
Contractarianism and Its Discontents: Reflections on Unincorporated Business Organization Law Reform

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The law is often like a Slinky: there are two opposing poles, there is tension between the poles, and when one pole pushes out too far from the other, there is a tendency for the tension to pull the deviating pole back or to flip the opposite pole to the front. Similarly, United States business organization law, particularly as applied to partnerships and limited liability companies (LLCs), is a terrain of conflict in which different theoretical approaches strive for dominance. Unlike the laws of physics that control a Slinky, however, there is no state of nature that forces us to any given legal theory, but rather we choose which applies at any time and from time to time.³

I. THE POLARITY

Before discussing United States partnership and LLC law reform over the last twenty years, we will use contemporary political theory and United States Supreme Court jurisprudence to illustrate one such polarity in American law. The polarity deals with concepts of liberty, the state, and the individual, and we believe it continues to undergird conversations about the nature of business entities and the role, if any, of government in regulating the economic relationships of persons who act together in a firm.

The polarity of the state and the individual begins at the broadest levels of contemporary liberal political theories. At one pole, there are the Rawlsians, who embrace John Rawls's "difference principle" in which social and economic inequalities are just only if they benefit the least-advantaged members of society and which leads one toward an activist welfare-based state.⁴ At the other pole are the heirs of Robert Nozick, who embrace Nozick's

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3. See LOUIS MENAND, *THE METAPHYSICAL CLUB: THE HISTORY OF IDEAS IN AMERICA* xi-xii (2001) (noting American pragmatic philosophy's perspective that all ideas are tools devised by people to cope with the world, that ideas are social constructs, and that their survival depends on their adaptability).

4. See generally JOHN RAWLS, *A THEORY OF JUSTICE* (rev. ed. 1999). Rawls did not extend his theory of

theory that a just distribution of goods results from the voluntary exchanges that transpire in a market society.⁵ This Nozickian approach leads one toward a laissez-faire “night watchman” state that is limited to the function of protecting its citizens from violence, theft, and fraud and to the enforcement of contracts. Like a Slinky, the debate between Rawlsians and Nozickians is dynamic, with the two approaches alternatively seeming to trump each other.

The United States Supreme Court has also grappled with the same polarity. For example, in the 1905 case of *Lochner v. New York*⁶ the Court struck down as unconstitutional a New York law prohibiting the employment of bakery workers for more than ten hours per day or sixty hours per week.⁷ The Court held that

[t]he statute necessarily interferes with the right of contract between the employer and employés [sic] The general right to make a contract in relation to his business is part of the liberty of the individual protected by the 14th Amendment of the Federal Constitution The right to purchase or to sell labor is part of the liberty protected by this amendment⁸

In reaching its decision, the Court framed the fundamental tension between the state and the individual:

In every case that comes before this court, . . . the question necessarily arises: Is this a fair, reasonable and appropriate exercise of the police power of the State, or is it an unreasonable, unnecessary and arbitrary interference with the right of the individual to his personal liberty or to enter into those contracts in relation to labor which may seem to him appropriate or necessary . . . ?⁹

The court took the laissez-faire position that maximum-hour laws represented an unconstitutional assault on individual liberty. In other words, people should be given the liberty to contract to work as they see fit.

This provoked Justice Holmes’s famous dissenting retort that “[t]he Fourteenth Amendment does not enact Mr. Herbert Spencer’s Social Statics.”¹⁰ Holmes was a pragmatist and did not believe that the law should lock into any particular political theory, but should instead retain the ability to slip and

justice to voluntary associations. See JOHN RAWLS, JUSTICE AS FAIRNESS 11-12 (2001).

5. See generally ROBERT NOZICK, ANARCHY, STATE AND UTOPIA (1974).

6. 198 U.S. 45 (1908).

7. *Id.* at 53.

8. *Id.*

9. *Id.* at 56.

10. 198 U.S. at 75. In other words, the Constitution does not embody a particular political and economic theory, whether a state-based paternalistic approach or an individual-based laissez-faire approach.

slide.¹¹ To Holmes, the law was indeed a Slinky and the common law was its best expression.¹² In his view, society's fixation on one particular theory leads to such events as the Civil War (in which Holmes fought and was severely wounded). Paraphrasing Lincoln at Gettysburg, Holmes remembered the lessons of that great Civil War.

