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DELAWARE AND THE MARKET FOR LLC LAW: A THEORY OF CONTRACTIBILITY AND LEGAL INDETERMINACY

MOHSEN MANESH*

Abstract: Incorporating in Delaware can be expensive. Corporations pay up to \$180,000 annually for this simple privilege—a figure that is substantially higher than incorporation in any other state. In their controversial article, *Price Discrimination in the Market for Corporate Law*, Professors Marcel Kahan and Ehud Kamar show that Delaware’s ability to charge a premium for incorporations, in the form of its annual franchise tax, is evidence of Delaware’s market power in the jurisdictional competition for corporate charters. Beyond simply charging a premium, however, Professors Kahan and Kamar show that Delaware further increases its profits by engaging in price discrimination—tailoring its premium according to the value each firm attributes to the privilege of incorporating in Delaware. This Article projects Professors Kahan and Kamar’s analysis onto the world of limited liability companies (“LLCs”). To assess Delaware’s market power in the jurisdictional competition for LLC charters, this Article examines the LLC analog of the corporate franchise tax. Instead of a franchise tax, every Delaware LLC is charged a flat annual tax of \$250. As this Article shows, Delaware’s LLC tax, unlike its corporate franchise tax, does not represent a premium and does not price discriminate. But why? The Article explores the possibility that, in the jurisdictional competition for LLC charters, Delaware lacks the kind of market power it has long enjoyed for corporate charters. To explain why this may be, the Article argues that the high level of contractibility and the resulting reduction in legal indeterminacy available under LLC law substantially diminish two of Delaware’s traditional competitive advantages, namely the network effects associated with its law and its expert judiciary. With these two competitive advantages diminished, Delaware LLC law, unlike its corporate law, is not an obviously superior product. And with several available substitutes in the market for LLC law, Delaware may be unable to command a premium.

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INTRODUCTION

Incorporating in Delaware can be expensive. Just ask 60% of the companies that comprise the Fortune 500.¹ These companies pay up to \$180,000 annually for the simple privilege of incorporating in the state²—a figure that is substantially higher than incorporation in any other state.³ In their controversial article, *Price Discrimination in the Market for Corporate Law*,⁴ Professors Marcel Kahan and Ehud Kamar show that Delaware's ability to charge a premium for incorporations, in the form of its annual franchise tax, is evidence of Delaware's market power in the jurisdictional competition for corporate charters.⁵ Beyond simply charging a premium, however, Professors Kahan and Kamar argue that Delaware further increases its profits by engaging in price discrimination—that is, by tailoring its premium according to the value each firm attributes to the privilege of incorporating in Delaware.⁶ The ability of Delaware to charge a premium and to price discriminate leads Professors Kahan and Kamar to conclude that in the competition for corporate charters, “it is evident that Delaware possesses substantial market power.”⁷

This Article projects Professors Kahan and Kamar's analysis onto the world of limited liability companies (“LLCs”). Like corporate charters, the competition for LLC charters is an example of regulatory competition. Firms can choose to organize as an LLC under the laws of any state, regardless of whether the firm conducts any business within that state. Thus, as is the case with corporate charters, a state can compete for LLC charters by providing the best law “product” with the aim of attracting fees, taxes, and business for the state's residents.

Although Delaware's dominance in the competition for corporate charters is well known and widely discussed,⁸ its position within the

¹ See *infra* note 30.

² See *infra* notes 49–52 and accompanying text.

³ See Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1062 (2000); Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1219–21 (2001).

⁴ Kahan & Kamar, *supra* note 3, at 1205–56. Professors Kahan and Kamar's claims drew the response of Delaware Vice Chancellor Leo E. Strine. See Leo E. Strine, Jr., *Delaware's Corporate-Law System*, 86 CORNELL L. REV. 1257, 1257–58 (2001).

⁵ Kahan & Kamar, *supra* note 3, at 1210–11.

⁶ *Id.* at 1214, 1217–50. In addition to its franchise tax, Professors Kahan and Kamar argue that Delaware price discriminates in a second way: through the incidence of litigation over matters of corporate law. *Id.* at 1242–50. This second form of price discrimination is not considered in this Article.

⁷ *Id.* at 1211.

⁸ See, e.g., Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 553–61 (2002); Kahan &

competition for LLC charters is not.⁹ LLCs, however, are becoming an increasingly accepted and prominent part of the business world.¹⁰ Although the LLC form is relatively new, the number of LLCs formed in the United States has in recent years dramatically outpaced corporations.¹¹ Today, LLCs, like corporations, can be publicly traded, multinational firms with billions of dollars of assets.¹²

To assess Delaware's market power in the competition for LLC charters, this Article examines the LLC analog of the corporate franchise tax. Instead of a franchise tax, every Delaware LLC is charged a flat annual tax of \$250, regardless of the LLC's size, income, or business conducted in the state.¹³ This Article shows that, unlike its corporate

Kamar, *supra* note 3, at 1209–14; Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1909–13 (1998).

⁹ Two in-depth empirical studies on the jurisdictional competition for LLCs remain unpublished as of this writing. Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis* 3–5 (Univ. of Tex. Sch. of Law, Law & Econ. Research Paper No. 126, 2008), available at <http://ssrn.com/abstract=1126257>; Bruce H. Kobayashi & Larry E. Ribstein, *Jurisdictional Competition for Limited Liability Companies* 1–3 (Univ. of Ill. Law & Econ., Research Paper No. LE09–017, 2009), available at <http://ssrn.com/abstract=1431989>. The authors of these studies disagree as to both methodology and implication. See Kobayashi & Ribstein, *supra*, at 18–21.

¹⁰ See Sandra K. Miller, *A New Direction for LLC Research in a Contractarian Legal Environment*, 76 S. CAL. L. REV. 351, 384–85 (2003) (reporting the results of a survey showing that fifty-two percent of practitioners frequently use LLCs instead of a corporation or other business entity to corroborate the author's proposition that "the LLC has become a widely accepted business entity in the legal community"); Peter J. Walsh, Jr & Dominick T. Gattuso, *Delaware LLCs: The Wave of the Future and Advising Your Clients About What to Expect*, A.B.A. BUS. L. TODAY, Sept./Oct. 2009, at 11 ("In less than two decades, Delaware limited liability companies (LLC) have gone from nouveau 'alternative' entity to the 'go-to' entity."). See generally Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, or LLPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459 (2010) (reporting empirical data confirming the ascent of the LLC as the dominant business form in the United States); Mohsen Manesh, *Legal Asymmetry and the End of Corporate Law*, 34 DEL. J. CORP. L. 465 (2009) (describing the multi-million dollar initial public offerings of two LLCs and a limited partnership).

¹¹ Chrisman, *supra* note 10, at 460 (providing empirical data to show that twice as many LLCs were formed in the United States in 2007 as corporations and that ten states and the District of Columbia had LLC formations outpace corporate formations by at least four to one).

