NOTES

WAIVING FAREWELL WITHOUT SAYING GOODBYE: THE WAIVER OF FIDUCIARY DUTIES IN LIMITED LIABILITY COMPANIES IN DELAWARE, AND THE CALL FOR MANDATORY DISCLOSURE

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I. INTRODUCTION

You are approached by a dear friend who says, "I have a terrific business concept—diamond mining in Siberia. Just a pickaxe, divining rod, and some elbow grease. It's going to be terrific. The problem is, I need a little bit of cash to get it off the ground. Any interest? I can offer you a share of the company." Although you know little about Siberia or investing, you decide to invest. He sends you a sixty-five-page LLC[1] operating agreement for Sub-Zero Mining, LLC ("it's mostly boilerplate"), which you review briefly and sign. You send it back to him, along with a check for your investment.

Six months later, having heard nothing from your friend, you run into him, and he is driving a brand-new sports car. You ask him, "How did the mining in Siberia go?"

"It was terrific," your friend explains. "I have more money than I know what to do with!"

Naturally, you ask for your share.

"Oh no," explains your friend. "You see, when I arrived, I realized that it would be too costly to share profits with you. I had the money to do it myself, so I started Arctic Mining LLC, and I was on my way!" When you ask how he could possibly think it was okay to start a new mining company without your consent, he explains that on page thirty-four of Sub-Zero's operating agreement, it clearly states that all relationships will be at "arms' length terms and conditions," which he says means he owed no fiduciary duties (the fundamental duties of diligence or loyalty) to you as an investor and was free to create, without your permission, a competing company.

Although this may seem intuitively like an improper outcome, if recent case law is any suggestion, your friend's actions would likely be protected under Delaware's current approach to waiving fiduciary duties in Limited Liability Companies ("LLCs").[2]

Fiduciary duties, the implied duties of care and loyalty implicit to any agency relationship, historically have been cornerstones of partnership and corporate theory. In its initial descriptions, a partner, manager, director, or officer in a business owed the "punctilio of an honor" to its investors or fellow partners, so as to prevent a manager from being allowed to act incompetently or in a self-dealing manner.[3]

1. "LLC" is the abbreviation for a limited liability company.

2. *See* Flight Options Int'l, Inc. v. Flight Options, LLC, No. 1459-N, 2005 Del. Ch. LEXIS 149, at *26 (Del. Ch. July 11, 2005) (suggesting that a provision stating that "transactions [between the parties] . . . will be on arms' length terms and conditions" was sufficient to waive and replace the traditional fiduciary duties between the parties); *infra* Part IV.A (suggesting the narrowing of the protections provided by the duty of "good faith" in Delaware courts).

3. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("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."). Although this case involved a partnership, the spirit of this definition has been cited in many other forms of fiduciary relationships. *See, e.g.*, Brown v. Halbert, 76 Cal. Rptr.

However, such a strict standard proved impractical for business. In the context of the duty of care, permitting passive or nonmanaging interests constantly to second-guess the actions taken by management could create substantial agency costs,[4] and make management too timid to make business decisions that might upset investors, thereby exposing the managers to litigation. Also, in the context of both the duty of care and loyalty, there may be times in which the nonmanaging interests may *want* to permit actions that otherwise might violate one of these duties in exchange for the management's continued services, such as to retain a quality manager that would otherwise leave the company. Thus, states have facilitated the evolution of the restrictive concepts of fiduciary duties to permit specific waivers of those duties in corporations.[5] States, however, have been reluctant to allow excessive modification and almost never allow it without the informed consent of the waiving party.[6]

LLCs are a recent addition to the world of business entities. Rising to popularity in the 1990s, LLCs combined the flexibility of partnerships with the limited liability of corporations.[7] This allowed parties to alter the structure of the entity to fit their exact goals. It was seen as the true embodiment of the freedom to contract, permitting the alteration or elimination of terms that were otherwise sacrosanct in traditional corporations.

Despite this flexibility, states have struggled with whether to permit the outright prospective waiver of fiduciary duties in LLCs. On the one hand, allowing the prospective elimination or modification of fiduciary duties in LLCs would undo the implicit and historic expectation of trust between managers and investors foundational to all other business entities. Permitting waivers also potentially incentivizes mismanagement and misdirection when negotiating with potential investors. On the other hand, LLCs were created to maximize parties' abilities to define their own

781, 789 (Ct. App. 1969) (corporations); Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981) (partnerships); Strain v. Seven Hills Assocs., 429 N.Y.S.2d 424, 432 (App. Div. 1980) (limited partnerships).

4. Agency costs are the costs created by the principal-agent relationship arising from the divergence between the interests of the principal and the agent's personal objectives, such as litigation, requiring the consent of large parties, or losing business due to risk aversion. Brett A. Margolin & Samuel J. Kursh, *The Economics of Delaware Fair Value*, 30 DEL. J. CORP. L. 413, 424–25 (2005).

5. For example, shareholders have the ability to approve actions that otherwise would violate fiduciary duties by vote, so long as they are fully informed. *See infra* Part II.C (discussing waiver of the duty of loyalty by vote).

6. These modifications included broader allowances for waiving duty of care provisions than loyalty provisions, as incentives for harmful violations were much greater in the loyalty context. *See id.*

7. *See infra* text accompanying notes 45–46 (discussing the rise in popularity of the LLC).

agreement. In addition, not allowing waivers could frustrate the goals of one of the more common users of LLCs, small businesses. Small businesses may not have sufficient capital or work to keep experienced managers busy full time, thus, they may wish to allow those managers to work in other capacities within the same industry.[8] Furthermore, with the growing conglomeratization of business, there is a much greater potential for technical or inadvertent conflicts that might otherwise hinder managers' abilities to work for specific companies.

In 2004, Delaware boldly revised its Limited Liability Company Act to "give maximum effect to . . . [the] freedom to contract"[9] by allowing LLCs to irrevocably modify, expand, or eliminate fiduciary duties in the LLCs operating agreement, subject only to the "contractual covenant of good faith and fair dealing."[10] Delaware based this change on a strict adherence to contractarian theory, placing minimal interference between the contracting parties, and offering, in theory, little opportunity for courts to interfere with the agreement.[11] In practice, the change has been very popular. According to a recent survey of lawyers in Delaware and other states that similarly allow limitations on fiduciary duties, 41 percent of LLC agreements drafted by them have attempted to limit or eliminate fiduciary duties.[12]

8. *See* Victor Brudney & Robert C. Clark, *A New Look At Corporate Opportunities*, 94 HARV. L. REV. 997, 1044–45 (1980) (discussing the viewpoints of corporations and managers regarding part-time work and business opportunities); Rutheford B. Campbell, Jr., *The "New" Fiduciary Standards Under the Revised Uniform Limited Liability Company Act: More Bottom Bumping from NCCUSL*, 61 ME. L. REV. 27, 50–51 (2009) ("My non-corporate deals were often promoted and managed by an entrepreneur with skills in a particular industry or business. These entrepreneurs typically had a strong desire to continue otherwise to be involved in the industry, either personally or through other entities in which they had an interest. The entrepreneurs in most of those cases were unwilling to act as manager for the entity, or for that matter even to promote the deal in the first place, unless they could get a waiver of the strict loyalty provisions. Without a waiver of the strict loyalty provisions, the entrepreneurs would likely, or perhaps certainly, be exposed to liability for transactions that amounted to competition with the entity, dealing with the entity as an adverse party, and usurping entity opportunities.").

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

10. *Id.* § 18-1101(c).

11. The contractarian theory in corporate law is the theory that the purchase of shares in a corporate entity constitutes a contractual relationship between the corporation and its shareholders. The theory posits that there is no need for mandatory provisions in governance documents, as parties are free to negotiate with each other, and the market will, thus, regulate itself. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 782–83 (2005).

12. Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 584–85 (2007) [hereinafter Miller, *What Fiduciary Duties Should Apply*] (citing Sandra K. Miller et al., *An Empirical Glance into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609, 618 (2006)).

However, as the hypothetical above suggests, Delaware's model is not necessarily perfect. Recent case law has rendered the implications of a waiver of fiduciary duties difficult to predict.[13] Similarly, the courts have failed to consistently determine what language is sufficient to effect such waiver.[14] This is particularly worrisome given the significant impact waivers may have on an LLC's operation, and the potential for parties to wrongfully assume the default fiduciary duties of care and loyalty are still in effect.[15] Although many have recognized these issues, few have explored potential solutions.[16]

The inherent tension between permitting negotiational autonomy and protecting the reasonable assumptions of parties is not unique to corporate law. Examples of prospective waiver of similar duties exist in many areas of law, including tort, medicine, securities, and the rules of professional conduct for lawyers. Although there are differences between the approaches to waiver of liability in these areas of law, one consistent element is the requirement that the waiving party be provided some form of disclosure. This may be relevant to address some of the issues with Delaware's current statute.

Disclosure can take many forms, from the expansive requirements for effective waiver of lawyers' conflicts of interest,[17] to simply requiring a party to provide a legislatively generated warning.[18] This Note suggests that in order to maximize efficient negotiation while maintaining consistency with Delaware's contractarian policy, Delaware should incorporate a limited disclosure requirement into its LLC waiver provisions. It should require all LLC operating agreements that purport to modify or waive fiduciary duties to include a highly visible, legislatively generated statement of the law, as well as specific, factual disclosures from

13. *See infra* text accompanying notes 87–96 (discussing the uncertainty of Delaware's waiver law due to its lack of testing in the courts).

14. *See infra* text accompanying notes 98–104 (discussing three Delaware cases with conflicting waiver language and varying results).

15. *See, e.g.*, Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 853 (Del. Ch. 2012) (recognizing that the problem with the current Delaware code is that "investors will have their expectations disrupted").

16. Campbell, *supra* note 8, at 51 (identifying the process for opting out of loyalty duties as "need[ing] adjustments"); Larry E. Ribstein, *Fiduciary Duties and Limited Partnership Agreements*, 37 SUFFOLK U. L. REV. 927, 961–64 (2004) (discussing fiduciary duties in the Uniform Limited Partnership Act); Allan W. Vestal, *Fundamental Contractarian Error in the Revised Uniform Partnership Act of 1992*, 73 B.U. L. REV. 523, 540 (1993) (discussing parties' ability to predict "unforeseen variations" in the partnership context).

17. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 22 (2010) (requiring a client to "reasonably understand[ ] the material risk that the waiver entails").

18. *See infra* Part IV (discussing the unresolved issues surrounding waivers of fiduciary duties).

each LLC manager of would-be violations of his or her duty of loyalty. This requirement would not only address some of the pitfalls of other disclosure regimes, such as introducing new uncertainty or risking ineffectiveness, but also create a powerful forum to promote informational symmetry and fair dealing. In fact, a disclosure requirement such as the one here proposed actually would advance the contractarian approach to fiduciary duties by providing the rules with the necessary support of the law to make them reasonable and fair.

This Note will begin in Part II with a brief overview of fiduciary law and how it is incorporated into corporate law. Part III will explain Delaware's laws governing the elimination of fiduciary duties in LLCs and the support that this statutory construction has gathered. Part IV will discuss the unresolved issues inherent in this formulation, such as judicial uncertainty and informational asymmetry, and explain what makes limitations on fiduciary liability particularly worthy of careful discussion. Part V will describe the potential solutions presented by commentators to resolve some of these issues and the reasons why including a disclosure requirement might be particularly desirable. Part VI will explore, by analogy, other areas of law in which prospective waivers operate, such as the professional conduct of lawyers and tort liability waivers, and discuss how these areas of law might influence the formation of a disclosure requirement for LLCs. Part VII will explore the risks of disclosure requirements and suggest how a mixture of mandatory general disclosure language and specific disclosure requirements can be affected to avoid some of these risks while still promoting Delaware's contractarian approach to LLC formation. Part VIII will conclude.

II. FIDUCIARIES, WAIVERS, AND THEIR FUNCTIONS IN TRADITIONAL CORPORATIONS

A. THE FIDUCIARY RELATIONSHIP

At its most basic level, a fiduciary is any person who holds a relationship of trust or confidence with another.[19] In law, fiduciary duties are a short-form definition for the general obligations and standards of conduct that the fiduciary agrees to undertake on the principal's behalf in exchange for compensation. Fiduciary duties are imputed by law onto

19. *Fiduciary Definition*, DICTIONARY.COM, http://dictionary.reference.com/browse/fiduciary (last visited Mar. 6, 2013).

various relationships of trust, including those of doctor-patient,[20] lawyer-client,[21] trustor-trustee,[22] and manager-investor.[23] Although fiduciary duties are often categorized in various ways, the two general categories of implied protection are those of competence (often called the duty of care) and avoidance of conflicts of interest (often called the duty of loyalty).

The primary function of fiduciary duties in corporate law is to balance enabling effective business operation with protecting minority investors' interests from abuse by managing parties. This is achieved by providing incentives to align both parties' interests.[24] In its most basic form, managers are obligated to protect the interests of investors in exchange for compensation and control over decisionmaking within the corporation.[25] In turn, investors maintain little influence over the management of their investment, other than some rights to fire directors, sell their interests in the open market, or sue for alleged negligence or breach of fiduciary duties. Although courts have used strong words to suggest fiduciary duties provide "the punctilio of honor" in protecting investors' interests,[26] even in traditional corporations, the law has developed into a series of complex compromises in regards to these duties, often permitting their waiver in certain contexts.[27]

B. WAIVER OF THE DUTY OF CARE

In the corporate context, as with other areas of law, the duty of care requires directors and officers to do their job competently. However, absent a conflict of interest, incentives for a manager to act incompetently are limited, since the manager gains little from being careless.[28] Furthermore, courts and legislatures alike recognize that "successful management

20. *E.g.*, Neade v. Portes, 739 N.E.2d 469, 500 (Ill. 2000); D.A.B. v. Brown, 570 N.W.2d 168, 172 (Minn. Ct. App. 1997).

21. Smoot v. Lund, 369 P.2d 933, 936 (Utah 1962); MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 1 (2010).

22. FirsTier Bank, N.A. v. Zeller, 16 F.3d 907, 910–11 (8th Cir. 1994); Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

23. Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).

24. *See* Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1047 (1991) ("How can one party be induced to do what is best for another without specifying exactly what is to be done?" (internal quotation marks omitted)).

25. *See id.* at 1048–60 (discussing the appropriation-incentive model of fiduciary duties).

26. *Meinhard*, 164 N.E. at 546.

27. *See Gantler*, 965 A.2d at 708–09 (holding that officers owe identical fiduciary duties to those owed by directors).

28. It is difficult to create hypotheticals in which a director would willfully violate the duty of care without implicating self-dealing.

. . . requires judgment,"[29] and requiring consensus or permitting excessive second-guessing on all management decisions would be nearly impossible.[30] Thus, the law has evolved to provide higher burdens of proof for potential duty of care violations[31] and even to permit some limited forms of waiver.[32]

C. WAIVER OF THE DUTY OF LOYALTY

The duty of loyalty has been treated with far less flexibility. By definition, conflicts of interest represent potential incentives for directors and officers to act in direct opposition to the interests of shareholders. These violations frequently involve self-dealing.[33] Thus, the need to protect shareholders' interests is greatly increased.