The so-called *Lochner* era lasted over thirty years, during which the Court invalidated numerous laws on due process grounds.¹³ With the 1937 "switch in time," however, the opposite pole came to dominate: *Lochner*-style jurisprudence all but disappeared, and the Court became supportive of regulatory interference in the economy.¹⁴ For example, in *West Coast Hotel v. Parrish*,¹⁵ the case that began the "switch," the Court considered the legality of a Washington state minimum-wage law for women and minors.¹⁶ In upholding the law—and directly overruling *Adkins v. Children's Hospital*,¹⁷ which struck down such a law in 1923—the Court stated:

[T]he violation alleged by those attacking minimum wage regulation for women is deprivation of freedom of contract The Constitution does not speak of freedom of contract. It speaks of liberty and prohibits the deprivation of liberty without due process of law The community may direct its law-making power to correct the abuse which springs from [employers'] selfish disregard of the public interest.¹⁸

In the contest between unrestrained individual contractual freedom and contractual freedom constrained by public interest considerations, public interest carried the day and the United States economy has been highly regulated ever since.¹⁹

11. See MENAND, *supra* note 3, at 49-69.

12. OLIVER WENDELL HOLMES, *THE COMMON LAW* (1881).

13. See *Adkins v. Children's Hosp.*, 261 U.S. 525, 559 (1923) (striking down minimum-wage law for women and children in the District of Columbia); *Hammer v. Dagenhart*, 247 U.S. 251, 276-77 (1918) (striking down law regulating child labor).

14. See William G. Ross, *When Did the "Switch in Time" Actually Occur?: Re-Discovering the Supreme Court's "Forgotten" Decisions of 1936-1937*, 37 ARIZ. ST. L.J. 1153, 1153 n.1 (2005) (discussing "switch in time" and collecting cases).

15. 300 U.S. 379 (1937).

16. *Id.* at 386; see also Ross, *supra* note 14, at 1153 n.1.

17. 261 U.S. 525.

18. 300 U.S. at 391, 399-400.

19. *Lochner* style jurisprudence may be rearing its head again. See *United States v. Lopez*, 514 U.S. 549, 551 (1995) (striking down Gun-Free School Zone Act of 1990 as exceeding Congress's power under Commerce Clause).

II. THE POLARITY AS EVIDENCED IN BUSINESS-ORGANIZATION LAW

In 1976, Michael Jensen and William Meckling formulated the conception that the corporation is a “nexus of contracts.”²⁰ Under this view, contractual relationships are the essence of the firm and “most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.”²¹ The firm is an aggregate of various inputs that produce an output of goods or services. Employees provide labor; suppliers provide goods and services; creditors provide debt financing; shareholders provide equity and monitor management’s performance; and management serves a coordination role and monitors employees.

All these inputs are bound together through contractual relationships. When particular parties do not enter specific contracts, the role of business organization law is, first, to recognize that transaction costs prevent all parties providing inputs from actually entering into contracts, and, second, to supply a set of “default” rules.²² These default rules are conceived of as hypothetical bargaining rules into which rational contracting parties would most likely enter if they were to actually contract and from which parties that actually enter into contracts can deviate. For example, a simple default rule in the partnership context is that partners share equally in partnership profits.²³ This rule is rarely followed in practice, and partners often enter an express or implied agreement to share partnership profits on some other basis.

In the public-corporation arena, transaction costs are particularly high (e.g., individual shareholders of General Motors cannot each bargain for terms), and legal rules generally substitute for private bargaining. Even in such a context, however, the contractarian believes the rules should represent hypothetical bargains. In close corporations, partnerships, and LLCs, contracting barriers are reduced, and in the contractarian view, the power of private bargaining increases. Thus LLC law in the United States has become the contractarian test case, and one frequently hears that the LLC is a “creature of contract,” a contractarian dream entity where any deal can be structured among the parties.²⁴

20. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976).

21. *Id.*

22. See generally Stephen A. Bainbridge, *Community and Statism: A Conservative Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856 (1997).

23. UNIF. P’SHIP ACT § 401(b), 6 U.L.A. pt. I, at 133 (1997) (“Each partner is entitled to an equal share of the partnership profits and is chargeable with a share of the partnership losses in proportion to the partner’s share of the profits.”).