¹² Consider, for example, the publicly traded Delaware LLC, Fortress Investment Group, which as of December 31, 2009, had approximately \$1.66 billion of assets and had 819 employees spread across their offices in New York, Atlanta, Berlin, Charlotte, Cologne, Dallas, Frankfurt, Hong Kong, London, Los Angeles, Munich, New Canaan, Shanghai, Sydney, Tokyo and Toronto. See Fortress Inv. Grp. LLC, Annual Report (Form 10-K), at 1, 79 (Mar. 1, 2010) [hereinafter Fortress 2009 Annual Report], available at <http://www.sec.gov/Archives/edgar/data/1380393/000119312510044300/d10k.htm>.

¹³ DEL. CODE ANN. tit. 6, § 18-1107(b) (2005 & Supp. 2008).

franchise tax, Delaware's LLC tax does not represent a premium and does not price discriminate.

This observation poses a puzzle for business law scholars. In the jurisdictional competition for corporate charters, Delaware has long exploited its market power by charging premium and discriminatory prices. In the jurisdictional competition for LLCs, however, Delaware does neither. But why?

This Article explores the possibility that, in the jurisdictional competition for LLC charters, Delaware lacks the kind of market power it has long enjoyed for corporate charters. To explain why this may be, this Article presents a theory based on contractibility and legal indeterminacy. Specifically, this Article shows how the high level of contractibility and the resulting reduction in legal indeterminacy available under LLC law substantially diminish two of Delaware's traditional competitive advantages.

To make this claim, this Article compares Delaware's corporate law product to Delaware's LLC law product. Previous scholarship has suggested that, in the jurisdictional competition for corporate charters, Delaware commands market power because of certain key features of its corporate law product. These features—which include (1) the network and learning effects of Delaware law, (2) the expertise of the Delaware judiciary, (3) the proficiency of Delaware's administrative services, and (4) Delaware's credible commitment to corporate law—make incorporation in Delaware more valuable than incorporation in any rival state. And, as a result, Delaware can charge a premium for its corporate law product and even price discriminate among its corporate customers.

This Article shows that, although Delaware's LLC law product seems to offer the same four competitive advantages offered by its corporate law product, two of these advantages—namely, the network effects of Delaware law and the expertise of its judiciary—are substantially less valuable to LLCs.¹⁴ The reasons for this relate to contractibility and legal indeterminacy.

Delaware corporate law includes a number of mandatory, and often indeterminate, provisions—most notably the judge-made law of fi-

¹⁴ In previous scholarship, Professors Ribstein and Kobayashi have raised doubts about the importance of network effects in the competition *among business forms*—namely the LLC versus the limited liability partnership (“LLP”). See Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 128 (2001). To the extent their skepticism about network effects applies more broadly to the jurisdictional competition *among states*, the account set forth in this Article—namely, that contractibility and reduced indeterminacy limit network effects—provides an explanation for why network effects would have limited importance in the LLC context.

duciary duties. These provisions bind all corporations and cannot be waived, modified, or otherwise clarified by contract.

In contrast, Delaware LLC law, like the LLC law of several other states, affords parties an extraordinarily high degree of contractibility, allowing LLCs to contractually tailor virtually all matters of the firm's internal governance in the terms of the LLC's governing agreement. This high level of contractibility has two consequences, both of which reduce the relative value of Delaware's LLC law product. First, contractibility means that not all Delaware LLCs will be subject to the same provisions. Contractibility thus allows for incompatibility within the Delaware LLC network, thereby limiting the linkage and therefore the network effects associated with Delaware LLC law. Second, contractibility means that, under LLC law, firms can reduce the level of legal indeterminacy that has long plagued Delaware corporations. Reduced indeterminacy not only eliminates the need for Delaware's interpretive LLC network but also marginalizes the importance of Delaware's expert judges in the interpretation and application of LLC law.

In this regard, heightened contractibility and reduced indeterminacy pose a problem for Delaware. Although contractibility and reduced legal indeterminacy may enhance the value of Delaware's LLC law product by making it appear more attractive to firms, Delaware is not unique in that regard. Several states grant an expansive freedom of contract under their LLC law. But heightened contractibility and reduced legal indeterminacy also harm Delaware uniquely by substantially diminishing the importance of two of Delaware's traditional competitive advantages. With its network and judicial advantages diminished, the remaining two features of Delaware's law product traditionally identified as its competitive advantages—the proficiency of its administrative services and its credible commitment—may be insufficient to differentiate Delaware from its rivals in the market for LLC law.

The claims and findings of this Article have several significant implications for both LLC and corporate law as well as for the jurisdictional competition for LLC charters. First, if, as this Article contends, mandatory provisions and legal indeterminacy are, in fact, key elements for Delaware's competitive success in the corporate context, then various incentives suggest that these same features will eventually appear in Delaware LLC law, most likely through a broadened judicial interpretation of the implied contractual covenant of good faith and fair dealing, which is mandatory and unwaivable under LLC law. Second, the difference between Delaware's corporate franchise and LLC taxes suggests that, in addition to the legal incentives created by contractibility and reduced indeterminacy under LLC law, firms have a

purely economic incentive to choose the LLC form over the corporate form. Together, these legal and economic incentives pose a serious challenge to the continued dominance of the corporate form and to Delaware's reliance on the franchise taxes derived therefrom. Finally, because neither Delaware nor any other state stands to gain substantial marginal revenue from attracting additional LLC charters, the findings of this Article suggest that states have little incentive to vigorously compete for LLC charters.

This Article proceeds as follows. Part I considers Delaware's market power in the corporate context through the lens of its corporate franchise tax.¹⁵ This Part explains that, as a result of its market power in the jurisdictional competition for corporate charters, Delaware can not only charge a substantial premium to firms that desire to incorporate in the state but can also engage in price discrimination among those firms.¹⁶ Part I then uses empirical data to assess Delaware's status in the jurisdictional competition for LLC charters, a competition that is still in its embryonic stages.¹⁷ This discussion shows that, notwithstanding Delaware's apparent success in attracting LLCs, Delaware fails to charge a substantial premium or price discriminate for its LLC law product.

Part II seeks to explain the discrepancy between Delaware's corporate franchise tax and LLC tax by examining the four facets of Delaware's corporate law product traditionally identified by previous scholarship as Delaware's competitive advantages in the market for corporate charters.¹⁸ Part II shows that these same competitive advantages appear to be present in Delaware's LLC law product.¹⁹ Thus, this Part concludes, a simple examination of these competitive advantages cannot alone explain Delaware's failure to charge a premium or discriminatory price for LLC charters.

Part III then deepens the traditional analysis by describing how the high degree of contractibility, and resulting reduction in legal indeterminacy, available under LLC law may affect the value of Delaware's LLC law product relative to its rival states.²⁰ This Part shows that heightened contractibility and reduced indeterminacy substantially diminish the importance of Delaware's network effects and judicial expertise—

¹⁵ See *infra* notes 25–64 and accompanying text.

¹⁶ See *infra* notes 25–105 and accompanying text.

¹⁷ See *infra* notes 65–105 and accompanying text.

¹⁸ See *infra* notes 106–161 and accompanying text.

¹⁹ See *infra* notes 106–161 and accompanying text.