Although aware of the importance of loyalty, courts and legislatures alike seem to have recognized that effective business operation may require some activities that otherwise violate this duty.[34] However, given the potential for abuse, the law has generally avoided permitting general or prospective waivers of this duty, instead dealing with waivers of the duty of loyalty on a case-by-case basis.[35] Furthermore, any such waiver is conditional on the managers fully informing the decisionmakers of all the specific risks inherent in such a waiver.[36] Thus, nearly all states have

29. Cooter & Freedman, *supra* note 24, at 1062.

30. *Id.* at 1047 ("[The] constant monitoring of the fiduciary's behavior, which would protect the beneficiary, often is prohibitively costly."). *See generally* Geoffrey Brennan & Loren Lomasky, *Inefficient Unanimity*, 1 J. APPLIED PHIL. 151 (1984) (discussing the inefficient shortcomings of unanimous consent in a group).

31. For example, directors are presumed to have acted in a competent, well-informed manner—the so-called business judgment rule. *E.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993). In addition, case law also suggests that the same presumption applies to officers. *Gantler*, 965 A.2d at 708–09; Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 876 (2005).

32. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (2013) (allowing incorporation documents to contain waivers of the duty of care of directors if the director does not intentionally violate the duty); MODEL BUS. CORP. ACT § 2.02(b)(4) (2006) (same).

33. *See, e.g.*, Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1281 (Del. 1988) (discussing the duties of inside directors when "among the bidders" of a project); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.").

34. An example would be permitting a valuable director to pursue a business opportunity that would otherwise cause him to resign from his position.

35. Claire M. Dickerson, *Is it Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111, 116 (1993) (stating that a "[f]iduciary duty, once imposed, may be removed, but only by a showing of disclosure and consent").

36. *See, e.g.*, *In re* Wheelabrator Techs. S'holder Litig., 663 A.2d 1194, 1201–02 (Del. Ch. 1995)

reached the conclusion that although "the duty of loyalty is not contractually modifiable, . . . it can be specifically waived."[37]

Such retroactive waiver is achieved through two alternative forms: shareholder or director approval.[38] For shareholder approval, the majority of shareholders can waive any potential violation of the duty of loyalty by vote, provided they are fully informed of the circumstances and not interested parties.[39] This form of waiver again represents a compromise. It likely would prove impossible to get unanimous approval from shareholders,[40] but requiring majority approval implies that at least 50 percent of shareholders' interests are protected. However, the financial and organizational burden of informing shareholders can be substantial. As such, directors and officers may alternatively seek waiver by a vote of the majority of informed, disinterested directors.[41] This approach still protects shareholders' interests because their interests are shielded by the fiduciary duties that the directors have to shareholders, and the party seeking waiver must fully inform those directors.[42] However, no state permits any form of prospective general waiver of the duty of loyalty in traditional corporations.[43] This is likely due to the perceived impossibility of adequately informing the parties of any and all potential breaches of loyalty that may arise in the future and the potential for abuse.[44]

(suggesting the difficulty in arriving at what would be sufficient waiver in the context of duty of loyalty).

37. Vestal, *supra* note 16, at 523.

38. A third alternative for absolving oneself from duty of loyalty violations is the doctrine of entire fairness, which permits such violations without approval if the defendant can prove his actions were substantively and procedurally fair. *See generally* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (defining the entire fairness doctrine). However, a discussion of this doctrine is outside the scope of this Note.

39. *See* Gantler v. Stephens, 965 A.2d 695, 712–13 (Del. 2009) (describing common law shareholder ratification).

40. *See supra* text accompanying note 29 (discussing manager judgment).

41. DEL. CODE. ANN. tit. 8, § 144(a)(1) (2013).

42. *Gantler*, 965 A.2d at 712–13.

43. In fact, in some states, including Delaware, approval of either the shareholders or directors in some situations only shifts the burden of proof of the defendant's propriety to the plaintiff. *See, e.g.*, Kahn v. Lynch Commc'ns Sys., 638 A.2d 1110, 1117 (Del. 1994) ("[A]n approval of [a merger] . . . by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff."); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 937 (Del. 1985) ("[A]pproval of a merger, as here, by an informed vote of a majority of the minority shareholders, while not a legal prerequisite, shifts the burden of proving the unfairness of the merger entirely to the plaintiffs.").

44. *See, e.g.*, Cooter & Freedman, *supra* note 24, at 1048–49 (recognizing the issues of uncertainty and informational asymmetry in duty of loyalty problems, and that the breaching parties will likely not share all information with the other parties).

III. THE WILD WEST: WAIVER OF FIDUCIARY DUTIES IN LLCS

A. THE LIMITED LIABILITY COMPANY

The limited liability company ("LLC") is still a relatively new business entity, reaching prominence in the 1980s and 1990s.[45] It arose by statute in the early 1990s in order to create an accessible corporate structure that combined the flexibility and pass-through taxation structure of partnerships with corporation-like liability protection.[46] States achieved this flexibility by creating default rules and permitting them to be contracted around or waived. These modifiable rules include management structure, voting rights, corporate formalities, and profit sharing.[47]

When it came time to decide whether to allow the modification of fiduciary duties, however, states' receptiveness varied greatly.[48] Permitting parties to freely contract was one of the central goals of the LLCs, but no prior business entities had allowed the wholesale waiver of fiduciary duties. States seemed unsure if they wanted to allow the modification of the core trust relationship upon which most corporate law was developed. Indeed, the concerns about permitting waiver of fiduciary duties are far from trivial. States had to struggle with concerns of incentivizing abusive or opportunistic conduct in managers and unsophisticated investors who were potentially unaware of the implications of such waivers. In addition, as privately held corporations, LLCs are not generally regulated by securities law; thus, nonmanaging members are not provided certain additional protections, such as disclosure requirements and more strict fraud provisions.[49] Nor is there generally a market for private interests in LLCs, leaving passive investors generally less able to sell their interests in the

45. The first state to codify the LLC was Wyoming in 1977. Larry E. Ribstein, *LLCs: Is the Future Here? A History and Prognosis*, 13 BUS. L. TODAY 11, 11 (2003). By 1996, every state had enacted an LLC act. *Id.* at 12.

46. *See* MICHAEL A. CHASALOW, ACING BUSINESS ASSOCIATIONS 242–43 (2010) (discussing the benefits of LLCs); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 407–08 (1992) (same).

47. Keatinge et al., *supra* note 46, at 417–19.

48. 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, 520–21 (2001) (explaining that some states have avoided discussing fiduciary duties, while various others have tried to explain how they might be waived).

49. *See* 17 C.F.R. § 240.10b-5 (2012) (making unlawful "untrue statements of material fact"). Only interests in most manager-managed LLCs are regulated by the Securities Exchange Commission. *See* SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (developing the four-prong test for determining what is a security); Reeves v. Teuscher, 881 F.2d 1495, 1500 (9th Cir. 1989) (applying security classification to manager-managed LLCs).

company should they no longer trust their managers with their money.[50]

In light of these concerns, some states have taken a more cautious approach to modifying fiduciary duties for LLCs. California is one such state, recognizing the LLC as a "hybrid business entity" with a legal existence "separate from its members," and thus, regulated by similar notions of duty.[51] In California, limitations to waiver of fiduciary duties are governed by Section 17005(d) of the Beverly-Killea Limited Liability Company Act ("California LLC Act"), drafted in 1994, which states that "fiduciary duties of a manager to the limited liability company and to the members of the limited liability company may only be modified in a written operating agreement with the informed consent of the members."[52]

The language of this provision, although not yet tested by the courts, suggests two potentially important limitations. First, the statue requires informed consent of the members to permit any modifications. This mandatory disclosure requirement provides a potentially high disclosure bar for managers to meet, and may even imply limitations to what may be waived, such as for activities that are too speculative or uncertain.[53] Second, the absence of the phrase "or eliminated" in the statute may suggest that fiduciary duties may not be completely removed from the agreement, thereby preserving some basic elements of trust inherent in fiduciary relationships.[54]

50. *See* Dennis S. Karjala, *Planning Problems in the Limited Liability Company*, 73 WASH. U. L.Q. 455, 466–69 (1995) (discussing shareholder oppression); Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW 1, 27 (1995) (discussing how limiting an investor's liquidation power can hurt passive investors).

51. Kwok v. Transnation Title Ins. Co., 89 Cal. Rptr. 3d 141, 147 (Ct. App. 2009) (referencing Denevi v. LGCC, 18 Cal. Rptr. 3d 276, 278 n.1 (Ct. App. 2004)).

52. CAL. CORP. CODE § 17005 (West 2013).

53. Marshall P. Horowitz & Gregg R. Sultan, *Limitation of Fiduciary Duties for LLC Members*, L.A. DAILY J., Aug. 6, 2010, *reprinted in* SNELL & WILNER 2 (2010), *available at* http://www.swlaw.com/assets/pdf/news/2010/08/12/LimitationofFiduciaryDuties_Horowitz_Sultan_WEB.pdf (recognizing that one "issue that may arise regarding the informed consent standard is [w]hether consent will be considered informed if obtained with respect to conduct generally described in the operating agreement far in advance of a competitive transaction, or if it must be based on specific disclosure of relevant facts" (alteration in original) (internal quotation marks omitted)). For further discussion of the implied limitations inherent in informed consent, see *infra* Part VI.A.

54. *Id.* at 1. This was the interpretation of similar language in the first draft of Delaware's Limited Liability Company Act ("Delaware LLC Act"), discussed *infra* text accompanying notes 62–63. Although there is no legislative evidence that this concept was discussed, the California Senate Judiciary Committee provides evidence that some lawmakers oppose permitting waiver of fiduciary duties at all for fear of its unanticipated effects on an LLC. *See* S. JUDICIARY COMM., BILL ANALYSIS, 2011–12 Reg. Sess., at 10 (Cal. 2012) (suggesting the "fiduciary duty the manager has to the LLC[ ] should be 'subject to waiver or modification at the whim of the LLC members.'" (quoting S. JUDICIARY COMM., ANALYSIS OF S.B. NO. 469, 1993–94 Reg. Sess., at 6. (Cal. 1993))). This may support the idea

Advocates for a more aggressive approach appealed to the contractarian nature of LLCs, claiming that the types of sophisticated parties that use LLCs should be able to truly define *all* aspects of their deal,[55] and avoid "incorporat[ing] uncertainty, inconsistency, and unpredictability into the world of negotiated agreements" created by fiduciary duties.[56] Similarly, advocates for expansive waiver also suggest that flexibility in fiduciary waivers more accurately reflects the needs of small businesses, which seek managers who are experienced in the relevant business, but often cannot afford to employ full-time managers. However, states and regulators that have sought more aggressive waiver provisions have struggled with exactly how to do so. For example, the Revised Uniform Limited Liability Company Act ("RULLCA") permits general waivers of all fiduciary duties, including waivers of the duty of loyalty.[57] Aware of the risk inherent in such a permissive statute, however, it includes the substantive limitation that any waiver cannot be "manifestly unreasonable," but it does not further define this standard, thereby leaving it open to judicial interpretation.[58]

B. THE WAIVER PROVISIONS IN DELAWARE

Delaware has one of the most aggressive statutes regarding fiduciary duty waiver provisions.[59] In order "to give maximum effect to the principle of freedom of contract,"[60] Delaware amended its Limited Liability Company Act in 2004 to unequivocally affirm the broad permissibility of generally waiving fiduciary duties.[61] The law states that

> [t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a

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that the courts will be hesitant to completely eliminate fiduciary duties.

55. *See* Paul M. Altman & Srinivas M. Raju, *Recent Case Law Developments Relating to Delaware's Alternative Entities*, 6 DEL. L. REV. 201, 221 (2003) (discussing the Delaware judiciary's firm adherence "to the principle of freedom of contract").

56. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 31 (2007).

57. REVISED UNIF. LTD. LIAB. CO. ACT § 110(d) (2006).

58. *Id.*

59. Since its enactment, Delaware's approach has been emulated by several other states, including Arkansas, Idaho, and Kentucky. Miller, *What Fiduciary Duties Should Apply*, *supra* note 12, at 592.

60. DEL. CODE. ANN. tit. 6, § 18-1101(b) (2013). *See also In re* Grupo Dos Chiles, LLC, No. 1447-N, 2006 Del. Ch. LEXIS 45, at *5–6 (Del. Ch. Mar. 10, 2006) ("Limited liability companies are designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.").

61. 77 Del. Laws c. 287, § 29 (2004).

> party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.[62]

Ironically, Delaware's first attempt to permit the elimination of fiduciary duties was rejected by its Supreme Court.[63] The Court interpreted the pre-2004 statutory provision, which allowed "duties and liabilities . . . [to] be expanded or restricted," as not allowing complete elimination of fiduciary duties, but rather requiring the preservation of some core principles of the fiduciary relationship.[64] Only two years later, Delaware's legislature amended the provision to include the phrase "eliminated," and expressly limited such waiver only by requiring "contractual covenant of good faith and fair dealing," to reaffirm its initial intentions.[65]

Some commentators have claimed that the 2004 amendment suggests a paradigm shift in Delaware's approach to fiduciary relationships in LLCs.[66] Delaware Chief Justice Myron T. Steele felt it was "abundantly clear"[67] that Delaware had redefined the fiduciary relationship of LLCs from that of a "dependency relationship" to a "contractual relationship."[68] With this change, Justice Steele suggested, came a new, less expansive interpretation of the covenant of good faith and fair dealing (and by extension, the judicially cognizable expectations of the involved parties), borrowing not from the heritage of trust-based fiduciary analysis, but that of contract law, which carries far fewer protections.[69] In essence, Delaware

62. DEL. CODE ANN. tit. 6, § 18-1101(c). Similar opportunities to limit liability were also provided via exculpation and indemnification provisions in the same amendment. *Id.* § 18-1101(e). At the same time, Delaware revised its Limited Partnership Act in a nearly identical way. *See id*. § 17-1101(c), (d), (f) (describing freedom of contract and fiduciary duty waivers for partnerships). Although these subjects are outside the scope of this Note, many of the same criticisms and suggestions could apply in those contexts as well.

63. *See* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160, 170–72 (Del. 2002) (interpreting nearly identical language in Delaware's Limited Partnership Act).

64. *Id.* at 167–68.

65. DEL CODE ANN. tit. 6, § 18-1101(c).

66. Steele, *supra* note 56, at 13. *See also* Vestal, *supra* note 16, at 524 ("The Revised Act rejects the fiduciary world view of the common law and the UPA for an essentially contractarian world view.").

67. Steele, *supra* note 56, at 14.

68. *Id.* at 13.

69. *Id.* at 23. Steele suggested that, in light of the 2004 amendment, "the courts must recognize that the contracting parties have not superimposed on their relationship a set of duties and liabilities

abolished the default presumption of a trust-based relationship between managers and investors if the express terms of the operating agreement alter it. To quote Justice Steele, “absent evidence to the contrary, it must be assumed that passive investors who authorize, in the unincorporated business entities’ enabling documents, the elimination or restriction of one or more fiduciary duties are fully informed of the risks and benefits.”[70]

C. SUPPORT FOR DELAWARE’S APPROACH

Support for the general prospective waiver of fiduciary duties and Delaware’s approach to waiver of fiduciary duties generally lies with contractarian theory.[71] In essence, this approach recognizes that there are instances in which parties may desire advanced waiver of fiduciary duties, such as to hire highly conflicted, but talented managers or to redefine obligations in a mutually agreeable way, despite the risks involved.[72] Contractarian theory posits that, as a potentially calculable risk, the waiver of fiduciary duties can be assigned value, allowing it to be negotiated and reallocated like any other contract term.[73]

As a corollary to this freedom, the ability to redefine or eliminate fiduciary duties is also beneficial because it allows for parties to avoid

drawn from common law fiduciary duty with its complex overlay of levels of scrutiny.” *Id.* For a more complete discussion of what these restrictions might be, see *infra* text accompanying notes 87–96.