24. See *Poore v. Fox Hollow Enters.*, 1994 WL 150872, at *2 (Del. Super. Mar. 29, 1994); UNIF. LTD. LIAB. CO. ACT § 110 cmt. (amended 2006), 6A U.L.A. 378 (Supp. 2006); see also *R&R Capital L.L.C. v. Buck & Doe Run Valley Farms L.L.C.*, 2008 WL 3846318, at *1 (Del. Ch. Aug. 19, 2008) (stating “for a Delaware limited liability company, the contract’s the thing”); *TravelCenters of Am. L.L.C. v. Brog*, 2008 WL 1746987, at *1 (Del. Ch. Apr. 3, 2008) (“[LLCs] are creatures of contract”).

Throughout the 1980s and 1990s and into the new millennium, the “nexus of contracts” conception has dominated the corporate law-and-economics academic literature, and because law-and-economics has developed a strong position in the United States academic hierarchy, “nexus of contracts” theory has had a strong following in the corporate-law arena. Such academic theories form part of the Zeitgeist that translates into judicial and practical perspectives. For example, in a recent article, the Delaware Supreme Court Chief Justice Myron Steele states that

a critique of the Delaware courts’ disposition of limited partnership and limited liability company governance disputes, through the lens of common law fiduciary duty rather than contractual analysis, will demonstrate that the latter is more efficient, more consistent with the parties’ business judgment . . . and fulfills *any rational view* about appropriate public policy.²⁵

Coming from the Chief Justice of America’s leading corporate-law state, this is heady contractarian stuff.

A critical issue raised by the contractarian view is how to approach rules of business organization law rules—specifically whether, and to what extent, there are mandatory rules or whether everything can be left to the parties’ contract. A purely contractarian approach would conclude that everything can be left to contract and that it is only the presence of transaction costs that creates default rules. The contractarian also would argue, from a normative position, that this is how it should be; it is both economically efficient and just that individuals constituting a firm should make arrangements without the constraint imposed by mandatory rules.²⁶ In this view, the state’s role is limited to contract enforcement; concepts of good faith and fair dealing are merely contract “gapfillers” or “default rules” to cover items that the parties would have covered by contract had they had the foresight to do so in the absence of transaction costs, and parties are free to decline to be bound by these default rules.²⁷ In a sense, contractarians would allow parties to contract as they would in a pre-state world with no socially imposed restrictions. Here it should be noted that contractarians adopt a particular view of contract: the ability of autonomous parties at arms’ length to give their unbridled consent to arrangements whose goal is their own wealth maximization. This particular vision of contract embodies contestable values as to which there is doctrinal

25. Myron Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 5-6 (2007) (emphasis added).

26. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 15 (1991) (making normative claims); see also Melvin A. Eisenberg, *The Conception That the Corporation Is a Nexus of Contracts and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 823-24 (1999). The pure contractarian view is Nozickian. See generally NOZICK, *supra* note 5.

27. Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 223 (2005).

disagreement.²⁸ One might argue that a difficult syllogism is at work here. For example, fiduciary duties are described as a form of contract (a hypothetical bargain), the contract is described in a particular normative fashion (privatized, so to speak), and then the compound is turned around to dissolve traditional notions of fiduciary duty.²⁹

In contrast to contractarians, traditionalists note that although many or even most contracts ought to be respected and enforced, there are fundamental problems with the contractarian view.³⁰ Traditionalists argue that the characterization of state-imposed limitations on action as “default rules” suggests that parties may choose to ignore restrictions society imposes to protect individuals, whether paternalistically, to avoid negative externalities, or for other reasons. Traditionalists start from the perspective that the state imposes thick restrictions that express public values and that substantially restrict parties’ ability to act, including their ability to alter their relationships.³¹ Traditionalists believe these values include things other than wealth maximization, such as “the Kantian Golden rule”³² and the fairness it implies, trust, community, the role of the collective in protecting individuals from their own vulnerabilities, and freedom from worry about potential agent improprieties. In this view, the contractarian “default rules” are no longer completely amendable because they have social roles that go beyond the contracting parties.

This being said, to our knowledge no one suggests a mandatory system in which parties to a business arrangement cannot enter their own deal and the state sets all parameters through legislative statutes or through judicial common-law application.³³ For example, all agree that participants in an LLC should be able to contract around default rules concerning profit sharing and participation in management in favor of other rules that embody the particular business arrangement.³⁴ The traditionalists accept the fact that private business

28. Compare Eisenberg, *supra* note 26, at 820-21, with Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 597-98 (1997).