²⁰ See *infra* notes 162–257 and accompanying text.

two key competitive advantages that have long distinguished Delaware from its rivals.²¹

Part IV considers the implications of the findings and claims made in this Article.²² Principally, this Part outlines several incentives for Delaware to increase the indeterminacy in its substantive LLC law.²³ This Part also considers what implications the findings and claims of this Article have on the regulatory competition between the LLC and corporate forms, the regulatory competition between states for LLC charters, as well as Delaware's LLC and corporate tax structures.²⁴

I. DELAWARE IN THE COMPETITION FOR BUSINESS ENTITY CHARTERS

A. Delaware's Dominance in the Competition for Corporate Charters

The competition among states for corporate charters is considered a textbook example of regulatory competition.²⁵ Because a firm can choose to incorporate in any state, regardless of whether it actually conducts any business in that state, every state competes to provide the best corporate law "product" to attract corporate charters.²⁶ The corporate law "product" offered by each state is comprised of three basic components: first, the substantive law of the state, which dictates the internal governance of the corporation; second, the judicial system of the state, which resolves disputes regarding the corporation's internal affairs; and, third, the state's administrative services, which provide certificates, accept filings, and collect taxes on behalf of the state.²⁷ A basic tenet of regulatory competition theory is that states compete for corporate charters primarily to secure the chartering fees and taxes associated with incorporation and, secondarily, to attract business for the lawyers and other service providers within the state.²⁸

In the competition for corporate charters, Delaware has since the beginning of the twentieth century stood alone as the decisive winner.²⁹ A majority of publicly traded companies and sixty percent of the For-

²¹ See *infra* notes 162–257 and accompanying text.

²² See *infra* notes 258–349 and accompanying text.

²³ See *infra* notes 262–325 and accompanying text.

²⁴ See *infra* notes 262–349 and accompanying text.

²⁵ Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 681 (2002).

²⁶ See Kahan & Kamar, *supra* note 3, at 1210 (describing the corporate law product that states provide in the market for corporate charters).

²⁷ *Id.*

²⁸ Kahan & Kamar, *supra* note 25, at 687.

²⁹ See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 3.

tune 500 are incorporated in Delaware.³⁰ No other state even approaches Delaware's market share.³¹ In deciding where to incorporate, firms effectively consider only two possibilities: their home state and Delaware.³² Indeed, Delaware's longtime dominance has led many scholars to conclude that the competition for corporate charters is over; Delaware has won.³³

One result of Delaware's dominance in securing corporate charters is that Delaware has been able to generate substantial revenue in the form of initial incorporation fees and, more importantly, the annual franchise taxes charged to Delaware corporations. The table below shows the annual revenue generated by Delaware from corporate franchise taxes from 2005 to 2009.³⁴

³⁰ In a study of all publicly traded non-financial firms, Professors Bebchuk and Hamdani found that 57.8% of all such companies and 59.5% of the Fortune 500 are incorporated in Delaware. Bebchuk & Hamdani, *supra* note 8, at 565–67. More recently, the Delaware Secretary of State has claimed that 63% of the Fortune 500 are incorporated in Delaware. 2009 DEL. DIV. OF CORPS. ANN. REP. 1 [hereinafter 2009 DELAWARE ANNUAL REPORT], available at <http://www.corp.delaware.gov/2009ar.pdf>.

³¹ The Bebchuk and Hamdani study found that Delaware's closest competitor, California, was the legal domicile for only 4.3% of the all publicly traded companies. See Bebchuk & Hamdani, *supra* note 8, at 567.

³² *Id.* at 575 (“[F]irms . . . are currently making a choice that is effectively between incorporating in their home state or in Delaware.”). The Bebchuk and Hamdani study found evidence of a strong “in-state” bias—a tendency for firms to incorporate in the state in which the firm is headquartered. See *id.* at 568–72. Roughly 33% of all publicly traded firms incorporate under the laws of the state in which the firm is headquartered. *Id.* at 572. Of the firms that choose to incorporate out-of-state, over 85% choose to incorporate in Delaware. *Id.* at 576–79.

³³ See, e.g., Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1778 (2002) (noting that “[t]he dominant view among corporate law scholars” is that Delaware “has ‘won’ the race for incorporations”); Carney & Shepherd, *supra* note 29, at 9–10 (noting others’ belief that “Delaware has been so victorious in the competition [for corporate charters] that only Delaware law matters, as a descriptive matter, and that Delaware has won the race”); Kahan & Kamar, *supra* note 25, at 684 (concluding that no states, other than Delaware, actively compete for corporate charters); Kamar, *supra* note 8, at 1909 (noting that “Delaware has emerged as a clear winner” in the jurisdictional competition for corporate charters).

³⁴ DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR’S RECOMMENDED BUDGET; FISCAL YEAR 2011, at 5 (2011) [hereinafter DELAWARE STATE BUDGET FY 2011], available at <http://budget.delaware.gov/fy2011/operating/11opfinsumcharts.pdf>; DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR’S RECOMMENDED BUDGET; FISCAL YEAR 2010, at 5 (2010) [hereinafter DELAWARE STATE BUDGET FY 2010], available at <http://budget.delaware.gov/fy2010/operating/10opfinsumcharts.pdf>; DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR’S RECOMMENDED BUDGET; FISCAL YEAR 2009, at 2 (2009) [hereinafter DELAWARE STATE BUDGET FY 2009], available at <http://budget.delaware.gov/fy2009/operating/09opfinsumcharts.pdf>; DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR’S RECOMMENDED BUDGET; FISCAL YEAR 2008, at 2 (2008) [hereinafter DELAWARE STATE BUDGET FY 2008], available at <http://budget.delaware.gov/fy2008/operating/08opfinsumcharts.pdf>; DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR’S

Year	Revenue from Corporate Franchise Taxes (in millions)	Percent of State Gross Revenue
2005	\$508.1	16.4%
2006	\$526.4	15.6%
2007	\$540.4	15.3%
2008	\$566.3	15.5%
2009	\$574.2	16.7%
Average	\$543.1	15.9%

* State of Delaware Governor's Recommended Budget for Fiscal Years 2007–2011

As this table illustrates, in 2009 alone, Delaware earned \$574.2 million, or almost 17% of its total annual revenue, from corporate franchise taxes.³⁵ To put this figure into perspective, consider the fact that Delaware is a relatively small state, with a population of only 885,122.³⁶ In 2009, the corporate franchise tax generated \$1648 for the average Delaware household.³⁷ Simply put, no other state is so dependent on the revenue generated from corporate charters.³⁸

B. *The Corporate Franchise Tax*

What does Delaware charge for the privilege of incorporating in the state? First, like most states, Delaware charges a nominal one-time

RECOMMENDED BUDGET; FISCAL YEAR 2007, at 2 (2007) [hereinafter DELAWARE STATE BUDGET FY 2007], available at <http://budget.delaware.gov/fy2007/operating/07opfinsumcharts.pdf>; DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR'S RECOMMENDED BUDGET; FISCAL YEAR 2006, at 2 (2006), available at <http://budget.delaware.gov/fy2006/operating/06opfinsumcharts.pdf>; DEL. OFFICE OF MGMT. & BUDGET, FINANCIAL SUMMARY: GOVERNOR'S RECOMMENDED BUDGET; FISCAL YEAR 2005, at 2 (2005), available at <http://budget.delaware.gov/fy2005/operating/05opfinsumcharts.pdf>.

³⁵ DELAWARE STATE BUDGET FY 2011, *supra* note 34, at 5.