70. Steele, *supra* note 56, at 9. In fact, Steele later suggested that since the 2004 amendment, Delaware legislative policy supports the removal of default fiduciary duties entirely. Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 223–24 (2009). However, this view has not gained traction in Delaware’s courts. For an extensive exploration of why fiduciary duties are still the default requirement, see, for example, Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 846–56 (Del. Ch. 2012) (leaving it to Delaware’s General Assembly to change the status quo), and Kelly v. Blum, No. 4516-VCP, 2010 Del. Ch. LEXIS 31, at *54 (Del. Ch. Feb. 24, 2010) (“[C]ontrolling members in a manager-managed LLC owe minority members ‘the traditional fiduciary duties’ that controlling shareholders owe minority shareholders.”) (citing Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 Del. Ch. LEXIS 54, at *25–29 (Del. Ch. Apr. 20, 2009)).

71. *See* Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 2–7 (1990) (analyzing the possibility of opting out of fiduciary duties based on contractarian theory and relevant economic literature); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993) (applying contract theory to fiduciary relations in general); Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 U. PA. L. REV. 1609, 1622 (2004) (recognizing a lack of clarity regarding whether contractarian theory or fiduciary principles govern fiduciary disputes).

72. *See* Butler & Ribstein, *supra* note 71, at 29–30 (discussing parties’ considerations of mutual benefit while contracting).

73. *Id.*; Klausner, *supra* note 11, at 782–83.

judicial uncertainty.[74] Fiduciary duties are, by the nature of ad-hoc common law, "vague and fact-oriented," inhibiting certainty and predictability in an agreement.[75] Uncertainty, in turn, can lead to undesirable results, such as expensive litigation and managerial timidity, which may harm both parties.[76] Similarly, prospective waiver is seen as superior to the traditional corporate approach to waiver, since it is often less expensive than holding votes for every potential violation, and permits management to negotiate for approval with greater bargaining power since it can be done before issues arise.[77] By allowing fiduciary duties to be redefined preemptively by contract, rather than relying solely on judicial intervention, parties can negotiate with a higher level of confidence in the enforceability of the deal, avoiding agency costs relating to uncertain management standards or inefficient business operations.[78]

Also, as a practical matter, Delaware has a strong financial interest in being management-friendly, as being home to incorporated entities is big business.[79] Managers are generally the parties that file for incorporation, and thus, tend to choose states in which the law is most beneficial to their

74. *See* Butler & Ribstein, *supra* note 71, at 30–31 (advocating that "courts should not always assume that the parties have adopted the default fiduciary duty term"); Steele, *supra* note 56, at 31 (suggesting that Delaware's application of fiduciary duties has been "inconsistent").

75. Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 NW. U. L. REV. 1, 55 (1985). *See also* Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1414–20 (1985) ("[Corporate governance laws] permit a wide, and in many respects unpoliceable, range of discretion with respect to the diligence, skill, intelligence, and judgment of managers."); Anna Manasco Dionne, Note, *Living on the Edge: Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency*, 13 STAN. J.L. BUS. & FIN. 188, 192 (2007) (discussing the costs of uncertainty in fiduciary duties in the contexts of insolvency and the business judgment rule); Steele, *supra* note 56, at 31 ("[W]hy should courts seek to incorporate uncertainty, inconsistency, and unpredictability into the world of negotiated agreements?"). This view also comports with common sense, insofar as standards like loyalty and fairness require evaluation of context-sensitive value judgments.

76. Brudney, *supra* note 75, at 1416–20. *See also* Bernard Black, Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1059 (2006) ("Too much fear of liability . . . may reduce rather than enhance the quality of board decisions.").

77. Imagine, for example, a corporate director who wants to own some stock in a competing business, but would like to keep his job. Why would shareholders approve such an action? Other than quitting, managers have much less negotiating leverage once they are already working in a management role, since they are already contractually bound by their fiduciary duties.

78. Butler & Ribstein, *supra* note 71, at 31.

79. Demetrios G. Kaouris, Note, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J. CORP. L. 965, 966 (1995) (recognizing the financial incentives of incorporation, such as taxes). For example, in 1990, Delaware collected over $200 million in franchise taxes alone, totaling 17.7 percent of the total tax collected for the state. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 8 (1993). This does not even take into account all the other revenue streams associated with incorporation, such as judicial proceedings, corporate offices, and the boon to the legal profession in that state.

interests.[80] Delaware has always been the national leader in business entity filings, particularly LLCs.[81] By allowing managers to waive fiduciary duties and limit their own liability to others, Delaware has again made itself more attractive to potential businesses and protected its valuable revenue stream.

IV. THE PROBLEMS WITH DELAWARE'S APPROACH

If the intention of Delaware's legislature was merely to maintain preeminence in filings, the current statutory approach to waiver of fiduciary duties has been incredibly successful.[82] However, many commentators feel that Delaware's statute underestimates the fundamental presumption of fiduciary relationships protection and fails to adequately resolve the concerns that the Delaware legislature intended to address.[83] Delaware's approach (as well as the approach in the RULLCA) still risks judicial interference by creating new uncertainty, and it ignores the reality that parties to an LLC operating agreement both may not be sophisticated and symmetrically informed.

A. NEW UNCERTAINTY

Although part of the goal of permitting prospective waiver of fiduciary duties was to avoid judicial uncertainty, it may have simply traded one ambiguity for another. Standards such as "manifest[ ] unreasonable[ness]"[84] and "good faith and fair dealing"[85] are rife with interpretation concerns. What is manifestly unreasonable or good faith, and how do those standards differ from common law fiduciary relationships? Other than an implication that waivers of fiduciary duties are more

80. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974) (arguing the management-friendly nature of Delaware's corporate laws is a "race for the bottom").

81. *See* Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 92 (2004) (listing, by state, LLC business filings).

82. However, if that is the legislative intent, then perhaps the statute should not state that its intention is to give "maximum effect to the principle of freedom of contract" as much as it is to give maximum effect to management favoritism. DEL. CODE ANN. tit. 6, § 18-1101(b) (2013).

83. As Professor Miller states, "It is hoped that the jurisdictions permitting the broad elimination of fiduciary duties will develop meaningful limitations to curb abusive conduct using contractually based concepts." Miller, *What Fiduciary Duties Should Apply*, *supra* note 12, at 589. *See also* Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 894–96 (1990) (discussing that, in reality, contracting parties may not act as they theoretically should).

84. REVISED UNIF. LTD. LIAB. CO. ACT § 110(d) (2006).

85. DEL. CODE ANN. tit. 6, § 18-1101(c) (2013).

extensive,[86] no more definitive line can be drawn without extensive analysis of a state's interpretation of that language, which may not itself be resolved. Thus, what does such a waiver truly achieve? Manager action will still be inhibited by a lack of clearly defined limitations, the potential for imposed judicial evaluation, and the fear of litigation.

Delaware's backstop protection of good faith and fair dealing is a prime example of this uncertainty. How willing will the judiciary be to abandon the trust-based interpretation of good faith? Case law defining the implied covenant of good faith and fair dealing, while well established in the contexts of employment, commercial, and insurance law, all of which are trust- or dependency-based applications,[87] remains largely untested when applied to corporate governance structure.[88] In dependency-based interpretations, the case law suggests that the covenant seeks to uphold the "objectively reasonable expectations"[89] of the parties and cause parties to "refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits[ ] of the bargain."[90] In this sense, good faith may simply be a proxy for the same subjective value judgment of manifest unreasonableness suggested under the RULLCA. More recent case law suggests, however, that in the context of corporate governance structure, this protection may be much more limited. In *Kuroda v. SPJS Holdings, LLC*, the Delaware Chancery Court held that a valid claim for breach of implied good faith and fair dealing

86. By clarifying that fiduciary duties may be eliminated, Delaware made it clear it did not want to require LLCs to retain any core fiduciary duties. *Compare id.* § 18-1101(c) (2003) (amended 2004) ("[Fiduciary] duties . . . may be *expanded or restricted* by provisions in a limited liability company agreement." (emphasis added)), *with id.* § 18-1101(c) (2013) ("[Fiduciary] duties . . . may be *expanded, or restricted or eliminated* by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." (emphasis added)). Under the revisions to the Uniform Limited Liability Company Act, the statute moved away from not permitting extensive waivers of fiduciary duties to a less restrictive, manifestly unreasonable standard. *Compare* UNIF. LTD. LIAB. CO. ACT § 103 (1996) (not permitting the restriction or elimination of a duty), *with* REVISED UNIF. LTD. LIAB. CO. ACT § 110(d) (2006) (permitting the restriction or elimination, provided such limitation is not "manifestly unreasonable").

87. Steele, *supra* note 56, at 16. *See also* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005) (analyzing good faith in insurance law); E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 442–44 (Del. 1996) (analyzing "various contexts where the concept of 'good faith' is employed").

88. Steele, *supra* note 56, at 16. Although there have been several cases that have struggled with this concept in the last few years, none have expressly resolved this issue, nor has it been addressed by Delaware's Supreme Court.

89. *E.I. DuPont*, 679 A.2d at 449.

90. *Dunlap*, 878 A.2d at 442 (quoting Wilgus v. Salt Pond Inv. Co., 498 A.2d 151, 159 (Del. Ch. 1985)) (internal quotation marks omitted).

must "allege a specific implied contractual obligation"[91] and "cannot be invoked to override the express terms of the contract."[92] The court also stated that, "Consistent with its narrow purpose, the implied covenant is only rarely invoked successfully."[93] This narrowed interpretation has also been echoed by Delaware's Supreme Court, and seems to suggest that a party's "reasonable expectations" shall not impute any expectation that arises from the historical trust-based foundation of corporate law.[94]

This leaves open the issue of whether the implied covenant of good faith means something akin to moralistic fairness—thus, suffering from similar risks to the RULLCA language—or is something more limited, covering only the enforcement of specific contractual obligations. On the one hand, any reasonableness standard may be inappropriately paternalistic—imposing a judge's subjective interpretation ex post to a contractual relationship may undo what was a truly informed decision by both parties, unduly injuring the party who sought the contract's protection.[95] Conversely, Delaware's more restrictive reading of good faith and fair dealing may be inconsistent with a party's expectation of moral fairness in the manager-investor relationship.[96]

Even without the expectation of trust, it is unclear how the contractual good faith standard might interact with potential issues involving the context in which a waiver is obtained. For example, would good faith invalidate a waiver of fiduciary duties if the reason one party sought the waiver was to participate in an undisclosed and premeditated deal that would benefit himself at the expense of the investor (an action stirring the implicit central notion of immoral deception and bad faith)? Absent a duty to disclose such information, perhaps not. Without further clarification, it is impossible for the parties to know what they are truly bargaining for when fiduciary duties are waived, and thus they cannot be in a position to participate in informed negotiation. Thus, many of the "costs" of litigation and managerial timidity may still exist despite attempts to provide

91. Kuroda v. SPJS Holdings, LLC, 971 A.2d 872, 888 (Del. Ch. 2009) (quoting Fitzgerald v. Cantor, No. 16297-NC, 1998 Del. Ch. LEXIS 212, at *3 (Del. Ch. Nov. 10, 1998)) (internal quotation marks omitted).

92. *Id.* (citing Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc., 622 A.2d 14, 23 (Del. Ch. 1992)).

93. *Id.* (citing Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co., No. 1668-N, 2006 Del. Ch. LEXIS 160, at *22 (Del. Ch. Aug. 25, 2006)).

94. Nemec v. Shrader, 991 A.2d 1120, 1125–26 (Del. 2010).

95. MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 147–50 (1993); *See also* Davis, *supra* note 75, at 27 (discussing why a principal may allow opportunistic decisionmaking of a fiduciary).

96. *See infra* Part IV.C (discussing the tension between social norms and contractartian norms).

otherwise.

Recent unpublished Delaware Chancery Court decisions have further added to this uncertainty by setting unclear standards as to what language is sufficient to effect waiver. First, Delaware courts seem undecided on how to interpret potentially conflicting terms. In 2009, the court in *Bay Center Apartments v. Emery Bay PKI, LLC* found that members' fiduciary duties were not waived, despite an operating agreement stating that "each member shall owe no duty of any kind towards the Company or the other Members,"[97] because a later provision read them back in by stating that members "shall have the same duties . . . to each other that members of a limited liability company formed under the Delaware [LLC] Act have to each other."[98] However, just four years earlier the Court of Chancery upheld a similar waiver in *Flight Options International, Inc. v. Flight Options, LLC* by finding that, although there was a provision implying fiduciary duties between all parties, the waiver provision was a "more specific contractual term" that targeted a specific relationship, and thus, modified the previous provision.[99]

Perhaps more troubling, however, is that while explicit waivers have been upheld,[100] the courts have been unclear as to what other language may suffice to eliminate or modify fiduciary duties. In *Flight Options*, the waiver provision merely stated that "transactions [between the parties] . . . will be on arms' length terms and conditions," which was sufficient to waive and replace general fiduciary duties.[101] In contrast, in *Kelly v. Blum*, the court found that an LLC agreement stating that "the Board of Managers shall manage the affairs of the Company in a prudent and businesslike manner, and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs"[102] was insufficient to

97. Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 Del. Ch. LEXIS 54, at *29 (Del. Ch. Apr. 20, 2009).

98. *Id.* at *28–29.

99. Flight Options Int'l, Inc. v. Flight Options, LLC, No. 1459-N, 2005 Del. Ch. LEXIS 149, at *27 (Del. Ch. July 11, 2005). While it may seem like *Bay Center*, as a more recent holding, has superior precedential value, neither case was published, both were heard by the Chancery Court, and *Bay Center* did not attempt to refute the *Flight Options* opinion. Thus, it is more accurate to suggest that there has been inconsistency in the Chancery Court's interpretation.

100. *See, e.g.*, Lonergan v. EPE Holdings LLC, 5 A.3d 1008, 1017 (Del. Ch. 2010) (holding the duty of care to be eliminated in a limited partnership agreement).

101. *Flight Options*, 2005 Del. Ch. LEXIS 149, at *26. *See also* Related Westpac LLC v. JER Snowmass LLC, No. 5001-VCS, 2010 Del. Ch. LEXIS 158, at *30 (Del. Ch. July 23, 2010) (refusing to impute fiduciary duties if doing so would "nullify the parties' express bargain").

102. Kelly v. Blum, No. 4516-VCP, 2010 Del. Ch. LEXIS 31, at *46 (Del. Ch. Feb. 24, 2010).

limit a board's fiduciary duties. Instead, the court interpreted this language to "place control of . . . affairs in the board of [m]anagers, rather than the [m]embers."[103] These outcomes, though not directly inconsistent, imply that Delaware may recognize nonexplicit waiver, but that specific, yet undefined, drafting rules will be applied. Allowing nonexplicit waiver in this way is problematic because it opens the door to accidental or covert waivers.[104] This not only increases the risk of unintentional consequences when drafting, but also further amplifies the potential for abuse by more knowledgeable parties.

B. Relative Knowledge of the Parties

Two of the major assumptions of efficient freedom to contract are that both parties are knowledgeable and have symmetrical information.[105] Knowledgeable parties are required for efficient negotiations, as that implies that parties can understand each contract term, assign to it an appropriate risk, and make informed decisions on how to allocate that risk. In the context of fiduciary waivers, not only is it perhaps impossible to be truly knowledgeable on the subject in its current form, but also sophistication is a very difficult thing for the law to measure. At the risk of being too under- or overinclusive, many laws seek compromise by creating base standards that approximate a party's knowledge in a specific context. For example, areas of securities law tend to use personal wealth as a proxy for knowledge, implying that once people have a certain level of liquidity or net worth, they are deemed to have either sufficient exposure to these types of transactions to be knowledgeable, or an ability to get a lawyer who can inform them.[106] In the context of LLCs, Delaware's Chancery Court seems to assume that parties are knowledgeable about the nuances of corporate law simply because they knew enough to form an LLC (or buy an

103. *Id.* at *47.