29. See Eisenberg, *supra* note 26, at 824.

30. Alternative terms such as *noncontractarian* and *anticontractarian* have been used to describe this view, but here we use *traditionalist* because “it is less conclusory and does not imply that the concepts reposed by [traditionalists] arose in negative response to [contractarianism].” J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities Is Incorrect as a Matter of Theory and Practice*, 1 J. BUS. & TECH. L. 431, 444 n.47 (2007).

31. See generally Brudney, *supra* note 28; Eisenberg, *supra* note 26.

32. IMMANUEL KANT, *GROUNDWORK OF THE METAPHYSICS OF MORALS* 95-107 (1785) (H.J. Paton trans., 1956); see also IMMANUEL KANT, *CRITIQUE OF PRACTICAL REASON* 37, 74 (1788) (Mary Gregor trans., 1956). This is the “categorical imperative” which, in one version, requires that each individual be treated as an end in himself or herself, not merely as a means for achieving other ends.

33. See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1470 (1989).

34. See generally J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 J. CORP. L. 97 (2000) (discussing alternative forms of LLC management and governance).

organizations have a valid wealth-maximization purpose and agree that parties often are able to decide upon their own arrangements. The questions concern balance: the level of private ordering that is appropriate, the level of public (legislative or judicial) involvement that is appropriate, and the justifications for rules that exist independently from contract.

In the traditionalist view, there are at least three overarching problems with the contractarian approach. First, there are contract problems of cognition (the “knowledge” part of contract, meaning recognition of all present and future issues raised by a contractual arrangement) and problems of volition (the “freely given” part of contract, meaning the power to do anything about the issues raised).³⁵ For example, an LLC’s operating agreement might ex ante eliminate a duty that managers not compete with the partnership, but when entering the contract the members may not be able to foresee a situation where a manager might not only compete with the LLC but, due to changed circumstances, would do so with what had been or might become the LLC’s key business relationship and basis for future success. Simple contractual provisions may mask enormous unforeseeable future problems. Further, individual members may lack the power to force changes to the contract they end up signing, particularly when LLC operating agreements are drafted by counsel for a dominant party. The question is whether contractual deviations from common-law duties should be permitted in such a setting, and if so to what extent.

Second, traditionalists believe that negative externalities may arise from a freedom-of-contract approach.³⁶ For example, although it may be arguable that hypothetically contracting parties would adopt limited liability protection as a default rule (because, for example, it enhances efficient capital formation and because well-capitalized business organizations create public good), it is undeniable that external costs arise from the limited liability choice.³⁷

35. See Victor Brudney, *Corporate Governance, Agency Costs and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1405 (1985).

36. See Allan W. Vestal, *Not ‘Like Sailors or Idiots or Infants’: Social Welfare Based Limits on Private Ordering in Business Association Law*, 8 EUR. BUS. ORG. L. REV. 71, 76-78 (2007). As one scholar has explained,

[T]he uniform acts facilitate managers’ creation of inefficient and self-serving bargains between themselves and investors regarding managers’ fiduciary duties. The rules are inefficient and unduly pro-management, and the statutory opt out provisions enable the creation of even more inefficient and pro-management terms. Operating under the uniform acts, managers of unincorporated business entities can exploit their informational and strategic advantages and generate untoward pecuniary gains for themselves at the expense of investors.

Rutherford B. Campbell, Jr., *Bumping Along the Bottom: Abandoned Principles and Failed Fiduciary Standards in Uniform Partnership and LLC Statutes*, 96 KY. L.J. 163, 189-90 (2008).

37. See generally J. William Callison, *Federalism, Regulatory Competition and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. CORP. L. 951 (2001); Allan W. Vestal & Thomas E. Rutledge, *Disappointing Diogenes: The LLC Debate That Never Was*, 51 ST. LOUIS U. L.J. 53

Further, “private ordering” creates social costs borne by persons and firms that are not necessarily engaged in private bargaining.³⁸ One cost of private ordering is the search and negotiation cost of people who participate in firms. If LLCs are allowed to deviate from traditional fiduciary duties, thereafter parties who negotiate to form LLCs will spend time and money searching for fiduciary-duty changes and negotiating fiduciary-duty rules, whether or not they ultimately deviate from the statutory “default” rule. This cost is imposed on all persons who enter into LLCs. In simple terms, assume 1,000 LLCs are being formed, and in each it costs the members \$1,000 to analyze fiduciary-duty issues and reach agreement. Assume one LLC actually decides to deviate from statutory rules and the benefit is \$900,000 to that LLC’s members. One might conclude that a policy allowing private ordering costs \$100,000 in the aggregate and is therefore inefficient and economically unjustified. Even if one firm’s benefit is \$1,100,000, one might argue that the ability to deviate externalizes the cost of one LLC’s action on the 999 firms that follow the statutory rules. Even then, there is a social-policy question as to whether the wealth transfer is appropriate. Thus, even adopting a law-and-economics perspective, the search and negotiation costs placed on all firms’ participants and potential participants need to be thrown in the hopper with whatever benefits are realized from private ordering to determine whether private ordering creates aggregate net positive value. This suggests that one cannot assume that the benefits of private ordering outweigh the costs (at least on an aggregate scale) and indicates that considerable (perhaps impossible?) empirical inquiry is needed to make an appropriate utilitarian cost-benefit analysis.

