciary relationships among partners. By the bargain principle, Professor Hynes means the

common-law rule that, in the absence of a traditional defense relating to the quality of consent (such as duress, incapacity, misrepresentation, or mutual mistake), the courts will enforce a bargain according to its terms to put a bargain-promisee in as good a position as if the bargain had been performed. The special status of fiduciary duties should be of a default nature only. Absent special circumstances, fiduciary duty contracts should be treated the same as other contracts.

The very existence of an agreement on the nature and extent of fiduciary duties tempers and qualifies the degree of trust the parties place in one another. Proposals by the fiduciary for modified rules serve to warn the other party against placing trust in the wrong person. To ignore this is to raise fiduciary duties almost to the status of natural law, an approach inconsistent with the fundamental tenets of American law.

Professor Hynes faults RUPA for mandatory fiduciary duty rules that offer relief to disappointed partners who would find no relief under the bargain principle. He also objects to RUPA's mandatory obligation of good faith and fair dealing. Although he does not object to a broad definition of good faith as a default rule, a broad definition of a mandatory term is problematic. It creates a risk of litigation over difficult decisions that may involve conflicting interests and can be exploited by a partner disappointed in the relationship who takes advantage of ambiguity and complexity and generates a dispute by claiming fellow partners acted in bad faith. Professor Hynes asserts that "honesty in fact," the formulation in the Uniform Commercial Code (UCC), is the least intrusive on the agreement of the partners, who can always bargain for a higher standard. RUPA lags behind LLC law in this regard because in a manager-managed company a member is not an agent solely by reason of being a member and, therefore, is not subject to mandatory rules.

Professor Hynes sees a level playing field where Professor Dickerson sees uneven, hilly terrain. A number of factors weigh on the side of allowing partners to define their relationship as they wish, assuming that they observe the normal decencies of the bargaining process. These factors include: the presumptively equal bargaining status of partners, arising from the fact that ordinarily each partner has something of near equal value to exchange with the other partners; the ability of a partner to leave a partnership at any time; and the right of every partner to equal management of the firm and to information concerning the firm.

Moreover, the law enforces bargains even if the party asserting a right is in a superior bargaining position. The law does not insist on equality of bargaining power because the reliability of nearly all bargains would be undermined. Under the UCC, the principle of unconscionability prevents

oppression and unfair surprise, but does not disturb allocations of risk because of superior bargaining power.

Professor Hynes also rejects Professor Vestal's formulation that the obligation of the fiduciary is to work for the collective good. He believes that such a concept places inappropriate burdens on an essentially private relationship, apart from the difficult question of defining the collective good. While admitting that it is unappealing to see the naive, the unsophisticated, and the inattentive held to bargains that they really did not appreciate, Professor Hynes fears that the cure of mandatory rules may be worse than the disease. To allow people to escape from contracts because they did not bargain or did not attend to the language of the agreement treats too lightly the expectancy of the other party and the importance of contracts, thus undermining their reliability.

Finally, Professor Hynes notes that the Uniform Limited Liability Company Act (ULLCA) is heavily based on RUPA. RUPA's rules on fiduciary duties are reflected in ULLCA's provisions with respect to member-managed LLCs and with respect to managers of manager-managed LLCs. He believes that it is appropriate to treat member-managed LLCs the same as partnerships with respect to fiduciary duties. He rejects Professor Dickerson's position that the manager-owner of an LLC can be subjected to a lower standard of performance than a partner because the limited liability of LLC members places a ceiling on the permitted harm they can suffer from obligations created by a co-owner. He believes that third-party liability is relevant to the duty of care, but not to the duty of loyalty, which turns on denial of a benefit and on opportunistic seizure of assets, not on exposure to liabilities.

*Professor Lawrence E. Mitchell*

Professor Mitchell writes as an expert in corporate law who, through this Symposium, encounters for the first time the debate over RUPA and partnership fiduciary law. He finds that the debate over RUPA has ignored, except superficially, what is most important. Metaphors, labels, and rhetoric have substituted for meaningful analysis. Unfortunately, the debate has been characterized as one between contractarianism and paternalism. Given our cultural biases, the characterization favors contractarianism. In addition, the range of insights that enrich the corporate area insufficiently inform the debate.

Much of the debate appears to assume that partnership is a statutory creature whose birth dates to the drafting of the Uniform Partnership Act (UPA) and that the principal purpose of the statute is to set out a form

contract. The assumption is that partnership is a creature of contract and that the only issue worth discussing, apart from the specific terms of the contract, is the extent to which the state may legitimately prescribe terms for those who choose to vary them. The contractarian/fiduciary argument, or its variant, the enabling/mandatory argument, began in corporate law. Its origins there, however, were not in legal conclusions, but in behavioral analysis. Starting with a set of assumptions about human motivations and the conditions under which they flourish, Fama and Jensen and Meckling argued that the appropriate way to think about the corporate legal fiction was contractual. To a large extent, this analysis is more descriptive than normative and merely offered a way of thinking about the manner in which real persons underlying the juridical person relate to one another. It remained for legal scholars with varying degrees of economic, psychological, sociological, and philosophical sophistication to take the metaphor and incorporate it into the normative enterprise of legal criticism. The metaphor of the contract rarely concluded debate, as it has in the partnership area.