³⁶ This estimate is current as of 2009. See *Delaware QuickFacts*, U.S. CENSUS BUREAU (2009), available at <http://quickfacts.census.gov/qfd/states/10000.html>.

³⁷ The average number of persons per household in Delaware was equal to 2.54 as of the year 2000. *Id.* Assuming the average number of persons per household in Delaware in 2009 is still 2.54, then the number of households in Delaware may be determined by dividing Delaware's estimated total population (as of 2009) by the average number of persons per household. \$574.2 million divided by that figure, 348,473, yields a quotient of \$1647.76. Professors Bebchuk and Hamdani report revenue of \$3000 per Delaware household; however, their figure is based on a hypothetical average household of four. See Bebchuk & Hamdani, *supra* note 8, at 583.

³⁸ See, e.g., Kamar, *supra* note 8, at 1927; Matt Stevens, Note, *Internal Affairs Doctrine: California Versus Delaware in a Fight for the Right to Regulate Foreign Corporations*, 48 B.C. L. REV. 1047, 1084–86 (2007) (citing statistics showing the dependence of Delaware on its franchise tax and suggesting that this dependence influences judicial interpretation in Delaware courts).

fee—as little as \$89—to a chartering corporation.³⁹ Second, and more importantly, Delaware charges a recurring annual franchise tax on each corporation that is incorporated in the state.⁴⁰

Delaware's franchise tax is unique among the fifty states in two respects.⁴¹ First, it represents a substantial premium over the franchise taxes imposed by any other state.⁴² Second, Delaware's franchise tax tends to price discriminate, charging more to firms that assign a higher value to incorporating in Delaware.⁴³

To appreciate its uniqueness, one must understand how Delaware's corporate franchise tax is structured. The franchise tax is determined by taking the lower of two computations.⁴⁴ The first computation (the "authorized share method") is based simply on the number of authorized shares of the corporation.⁴⁵ Under the authorized share method, a Delaware corporation with 5000 or fewer authorized shares is charged \$75 annually, a Delaware corporation with more than 5000 but no more than 10,000 authorized shares is charged \$150 annually; and a Delaware corporation with more than 10,000 authorized shares is charged an annual tax of \$150 plus \$75 for each additional 10,000 authorized shares above the initial 10,000 shares.⁴⁶ The second computation (the "APVC method") is based on the corporation's assumed par value capital.⁴⁷ Under the APVC method, the franchise tax is generally determined by multiplying a corporation's total gross assets by the ratio of the corporation's authorized shares to issued shares.⁴⁸

Because the actual franchise tax is equal to the lower of the authorized share method and the APVC method, one must compute the tax under both methods to determine a corporation's actual tax liability. Under either methodology, the franchise tax is capped to a maximum of \$180,000 per year.⁴⁹ The table below presents computations

³⁹ See DEL. CODE ANN. tit. 8, § 391(a)(1) (2001 & Supp. 2008).

⁴⁰ See *id.* § 501 (West, Westlaw through 2010 legislation).

⁴¹ Kahan & Kamar, *supra* note 3, at 1221.

⁴² *Id.* at 1218, 1221; see also Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 255–57 (1985).

⁴³ Kahan & Kamar, *supra* note 3, at 1221, 1223.

⁴⁴ DEL. CODE ANN. tit. 8, § 503(a) (West, Westlaw through 2010 legislation).

⁴⁵ *Id.* § 503(a)(1).

⁴⁶ *Id.*

⁴⁷ *Id.* § 503(a)(2).

⁴⁸ *Id.* The franchise tax is calculated differently under the APVC method if either (i) the actual par value of a corporation's shares is greater than the assumed par value (as computed under the APVC method), or (ii) the corporation's shares have no par value. Both scenarios, however, are rare. See Kahan & Kamar, *supra* note 3, at 1221 n.70. Firms typically set par value to a very low level that is greater than zero. *Id.* Accordingly, all calculations of the franchise tax in this Article assume a very low par value greater than zero.

⁴⁹ DEL. CODE ANN. tit. 8, § 503(c).

under the authorized share method, the APVC method, and the actual resulting franchise tax for six hypothetical Delaware corporations.⁵⁰

	Authorized Shares	Issued Shares	Total Gross Assets (in millions)	Authorized Shares Method	APVC Method	Actual Franchise Tax
Corporation A	15,000	5,000	\$1.0	\$225	\$1,050	\$225
Corporation B	75,000	5,000	\$1.0	\$675	\$5,250	\$675
Corporation C	5,000,000	2,500,000	\$30.0	\$37,575	\$21,000	\$21,000
Corporation D	5,000,000	2,500,000	\$90.0	\$37,575	\$63,000	\$37,575
Corporation E	30,000,000	20,000,000	\$90.0	\$180,000*	\$47,250	\$47,250
Corporation F	30,000,000	20,000,000	\$900.0	\$180,000*	\$180,000*	\$180,000*

* The franchise tax computation is capped at the statutory maximum of \$180,000 annually

As this table illustrates, the franchise tax in Delaware can be substantial, particularly for larger, typically publicly traded firms. For example, it has been estimated that 80% of the corporations listed on the New York Stock Exchange pay the maximum franchise tax.⁵¹ Regardless of which methodology is used, any Delaware corporation with more than 24 million authorized shares and assets over \$514 million (or less depending on the ratio of authorized to issued shares) will pay the maximum franchise tax of \$180,000.⁵²

With these examples, one can begin to appreciate the unique qualities of Delaware's corporate franchise tax. First, the franchise tax represents a substantial premium when compared to the franchise tax of any other state.⁵³ All states, with the exception of Delaware, fall into one of two groups. The first group is states that charge domestic corporations either no franchise tax or only a nominal franchise tax.⁵⁴ In these states, the annual tax on domestic corporations is zero or insub-

⁵⁰ The examples in this table assume that each corporation has a par value of \$0.001 per share. Computations were made with the assistance of the Franchise Tax Calculator Spreadsheet made available by the Delaware Secretary of State Department of Corporations at <http://corp.delaware.gov/taxcalc.shtml>.

⁵¹ Kahan & Kamar, *supra* note 3, at 1224–25. This estimate was based on 1999 data, at a time when Delaware's franchise tax was capped at \$150,000. *Id.*

⁵² Under the authorized share method, any corporation with more than 23,980,000 authorized shares would be assessed the maximum franchise tax of \$180,000. Likewise, under the APVC method, any corporation with more than 23,980,000 authorized shares, and more than \$514,000,000 gross assets, regardless of the number of issued shares, would be assessed the maximum franchise tax of \$180,000. Because under the APVC method the franchise tax is determined by multiplying the firm's total gross assets by the ratio of the corporation's authorized shares to issued shares, the fewer issued shares a firm has, the less total assets would be necessary to incur the maximum tax.

⁵³ Kahan & Kamar, *supra* note 3, at 1218, 1221.