Third, to traditionalists, the contractarian approach implicates questions of *fairness and responsibility*—values other than wealth maximization.³⁹ For example, in *Alexander v. Sims*,⁴⁰ Messrs. Alexander and Sims were partners in a jewelry store from 1942 until Sims died in 1950.⁴¹ Shortly before Sims died, when Alexander, though not Sims, knew that Sims’s condition was terminal, Alexander and Sims signed an agreement providing that upon the death of either of them, the decedent’s partnership interest would become the survivor’s property.⁴² Using the common law (as embodied in the then venerable Uniform Partnership Act), the court refused to enforce the contract based on “the rule which requires partners to exercise the *utmost good faith* in their dealings with each other.”⁴³ While we suspect that most people would agree

(2006).

38. See Vestal & Rutledge, *supra* note 37, at 76-78.

39. *Id.* at 72-73.

40. 249 S.W.2d 832 (Ark. 1952).

41. *Id.* at 832-33.

42. *Id.* at 833-34.

43. *Id.* at 836.

that the court's decision was fair, we also suspect that many of those same people would add that Sims should not have signed the agreement in the first place.

We submit that the outcome of *Alexander v. Sims* might indeed have been different under contemporary partnership law, in which the duties of loyalty are statutorily limited to duties not to use partnership property for personal benefit, not to compete with the partnership, and not to act adversely to the partnership;⁴⁴ the former duty of good faith may have been relegated to a principle of contract interpretation;⁴⁵ and the former disclosure duty has been relegated to a subset of the weakened good-faith obligation.⁴⁶ In *Alexander v. Sims* the contract was straightforward, further interpretation was not needed, there was adequate mutual consideration, the parties were not under duress, and the agreement does not seem manifestly unreasonable. Under the Revised Uniform Partnership Act, Sims's estate might lose.⁴⁷ Traditionalists can argue, however, that fairness principles of good faith and fair dealing should still have a place in order to protect people from their own vulnerabilities and that although a dog-eat-dog world might be efficient, it also might be one that we would not choose to live in. Some would argue that a dog-eat-dog world is deeply inefficient. If fairness (as applied by the courts in extreme cases) is a desired value, it is ignored in the contractarian equation.

III. PARTNERSHIP AND LLC LAW "REFORM"

Turning attention to partnership and limited-liability-company law "reform" over the last fifteen years, one can see the ascendancy of the contractarian approach. Historically, the status of "partner" has inherently involved fiduciary duties among the partners.⁴⁸ The received learning prescribed a rigorous prohibition of transactions that, even if they produced benefit for the partnership, could result in a diversion of benefit to the acting partner that would be difficult to detect or to measure. Recognizing the social cost of lost ventures that would not be undertaken if there could be no deviation from

44. UNIF. P'SHIP ACT § 404(b), 6 U.L.A. pt. I, at 143 (1997).

45. UNIF. P'SHIP ACT § 404(d) cmt. ("The obligation of good faith and fair dealing is a contract concept, imposed on the partners because of the consensual nature of a partnership. It is not characterized, in RUPA, as a fiduciary duty arising out of the partners' special relationship.") (internal citation omitted).

46. *Id.* ("In some situations the obligation of good faith includes a disclosure component.").

47. *See id.* § 103(b)(3) (providing generally that fiduciary duties can be modified if not "manifestly unreasonable"); *see also* Mark J. Loewenstein, *Fiduciary Duties and Unincorporated Business Entities: In Defense of the "Manifestly Unreasonable" Standard*, 41 TULSA L. REV. 411, 440 (2000) (defending "manifestly unreasonable" standard). *But see* J. William Callison, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1 J. SMALL & EMERGING BUS. L. 110, 158-60 (1997) (criticizing "manifestly unreasonable" standard).