104. Even the court in *Flight Options* recognized this concern. *Flight Options*, 2005 Del. Ch. LEXIS 149, at *28 n.33 (recognizing that future courts might acknowledge the "broadly imposed" nature of the member's fiduciary duties in the agreement and require such "important duties" to be more "precisely delineated").

105. *See* TREBILCOCK, *supra* note 95, at 102–03, 144 (identifying both asymmetrical information and "symmetrical information" problems as shortcomings of contractarian advocates).

106. *See, e.g.*, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11251-01, 11253 (proposed Mar. 16, 1982) (to be codified at 17 C.F.R. pts. 230, 239) (defining "accredited investors"); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400-01, 405 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275) (stating the purpose of defining "accredited natural person").

interest in one).[107]

There are several problems with this assumption. First, the types of businesses and individuals that form LLCs vary greatly in relative knowledge and sophistication.[108] The barriers to creating an LLC are small, and the barriers to participation are nonexistent. There are no guarantees that the parties understand the fundamental functions of corporate law, much less the implications of fiduciary duties or their waiver.[109] As Marvin A. Chirelstein suggests,

> Security-holders do indeed expect to be treated "fairly," but they have no accurate perception about the limits placed on fiduciary conduct by the states in which their issuers are incorporated, and of course not one investor in a thousand would be likely to be sure which state that was. In effect, fiduciary risks are not and probably cannot be anticipated.[110]

However, many LLCs are created before the entity has sufficient capital to afford a lawyer, and transactions are often done using available template agreements.[111] As such, many of the nuanced elements of LLC

107. *See, e.g.*, Abry Partners V, L.P. v. F & W Acquisition LLC, 891 A.2d 1032, 1063 (Del. Ch. 2006) (noting that Delaware's statutory provisions permitting the elimination of fiduciary duties in noncorporate firms are justified because "[i]n the alternative entity context, . . . it is more likely that sophisticated parties . . . carefully negotiated the governing agreement"); *Flight Options*, 2005 Del. Ch. LEXIS 149, at *27 (suggesting the sophistication of the parties can be presumed based on the entity's existence and the existence of corporate council) (citing Kier Constr., Ltd. v. Raytheon Co., No. 19526, 2005 Del. Ch. LEXIS 36, at *5 (Del. Ch. Mar. 10, 2005)); R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC, No. 3803-CC, 2008 Del. Ch. LEXIS 115, at *26 (Del. Ch. Aug. 19, 2008) (reasoning that the court need not intervene on behalf of the plaintiffs because doing so would "disregard a negotiated agreement among sophisticated parties").

108. In a study by Professor Sandra K. Miller that polled business attorneys in many states, over 85 percent of LLCs do not actively negotiate their operating agreement, and 40 percent do not even have an operating agreement. Miller, *What Fiduciary Duties Should Apply*, *supra* note 12, at 585.

109. *See* Brudney, *supra* note 75, at 1417–18 ("Certainly investors were not aware of, and could not have anticipated, developments in corporate law that eroded the constraints on management self-dealing and self-aggrandizement embodied in earlier fiduciary principles."); Elliott J. Weiss & Lawrence J. White, *Of Economics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 553 (1987) (finding no changes in investment in the wake of seven major and unanticipated changes in Delaware corporate law). Although there is little reliable empirical evidence of this, the statistics behind Professor Miller's study suggest parties' hesitancy to modify or define the LLC through its operating agreement, due to a potential discomfort with the law. Miller, *What Fiduciary Duties Should Apply*, *supra* note 12, at 584–85. Furthermore, this study only polled attorneys, and thus, may underrepresent unsophisticated parties, as those who do not use attorneys may be even less aware of the law.

110. Marvin A. Chirelstein, *Towards a Federal Fiduciary Standards Act*, 30 CLEV. ST. L. REV. 203, 219 (1981).

111. Professor Miller's study found "widespread usage of simple no-frills LLC agreements" among even those who are represented by attorneys (85 percent). Miller, *What Fiduciary Duties Should Apply*, *supra* note 12, at 585.

operation may be overlooked or left unaddressed in the operating agreement. Even if the parties choose to be represented by a lawyer, that lawyer may not necessarily understand the implications of waiving fiduciary duties, and therefore, may not be an appropriate agent to inform the client.[112]

This becomes an even larger issue if informational sophistication is not symmetrical. Given the complexity of this area of law, opportunities for exploitation that arise from one party having more information regarding waiver are substantial. Unsophisticated parties may not notice they have waived their fiduciary duties, thereby permitting a potentially large disproportional benefit for the other party. Similarly, if one party is unaware of the implications of that duty, that party may not know to ask relevant questions prior to agreeing to such waiver, including questions such as whether the person had any current conflicts of interest or planned to knowingly compete against the company. Indeed, one study suggested that, of the attorneys polled, 56 percent involved in LLC formation frequently represented controlling interests, as compared to only 20 percent who frequently represented minority interests.[113] This suggests that there are far fewer minority interests able to leverage the potential knowledge of their attorney than majority interests, who, therefore, may try to take advantage of the minority investors' lack of knowledge.

C. THE FUNDAMENTAL EXPECTATION OF FIDUCIARY DUTIES

One of the other significant oversights in Delaware's statutory construction is that it underestimates how engrained fiduciary duties are in the formation of any management-investor relationship. As Professor Lyman Johnson states, "the [contractarian] model ignores the way in which the very practice of contracting in markets is grounded on noncontractual social and legal values."[114] LLCs are, by definition, a business entity. In all

112. In Professor Miller's study, only 43 percent of Delaware lawyers participated in continuing legal education on fiduciary duties, and only 19 percent of lawyers from other states surveyed participated. *Id.*

113. *Id.* at 584. A subsequent study showed a slightly less skewed result (84 percent versus 67 percent), but Professor Miller suggested that these numbers were misleadingly close, as there are far more minority interest holders than majority interest holders. *Id.* at 585. In addition, Professor Miller's study only polled attorneys, and thus, does not capture the statistics related to unrepresented parties. *Id.* at 584–85.

114. Johnson, *supra* note 83, at 894. *See also* Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 249 (1994) ("Given the limits of cognition, the core duty-of-loyalty rules should not be subject to a general waiver."). Professor Eisenberg asserts that when persons contract they have "undue optimism" and, therefore, tend to judge the other party based on their relationship at the time they are contracting. *Id.* Hence, parties tend to underestimate the risks that

other traditional forms of business entities, and even LLCs in other states, investors can correctly assume that fiduciary duties are implicit rights.[115] Not only is this assumption of trust between an investor and the investee based in historical practices, but it also accords with our intuitive sense of fairness. Much as the hypothetical at the beginning of this Note seemed intuitively wrong, this fundamental expectation of a trust-based relationship is one that investors likely will carry implicitly with them into any arrangement with LLCs. Delaware's response of merely changing the statute and affirming its desire to promote the freedom to contract seems to give inadequate notice to overcome the "generally shared expectations of corporate behavior."[116]

The fundamental nature of fiduciary duties also explains why waivers should be treated with special concern from a practical perspective. Fiduciary duties, as the baseline standards of conduct for the relationship between manager and investor, have the potential to influence the meaning of almost every term within the operating agreement. Any term in the operating agreement that requires a manager's discretion, including day-to-day operations, decisions to sell the company, expansion of the company, capital calls, disbursements, or profit allocations, could be potentially impacted by a change in the fiduciary relationship between the parties.[117] By changing these duties, it not only changes a manager's accountability to an investor in the abstract, but also the level of scrutiny applied by the courts for every action that the manager takes.[118] This pervasive nature of fiduciary duties within an LLC agreement justifies significant caution in permitting their waiver.

waivers will entail, and waivers tend to allow opportunistic behavior. *Id.*

115. *See supra* Parts II–III.A (discussing traditional fiduciary duties and LLCs); Scott Gordon Wheeler, Comment, *LLC Fiduciaries: Where Has All the Good Faith Gone?*, 59 U. KAN. L. REV. 1063, 1090 (2011) ("Unlike most contracts, the formation of an LLC envisions joint and sustained enterprise.").

116. Johnson, *supra* note 83, at 886. *See generally* Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990) (exploring influence of interest groups on court outcomes).

117. *See* Eisenberg, *supra* note 114, at 249 ("[B]ecause of bounded rationality the beneficiaries could not possibly identify all the varying circumstances to which a general waiver of the duty of loyalty would apply.").

118. In Delaware, if fiduciary duties are eliminated in an LLC, the standard of good faith and fair dealing would be the only standard by which courts would interpret managers' actions, unless otherwise specified in the agreement. *See supra* text accompanying notes 89–96 (discussing the expectations of contracting parties).

V. POTENTIAL SOLUTIONS

Although many commentators have been quick to acknowledge the shortcomings of Delaware's approach to waiving fiduciary duties,[119] few have explored any solutions in detail. Solutions to address these issues fall into two general categories: substantive limitations within the statute and disclosure requirements.

A. EXPANDED SUBSTANTIVE LIMITATIONS

Expanded substantive limitations, such as the manifestly unreasonable[u1] requirement under the RULLCA (or the informed consent restriction under California's statute), that provide more protection for investors than the good faith and fair dealing requirement are a tempting solution, as they seem like a fair balance between the benefits and disadvantages of permitting waivers. On the one hand, by not prohibiting *all* waivers of fiduciary duties, these restrictions recognize that there may be some instances in which waivers should be permitted. On the other hand, these restrictions also recognize the risks inherent in permitting waiver, such as the potential for abuse or knowledge asymmetry.[120] To balance these concerns, substantive restrictions allow for a context-sensitive approach: judges use commonsense discretion in their evaluation of a waiver provision in light of all the information available surrounding the provision, and in doing so, avoid unfair outcomes, by calibrating the specific circumstances of that case.

However, Delaware has made it clear that such expanded limitations are against its policy of maximizing the freedom of contract, since such a limitation would expressly limit which terms parties can negotiate.[121] Such limitations also greatly inhibit predictability for the negotiating parties by inviting ex post judicial second-guessing of whether their terms meet those limitations, which could unravel the bargained-for terms of an agreement. While Delaware courts seem willing to second-guess the fairness of the negotiations that take place,[122] they do not want to review the fairness of

119. Campbell, *supra* note 8, at 51 (identifying the opting out standards of the RULLCA as "need[ing] adjustments"); Ribstein, *supra* note 16, at 927–30 (discussing fiduciary duties in the Uniform Limited Partnership Act); Vestal, *supra* note 16, at 540 (discussing parties' ability to predict "unforeseen variations" in the partnership context).

120. *See supra* Part IV.B (discussing the relative knowledge of parties when waiving fiduciary duties).

121. *See* DEL. CODE ANN. tit. 6, § 18-1101(b) (2013) (seeking to give the "maximum effect to the freedom of contract").

122. This seems to be the suggestion of the definition of good faith and fair dealing, as implied by

the terms themselves, as would be the risk with substantive limitations such as reasonableness. In addition, such restrictions do not themselves ensure the parties know of those limitations prior to negotiating the terms, and thus, do not truly resolve the issue of asymmetrical information (the fairness of the negotiations). Instead, such limitations simply kick the can down the road. Thus, such substantive limitations are an inappropriate solution for Delaware.[123] Instead, these concerns must be addressed in a way that avoids contractual uncertainty by not only limiting judicial discretion in analyzing the content of the agreement, but also stimulating information sharing between the parties to allow for informed negotiations.

B. Disclosure and Information Sharing

To that end, requiring some form of disclosure or information sharing for the elimination or modification of fiduciary duties in Delaware would be an elegant solution to many of the issues present in its current fiduciary duty waiver provisions. The numerous potential benefits to disclosure requirements include the following:

1. Notice

First, requiring information sharing between negotiating parties would ensure that both parties understand that fiduciary duties can be waived and whether or not they are being waived in their agreement. As previously mentioned, although Delaware technically may have abolished the expectation of trust-based standards in LLCs, that does not mean that the participating investors are aware of this change, particularly when it does not comport with their expectations. By requiring disclosure, the legislature can promote more efficient dissemination of a change in the law, rather than simply relying on statutory amendments or case decisions.[124] Furthermore, requiring disclosure can resolve issues of subversive or

the Delaware courts.

123. The good faith and fair dealing restriction in Delaware may be subject to similar criticism given the more expansive interpretation that integrates the expectations of trust between the parties. Limiting the interpretation of good faith and fair dealing to a contractual interpretation avoids imposing judicial interpretation *over* the express terms of the agreement and does not expressly limit what terms can and cannot be negotiated. It is for this reason that the latter interpretation is a more appropriate interpretation of Delaware's statute in light of its legislative purpose. *See supra* text accompanying notes 87–96 (discussing recent case law on good faith and fair dealing).

124. Evidence suggests that these forms of dissemination do little to inform public investors, much less investors in closely held LLCs, which means that investors still might not be aware of the law when negotiating agreements. *See supra* text accompanying note 109 (discussing the relative understandings of parties regarding corporate law and fiduciary duties).

accidental waiver. The sufficiency of the disclosure may come under the court's scrutiny, thus, incentivizing clear information sharing.

2. Informational Asymmetry

Disclosure can also protect against informational asymmetry between parties. If, for example, the disclosure requirement demanded a clear explanation of the law, it would reduce the risks of one party having disproportionate understanding of the underlying legal concepts. Even if the language is itself insufficient to fully inform a less sophisticated party, its prominence in the agreement might prompt discussion so as to help that person better understand the law, more adequately appreciate and value the associated risks, and participate in informed negotiations.

In addition, if the disclosure calls on the party seeking waiver to disclose any existing or planned action that would otherwise create a breach of fiduciary duties, it would help to alleviate the concerns of fact-specific, informational asymmetry. In theory, any intentional or planned breach would be shared between the parties and would permit the uninformed party to factor that information into its risk evaluation. This structure incentivizes maximum disclosure by providing a safe harbor against allegations of fraud or breach of good faith for specific, well-defined disclosures.[125]

3. Promoting Contractarian Policy

As stated before, the goal of contractarian policy is to permit parties to freely negotiate for any terms they desire. Creating a disclosure requirement does not create inconsistencies with this policy; in fact, it may remedy some of the largest criticisms rallied against it. Contractarian theory relies on the presumption that investors know the law. This presumption is only correct if the law is sensible and aligns with investors' intuitions.[126] By adding a disclosure requirement, Delaware can protect parties whose intuitions do not align with the current law. This is achieved

125. This sort of requirement also raises important questions regarding what level of disclosure should be sufficient. This subject is discussed in greater detail *infra* Part VI.

126. *See* Brudney, *supra* note 75, at 1411–12 ("[I]nvestors are assumed to know not only the essential terms of the arrangements with management in the particular corporation, but to understand the possibilities for managerial discretion embodied in relevant corporate statutes and case law."); Johnson, *supra* note 83, at 887–88 (suggesting that solutions for corporate legal issues will "ultimately be found outside the walls of corporate law" and will instead be "rooted in exogenous and broad-based social norms"), *supra* text accompanying notes 50–57 (discussing California and the RULLCA's more cautious approach to modifying fiduciary duties).

not by patronizing the investors, but by putting them on notice of the potential gap in their understanding of the law ex ante and giving them an opportunity to bridge that gap. A disclosure requirement does not obligate, nor should it obligate, the unknowledgeable party to become informed. Instead, the goal should be to give them a reasonable opportunity to do so. In this sense, a disclosure requirement may reinforce the legislature's goal to promote the freedom of contract by addressing the potential informational asymmetry and providing a forum ex ante in which parties are more able to understand and negotiate the terms of the deal.