⁵⁴ *Id.* at 1219.

stantial.⁵⁵ The second group is states that charge both domestic and foreign corporations a tax based on some measure of the corporation's business in that state.⁵⁶ For these states, there is effectively no surcharge for the privilege of incorporating in the state. Because domestic and foreign corporations are taxed equally, it makes no difference whether a corporation is incorporated in the state.⁵⁷ Delaware is the only state that imposes a significant franchise tax on domestic corporations, wholly unrelated to the amount of the corporation's business in the state.⁵⁸ In this way, Delaware charges its domestic corporations a significant premium simply for the privilege of incorporating in the state.⁵⁹

Second, Delaware's franchise tax tends to price discriminate. More specifically, Delaware's franchise tax is structured so that it charges more to firms that assign a higher value on incorporation in Delaware.⁶⁰ Because the franchise tax is based on the lower of two methodologies, only firms with both a high number of authorized shares and a high gross asset value will have a substantial franchise tax liability.⁶¹ Such firms tend to be large, often publicly traded companies.⁶² And large, publicly traded companies tend to assign a higher value to incorporation in Delaware than smaller or private companies.⁶³ No other state employs a similarly structured franchise tax.⁶⁴

C. *Delaware in the Competition for LLC Charters*

Unlike the competition for corporate charters, the competition for LLC charters is still in its embryonic stages. The first LLC statute was adopted in 1977,⁶⁵ and Delaware did not adopt its first LLC statute until

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.* at 1219–20.

⁵⁸ *Id.* at 1220–21.

⁵⁹ See Kahan & Kamar, *supra* note 3, at 1220–21.

⁶⁰ See *id.* at 1223–30.

⁶¹ See *id.* at 1223–24.

⁶² *Id.*

⁶³ *Id.* at 1225–30.

⁶⁴ *Id.* at 1221.

⁶⁵ See William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 855–59 (1995); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1460–68 (1998).

1992.⁶⁶ But even in this short time, Delaware seems to have emerged as the national leader in the competition to attract LLC charters.⁶⁷

Consider the annual number of new LLCs formed in Delaware compared to corporations. The table below shows the number of new corporations and LLCs formed in Delaware from 2003 to 2009.⁶⁸

Year	New Corporations	New LLCs	Ratio of New LLCs to New Corporations
2003	32,664	55,381	1.70
2004	33,636	68,641	2.04
2005	34,377	87,630	2.56
2006	34,733	96,831	2.79
2007	35,700	111,820	3.13
2008	29,501	81,923	2.78
2009	24,955	70,274	2.82

* Delaware Department of State, Division of Corporations Annual Reports from 2003–09

During the five-year period ending in 2009, the number of new Delaware LLCs outpaced corporations anywhere from 256% to 313%.⁶⁹ To put these numbers in perspective, consider that in 2007 alone, an average of 430 LLCs were formed on each weekday in Delaware.

Perhaps more remarkable than the simple number of LLC formations in Delaware is the virtual monopoly Delaware enjoys in the market for large and publicly traded LLCs. Although Delaware's dominance in attracting the charters of publicly traded corporations is well

⁶⁶ Limited Liability Company Act, 68 Del. Laws 1329 (1992) (codified as amended at DEL. CODE ANN. tit. 6, §§ 18-101 to -1109 (1999)); see also David L. Cohen, *Theories of the Corporation and the Limited Liability Company*, 51 OKLA. L. REV. 427, 475 (1998); Hamill, *supra* note 65, at 1475–76.

⁶⁷ See, e.g., Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 125–26 (2006) (“[LLCs] are frequently formed in Delaware, and Delaware shows the potential to acquire jurisdictional domination here, akin to its role in corporate law.”).

⁶⁸ 2009 DELAWARE ANNUAL REPORT, *supra* note 30, at 1; 2008 DEL. DIV. OF CORPS. ANN. REP. 1 [hereinafter 2008 DELAWARE ANNUAL REPORT], available at <http://corp.delaware.gov/2008AR.pdf>; 2007 DEL. DIV. OF CORPS. ANN. REP. 1 [hereinafter 2007 DELAWARE ANNUAL REPORT], available at <http://corp.delaware.gov/2007DivCorpAR.pdf>; 2006 DEL. DIV. OF CORPS. ANN. REP. 1 [hereinafter 2006 DELAWARE ANNUAL REPORT], available at http://corp.delaware.gov/2006%20Annual%20Report%20with%20Signature%20_2_.pdf; 2005 DEL. DIV. OF CORPS. ANN. REP. 1 [hereinafter 2005 DELAWARE ANNUAL REPORT], available at <http://corp.delaware.gov/2005%20doc%20ar.pdf>.

⁶⁹ Cf. Ann E. Connaway, *Lessons To Be Learned: How the Policy of Freedom To Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporate Law*, 33 DEL. J. CORP. L. 789, 801–02 (2008) (noting that since Delaware's passage of its LLC statute in 1992, more LLCs have formed in Delaware than all other types of business associations combined).

documented,⁷⁰ its status in the competition for large and publicly traded LLCs is not.⁷¹ To examine Delaware's status in the competition for large and publicly traded LLCs, Appendix A lists every LLC that filed for or completed an initial public offering between March 31, 2004 and March 31, 2010,⁷² as reported by the Hoover IPO Reports database available on LexisNexis. The results are summarized below.

LLC Domicile	LLC IPOs
Delaware	15
Other States	0
Total	15

These results are a vivid illustration of Delaware's success in attracting large and publicly traded LLCs. Of the fifteen LLCs that filed for or completed an initial public offering between March 31, 2004 and March 31, 2010, every one of them was chartered in Delaware.⁷³

This finding is consistent with those of Professors Bruce Kobayashi and Larry Ribstein, who found that for large LLCs (namely, those with more than fifty employees) that elect to organize outside of their home state, over 61% elect to organize under Delaware law.⁷⁴ The next closest state, Virginia, has less than 3% of the market share for large LLCs organized outside of their home state.⁷⁵

Delaware's success in attracting LLCs is reflected in its state budget. Although LLCs are typically pass-through entities for federal tax pur-

⁷⁰ See, e.g., Bebchuk & Hamdani, *supra* note 8, at 565–68, 579–80.

⁷¹ Although Professors Kobayashi and Ribstein try to assess Delaware's success in attracting large LLCs, their data is limited to private LLCs only and includes private LLCs with as few as fifty employees, which is relatively few by large firm standards. See Kobayashi & Ribstein, *supra* note 9, at 23–24. Professors Dammann and Schündeln's study is likewise limited to private LLCs only. See Dammann & Schündeln, *supra* note 9, at 6.

⁷² Firms that filed for, but did not complete, an IPO are included in Appendix A, *infra*, because such firms provide insight into Delaware's success in attracting large, but privately held LLCs.

⁷³ Delaware appears to enjoy a similar monopoly with respect to limited partnerships. See Manesh, *supra* note 10, at 476, 515–17. Although it is beyond the scope of this Article, many of the claims and conclusions in this Article with respect to LLCs could also be applied to limited partnerships.