Professor Mitchell has consistently rejected the corporation as contract metaphor, less because of its lack of descriptive power than because of the assumptions said to underlie it and the norms that were invariably attached to it. In the RUPA debate, the contractual notion has been used to question the legitimacy of fiduciary obligation in partnerships generally. It has been used to conclude debate, not to begin it. The current debate answers only superficially — if at all — the questions of the purpose of permitting this particular contractual relationship to exist, the norms to be served, and its background assumptions.

RUPA's "compromise" is not a compromise at all; it has destroyed any semblance of fiduciary obligation. On the other hand, corporate law suggests a sensible interpretation of RUPA's fiduciary duty provisions in a manner consistent with the professed intention of the drafters. RUPA Section 404(e), permitting a partner to advance self-interest, can be interpreted to state a benefit/detriment test of the sort developed in corporate law: A partner breaches no statutory or contractual duty to the partnership or its partners by engaging in transactions with, or in competition with, the partnership, unless the transaction or competition results in detriment to the partnership or the other partners. If a partner's self-interested conduct results in detriment to the partnership or the other partners, a judicial fairness test applies. An uninterested director approach could be used, perhaps coupled with a fairness or a reasonableness standard.

Arguments in support of fiduciary obligation cannot be couched in favor of the individual. Unschooled people cannot appreciate such argu-

ments. In order to be persuasive, arguments supporting the imposition of fiduciary duty must be much more specific in identifying the social and individual benefits to be derived. A sense of permanence and stability is important to society. Fiduciary duties foster the development of trust and make it more rational. Trust reduces uncertainty in a complex world. Fiduciary duty gives each party a reason to trust the other in a long-term relationship of unforeseeable consequences because it requires each party to act as if it were trustworthy. By instructing the partners as to the type of behavior that is required of them, it has the potential to forestall legal disputes by giving the parties an incentive to negotiate. By providing a mechanism to assure business stability, it permits longer-term management than would be rational with a combination of free dissolution and unbounded self-interest. Although this stability contributes to the welfare of the particular enterprise, it also has the potential to reduce the dislocations when an operating business falls apart. Thus, social efficiency is served.

Economics provides sufficient justification for fiduciary duties, but ethics are also important. Fiduciary duty serves more than the value of efficiency. It potentially has a meaningful impact in shaping the kind of society we choose to be or to become. The language of fiduciary obligation conveys an attitude, a way of thinking about a relationship, which is not at all ambiguous for the task.

*Professor Allan W. Vestal*

Professor Vestal first considers the recent litigation concerning the expulsion of a partner from Cadwalader, Wickersham & Taft. He outlines two analyses of fiduciary duties, either one of which supports the victory for Cadwalader's expelled partner. There is an absolutist strain of partnership law that forces the partners to either all sink or all swim. Under this analysis, it is inappropriate to amend a partnership agreement to include an expulsion mechanism and then expel targeted partners. Indeed, it is arguably inappropriate to rely on a preexisting expulsion clause.

Professor Vestal asserts that, by joining a partnership, each partner agrees to advance the collective interest and not the partner's own, short-term, individual interest. Borrowing from corporate law, he argues that the partnership should prove that the challenged action advanced a legitimate business purpose of the collective. If the partnership makes this threshold showing, the burden shifts to the objecting partner to prove that the partnership had less injurious options.

Professor Vestal concludes that the result in a Cadwalader-type situation is far from certain under RUPA and its progeny. First, RUPA reflects

an erosion of traditional norms. Second, RUPA fails to fully implement either the traditional structure or the competing philosophy. It represents an uneasy and unworkable compromise between the two.

RUPA reflects the belief that the relations of partners are best characterized as matters of contract, not status. The statute rejects the historical fiduciary obligations of partners, yet states no other internally consistent view of the nature of partners' obligations *inter se*. Although the situation is not as clear with respect to other forms, it appears that the trend is clearly toward a more contractarian approach. The fiduciary duty and modification rules of ULLCA follow those of RUPA, with the exception of nonmanager members in manager-managed LLCs who have no fiduciary duties.

Over the last decade, the law of unincorporated firms has been atomized in three ways. First, new forms have been introduced, particularly limited liability partnerships (LLPs) and LLCs. Second, as to each business form, statutory uniformity among the states has broken down. Third, we have permitted broader contractual modification of noneconomic statutory provisions.

Uniformity has some obvious advantages. It reinforces the notion that this is a national society, not a balkanized collection of state economies. It reduces search costs and all but eliminates the maneuvering of firm participants seeking advantage through choice of law.

On the other hand, there are arguments that nonuniformity comes from beneficial experimentation and that nonuniformity may be desirable if participants are able to adopt the state law that gets them closest to their optimal bargain, thus reducing negotiation costs. This claimed advantage must be weighed against the higher search costs involved in identifying the best law and the possible uncertainty as to whether the parties have the power to make a plenary choice of law.