VI. CONCEPTUALIZING DISCLOSURE: THEORY AND THE TREATMENT IN OTHER FORMS OF PROSPECTIVE LIABILITY WAIVERS

Although disclosure is an enticing requirement, it is important to remember that disclosure requirements themselves prescribe a complex weighing of various concerns and policies and can take many forms. One academic, for example, has suggested that waivers of fiduciary duties should require "a prominent, concise statement in plain English on the outside front cover page of the operating agreement describing and explaining the essential terms of the opt-out and the reformulat[ion]" of the parties' fiduciary duties.[127] California, for example, has adopted the broad requirement of informed consent. Others have advocated that merely requiring the waiving language to be explicit would be adequate protection.[128] Further energy must be expended to explore what variables may be manipulated in the context of disclosure requirements and how these variables have been applied to other areas of law that also permit the prospective waiver of liability.

A. THEORY

In its most basic form, disclosure requirements are about requiring a particular party to ensure that the other party understands the law or situation to which he or she is consenting.[129] In the legal context, disclosure

127. Campbell, *supra* note 8, at 44 .

128. *See, e.g.*, Wheeler, *supra* note 115, at 1094 (stating that Kansas should require waivers to be explicit to avoid uncertainty between the parties).

129. *See* RUTH R. FADEN & TOM L. BEAUCHAMP, A HISTORY AND THEORY OF INFORMED CONSENT 26–31 (1986) (discussing the legal functions underlying informed consent in the context of a doctor's duty to provide informed consent); John L. Diamond, *Assumption of Risk After Comparative Negligence: Integrating Contract Theory into Tort Doctrine*, 52 OHIO ST. L.J. 717, 738–39 (1991) (discussing the treatment of culpability for defendants in various tort cases involving the assumption of

requirements arise under various doctrinal names depending on the law, such as mandatory disclosure, assumption of risk, or informed consent, and each have slight differences in structure and function. In reviewing these doctrines, it is useful to first break down these requirements into the three separate decisions that must be made in constructing any disclosure regime: (1) who must disclose; (2) what information is required to be disclosed; and (3) whether there are any implied or express limitations to the effectiveness of the disclosure.

The allocation of the duty to provide disclosure, quite sensibly is generally allocated to a party seeking exculpation from a preexisting or presumptive duty.[130] However, the amount and type of information provided in a disclosure requirement, as well as the burden of proof, can vary greatly. At its most limited, the disclosure can merely require the disclosing party to provide legislatively generated information, often in the form of a mandatory disclosure document.[131] In these cases, the burden of proof for disclosure is merely providing the document, and there is no burden of proving the sufficiency of the disclosing language. More commonly, disclosure requirements obligate the disclosing party to provide information they create themselves. The obligation to provide information can also vary greatly in the depth of information required. Disclosure requirements can mandate disclosure of (1) only facts; (2) the facts and the potential nonlegal consequences of those facts; or (3) the facts, their nonlegal consequences, and the legal consequences. For example, a law can require disclosure of a fact,[132] a consequence,[133] or all three.[134] Under these types of disclosure, the disclosing party generally must prove not only that he or she provided the waiver, but also that the waiver itself was sufficient to adequately explain the risks. How much information is required is typically dictated by a balancing of the need for paternal protection of the

risk).

130. Examples of this are tort liability waivers, doctor-patient informed consent, or advanced waivers in the legal practice. *See infra* Part VI.B (discussing the relative knowledge of parties).

131. *See infra* Part VI.B.4 (discussing legislatively generated disclosure mandates).

132. For example, the phrase "passenger acknowledges that this airplane may explode" connected to the purchase of a plane ticket.

133. For example, the phrase "this airplane may explode, which may cause death or serious harm" connected to the purchase of a plane ticket.

134. For example, the phrase "this airplane may explode, which may cause death or serious harm, and that by signing, the passenger hereby agrees that he or she is waiving the ability to sue carrier for those harms" connected to the purchase of a plane ticket. For doctor-patient informed consent, it generally requires disclosure of only facts and nonlegal consequences. *See infra* Part VI.B.2 (discussing informed consent in the medical profession). Lawyers, in contrast, generally are required to disclose facts, nonlegal consequences, and legal consequences. *See infra* Part VI.B.3 (discussing informed consent in the legal profession).

waiving party against the burden it creates for the disclosing party.

Disclosure requirements also are often combined with other express limitations, such as the fiduciary duty waiver provisions in Delaware LLCs. In addition, there are often implied limitations based on how much information must be provided. For example, if the waiver must include specific potential consequences of unforeseen or unforeseeable events, there would be a potential implied limitation based on the ability to predict these events. In those cases, general waiver likely would be impossible.

B. OTHER FORMS OF PROSPECTIVE LIABILITY WAIVERS

The concept of prospective liability waivers is not unique to LLCs. In addition to permitting duty of care waivers in traditional corporate law,[135] many other areas of law have dealt with similar waivers of liability in presumed relationships of trust and have had much more time to be tested and evolve than the laws governing LLCs.[136] As such, these areas of law may help illuminate the policies behind permitting such waivers, suggest solutions, and direct us to a more properly aligned outcome.

1. Common Law Liability Waivers in Tort

One of the most basic and historic forms of prospective waivers are liability waivers in tort, often referred to as "express assumptions of risk."[137] In this context, a party is not seeking the waiver of a fiduciary duty, but rather is using contractual means to limit the implied duty of care that is otherwise owed to the public at large.[138]

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135. *See supra* text accompanying note 127 (discussing disclosure of fiduciary waivers in a prominent front cover page).

136. For example, doctor-patient informed consent was articulated as an independent cause of action in negligence for the first time in 1957. Richard A. Heinemann, Note, *Pushing the Limits of Informed Consent:* Johnson v. Kokemoor *and Physician-Specific Disclosure*, 1997 WIS. L. REV. 1079, 1081–82 (1997) (citing Salgo v. Leland Stanford Jr. Univ. Bd. of Trs., 317 P.2d 170, 181 (Cal. Dist. Ct. App. 1957)). *See also* Taylor v. Chicago, R.I. & P. Ry. Co., 170 N.W. 388, 391 (Iowa 1919) (involving waiver of an employer's negligence); Boll v. Sharpe & Dohme, Inc., 121 N.Y.S.2d 20, 21–22 (App. Div. 1953) (involving express waivers of due care liability). Also, it is important to note that this section is intended to illustrate the policy considerations involved in permitting advanced waiver. These examples are of trust-based relationships, rather than contractual ones.

137. RESTATEMENT (SECOND) OF TORTS § 496(B) (1965) (defining express assumption of risk as "[a] plaintiff who by contract or otherwise expressly agrees to accept a risk of harm arising from the defendant's negligent or reckless conduct" and stating that such person "cannot recover for such harm, unless the agreement is invalid as contrary to public policy"). The original concept of assumption of risk in tort liability appeared around 1900, deriving from the master-servant relationship in certain employment contexts. *See, e.g.*, *Taylor*, 170 N.W. at 389 (discussing the assumption of risk during plaintiff's employment in a train yard).

138. *See* Palsgraf v. Long Island R. Co., 162 N.E. 99, 102 (N.Y. 1928) (Andrews, J., dissenting)

As with fiduciary waivers, courts have recognized the important and often necessary role liability waivers have in society permitting desirable activities, such as high-risk recreational activities,[139] employment, or transportation. However, the common law has developed a number of important restrictions to this right. As a preliminary matter, such waiver is ineffective for intentional, reckless, or grossly negligent torts,[140] avoiding the promotion of socially undesirable activities. Similarly, the waiver must be subject to a meaningful bargaining opportunity and not simply an adhesion contract, such that it reflects an actual, bargained-for exchange.[141]

In terms of the waiver itself, exculpation will only be effective to the extent that the waiving party reasonably understands the particular risk involved.[142] Thus, the language of the waiver cannot be general or overbroad and must reasonably identify the magnitude or probability of the specific risk, if it is not reasonably self-evident.[143] Similarly, courts look

("Due care is a duty imposed on each one of us to protect society from unnecessary danger, not to protect [certain specific people] alone.").

139. *See* Alexander J. Drago, *Assumption of Risk: An Age-Old Defense Still Viable in Sports and Recreation Cases*, 12 FORDHAM INTELL. PROP. MEDIA & ENT. L.J. 583, 608 (2002) ("Courts generally allow a defendant to avoid liability in sports or recreational cases if the plaintiff has expressly relieved the defendant of liability (by release and waiver), or if the injury was caused by a risk inherent in the activity."); Knight v. Jewett, 834 P.2d 696, 711 (Cal. 1992) ("[A] participant in an active sport breaches a legal duty of care to other participants—i.e., engages in conduct that properly may subject him or her to financial liability—only if the participant intentionally injures another player or engages in conduct that is so reckless as to be totally outside the range of the ordinary activity involved in the sport."); *id.* at 722 (Kennard, J., dissenting) (disagreeing with the majority's "no-duty-for-sports rule"); Gauvin v. Clark, 537 N.E.2d 94, 96 (Mass. 1989) ("The courts are wary of imposing wide tort liability on sports participants, lest the law chill the vigor of athletic competition.").

140. *See* Jones v. Dressel, 623 P.2d 370, 376 (Colo. 1981) ("An exculpatory agreement . . . must be closely scrutinized, and in no event will such an agreement provide a shield against a claim for willful and wanton negligence.") (citing Barker v. Colo. Region-Sports Car Club of Am., Inc., 532 P.2d 372, 376–78 (Colo. App. 1974)); Falkner v. Hinckley Parachute Ctr., Inc., 533 N.E.2d 941, 946 (Ill. App. Ct. 1989) (finding liability for "willful and wanton conduct"); Boucher v. Riner, 514 A.2d 485, 488 (Md. Ct. Spec. App. 1986) (finding liability for "willful, wanton, reckless, or gross conduct").

141. *See Jones*, 623 P.2d at 374 (finding assumption of the risk comes from "accept[ing] the benefits of a contract"); Masciola v. Chi. Metro. Ski Council, 628 N.E.2d 1067, 1071 (Ill. App. Ct. 1993) (finding assumption of the risk must not be based on a "substantial disparity in the bargaining position of the parties"); Weaver v. Am. Oil Co., 276 N.E.2d 144, 148 (Ind. 1971) (finding assumption of the risk agreements "unconscionable . . . due to a prodigious amount of bargaining power" held by one party); Barnes v. N.H. Karting Ass'n, 509 A.2d 151, 154 (N.H. 1986) (prohibiting "obvious disadvantage[s] in bargaining power"); Allright, Inc. v. Elledge, 515 S.W.2d 266, 267 (Tex. 1974) (invalidating an assumption of the risk agreement due to a "disparity of bargaining power").

142. *See, e.g.*, Sirek v. Fairfield Snowbowl, Inc., 800 P.2d 1291, 1295 (Ariz. Ct. App. 1990) ("[The] language should alert the party agreeing to such a provision that it is giving up a very substantial right."); Brown v. Racquetball Ctrs., Inc., 534 A.2d 842, 843 (Pa. Super. Ct. 1987) ("[The agreement should] spell out the intention of the parties with the greatest of particularity.").

143. *See* Gilkeson v. Five Mile Point Speedway Inc., 648 N.Y.S.2d 844, 846 (App. Div. 1996) ("The release makes no reference to specific risks inherent in [the event], but merely refers to assuming

less favorably on waivers that are in small print, hidden in the document, use obtuse language, or otherwise undermine reasonable notice of the waiver.[144] In this sense, sophistication of the waiving party is normalized to an objective reasonableness standard, taking into account the context of the transaction and a jury's common sense.

Also, since the assumption of risk doctrine is an affirmative defense to a negligence claim,[145] the burden of proof of sufficient notice rests with the party seeking to enforce the waiver. Thus, the benefitting party is greatly incentivized to provide any waiver in clear, prominent, and easily understood language that fully explains the risks involved.[146] Similarly, this doctrine does not excuse the party seeking exculpation if that party is itself unsophisticated or unknowledgeable of those risks. As the party offering the activity or service, it is presumed to have experience in that activity and is, thus, responsible for knowing of the risks inherent in it. It is no excuse, for example, for a party to claim that it was unaware of the risks involved and relied on general exculpatory language. In this sense, it is the duty of a person seeking the benefit of the waiver both to understand the risks of the activity and to explain those risks to the participant.

2. Informed Consent in the Medical Profession

The doctor-patient relationship represents one of the most fundamental fiduciary relationships in our society.[147] A doctor, entrusted with a patient's life, is held to the highest standards of care and competency.[148] Not only are doctors prevented from obtaining informed

the risk of the negligence of the releasees which may cause serious injury or death. We conclude that plaintiff was not apprised of the risks involved in the situation." (internal quotation marks omitted)); Diamond, *supra* note 129, at 741–42 ("[A]ssumption of the risk requires knowledge of a specific risk." (internal quotation marks omitted)).

144. Drago, *supra* note 139, at 589–90.

145. Stanton v. Miller, 583 N.E.2d 1080, 1081 (Ohio Ct. App. 1990); Howell v. Clyde, 620 A.2d 1107, 1113 (Pa. 1993).

146. In fact, many states require these standards to create an enforceable waiver. *See, e.g.*, Paralift, Inc. v. Superior Court, 29 Cal. Rptr. 2d 177, 182 (Ct. App. 1993) (finding that a skydiving release was "a clear unequivocal wavier of liability for negligence and contains no ambiguities in expressing the intent of the parties"); Madison v. Superior Court, 250 Cal. Rptr. 299, 304 (Ct. App. 1988) (finding sufficient "heavy bold type . . . expressly stat[ing] . . . relie[f] from any liability for . . . negligence").

147. The Hippocratic Oath, setting forth the essential tenets of a doctor's fiduciary duty to patients, has existed since antiquity. Peter Tyson, *The Hippocratic Oath Today*, NOVA (Mar. 27, 2001), http://www.pbs.org/wgbh/nova/body/hippocratic-oath-today.html (last visited Apr. 13, 2013).

148. *Id.* Due to their compensation structure, and their interaction with clients, doctors have fewer conflicts of interest or breaches of the duty of loyalty than the duty of care. That does not mean, however, that conflicts do not exist. *See, e.g.*, Daniel Carlat, Op.-Ed., *Diagnosis: Conflict of Interest*, N.Y. TIMES, June 13, 2007, at A21, *available at* http://www.nytimes.com/2007/06/13/opinion/13carlat.

consent to waive their duty of care, but also absent an emergency in which patient consultation is impossible, doctors are not even permitted to make decisions for patients without their informed consent.[149] This consent, to be effective, requires that "patients . . . know and understand all relevant information concerning their medical condition and the proposed treatment, including the risks, benefits, and alternatives to the proposed treatment."[150] Initially, this standard was evaluated from the perspective of what a reasonable doctor would provide in the circumstances. However, as time went on, this standard evolved from normalization based on the perspective of the information-providers (for example, doctors know best as to what would be sufficient information) to a requirement that doctors provide all the information that a reasonable patient would want in the situation.[151] Commentators suggest that this change was caused by the fear of the "conspiracy of silence," which suggests that, by allocating the sufficiency requirement to the party that was required to disclose, it incentivized doctors to collude with one another to lower the standards of sufficient disclosure.[152] Thus, in response, courts reallocated the burden of proving sufficiency to doctors.

html?_r=l& (suggesting that there are risks of conflicts of interest when pharmaceutical companies subsidize the training costs of doctors).