48. *See* Triple Five of Minn., Inc. v. Simon, 280 F. Supp. 2d 895 (D. Minn. 2003) (holding partners may not destroy fiduciary character of partnership by agreement), *rev'd on other grounds*, 404 F.3d 1088 (8th Cir. 2005).

unflinching rules, the law further contemplated that the principal could give informed consent to particular actions by the agent—but this generally required full and contemporaneous disclosure of all facts and benefits, and did not necessarily allow blanket global prior approval of, for example, usurpation of opportunities or competition.⁴⁹ The common law also did not cabin fiduciary duties into limited categories—judges could and did impose societal conceptions of fairness, generally under a “good faith and fair dealing” rubric.⁵⁰

The emblematic judicial proclamation of the traditional school was *Meinhard v. Salmon*,⁵¹ in which Judge Cardozo announced,

Many forms of conduct permissible in a workaday world for those acting at arms' length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. 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 expectations. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.⁵²

That was then, this is now.

The Revised Uniform Partnership Act (RUPA), adopted in the 1990s and enacted by most states, strikes a balance between contractarian and traditionalist views. Some would argue that a good compromise gores each side's oxen and, therefore, that RUPA has it about right.⁵³ Others would argue that RUPA leans too heavily toward the contractarian side of the fence.⁵⁴ Still

49. See J.W. CALLISON & M.A. SULLIVAN, *PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS* §§ 12:12-12:13 (2004).

50. See *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 214-15 (N.Y. 1917) (developing foundation for modern doctrine of good faith and fair dealing).

51. 164 N.E. 545 (N.Y. 1928).

52. *Id.* at 546. Some would argue that Cardozo went too far by enunciating this standard, creating a mark too high for partners in commercial relationships to achieve and thus inviting the system to overcorrect (the “Slinky effect” again) from fiduciary standards with an “uncompromising rigidity.” See Robert W. Hillman, *Private Ordering Within Partnerships*, 41 U. MIAMI L. REV. 425, 458 (1987) (“Although colorful, the judicial rhetoric inevitably overstates the standard of conduct the law actually imposes on partners Partners are not disinterested trustees, and the likelihood that most partners operate under a ‘punctilio of an honor the most sensitive’ standard is remote.”).

53. See Donald J. Weidner, *RUPA and Fiduciary Duty: The Texture of Relationship*, 58 LAW & CONTEMP. PROBS. 81, 86 (1995).

54. See Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 524 (1993) (criticizing contractarian view of partnerships as procedurally and substantively defective).

others would argue that RUPA is not sufficiently contractarian.⁵⁵

RUPA lists core duties of loyalty and care that apply in all partnership contexts.⁵⁶ It would make those duties exclusive.⁵⁷ It allows the partnership agreement to modify the duties *ex ante*.⁵⁸ Further, it makes modification subject to statutory constraints and to a provision that duties cannot be eliminated by agreement.⁵⁹ RUPA also provides that there are no fiduciary duties during the formation stage or after dissolution, which is deeply contractarian.⁶⁰

Additionally, the historical duty of good faith and fair dealing has been moved from a fiduciary duty to a contractual obligation of uncertain impact, which is contractarian,⁶¹ and disclosure obligations generally have ceased to be a fiduciary duty.⁶² These decisions have been repeated in the 2001 Uniform Limited Partnership Act (ULPA (2001))⁶³ and in the first Uniform Limited Liability Company Act (ULLCA I).⁶⁴

Some states have gone much farther down the contractarian path. For example, Delaware proclaims, “It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of agreements.”⁶⁵ While we are unsure what giving “maximum effect to the principle of freedom of contract” means, we do know that the intent behind the rhetoric is to keep the courts out of what is believed to be the parties’ private affair. We question whether the parties’ affairs are truly private and believe that there is a public aspect to what some think are private relationships. The Delaware statutes also contained language that “duties may be expanded or restricted by provisions in an agreement.”⁶⁶ Pretty contractarian.

55. See Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW 45 (1993).

56. See UNIF. P'SHIP ACT § 404(b), 6 U.L.A. pt. I, at 143 (1997). This is traditionalist; the contractarian would argue that even the existence of duties should depend on the hypothetical bargain and should vary from deal to deal and expectation to expectation.

57. See *id.* This is contractarian—the traditionalist would argue that they should be more open-ended in order to cover non-listed actions that are wrong and unfair nonetheless.