Professor Vestal addresses the recent thesis advanced by Professors Larry Ribstein and Bruce Kobayashi, which suggests that the breakdown in uniformity is a positive development. They suggest that the atomization of unincorporated firm law may be desirable over the long term because uniformity will spontaneously emerge where uniformity is efficient. They claim that LLC statutory provisions moved toward desirable uniformity even prior to a proposal sponsored by the National Conference of Commissioners on Uniform State Law (NCCUSL), and that without NCCUSL's prodding, LLC statutes already have become uniform on issues for which uniformity is important.

Professor Vestal concludes that Ribstein and Kobayashi's theory of desirable and undesirable uniformity is so narrowly stated that it ignores a



social value of interstate, interform uniformity on noneconomic dimensions such as fiduciary duties. A common set of fiduciary duties may have value by reaffirming behaviors that benefit society, such as the value of telling the truth. Quite apart from the economic value of telling the truth — reducing information costs, facilitating exchange, and improving resource allocation — society may determine that it wants participants in unincorporated firms to tell the truth even when it is not demonstrably efficient for them in the short term to do so. In addition, the Ribstein-Kobayashi theory needs to meet the possibility that network externalities may lead to results that are socially suboptimal, albeit uniform, and that contractual provisions cannot substitute for partnership law.

*Professor Larry E. Ribstein*

Professor Ribstein begins with the basic premise that fiduciary duties are simply a species of contract and not a distinctive topic. He states that a transaction cost economics approach, which views fiduciary duties as presumptive contract rules, better explains the positive law of fiduciary duties than do noncontractarian approaches that attempt to identify fiduciary duties as a distinctive set of absolute duties. In particular, a transaction cost approach more effectively explains the variation across different relationships. He applies this analysis to fiduciary waivers in unincorporated firms.

Professor Ribstein states that mandatory rules are unable to cope with the significant variability of contracts. The benefits of fiduciary duties vary in different contexts, depending on factors such as discretion delegated, monitoring possibilities, power to exit the relationship, power to remove the fiduciary, reputational incentives, and third-party monitoring. Costs also vary from firm to firm. Fiduciaries have varying costs of forgoing opportunities outside the firm. Firms and insiders have potential scope economies of information in buying from and selling to each other by reason of information acquired in their other dealings. It may be in the beneficiary's interest to delegate open-ended decisionmaking to the fiduciary. Prohibiting waivers may preclude efficient compensation agreements. There may be high enforcement costs. In short, the appropriate scope of fiduciary duties depends on the other terms of the contract, especially exit and governance provisions and other constraints on managerial conduct. The parties are more able than courts to determine the level of duties that fits their relationship.

Fiduciary waivers in unincorporated firms closely resemble the sort of "real" contracts that anticontractarians have held out as models in the public

corporation debate. Accordingly, it is no surprise that their arguments against freedom of contract now must shift ground to such factors as defects in reasoning or in the bargaining process. The challenge for anticontractarians is to show that these defects are so pronounced for fiduciary waivers as to distinguish them from contracts that are normally enforced. Arguments based on unknowable or unforeseeable risks overstate the ignorance of beneficiaries. Arguments based on asymmetric information are both breathtakingly broad and unconvincing because they do not explain why the parties cannot and do not contract in light of their information costs and deficiencies.

Anticontractarians have moved beyond unforeseeability to stress cognition problems that prevent complete processing of information, and therefore, cause people to make contracts that are irrational in light of what they know. These arguments overstate irrationality. In some cases, information may be too costly to make it worthwhile. Further, even if individuals are irrational, entire markets are not. Finally, investor irrationality, if it exists, is most likely to be a problem in idiosyncratic deals in which there is direct bargaining.

Professor Ribstein disagrees with Professors Dickerson, Mitchell, and Vestal about the social costs of waivers. He believes that any "opportunistic" conduct permitted by contract injures only the beneficiary, who can contract to minimize the risk. Those opposed to waivers never clearly identify the so-called noneconomic values slighted by enforcement of waivers. The argument that mandatory fiduciary duties force managers to act in ways that are good, that are ethical, or that instill trust suggests that there is a legal standard of "right" behavior that exceeds legal and contractual standards. Yet that behavior is not defined. Finally, there are noneconomic values that favor enforcement, such as the value of individual autonomy.

Professor Ribstein argues that anticontractarians have misconstrued the case law relating to partnership fiduciary duties. Restrictions in RUPA and in the ULLCA reverse long-standing case law favoring enforcement of contracts. Courts permit parties to alter default rules in their agreements so long as they are held to good faith compliance.

In Professor Ribstein's opinion, the Delaware statutory approach appropriately supports the enforcement of waivers. Further, there is a trend toward statutes that provide for enforcement of choice of law clauses in commercial agreements, including RUPA — which clarifies that default rules on choice of law are subject to contrary agreement — and LLC, LLP, and limited partnership statutes that provide for registration of foreign entities and for the application of the law of the state of formation. As a

result of the enforcement of contractual choice of law, the parties can choose to be governed by the broad Delaware opt-out provisions. In general, the choice of law rules suggest that mandatory fiduciary duties are virtually a dead issue.