149. *See, e.g.*, Canterbury v. Spence, 464 F.2d 772, 780 (D.C. Cir. 1972) ("[C]onsent . . . is the informed exercise of a choice, and that entails an opportunity to evaluate knowledgeably the options available and the risks attendant upon each."); Wall v. Brim, 138 F.2d 478, 481 (5th Cir. 1943) (finding liability where a surgeon proceeded with a complicated surgery when the patient only agreed to a simple procedure); Natanson v. Kline, 350 P.2d 1093, 1103 (Kan. 1960) (finding that "where the physician . . . has failed to point out the probable consequences of the course of treatment, he may be subjected to a claim of unauthorized treatment"); Gray v. Grunnagle, 223 A.2d 663, 668–69 (Pa. 1966) (describing consent as "an active circumstance of concurrence"). Allegations of this type generally are raised as negligence claims, but also are brought as breaches of contract and agency law. *See Gray*, 223 A.2d at 669 (stating that the bargained-for exchange is good medical information and treatment for payment, and failure to get consent is a breach). Furthermore, the requirement of informed consent is assumed in emergency situations in which informed consent is rendered impossible. *Wall*, 138 F.2d at 481.

150. Cathy J. Jones, *Autonomy and Informed Consent in Medical Decisionmaking: Toward a New Self-Fulfilling Prophecy*, 47 WASH. & LEE L. REV. 379, 427 (1990).

151. Richard E. Shugrue & Kathryn Linstromberg, *The Practioner's Guide to Informed Consent*, 24 CREIGHTON L. REV. 881, 884–86, 901 (1991) (citing the evolving theory of self-determination of the rights of patients in informed consent cases).

152. *Id.* at 901.

3. The Law Governing Lawyers[153]

a. On Waiving Conflicts of Interest

Perhaps one of the most apt comparisons to the waiver of fiduciary duties is the advanced waiver of conflicts of interest in the practice of law. Like directors and officers of a corporation, state bar associations place severe restrictions on lawyers for conflicts of interests.[154] However, unlike corporate management, in which one management position will likely be enough to support full-time employment, one client is rarely sufficient to support an entire law practice and most lawyers work for multiple clients. Thus, there is a greater likelihood for potential conflicts.[155] In this sense, lawyers face many of the same pressures that have drawn people to advocate for prospective waivers of fiduciary duties in LLCs, and like LLCs, advanced waivers similarly are hotly debated.

Under the Model Rules of Professional Conduct ("Model Rules"), prospective waivers of conflicts of interest are permitted to the extent "the client reasonably understands the material risk that the waiver entails"[156] and "the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client."[157] The Restatement (Third) of The Law Governing Lawyers largely echoes this approach.[158] The client's understanding of the "material risks" are dependent on an "affirmative revelation by the attorney of all the facts, legal implications, possible effects, and other circumstances relating to the

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153. In the following section, I will focus heavily on the 2009 ABA Model Rules of Professional Conduct and Restatement (Third) of the Law Governing Lawyers.

154. *See infra* text accompanying note 167 (discussing lawyer's reasonable beliefs regarding conflicts of interest).

155. ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 372 (1993) (withdrawn based on other grounds in ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 436 (2005)). This is particularly true in light of the imputation rules that govern lawyer's conduct. *See, e.g.*, Silver Chrysler Plymouth, Inc. v. Chrysler Motors Corp., 518 F.2d 751, 754 (2d Cir. 1975) (reasoning that the greater potential for conflict in large firms necessitates determining whether a former lawyer was in a position to obtain confidential information before imputing conflict of interest to him from his former firm); MODEL RULES OF PROF'L CONDUCT R. 1.9(b) (2010) (imputation of conflict of interest from former firm).

156. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 22. The Model Rules define informed consent broadly, requiring the lawyer to provide "adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." *Id.* R. 1.0(e).

157. *Id.* R. 1.7(b)(1). The Model Rules also limit waivers that would otherwise be prohibited by law or involve assertions of claims in direct opposition of one another in front of the same tribunal. *Id.* R. 1.7(b)(2)–(3).

158. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. d (2010).

proposed representation,"[159] as well as the client's "sophistication in the matter in question."[160] In this sense, as with tort liability waivers, the efficacy of waiver depends on the client's subjective understanding of the associated risks. The lawyer, as the beneficiary of the waiver, bears the burden of adequately disclosing those risks.[161] In addition, these risks include not just the asymmetry of personal information available to the lawyer, such as his or her client lists, prospective clients, and the likelihood of one of those clients coming into conflict, but also the potential asymmetry of legal knowledge (which can be attributed to the lawyer's professional training in the law).

Although both the Model Rules and Restatement seem to struggle with the extent to which prospective waiver is possible,[162] both suggest that it may be theoretically possible to provide general prospective waiver for most conflicts, provided the client is sufficiently sophisticated and independently represented.[163] This suggestion, however, seems misguided. For one, although independent representation may supplement the client's knowledge of the legal profession, it cannot act as a proxy for the specific facts surrounding potential client conflicts and the practice of the lawyer seeking waiver. Furthermore, the uncertainty of facts surrounding the

159. Fin. Gen. Bankshares Inc. v. Metzger, 523 F. Supp. 744, 771 (D.D.C. 1981).

160. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. d. *See also* MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 22 (discussing the reasonable understanding of the parties in waiving conflicts of interest). It is unclear precisely what "sophistication in the matter in question" means, but the Model Rules suggest it may mean sophistication in conflicts of interest (such as lawyers themselves, or a large corporation that has had substantial experience with lawyers and their conflicts). *Id. See also* Nathan M. Crystal, *Enforceability of General Advance Waivers of Conflicts of Interest*, 38 ST. MARY'S L.J. 859, 873–76 (2007) (suggesting that sophistication in the matter in question is vague, and no courts have clearly ruled on this basis).

161. Also, as with tort liability waivers, the lawyer-defendant must prove not only that the waiver was given, but also that the waiver provided sufficient language to adequately inform his or her client.

162. *See* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. d (discussing a client's consent to future conflicts); MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 22 (same). This implication comes from the fact that the client cannot effectively appreciate the possible effects of such a waiver. *Id.*

163. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 122 cmt. d. The suggestion of independent representation implies the protection of an additional fiduciary, which operates similarly to the role of directors in a traditional corporate model. *See* MODEL RULES OF PROF'L CONDUCT R. 1.0 cmt. 6 ("[G]enerally, a client or other person who is independently represented by other counsel in giving the consent should be assumed to have given informed consent."); *supra* text accompanying notes 40–41 (discussing wavier by vote of informed, disinterested directors). The exceptions to general waiver are suggested to be limited only by representation "prohibited by law" or representing directly adverse litigants. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(2)–(3) (allowing waiver when the "representation is not prohibited by law" or "does not involve the assertion of a claim by one client against another client . . . in the same litigation"); ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 436 (2005) (same).

original lawyer's practice may impliedly limit some forms of adequate disclosure, due to both unforeseeable future events and the potential confidentiality conflicts in even disclosing the information necessary to obtain informed consent.[164] Thus, it seems unlikely that the informational asymmetry could ever be adequately bridged to permit general prospective waiver in some cases.

As a policy matter, advocates for the broad permissibility of waiver to conflicts of interest claim it is justified because it gives clients the freedom to choose who represents them.[165] This argument—that clients should be able to evaluate the potential risks of hiring a conflicted or potentially conflicted lawyer and make their own informed decision—essentially echoes the contractarian arguments in favor of LLC waivers.[166] However, this is an imperfect analogy. Conflict waivers in the legal profession are subject to very restrictive express limitations. For example, a client may withdraw his or her waiver at any time, and waivers of future conflicts become ineffective if the attorney can no longer reasonably believe he or she can serve both clients with adequate competence and diligence.[167] Thus, the interplay of the various Model Rules suggest a much narrower window of conduct than the waiver provisions themselves suggest, emphasizing the permissibility of waiving technical violations, rather than ones that could actually substantively harm a client.

b. On Waiving Attorney Malpractice Liability and Defining the Scope of Representation

The rules are far less forgiving in the area of prospectively waiving attorney malpractice liability. The Model Rules suggest any prospective limitation on a lawyer's liability is a violation of the rules unless the client is independently represented.[168] Although this may seem like a fairly

164. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (requiring informed consent prior to disclosing any "information relating to the representation of the client").

165. Jonathan J. Lerner, *Honoring Choice by Consenting Adults: Prospective Conflict Waivers as a Mature Solution to Ethical Gamesmanship—A Response to Mr. Fox*, 29 HOFSTRA L. REV. 971, 972 (2001) (arguing that the prohibition of the use of waivers prevents "one of the most sacrosanct client rights—the right to select counsel of choice").

166. Similar concerns of agency costs, such as malpractice litigation and rising fees, are also prevalent. *See, e.g.*, Richard W. Painter, *Advance Waiver of Conflicts*, 13 GEO. J. LEGAL ETHICS 289, 312 (2000) (arguing that a "bright line rule[ ]" should be used as to prevent increases in fees arising from uncertainty).

167. MODEL RULES OF PROF'L CONDUCT R. 1.7 cmt. 21. Whether such revocation requires the lawyer to stop representing other clients depends on the surrounding circumstances. *Id.* As discussed previously, *see supra* Part VI.B.3.a, these waivers of conflicts cannot function to alleviate liability for malpractice.

168. MODEL RULES OF PROF'L CONDUCT R. 1.8(h).

relaxed standard, the Model Rules acknowledge that any waiver of liability may "undermine competent and diligent representation,"[169] and make it clear that the other rules of professional conduct still apply.[170] This suggests that although the existence of an agreement limiting malpractice liability may not violate the Model Rules, any violation of diligence or competence would, and may result in disciplinary actions. The Restatement (and courts generally) takes a stronger stance against liability waivers, simply stating that "[a]n agreement prospectively limiting a lawyer's liability to a client for malpractice is unenforceable."[171] In fact, the Restatement expressly states that a lawyer will be subject to professional discipline for making such an agreement, regardless of whether his or her client is independently represented.[172] However, both the Model Rules and the Restatement permit the limitation of scope of services, so long as it is "reasonable under the circumstances and the client gives informed consent."[173] As with waivers of conflicts of interest, the reasonableness of the consent depends on how extensive the disclosure was to the client (including the disadvantages, nonlegal consequences, and legal consequences of the waiver), how close to the formation of the relationship the limitation was given, the relative sophistication of the client, and all other circumstances.[174] The reasonableness of a limitation on scope also factors in the amount of payment received by the lawyer for limited service.[175]

Although seemingly contradictory, the conflict and malpractice rules represent an important distinction. The malpractice rule suggests that, once a duty is formed between a lawyer and client over a certain matter, a lawyer cannot convince a client to waive the lawyer's liability should he or she perform that service inadequately. This rule seems to be particularly concerned with preventing lawyers from getting away with poor service within the scope of their expected duties. However, a lawyer can limit the

169. *Id.* R. 1.8 cmt. 14.

170. *See id.* R. 1.2 cmt. 8 ("All agreements concerning a lawyer's representation of a client must accord with the Rules of Professional Conduct and other law.").

171. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 54(2) (2010).

172. *Id.* § 54(4).

173. MODEL RULES OF PROF'L CONDUCT § 1.2(c). *See also* RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 19(1).

174. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 19(1). The Restatement also makes it clear that any contract limiting representation should be construed from the standpoint of a "reasonable client" in the given circumstances, suggesting the burden of proof remains with the lawyer. *Id.*

175. *Id.* This may suggest that the courts will look into the adequacy of the bargain itself as evidence of the parties' intent.

scope of his or her duties to a client prospectively, so long as he or she can adequately inform the client. Additionally, the scope rule seems to suggest that, so long as the scope of duties a lawyer owes to his or her client is well defined and bargained for, the parties can limit the lawyer's responsibilities to the client. This dichotomy seems to mimic the contractarian debate in LLCs, in that the desirability of permitting waiver depends largely on what duties are fairly expected by the unknowledgeable party.[176] However, unlike the fiduciary waiver laws in Delaware, limitations to a lawyer's scope of duties are only permitted if they are reasonable; thus, they are far more protective of the nondisclosing party.

4. Legislatively Generated Disclosures

Another interesting, albeit rare, form of liability waivers involve legislatively generated disclosures required in various consumer-based markets.[177] These disclosure requirements typically dictate the content, form, and location of the disclosure expressly in the state itself.[178] In other cases, these disclosures may only provide a heading or template for the disclosure, and require some additional information be provided by the disclosing party.[179] These sorts of disclosures are generally used in transactions in which the disclosing party already has some duty to disclose, such as in residential real estate transactions,[180] lending,[181] and

176. *See supra* Part IV (discussing the potential problems with the Delaware waiver provision).

177. These forms have been used more frequently in certain states, such as California and Illinois, but have also been used in some federal regulations. *See, e.g.*, CAL. BUS. & PROF. CODE § 17530.7 (West 2013) (funeral casket warnings); CAL. CIV. CODE § 1793.23(f) (West 2013) (Lemon Law disclosure); 205 ILL. COMP. STAT. § 670/16(m) (2012) (Consumer Installment Loan Act); 815 ILL. COMP. STAT. § 137/95 (2012) (requiring a capitalized warning to be made prior to making a "high risk loan"); 12 C.F.R. § 213.3 (2013) (prescribing Regulation M disclosure requirements); 45 C.F.R. § 164.520(b) (2007) (requiring health information sharing disclosures). *But see* MICH. COMP. LAWS § 445.853 (2009) (regulating Michigan retail installment contract disclosures).

178. For example, the Illinois statute governing notice requirements for collision damage waivers relating to car rentals provides the notice language, as well as where in the contract the notice must be placed, and that it must be "in boldface type and in no smaller print than 10 point type." 625 ILL. COMP. STAT. § 27/20(b) (2012).

179. For example, the Health Insurance Portability and Accountability Act ("HIPAA") requires a separate disclosure for any health institution that takes a patient's information. This disclosure must include a heading that states, "THIS NOTICE DESCRIBES HOW MEDICAL INFORMATION ABOUT YOU MAY BE USED AND DISCLOSED AND HOW YOU CAN GET ACCESS TO THIS INFORMATION. PLEASE REVIEW IT CAREFULLY." 45 C.F.R. § 164.520(b)(1)(i). In addition, the regulations explain what information must be provided (including at least one example of the institution's procedures), and that it be written in plain language. *Id.* § 164.520(b)(ii)(a).