⁷⁴ See Kobayashi & Ribstein, *supra* note 9, at 22–23, 34–35. Professors Dammann and Schündeln report similar results. See Dammann & Schündeln, *supra* note 9, at 8. Of LLCs with more than one thousand employees that elect to organize outside of their home state, Professors Dammann and Schündeln find that over eighty-two percent elect to organize under Delaware law. *Id.*

⁷⁵ Kobayashi & Ribstein, *supra* note 9, at 34–35.

poses,⁷⁶ several states, including Delaware, charge an entity-level tax to LLCs organized or doing business in the state.⁷⁷ And, as a result of the ever-increasing formation of LLCs in Delaware, the annual tax charged to domestic LLCs is becoming increasingly important to Delaware's revenue stream. The table below shows the actual revenue generated by Delaware from the annual tax charged to LLCs and limited partnerships ("LPs") from 2005 to 2009 and the projected revenue to be generated in 2010 and 2011. Although this data includes revenue attributable to both annual LLC and LP taxes, because the number of LLCs formed in Delaware in recent years has been approximately ten times the number of LPs,⁷⁸ the increase in this revenue can be reasonably attributed to the proliferation of LLCs in Delaware.

Year	Revenue Attributable to Annual Taxes from LLCs and LPs (in millions)	Percent of Gross State Revenue
2005	\$63.4	2.0%
2006	\$76.5	2.3%
2007	\$91.9	2.6%
2008	\$107.6	2.9%
2009	\$137.1	4.0%
2010	\$147.8**	4.7%**
2011	\$158.1**	5.0%**

* State of Delaware Governor's Recommended Budget for Fiscal Years 2007-2011
 ** Projected

⁷⁶ DAVID J. CARTANO, FEDERAL AND STATE TAXATION OF LIMITED LIABILITY COMPANIES 111-12 (2010 ed. 2009); Ribstein & Kobayashi, *supra* note 14, at 94-95.

⁷⁷ See MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK §§ 3:111, :120 (2009-2010 ed. 2009).

⁷⁸ The number of LLCs formed in Delaware compared to LPs and LLPs (combined) from 2003 to 2009 is shown below.

Year	New LPs/LLPs	New LLCs	Ratio of New LLCs to New LPs/LLPs
2003	5,929	55,381	9.34
2004	7,753	68,641	8.85
2005	8,802	87,630	9.95
2006	9,948	96,831	9.73
2007	9,813	111,820	11.39
2008	7,623	81,923	10.74
2009	5,488	70,274	12.81

See 2009 DELAWARE ANNUAL REPORT, *supra* note 30, at 1; 2008 DELAWARE ANNUAL REPORT, *supra* note 68, at 1; 2007 DELAWARE ANNUAL REPORT, *supra* note 68, at 1; 2006 DELAWARE ANNUAL REPORT, *supra* note 68, at 1; 2005 DELAWARE ANNUAL REPORT, *supra* note 68, at 1.

The numbers above demonstrate that, like corporate franchise taxes, the revenue Delaware generates from LLC taxes represents an important—and growing—part of its total annual revenue.⁷⁹

In sum, the picture that emerges from these data is that Delaware's success in attracting corporate charters is being recreated in the LLC context. Although substantial market share does not always equate to market power,⁸⁰ the impressive rate at which LLCs continue to form in Delaware, coupled with Delaware's apparent success in attracting large and publicly traded LLCs, together suggest that Delaware would command substantial market power. And, as it has in the corporate context, one would reasonably expect Delaware to exploit this market power to charge a premium and even price discriminate among LLCs for the simple privilege of organizing under Delaware law. But, as shown in the next Section, Delaware has done neither.

D. *The LLC Tax*

What does Delaware charge LLCs organizing under Delaware laws? Like corporations, Delaware charges all new LLCs a nominal one-time fee—\$90 in the case of LLCs—to organize under Delaware law.⁸¹ Unlike corporations, however, Delaware LLCs are not subject to a variable franchise tax. Instead, Delaware charges all domestic LLCs a flat \$250 annual tax, regardless of the LLC's size, income, or business conducted in the state.⁸²

Noticeably, Delaware's LLC tax lacks the two unique features of its corporate franchise. First, unlike its corporate franchise tax, Delaware's LLC tax does not represent a significant premium for the privilege of organizing in Delaware. Second, Delaware's LLC tax does not price discriminate.

⁷⁹ DELAWARE STATE BUDGET FY 2011, *supra* note 34, at 6; DELAWARE STATE BUDGET FY 2010, *supra* note 34, at 6; DELAWARE STATE BUDGET FY 2009, *supra* note 34, at 2; DELAWARE STATE BUDGET FY 2008, *supra* note 34, at 2; DELAWARE STATE BUDGET FY 2007, *supra* note 34, at 2.

⁸⁰ *See, e.g.* AM. BAR ASS'N, MARKET POWER HANDBOOK: COMPETITION LAW AND ECONOMIC FOUNDATIONS 71–72 (2005). Even so, market share often serves as a rough proxy for measuring market power. *Id.* at 84, 100–01.

⁸¹ The fee includes a standard \$70 filing fee, see DEL. CODE ANN. tit. 6, § 18-1105(a)(3) (West, Westlaw through 2010 legislation), and a \$20 courthouse municipality fee. *See id.* § 18-206(e) (2005 & Supp. 2008).

⁸² *Id.* § 18-1107(b) (2005 & Supp. 2008).

1. The LLC Tax Is Not a Substantial Premium

In the corporate context, Delaware is unique in that it is the only state that charges firms a significant premium for the privilege of incorporating in the state.⁸³ This is because Delaware's franchise tax can impose a significant tax liability on a corporation wholly unrelated to the amount of business that corporation conducts in the state.⁸⁴

In the LLC context, Delaware charges all domestic firms \$250 for the privilege of organizing in the state. For reasons that may seem plainly obvious, Delaware's LLC tax does not represent a substantial premium when compared to other states.

Appendix B summarizes the annual entity-level taxes the various states charge to domestic LLCs. These taxes are the LLC analog of corporate franchise taxes. In addition, for the sake of completeness, Appendix B also summarizes the various other fees—including initial filing and periodic reporting fees—that states charge domestic LLCs. Although typically insubstantial, such fees are nonetheless a component of the price that states charge domestic LLCs. And, in a few instances, such fees are actually larger than the annual entity-level tax charged to LLCs.⁸⁵

As Appendix B shows, all states fall into one of three groups. In the first group are twenty-seven states that charge no entity-level tax on domestic LLCs. When compared to these states, Delaware's LLC tax may seem to represent a premium price,⁸⁶ but at a rate of only \$250 per year, one that is negligible to all but the most miserly firms.

In the second group are eleven states (and the District of Columbia) that charge both domestic and foreign LLCs an annual entity-level tax based on some measure of the LLC's business in that state. For these states, the LLC tax is a charge for the privilege of doing business in the state, rather than a charge for organizing in the state. Because domestic and foreign LLCs are taxed equally on the in-state portion of their tax base, it makes no difference whether an LLC is organized in that state.⁸⁷ These states are, therefore, like the first group of states that

⁸³ Kahan & Kamar, *supra* note 3, at 1221.

⁸⁴ *Id.* at 1218.

⁸⁵ Consider Tennessee for example. LLCs organized in Tennessee are required to pay up to \$3000 per year in connection with the filing of their annual report. *See* Appendix B, *infra*. The state also charges LLCs an annual entity-level tax, although that tax may be as low as \$100 per year. *Id.*

⁸⁶ In fact, although Massachusetts does not charge LLCs an entity-level tax, it does charge domestic LLCs a \$500 annual filing fee, which is actually greater than Delaware's \$250 LLC tax.