58. See *id.* § 103(b)(3). This is contractarian—the traditionalist might argue that consent should only occur on a case-by-case basis with contemporaneous disclosure of particular facts.

59. See *id.* This is traditionalist—the contractarian would argue that people with power to contract freely should be able to eliminate duties and that modifications should be subject only to such rules as duress and unconscionability, not to reasonableness manifest or otherwise.

60. See UNIF. P'SHIP ACT § 404(b), 6 U.L.A. pt. I, at 143 (1997).

61. See *id.* § 404(d).

62. See *id.* § 404(d) cmt. 4.

63. UNIF. LTD. P'SHIP ACT, 6A U.L.A. 325 (2001). Section 408 of this Act sets forth general-partner fiduciary duties and obligations, and section 110 contains standards for modifying such duties and obligations.

64. UNIF. LTD. LIAB. CO. ACT, 6B U.L.A. 555 (1996). Section 409 of this Act sets forth member and manager fiduciary duties and obligations, and section 103 contains standards for modifying such duties and obligations.

65. DEL. CODE ANN. tit. 6, § 17-1101(b)-(d) (2005) (as amended by chapter 343 of the Laws of Delaware).

66. DEL. CODE ANN. tit. 6, § 17-1101(d)(2) (prior to amendment in 2004).

Although some decisions of Delaware Chancery Court contained dicta to the effect that “expanded or restricted” might mean “eliminated,”⁶⁷ in 2001 the Delaware Supreme Court, in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*,⁶⁸ announced its view (again in dicta) that “restrict” does not mean “eliminate.”⁶⁹ In response to this decision, the Delaware legislature amended the statute in 2004 to provide that duties may be “expanded or restricted or eliminated by provisions in the agreement.”⁷⁰ Contractarianism triumphant. The Chief Justice of the Delaware Supreme Court urges that we

come to grips with the reality that the contractual relationship between parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes—not the status relationship of the parties. When the parties specify duties and liabilities in their agreement, the courts should resist the temptation to superimpose upon those contractual duties common law fiduciary principles.⁷¹

IV. RISKS ATTENDANT UPON EXTREME CONTRACTARIAN APPROACH

There are many risks resulting from triumphant contractarianism in the unincorporated business organization setting. First, contractarianism incorrectly assumes human prescience. It changes how the law approaches risks when people entrust others with their property and livelihoods over the long-term, and it overemphasizes the power of contract drafters to see the future and to draft for it. The move to a contractarian approach does not respect the fact that (a) managerial power creates opportunities for abuse and (b) the creativity of those who seek to abuse power may overtake the ability of those who attempt, by contract, to constrain both power and creativity. A large burden is placed on lawyers who need to draft particular contracts with a view to multivariate possibilities and, despite best efforts, contractual constraints may be insufficient. Customized terms involve high drafting costs, risk of negotiating or drafting error, uncertainty regarding the terms’ validity, lack of judicial precedent regarding the terms’ meaning or effect, and lack of investor or third-party familiarity with the terms.⁷²

Second, the removal of “good faith and fair dealing” from a fiduciary concept to a contractual concept eliminates the ability of courts to determine

67. See *Gotham Partners, L.P. v. Hallwood Realty, L.P.*, 795 A.2d 1 (Del. Ch. 2001), *rev'd in part*, 817 A.2d 160 (Del. 2002); *Sonet v. Timber Co.*, 722 A.2d 319, 323 (Del. Ch. 1998).

68. 817 A.2d 160 (Del. 2002).

69. *Id.* at 170-72.

70. DEL. CODE ANN. tit. 6, § 17-1101(b)-(d) (2004).

71. Steele, *supra* note 25, at 25.

72. See Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 350 (1996).

“fairness.” A *contractual* good-faith duty operates to constrain behavior within arm’s length relationships by expanding contractual provisions to meet clear expectations of the parties. Its function is to allow the contract to mean what it says.⁷³ A *fiduciary* good-faith duty allows courts to police misconduct that is outside the contract based on broader societal concepts of fairness. They are not equivalent concepts, and they do not create equivalent remedies.