180. See Section 1102 of the California Civil Code for specific examples of the disclosure documents. CAL. CIV. CODE § 1102 (West 2013). A more in-depth explanation can be found at CAL. DEPT. REAL ESTATE, DISCLOSURES IN REAL PROPERTY 8 (6th ed. 2005), *available at* http://www.dre.ca.gov/files/pdf/re6.pdf (requiring disclosures in residential real estate transactions).

financial brokerage relationships,[182] but the legislature wanted to ensure the particular element of that disclosure was highlighted (especially if that element is significant or governs obtuse rules) to avoid informational asymmetry in negotiations. For example, when selling a "Lemon Law" vehicle in California, sellers have a duty to disclose that fact to any buyer.[183] However, in order to "serve the interests of consumers who have a right to information relevant to their buying decisions,"[184] the California legislature requires the buyer to sign a disclosure statement that reads,

> THIS VEHICLE WAS REPURCHASED BY ITS MANUFACTURER DUE TO A DEFECT IN THE VEHICLE PURSUANT TO CONSUMER WARRANTY LAWS. THE TITLE TO THIS VEHICLE HAS BEEN PERMANENTLY BRANDED WITH THE NOTATION "LEMON LAW BUYBACK."[185]

This type of disclosure raises two interesting concepts. First, although it does create a duty to disclose, the disclosing party's burden of proof is met merely by showing the signed disclosure statement, without having to prove the sufficiency of that language. In this sense, these types of disclosures act as a safe harbor for the disclosing party; once the legislatively generated disclosure statement is provided, the duty is met.[186] Second, these disclosures do not generally include an extensive description of the law or its consequences. Instead, they tend merely to indicate that particular legal rights may be affected,[187] which suggests that the legislature felt it was sufficient merely to make the nondisclosing party aware of the law, rather than explaining it to them. This suggests that the law in these cases is not preoccupied with providing complete informational symmetry, but instead providing fair notice to the

181. *See* 12 U.S.C. § 2603 (2006) (stating the regulatory agency uniform settlement statement for lending institutions); 205 ILL. COMP. STAT. § 670/16(m) (Consumer Installment Loan Act); 815 ILL. COMP. STAT. § 137/95 (requiring a capitalized warning to be made prior to making a "high risk loan"); Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 208–09 (2008) (surveying studies finding that financial education programs have no effect or only small paradoxical results).

182. *See, e.g.*, 815 ILL. COMP. STAT. § 175/15-30 (financial brokerage transactions).

183. CAL. CIV. CODE § 1793.22(f)(1) (West 2013).

184. *Id.* § 1793.23(a)(4).

185. *Id.* § 1793.23(f).

186. The nondisclosing party's only recourse (other than disputing the procedure in which he or she gave consent) would seem to be to challenge the validity or sufficiency of the law itself. Considering that the duty to disclose is itself legislatively generated, this seems unlikely to be a winning argument.

187. *See, e.g.*, 815 ILL. COMP. STAT. § 175/15-30 (financial brokerage transactions). HIPAA's required heading even goes a step further and reminds the reader to "PLEASE REVIEW IT CAREFULLY." 45 C.F.R. § 164.520(b)(1)(i) (2013).

nondisclosing party of a potentially harmful legal situation that they otherwise may have overlooked.

C. THE ANALOGY TO FIDUCIARY DUTIES IN LLCS

As this survey suggests, prospective waivers of duties in these other areas of law obligate the party seeking waiver to provide disclosure. Although this revelation ultimately may not be surprising, it reaffirms the concern that the law generally shows for individuals who might assume that a trust-based duty otherwise exists between the parties. The risk of insufficient disclosure lies with the party who seeks to modify or waive the relationship because that party is at fault for wanting to modify the relationship that is otherwise expected between the parties.

Although this may seem like an apt comparison for Delaware, it presupposes that the expectation of a duty exists and that one party is at fault for any change to that relationship. Conceptually, however, Delaware's contractarian approach assigns no moral fault to the change in the relationship, instead presuming that the LLC investor has no inherent expectation of fiduciary duties with the managers of that LLC.[188] In addition, managers of an LLC are not necessarily in a superior position to understand or explain fiduciary laws, and thus, unlike lawyers, it may not be fair to require that they explain the law to investors. However, as with many of the other mandatory disclosure regimes discussed, since the advanced waiver of the fiduciary duties of an LLC manager may have a significant impact on an agreement and are obtuse by nature, it may too justify requiring some burden of disclosure on the managers themselves.

Although the burden of explaining the legal impact of waiving fiduciary duties may seem to be outside the scope of appropriate disclosure requirements for LLC managers, the disclosing party's knowledge regarding his or her planned or existing breaches of the would-be fiduciary duties does not. As with advanced conflict waivers in the legal profession, the disclosing party is in possession of the unique facts and circumstances that are motivating his or her desire to seek a waiver. These facts are more appropriate for disclosure, as they would affect the intrinsic fairness of the negotiations, since the nondisclosing party would otherwise not have access to them or the ability to require disclosure before agreeing.[189]

188. *See* Steele, *supra* note 56, at 14 (discussing that the presumption of fiduciary duties makes for more difficult drafting requirements than if they were not default rules).

189. Unlike traditional contracts, in which representations and warranties commonly are negotiated by "smoking out" information underlying the parties' actions, no such section exists in

As this brief survey suggests, legislators tend to favor the use of informed consent when creating disclosure requirements.[190] However, this survey also indicates that this standard is criterially vague. Although little legislation specifies this, the law seems to vary on how many of the elements of disclosure must be included (such as the facts, general consequences, and / or legal consequences). For example, as discussed in conflict waivers in the legal profession, informed consent requires the "affirmative revelation by the attorney of all the facts, legal implications, possible effects, and other circumstances" to be effective.[191] In contrast, although not expressly stated, many liability waivers and informed consent documents do not expressly define any legal consequences.[192] It is unclear precisely why this difference exists. It may be that lawyers, by profession, are presumed to know the law and are required to explain it and the legal consequences to their clients, in seeking waivers. Conversely, it may be that the legal consequences in liability waivers and informed consent, unlike waivers of liability or conflicts in law, are reasonably self-evident, needing no explanation.[193] This is a relevant distinction because the former suggests the obligation to explain legal consequences is unique to the legal profession since lawyers are uniquely trained in the law, and thus, should not apply to LLC waivers. The latter, in contrast, suggests that such an obligation to explain the law may be imputed in any area of law that is particularly difficult to understand, which is true of the law of fiduciary duties in LLCs.

common LLC operating agreements; thus, there is no forum for this type of information sharing. CHARLES M. FOX, WORKING WITH CONTRACTS 10 (2d ed. 2008).

190. In addition to the areas of law discussed in this part, recall from Parts II.C and III.A that a similar standard of informed consent is used in traditional corporate law and California's LLC Act.

191. Fin. Gen. Bankshares, Inc. v. Metzger, 523 F. Supp. 744, 771 (D.D.C. 1981). The Model Rules require the lawyer to have "communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." MODEL RULES OF PROF'L CONDUCT R. 1.0(e) (2010).

192. For example, liability waivers often are upheld without explaining what the legal consequences of waiving liability are. *See, e.g.*, Baker v. Superior Court, 181 Cal. Rptr. 311, 315–19 (Ct. App. 1982) (fireman's rule); Chapman v. Craig, 431 N.W.2d 770, 771–73 (Iowa 1988) (same); Wertheim v. U.S. Tennis Ass'n, 540 N.Y.S.2d 443, 444 (App. Div. 1989) (holding that tennis umpire assumed the risk of "injuries normally associated with the sport"); Howell v. Clyde, 620 A.2d 1107, 1112–113 (Pa. 1993) (plaintiff injured by fireworks cannon).

193. Some liability waivers have been held to be effective without expressly identifying all obvious legal or nonlegal consequences. The entire doctrine of implied assumption of risk is predicated on some liabilities not needing to be expressly waived, as they are self-evident. Drago, *supra* note 139, at 590–92.

D. SHOULD LLCS PERMIT GENERAL ADVANCED WAIVER?

Despite the hesitancy of other areas of law to permit general advanced waiver, why might it be socially desirable to allow it in the context of LLCs? The dynamics in LLCs are different in several important aspects. The most obvious difference is policy. As discussed, Delaware's legislature has expressly stated that the intention of permitting managers of LLCs to waive fiduciary duties is to promote an alternative corporate entity that is based upon the freedom of contract.[194] However, policy, without a reasonable basis for its support, should not alone justify a law.[195] Why give maximum effect to the freedom of contract if it creates unfair or unreasonable outcomes? Thus, one must dig deeper to find justification for permitting such broad waivers.

Instead, the justification lies with the cost-benefit analysis of the nature of LLC investment. Both liability waivers in tort and advanced waivers to conflicts in the practice of law recognize the social tensions that make permitting some forms of waiver desirable.[196] However, in all the areas of law discussed, with the exception of some legislatively generated disclosures, the risks of harm resulting from these waivers are substantial. In tort and medicine, the potential harms to a nondisclosing party resulting from violations of the fiduciary's duties are generally physical harm or even death. In the practice of law, violations of duties risk personal liberty or financial harm.[197] These risks are, from the perspective of the waiving party, potentially unlimited. Prospective waiver in those areas of law exposes the client to a spectrum of harm that is only limited by the party's entire life, freedom, or financial well-being. Thus, general advanced waiver in these contexts creates the potential for not only unforeseeable types of harm, but also unforeseeable magnitude of harm.

This is not so for LLCs. LLCs, by definition, are limited liability entities. Thus, the magnitude of exposure to risk by the waiving party, and its subsequent potential harm, is limited to the waiving party's contribution

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

195. *See supra* text accompanying notes 114–16 (discussing the fundamental expectations of parties upon investing in companies).

196. These actions are either socially or contractually desirable. *See supra* Part VI.B.1–.3 (discussing waivers in torts, medical practice, and legal practice).

197. Although this financial harm most likely is civil litigation exposure, the harm may also be less favorably negotiated deals due to shared information. It may be that the relatively smaller harm of financial exposure, as opposed to that of physical harm or death, is what makes conflict waivers more palatable.

to the LLC.[198] In this sense, permitting waiver of fiduciary duties in LLCs provides the same benefits as waiver in other contexts[199] while allowing the waiving party to assign a finite magnitude of risk to the waiver. This limitation largely justifies having more expansive waiver rules, as well as fewer substantive restrictions, since the amount of exposure is part of the bargained-for exchange.

General prospective waiver of fiduciary duties in LLCs is also desirable for the very reasons contractarians support it.[200] As a business entity, LLCs can serve an important and unique function by allowing the parties to define all aspects of their relationship without fear of judicial intervention or excessive agency costs.

E. A NOTE ON SECURITIES LAW

It is important to note that some, but not all, waivers of fiduciary duties in LLCs should likely be disclosed under the national securities laws of Regulation D. In seeking to "insure honest securities markets and thereby promote investor confidence," the United States has adopted a policy of full disclosure in regulating the sale of securities.[201] An interest is considered a security if it is "(1) an investment of money (2) in a common enterprise (3) with profits to come solely from the efforts of others."[202] This includes interests in manager-managed LLCs.[203] The Securities and Exchange Commission ("SEC") requires issuers with a duty to disclose all "material fact[s]" to potential investors,[204] so that investors are able to

198. Of course, LLCs can be "pierced," exposing a waiving party to unlimited liability if the person is not treating the entity as separate from the person, such as keeping it undercapitalized or commingling funds. This risk, however, derives not from the party's decision to waive, but instead from isolated wrongdoing for which waiver law should not account. *See* CHASALOW, *supra* note 46, at 67–69 (discussing actions that trigger piercing the corporate veil).

199. These benefits include promoting socially desirable activities, providing more freedom for parties to define their relationships with one another, or providing more predictability within those relationships.

200. *See supra* Part III.C (discussing the benefits of contractarian policies).

201. SEC v. Zandford, 535 U.S. 813, 819 (2002) (quoting United States v. O'Hagan, 521 U.S. 642, 658 (1997)). *See also* Grandon v. Merrill Lynch & Co., Inc., 147 F.3d 184, 188 (2d Cir. 1998) (discussing the SEC's prohibition of deceptive practices).

202. Reeves v. Teuscher, 881 F.2d 1495, 1498–99 (9th Cir. 1989) (citing Matek v. Murat, 862 F.2d 720, 725 (9th Cir. 1988)).

203. *See id.* at 1499 (applying security classification to manager-managed LLCs); Brian Sweigman, *The Treatment of LLC Membership Interests under Current Securities Regulations*, 16 PUB. INVESTORS ARB. B. ASS'N B.J. 265, 266–67 (2009) (discussing LLC interests as securities under SEC regulations).

204. 17 C.F.R. § 240.10b-5 (2012). The materiality of an omitted fact is defined as something a reasonable shareholder is substantially likely to consider important. TSC Indus., Inc. v. Northway, Inc.,

understand what they are purchasing. The SEC requires issuers to disclose the "most significant factors that make [an] offering speculative or risky" and the effects of those factors on the offering, such as market risk, management's experience, and risks resulting from the company's specific operation,[205] which would most likely include a disclosure related to the waiver of the duty of loyalty.[206]

The disclosure requirements of securities laws alone, however, are insufficient to protect all potential investors for two reasons. First, it is unclear if interests in member-managed LLCs are securities, possibly making them not subject to the disclosure requirements of SEC Regulation D.[207] Second, SEC Rule 504 does not require risk disclosures for the sale of an interest in an entity that has sold no more than $1,000,000 in interests in a twelve-month period.[208] Thus, the disclosure requirements under the SEC would not apply to many small businesses or many sales of LLC interests to secondary buyers, both of which represent subgroups of investors who may be less sophisticated, and thus, would benefit more from such disclosures.

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426 U.S. 438, 449 (1976) ("[A]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

205. 17 C.F.R. § 229.503. *See also id.* § 230.502(b)(1); Accredited Investor and Filing Requirements, 54 Fed. Reg. 11369-01, 11372 (Mar. 20, 1989) (to be codified at 17 C.F.R. pts. 200, 230, 239) (explicitly stating the requirement of sufficient disclosure to avoid antifraud liability); Securities Offering Reform, 70 Fed. Reg. 44722-01 (Aug. 3, 2005) (to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 249, 274) (explaining the expansion of Item 503 "risk disclosures" to various other forms of offering beyond 1933 filings). Some of these risk disclosure requirements are waived if the offering is limited and there is proof that the involved parties are sufficiently sophisticated. *See, e.g.*, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, 47 Fed. Reg. 11251-01, 11253–56 (Mar. 16, 1982) (to be codified at 17 C.F.R. pts. 230, 239) (defining "accredited investors"); Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, 72 Fed. Reg. 400-01, 405 (proposed Jan. 4, 2007) (to be codified at 17 C.F.R. pts. 230, 275) (stating the purpose of defining "accredited natural person").

206. For the relative importance of the duty of loyalty, compare *supra* Part II.C (discussing the waiver of the duty of loyalty), with *supra* Part II.B (discussing the wavier of the duty of care).

207. *See, e.g.*, Conde v. SLS West, LLC, No. 104CV1925JDTTAB, 2005 WL 1661747, at *8 (S.D. Ind. July 15, 2005) ("Members of a manager-managed LLC are more likely to be passive investors in need of the protections afforded by the federal securities laws. By the same token, members of member-managed LLCs who are able to actively participate in the management affairs of the entity are less likely to need such protections. But even these characteristics may differ based on the economic realities and facts of each case, making it difficult to establish bright line rules in this area." (citations omitted)).

208. 17 C.F.R. § 230.504(b)(1).

VII. A PROPOSED SOLUTION

A. THE ISSUES WITH DISCLOSURE REQUIREMENTS

Although other areas of law suggest that liability waivers should include a disclosure requirement, commentators have also long recognized that disclosure requirements come at a price.[209] Below are some of the common criticisms of mandated disclosure requirements that have arisen in various areas of law, as well as a few issues unique to any proposed disclosure requirement in waiving fiduciary duties.

One of the most obvious and significant problems with requiring any form of disclosure is where to draw the line—how much information must be given to affect sufficient disclosure? As seen in other areas of law, sufficiency is generally interpreted by courts on a subjective scale of reasonableness.[210] As previously discussed, this is problematic in light of Delaware's contractarianism and its desire to avoid judicial uncertainty. By injecting a reasonableness standard into the effective waiver of fiduciary duties, the ability to ensure consistent outcomes substantially diminishes, since judges could have free reign to debate the fairness of the disclosure, and it impedes parties' ability to have a deal that reflects their intent.