⁸⁷ *See* Kahan & Kamar, *supra* note 3, at 1219–20 (noting, in the context of corporate franchise taxes, that in states where “domestic and foreign corporations are taxed equally on the in-state portion of their tax base, corporations face no additional cost to incorporat-

charge no entity-level tax on domestic LLCs. Because foreign and domestic LLCs are taxed alike, each state in this second group in effect charges no additional price for the privilege of organizing in the state.

That leaves twelve states in the third group. Each of these states charges domestic LLCs a flat or minimum annual tax, regardless of the amount of the LLC's business in the state. Each of these states, thus, charges domestic LLCs simply on the basis of organizing in the state. Five states within this last group—Arkansas, Connecticut, Delaware, Rhode Island, and Vermont—charge all domestic LLCs a flat annual tax. The remaining eight—Alabama, California, Kentucky, New York, Ohio, Tennessee, West Virginia, and Wyoming—charge both domestic and foreign LLCs based on some measure of the LLC's business in that state, but subject to a minimum tax. Because a domestic LLC in these states would still be subject to a minimum tax even if it had no business within the state, the minimum tax represents a tax charged simply for the privilege of organizing in the state.

Within this group, Delaware is squarely unexceptional. The average tax rate among these states is \$238 annually.⁸⁸ Indeed, five states in this last group charge domestic LLCs a minimum annual tax equal to or greater than Delaware's: Arkansas (\$300 flat), California (\$800 minimum), Connecticut (\$250 flat), Rhode Island (\$500 flat), and Vermont (\$250 flat).

2. The LLC Tax Does Not Price Discriminate

In the corporate context, Delaware's franchise tax tends to price discriminate.⁸⁹ Corporations that attribute a higher value to being incorporated in Delaware, typically large, publicly traded firms, are charged a higher franchise tax than smaller firms.⁹⁰

In the LLC context, however, Delaware does not price discriminate. The flat structure of the LLC tax simply prevents that. Because all LLCs are charged the exact same annual tax of \$250, Delaware cannot

ing"); Kahan & Kamar, *supra* note 25, at 688 (noting, in the context of corporate franchise taxes, that a "tax based on business conducted in the state does not generate any revenues from incorporations because a company incorporated in the state pays the same amount of tax as it would if it were incorporated elsewhere").

⁸⁸ \$238 represents the average of the minimum tax possible for LLCs organized in Alabama (\$100), California (\$800), Kentucky (\$175), New York (\$25), Tennessee (\$100), West Virginia (\$50), and Wyoming (\$50), and the flat tax imposed on LLCs organized in Arkansas (\$300), Connecticut (\$250), Delaware (\$250), Rhode Island (\$500), and Vermont (\$250).

⁸⁹ See Kahan & Kamar, *supra* note 3, at 1223–29.

⁹⁰ *Id.*

charge any firm more (or less) based on that firm's desire to be organized in Delaware.

Arguably, Delaware's failure to price discriminate among LLCs in the way that it has for corporations is not surprising given the differences between these two forms of business associations. When compared to LLCs, which are "creatures of contract" and can therefore take on any number of idiosyncratic forms, the corporation is a relatively standardized business form, subject to certain mandatory rules,⁹¹ including rules regarding the corporation's capitalization and capital structure.⁹² In the corporate context, Delaware can use this standardization to scale its franchise tax to each firm's capitalization in a way that can be simply applied to all corporations. If Delaware tried to take this same approach with respect to LLCs, one could argue, then LLCs would simply engage in regulatory arbitrage, taking advantage of the contractual freedom afforded under LLC law to arrange their capital structures in a way that minimizes the LLC tax.

This observation, however, cannot explain why Delaware has failed to charge LLCs a scalable tax based on some other, noncontractible aspect of the firm that could be simply applied to all LLCs. For example, one could easily imagine an LLC tax based on the LLC's total gross assets—a metric that Delaware already uses for computing the franchise tax charged to corporations.⁹³ By basing its tax on each LLC's total gross assets, Delaware could achieve in the LLC context price discrimination comparable to what it has in the corporate context. Assuming this metric is good enough to use in the corporate context, it is hard to see how LLCs could engage in arbitrage to minimize their tax in the LLC context.

The lack of price discrimination for LLCs is significant because it effectively means that Delaware offers larger firms a steep "discount"—up to \$179,750 per year—to organize as LLCs rather than corporations.⁹⁴ To illustrate this discount, consider the example of Fortress Investment Group, a Delaware LLC that went public in February 2007.⁹⁵ Fortress is the type of large, publicly traded firm that would most value

⁹¹ See *infra* notes 188–197 and accompanying text.

⁹² See, e.g., DEL. CODE ANN. tit. 8, § 102(a)(4) (West, Westlaw through 2010 legislation); *id.* § 151 (2001).

⁹³ See *id.* § 503(a)(2) (West, Westlaw through 2010 legislation).

⁹⁴ For a discussion of the implications of this so-called "discount," see *infra* notes 326–333 and accompanying text.

⁹⁵ See Michael J. de la Merced, *Fortress Goes Public, a First for Hedge Funds Inside U.S.*, N.Y. TIMES, Feb. 9, 2007, at C2; Dan Seymour, *In a First, Hedge Fund Launches on NYSE; Fate of Fortress Eyed Closely by Peers*, WASH. POST, Feb. 10, 2007, at D1.

incorporation in Delaware.⁹⁶ At the end of 2009, the firm had assets summing to approximately \$1.66 billion.⁹⁷ As of February 24, 2010, Fortress had 145,834,435 Class A shares and 307,773,852 Class B shares issued and outstanding.⁹⁸ Under the terms of its LLC governing agreement, Fortress is authorized to issue 1 billion Class A shares, 750 million Class B shares, and 250 million preferred shares.⁹⁹ As illustrated in the table below, if Fortress were a Delaware corporation, it would pay the maximum annual franchise tax of \$180,000 under either the authorized shares method or the APVC method.¹⁰⁰ Fortress, however, is organized as a Delaware LLC, subject only to the \$250 LLC tax.

	Authorized Shares Method	APVC Method	Computed Tax
Corporate Franchise Tax	\$180,000*	\$180,000*	\$180,000*
LLC Tax	n/a	n/a	\$250
Tax Savings to LLC		\$179,750	

* The franchise tax is capped at the statutory maximum

Although an annual savings of \$179,750 might seem negligible for billion dollar firms like Fortress, consider the more marginal cases, like the hypothetical firms from Table 2 above. Table 7 below shows the tax savings each firm would enjoy if it were organized as a Delaware LLC rather than a Delaware corporation, and the percentage difference such savings would represent.

	Total Gross Assets (in millions)	Corporate Franchise Tax	LLC Tax	Annual LLC Tax Savings	Annual Percent Difference in Taxes
Corporation A	\$1.0	\$225	\$250	(\$25)	90%
Corporation B	\$1.0	\$675	\$250	\$425	270%

⁹⁶ See Kahan & Kamar, *supra* note 3, at 1225–28 (arguing that public companies place a higher value than nonpublic companies on incorporation in Delaware and that “among public corporations, the value of incorporation in Delaware increases with the size of the company”).