Third, we are not capable of foreseeing the long-range effects of radical changes, and it is likely that unintended consequences will arise. The burden should be placed on those seeking to deviate from historical norms to demonstrate why traditional approaches are lacking. Broad fiduciary duties have long coexisted with a dominant free market ideology. One might argue that within closely held businesses the disciplinary effect of fiduciary duty has helped firms to function coherently and to compete effectively. An unintended consequence of contractarianism might be to increase costs (specifically monitoring costs) and to decrease efficiency.⁷⁴ In our view, courts have not run amok when using fiduciary duties to cabin the agent’s behavior and have brought them into play when most people would say the outcome is fair and just.

Fourth, when a controlling owner is involved in management of a business, the combination of legal mandate and power will often result in the elimination of the fiduciary duties that are designed to burden those with power. That which is now discretionary may become the standard, and this creates an unexamined bias toward managerial power. There should, at a minimum, be discussion of whether this shift is warranted or desirable.⁷⁵

For the foregoing reasons and others, we think the contractarian revolution went too far. We do not think that an emphasis on allowing people to make their own deal is wrong, but we do think that the belief that private deals trump all else is wrong. We think it is necessary for business law drafters to catch their breath, step back, and engage in a bit of reexamination of fundamental principles.

V. MOVEMENT TOWARD THE OTHER POLE

Neither contract nor fiduciary appears in nature. Both are social constructs, and each is essentially a creature of choice (whether deliberate or not). Obviously, we believe that the contract-dominance pole of the Slinky has been extended too far and that there needs to be greater balance. Fortunately, the other end of the Slinky may be catching up. First, the Uniform Law Commissioners have backed off somewhat on their own contractarian premise when promulgating the second ULLCA, which was enacted in 2006 (ULLCA

73. See generally *Or. RSA No. 6, Inc. v. Castle Rock Cellular of Or. Ltd. P’ship*, 840 F. Supp. 770 (D. Or. 1993), *aff’d*, 76 F.3d 1003 (9th Cir. 1996); *Katz v. Oak Indus. Inc.*, 508 A.2d 873 (Del. Ch. 1986).

74. See *Vestal*, *supra* note 36, at 76-78 (discussing roots of plenary private ordering).

75. See *Campbell*, *supra* note 36, at 189-90.

II).⁷⁶ For example, in ULLCA II the enumerated fiduciary duties of loyalty are no longer exclusive.⁷⁷ The lack of exclusivity allows judges to rule that there is a fiduciary duty of good faith and fair dealing, or of disclosure, in certain circumstances where doing otherwise would lead to unfair results. It also permits judges to find fiduciary duties during the entity's formation period, or to act in other cases where fairness and justice require that they act more broadly than a constipated statute would otherwise allow.

Further, ULLCA II does not permit the wholesale elimination of fiduciary duties.⁷⁸ That being said, ULLCA II does allow elimination or modification of any or all of the enumerated core duties of loyalty: not to use firm property for personal benefit, not to compete, and not to act adversely as long as the elimination or modification is not manifestly unreasonable.⁷⁹ Presumably, the duty of good faith and fair dealing (now found in the penumbra of the statute) cannot be eliminated *in toto* because the statute expressly does not allow elimination.⁸⁰ Finally, the drafters considered and rejected Delaware-like "freedom of contract" language because some had no idea what it meant and others did not want to empower the ultra-contractarian view.⁸¹ We shall see whether these turnings ultimately cause change in general and limited partnership acts, how they are received by the various states in modifying their unincorporated business organization statutes, and how they are received by the courts and by persons who draft contracts and advise clients, the lawyers.

VI. CONCLUSION

In conclusion, a laissez-faire "freedom of contract" view has dominated the development of unincorporated business organization law over the last fifteen years. When dealing with these entities, the lawyer needs to be aware of this—and to beware. When engaging in law reform, drafters need to respect the fact that there are fundamental policy choices to be made. This area has been fascinating and intellectually rich, and it will be particularly interesting to see how the balance between societal interests and individual interests is addressed over the next decades. We are relatively sure that contractarianism has reached its limits, but our wonderment is whether, as the fall of the Berlin Wall fades into memory, people who work with and influence law will move back toward the once-upon-a-time recognition that private business decisions are not devoid of public-good considerations and that there is a role for the public acting together as the state.

76. UNIF. LTD. LIAB. CO. ACT §§ 101-106, 6B U.L.A. 425 (2006).

77. *Id.* § 409(b).

78. *Id.* § 110(c)(4).

79. *Id.* § 110(d).

80. UNIF. LTD. LIAB. CO. ACT § 110(d)(4) ("If not manifestly unreasonable an operating agreement may . . . alter any other fiduciary duty.").

81. *Id.* § 409 cmt.