Subjective standards also have other undesirable effects. For one, the fear of inadequate language spurs parties to spend more money for lawyers to draft the language.[211] In addition to additional costs, this fear also may increase the length and complexity of the disclosure document. Thus, the

209. *See, e.g.*, Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure*, 159 U. PA. L. REV. 647, 735–36 (2011) (discussing the unintended costs of disclosure); Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 1–5 (2005) (suggesting that disclosing conflicts of interest incentivize lawyers to give biased and corrupt advice); Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679, 692–97 (2004) (questioning the conditions under which readers would indeed serve as agents for nonreaders); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1346–47 (1981) (arguing that manufacturers focus warranty content to attract marginal consumers and repeat business); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 638–39 (1979) (arguing that few readers can force disclosers to provide better terms); Jeremy Sugarman et al., *The Cost of Ethics Legislation: A Look at the Patient Self-Determination Act*, 3 KENNEDY INST. ETHICS J. 387, 392–93 (1993) (discussing the bureaucratic costs of maintaining disclosure in the medical context).

210. *See, e.g.*, RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 19 cmt. c (2010) (limitations of scope); *id.* § 122 cmt. d (waivers of conflicts of interest); Drago, *supra* note 139, at 588–90 (tort waivers); Shugrue & Linstromberg, *supra* note 151, at 893–98 (informed consent).

211. Ben-Shahar & Schneider, *supra* note 209, at 736. This is particularly true if the disclosure requires the explanation of law, which may evolve over time.

disclosure risks becoming "too copious and complex for the disclosee to handle effectively."[212] Similarly, the steep cost and complexity of providing sufficient disclosure might simply scare off parties who otherwise want to limit their fiduciary duties, thereby stifling the freedom of contract.

The concern of sufficiency is particularly heightened if the disclosure requires the disclosing party to explain the legal standards of waiver themselves.[213] Not only are the basics of fiduciary law difficult to explain,[214] but also as previously discovered, the law in Delaware is in a state of fluctuation.[215] New rules and holdings are developed frequently, and the burden seems substantial to ensure any form of disclosure is precisely correct. Although such burdens may not be uncommon in disclosure regimes,[216] it could have an inappropriate cooling effect on the freedom of parties to dictate the terms of their agreement.

Relatedly, requiring a separate disclosure document that paraphrases and explains the manager's reformed duties in plain language would create a substantial risk of inconsistency in the contract.[217] How would a court resolve conflicts between the disclosure document and the contractual language? Would any perceived inconsistency between the two invalidate the waiver entirely? There does not seem to be a clear answer,[218] and this uncertainty could easily frustrate the intention of the parties.

Another potential risk of disclosure requirements is simply that it is ineffective at informing the less sophisticated party. This can be a problem if the disclosure is too complicated, if it is not prominently displayed, or if

212. *Id.* at 687. This is called the overload effect. *Id.* at 686. Disclosures can also cause accumulation problems, which involve requiring too many disclosures, and thus, not being able to process their meaning. *Id.* at 687–89. This is not relevant to this discussion, however, as LLC agreements do not include other mandatory disclosures.

213. Requiring the waiving party to explain the law might be desirable, as with waivers of conflicts of interest in the legal profession, since it is the waiver of a complex legal right, and many people will be unaware of the associated risks. This issue of imputing reasonableness into disclosure requirements is far less of a problem in the express disclosure of specific intended violations, as those violations likely already invite judicial scrutiny. *See supra* text accompanying notes 89–96.

214. *See supra* Part II (discussing the role of fiduciaries and waivers in traditional corporations).

215. *See supra* Part IV.A (discussing issues with uncertainty that arise with Delaware's waiver provision).

216. *See supra* Part VI.B.1–4 (discussing other forms of prospective liability waiver).

217. Such a disclosure requirement was suggested by, for example, Professor Campbell. Campbell, *supra* note 8, at 52.

218. Indeed, the difficulty in describing a fiduciary relationship has been discussed in the debate on whether Delaware should eliminate fiduciary duties by default. *See* Steele, *supra* note 56, at 9 (discussing that the presumption of fiduciary duties makes for more difficult drafting requirements than if they were not default rules).

the party is simply incapable of grasping the implications of the waiver. This is the problem inherent with simply requiring waiver to be explicit.[219] LLC agreements can be extremely long and complicated documents, and the drafting may mask the term, or else be unclear, despite its significance. Furthermore, explicit waiver may not resolve personal information asymmetry of the party seeking waiver.[220]

B. General Notice and Specific Disclosure: A Proposed Solution

A good disclosure requirement for the waiver of fiduciary duties would achieve several goals. First, it would provide notice of the change to the law, minimizing unintentional or uniformed waiver, but not overly burdening the disclosing party by requiring them to explain the law. Second, it would incentivize sharing specific information that is unique to one party and relevant to the negotiation of the waiver, such as one party's intent to compete against the company. This is specifically important for the duty of loyalty, which is where the most material potential problems may arise, and where the law differs from that of publicly traded entities.[221] Third, the disclosure requirement should also potentially provide a forum to address some of the current misunderstanding and vagueness in the law. The best way to achieve these goals is to address the issues of notice of the law and specific disclosures of would-be violations separately. This can be achieved by requiring any LLC operating agreement that seeks to eliminate or modify its fiduciary duties to provide, on a separate page of the document, a legislatively generated mandatory disclosure statement that notifies the potential investor that this agreement attempts to waive fiduciary duties, as well as by requiring each manager at the time of formation to expressly disclose all existing or planned violations of his or her would-be duty of loyalty. Although imperfect, this approach seems to strike the best balance of informing uninformed parties, while also alleviating judicial uncertainty and minimizing agency costs.

1. Notice of the Law

Perhaps the most elegant way to address the desire to inform parties of the law, without allocating the burden of proving the sufficiency of disclosure to the disclosing party, is simply to give the task to the

219. This was the conclusion of the law review note written by Scott Gordon Wheeler on this subject. Wheeler, *supra* note 115, at 1096–97.

220. *See* Fox, *supra* note 189, at 9 (suggesting that there is no forum for "representations and warranties" to be negotiated in an LLC operating agreement).

221. *See supra* Part III.B (discussing Delaware's waiver provision).

legislature. The legislature should require that the disclosure be included in the operating agreement as a condition to modifying or eliminating the fiduciary duties of the parties. This notice could vary substantially in terms of its depth depending on the legislature's desire to inform the parties, ranging from merely a statement that the fiduciary duties in the agreement have changed, to actually articulating the legislature's view on the law itself.

Any attempt to articulate the law, although tempting for the sake of clarity,[222] would most likely prove to be an ineffective solution. Commentators have largely been critical of these types of disclosures, mainly for their inefficacy in informing the disadvantaged party, based on either the complexity of the disclosing language, the volume of disclosures already in the language, or the party's unwillingness to read it.[223] Fiduciary duties are undoubtedly a complex topic,[224] and detailed disclosures would certainly risk these issues. Thus, the legislature should be hesitant to include a substantial explanation of the law governing waivers of fiduciary duties.[225]

Instead, disclosures should simply be structured to suggest the potential significance of the waiver, allude generally to what they are waiving, and recommend the parties discuss this term in greater detail. An example of such language would be,

> THIS LIMITED LIABILITY COMPANY OPERATING AGREEMENT LIMITS, MODIFIES, OR ELIMINATES SOME OR ALL OF THE DEFAULT FIDUCIARY DUTIES BETWEEN THE PARTIES TO THIS AGREEMENT, SUCH AS THE MANAGERS' DUTY OF CARE AND / OR THE DUTY OF LOYALTY TO THEIR INVESTORS.

222. For example, the legislature could use the opportunity to eliminate some of the uncertainty that the courts have struggled with in recent case law. Delaware's legislature could potentially use this forum to specify more precisely what it intended the bounds of contractual good faith and fair dealing to be.

223. *See* Ben-Shahar & Schneider, *supra* note 209, at 666 ("There is much evidence that consumers do not read [Truth in Lending Act] disclosures, are overloaded by the number of disclosures, and do not understand the basic disclosed features of the loan."); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 789–98 (2006) (suggesting, by way of survey, that the Truth in Lending Act was largely ineffective). Also, some commentators suggest such disclosures do not improve the negotiated terms. *See, e.g.*, Sherrill Shaffer, *The Competitive Impact of Disclosure Requirements in the Credit Card Industry*, 15 J. REG. ECON. 183, 195–96 (1999). However, these studies are largely in nonnegotiable contract arrangements, such as credit cards, rather than in fully negotiated contracts, such as LLC operating agreements.

224. *See supra* Part IV.A (discussing the uncertainty arising from Delaware's waiver provision).

225. The biggest element of concern is the central concept of trust, which could be expressed by merely referring to the fact that fiduciary duties have been modified, and that Delaware permits it to the extent it can be restricted by contractual good faith and fair dealing.

> PLEASE READ [THE RELEVANT SECTIONS OF THE AGREEMENT] OF THE AGREEMENT CAREFULLY AND DISCUSS THESE SECTIONS WITH THE MANAGERS OF THIS COMPANY.[226]

Any such disclosure should be prominently located, either as a standalone document or as a heading located prominently within the first pages of the operating agreement,[227] to maximize its notice-generating effect. Similarly, any language provided by the legislature should be clear, concise, and in plain English, and should provide minimum requirements for format.[228]

Even though such a disclosure would not provide a forum for clarifying the uncertainty in the legal implications of such waiver, even the most basic would likely suggest to the uninformed party the significance of such a waiver, thereby increasing the likelihood that the party will consult a lawyer or discuss the matter with the other party.[229] In addition, using broad and commonsense terms such as "loyalty" and "care" to describe fiduciary duties avoids mischaracterization of the law, but gives investors a sense of what these duties involve. Moreover, citing the relevant sections of the agreement and reminding the investors to read those sections carefully will highlight to the investors what language to focus on when negotiating those terms, helping to avoid "gotcha" waivers buried deep in the operating agreement. The reminder to discuss the waiver with the managers will simply urge the sort of discussion that would alleviate some of the potential informational asymmetry between the parties and help close the gap of disclosure requirements for offerings without a prospectus.

2. Specific Disclosures

Second, in order to avoid undisclosed and premeditated breaches of loyalty,[230] each LLC manager (or any LLC member that has management duties) should be required when the manager joins the LLC to disclose any plans the manager may have to violate his or her would-be duty of loyalty

226. This example is roughly modeled after the HIPAA disclosure language, discussed *supra* note 179 and accompanying text.

227. Additionally, the legislature could, as Professor Campbell suggested, require it be affixed to the outside front cover page of the operating agreement. Campbell, *supra* note 8, at 44.

228. Such a requirement is often part of legislation requiring disclosure or is later read in by courts. *See, e.g.*, *supra* note 178 and accompanying text.

229. It is for this reason that this would still be superior to solely requiring explicit waiver.

230. Recall that only breaches of loyalty, not breaches of care, are likely to represent fraud-like activities because of the manager's incentives to violate it. *See supra* Part II.C (discussing waiver of the duty of loyalty).

or any preexisting would-be violations of the duty. Each manager would be required to compose a separate disclosure statement of his or her loyalty violations at the time the operating agreement is formed and attach it as an addendum to the operating agreement. If an investor can prove that, at the time of the disclosure, the manager failed to disclose adequately its preexisting violations or its intent to violate the would-be duty of loyalty, the manager would be estopped from relying on the modification or waiver of his or her fiduciary duties.

Although this seems like a harsh standard, it would require informationally privileged parties to maximally share that information with the investor, thus giving that investor more complete information to efficiently evaluate the risks associated with waiving those rights. In fact, such a standard will most likely specifically target the types of loyalty violations that even Delaware's more restrictive reading of contractual good faith and fair dealing was meant to protect against. In omitting any material facts that exist prior to the negotiations, it seems likely that such intentional deceit in the context of negotiating a waiver would qualify as "unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits[ ] of the bargain."[231] Furthermore, the open-endedness of the sufficiency requirement in this context would be no different from the analysis the court would likely provide under good faith and fair dealing; thus, it does not likely disadvantage the disclosing party. In fact, requiring such disclosures would likely benefit the disclosing party, as such disclosures would serve an evidentiary function of proving what they had disclosed to the other party.

In order to avoid making this disclosure requirement too burdensome, it should be limited in several ways. First, a party should only be required to disclose the facts that would otherwise potentially violate his or her fiduciary duties, not the potential legal consequences of those facts. In this way, the disclosing party is not responsible for informing the other party of the legal implications of waiver and the nondisclosing party is shielded from overinclusive disclosure statements that might impede his or her understanding of the most important information. Second, for future potential violations, the disclosing party would only be responsible for disclosing intentional plans to violate a duty, rather than being required to disclose any potential risk of a violation. In this way, the disclosing party will not be incentivized to use disclosure boilerplate with overbroad and

231. Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005) (quoting Wilgus v. Salt Pond Inv. Co., 498 A.2d 151, 159 (Del. Ch. 1985)) (internal quotation marks omitted).

overinclusive statements that may harm effective communication. Although less sophisticated parties may not be expressly aware of the consequences of such a waiver if only the facts are given, it would likely generate further discussion between the parties, increasing the levelness of the playing field during negotiations. Third, this disclosure should only be required when a manager or managing member joins the entity, or when the fiduciary duties are modified in the operating agreement by amendment.

This disclosure requirement does have some weaknesses. For example, the question of whether a given disclosure is sufficient will create some ambiguity in the enforceability of the wavier provisions. However, this will likely be no different from the ambiguity created by the good faith requirement, but will ensure a more reliable mechanism to determine whether or not such disclosures took place.

In addition, by not requiring the disclosure to remain current at all times for each manager, the disclosure requirement will not cover most opportunistic behaviors made after the manager joins the LLC. Similarly, investors may have a difficult time proving that a manager intended, before the formation of the operating agreement, to violate the duty of loyalty. However, there is no practical way to overcome such difficulties of proof, and these sorts of opportunistic behavior are, in theory, future risks that arise after the contract is formed. These are unknown by the parties at the time of contracting, and thus, do not represent informational asymmetry, since they are distinct from current plans to violate duties. In addition, over time, requiring the managers to constantly "re-up" their disclosures would likely become overly burdensome for the managers, and would become too long to be effective. Instead, providing at least a snapshot of potential loyalty violations will provide at least some base knowledge to investors, so that they can more accurately understand the practical risks of their investment. This, combined with the mandatory disclosure language, will incentivize information sharing across all relevant parties and provide an effective forum to avoid judicial uncertainty, while still protecting potentially unsophisticated or unknowledgeable investors.

VIII. CONCLUSION

Although, on its face, Delaware's approach to waiving fiduciary duties in LLCs can be seen as a triumph for the state's aggressively contractarian policy, the success of this approach is undermined due to its potential for informational asymmetry and uncertain legal standards. There seem to be very strong indications that some form of disclosure is desirable, both to accommodate sufficient notice and to provide a forum for fact-related disclosures. However, such a requirement should be approached with caution, and Delaware's legislators should be wary of requiring any form of disclosure that impedes predictability in negotiations. Delaware's laws, as this Note suggests, are in a unique position to benefit from a hybrid disclosure statement that combines legislature-mandated language with party-generated disclosures, which would encourage disclosure of information that might otherwise impede effective negotiations. If crafted judiciously, such a disclosure regime could have a substantial impact on both leveling the negotiation playing field and addressing some ambiguities in the law itself. In doing so, such a requirement would actually reinforce and strengthen Delaware's contractarian policies by providing it with a reasonable forum to increase the knowledge available to all parties when negotiating an LLC's formation, thereby promoting the central notions of good faith and fair dealing.