⁹⁷ Fortress 2009 Annual Report, *supra* note 12, at 79.

⁹⁸ *Id.* at cover page.

⁹⁹ FORTRESS INV. GRP. LLC, THIRD AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT, in Annual Report (Form 10-K), Exhibit 3.2, at Section 3.2(d) (Mar. 28, 2008) [hereinafter FORTRESS LLC AGREEMENT], available at <http://www.sec.gov/Archives/edgar/data/1380393/000095013608001568/file2.htm>.

¹⁰⁰ Fortress’s assets, as reported on its audited balance sheet, see Fortress 2009 Annual Report, *supra* note 12, at 37, are assumed equal to the company’s “gross assets” for purposes of computing its hypothetical franchise tax.

Corporation C	\$30.0	\$21,000	\$250	\$20,750	8,400%
Corporation D	\$90.0	\$37,575	\$250	\$37,325	15,030%
Corporation E	\$90.0	\$47,250	\$250	\$47,000	18,900%
Corporation F	\$900.0	\$180,000	\$250	\$179,750	72,000%
Fortress	\$1,660.3	\$180,000	\$250	\$179,750	72,000%

As this table illustrates, for smaller, more price-sensitive firms, the tax savings can be significant. Indeed, for any firm with more than 20,000 authorized shares and \$714,285 in assets (or less depending on the ratio of authorized to issued shares),¹⁰¹ the absence of LLC price discrimination means that such firms will pay more in taxes as a Delaware corporation than as a Delaware LLC.

E. Implications of Pricing on Delaware's Market Power

The foregoing discussion has shown that a comparison of Delaware's corporate franchise tax to its LLC tax reveals a curious discrepancy. In the jurisdictional competition for corporate charters, Delaware has long exploited its market power by charging premium and discriminatory prices.¹⁰² In the jurisdictional competition for LLCs, however, Delaware does neither. The implications of this finding are not obvious.

To be clear, the fact that Delaware does not charge premium or discriminatory prices for its LLC law product does not preclude the possibility that Delaware has some kind of market power in the jurisdictional competition for LLC charters. But, if Delaware does enjoy market power, it is not reflected in Delaware's LLC prices. Nonetheless, it is possible that Delaware's market power is exploited in other, less obvious ways. Or, it may be that Delaware has simply elected to not exploit its market power altogether. Either scenario would raise its own interesting questions.¹⁰³

Another possibility is that Delaware's failure to charge premium, discriminatory prices for its LLC law product reflects the fact that, in the jurisdictional competition for LLC charters, Delaware lacks market power—or at least the kind of market power it has long enjoyed for corporate charters. To be sure, Delaware's apparent success in attracting large,

¹⁰¹ Under the authorized share method, any corporation with 20,001 or greater authorized shares would be assessed a franchise tax of at least \$300. Likewise, under the APVC method, any corporation with 20,001 or greater authorized shares, and \$714,285 or greater gross assets, regardless of the number of issued shares, would be assessed a franchise tax exceeding \$250.

¹⁰² See Kahan & Kamar, *supra* note 3, at 1217–30.

¹⁰³ For example, if Delaware has market power for LLCs and can charge a premium, why has it failed to do so, even as it is facing a deficit in its annual state budget? See, e.g., Suzette Parmley, *Delaware Debates Expanding Gambling*, PHILA. INQUIRER, Apr. 1, 2010, at C1.

publicly traded and out-of-state LLCs, militates against the possibility that Delaware has *no* market power.¹⁰⁴ But Parts III and IV show why, in the jurisdictional competition for LLC charters, Delaware may lack the same competitive strengths and, therefore, the same market power that it has long enjoyed in the competition for corporate law.¹⁰⁵

II. DELAWARE'S TRADITIONAL COMPETITIVE ADVANTAGES

One obvious explanation for the curious discrepancy in the prices Delaware charges for its LLC and corporate law products would be that, in the competition for LLC charters, Delaware's law product does not offer the same advantages that it does in the market for corporate law. But, as this Part shows, a cursory examination of Delaware's LLC law product suggests that this is not the case.¹⁰⁶

In the corporate context, Delaware's market power derives from the fact that it provides a superior product with imperfect substitutes.¹⁰⁷ As Professors Kahan and Kamar have explained:

In perfectly competitive markets, producers sell products at the price equal to the marginal cost of production. Because any product in such a market has perfect substitutes, competition drives the price down to the lowest level at which producers are willing to manufacture and sell the product [P]roducers with market power can increase their profits by charging a price above marginal costs. Market power exists whenever a producer offers a product that has only imperfect substitutes. A producer in such a market need not fear competition by rivals offering an identical product, and can therefore set prices high enough to earn positive economic profits.¹⁰⁸

Although all states have corporate statutes, Delaware's corporate law product offers certain competitive advantages that serve to differentiate it from its rivals in the market for corporate law. Past scholarship has traditionally identified these competitive advantages to include (1) the network effects associated with Delaware's substantive law, (2) the expertise of the Delaware judiciary, (3) the speed and efficiency of Delaware's administrative services, and (4) Delaware's credible com-

¹⁰⁴ See *supra* notes 72–75, 80 and accompanying text.

¹⁰⁵ See *infra* notes 162–349 and accompanying text.

¹⁰⁶ See *infra* notes 107–161 and accompanying text.

¹⁰⁷ See Kahan & Kamar, *supra* note 3, at 1215.

¹⁰⁸ *Id.*

mitment to meet corporate needs.¹⁰⁹ These competitive advantages give Delaware's corporate law product market power over its rival states. Because firms value these features of Delaware's corporate law product, Delaware is able to charge, and firms are willing to pay, a premium price to incorporate in the state.¹¹⁰

This Part shows that each of these competitive advantages appears to be present in Delaware's LLC law product. Put differently, a comparison of Delaware's corporate and LLC law products suggests that Delaware would enjoy similar market power in the competition for LLC charters. Thus, the four competitive advantages traditionally identified by past scholarship cannot alone explain why Delaware fails to charge a premium or discriminatory price for its LLC law product.¹¹¹

A. Network Effects and Learning Effects

In the corporate context, Delaware law benefits from certain network effects and learning effects resulting from Delaware's historical and continuing popularity with corporations.¹¹² Although the difference between network effects and learning effects can be nuanced,¹¹³ both basically relate to Delaware's popularity as a corporate domicile.

In short, learning effects are backward-looking and arise from Delaware's historical popularity among corporations.¹¹⁴ So, for example, because Delaware has been the longtime leader in attracting corporate

¹⁰⁹ See, e.g., Bebchuk & Hamdani, *supra* note 8, at 580, 586–89; Fisch, *supra* note 3, at 1068; Kahan & Kamar, *supra* note 3, at 1212–13; Kamar, *supra* note 8, at 1923–27; see also 2009 DELAWARE ANNUAL REPORT, *supra* note 30, at 1 (noting that “[b]usinesses choose Delaware not for one single reason, but because we provide a complete package of incorporation services” including the expert Chancery Court and “prompt, friendly, and professional [administrative] service[s]”); Connaway, *supra* note 69, at 801 (noting that Delaware enjoys similar competitive advantages in the competition for alternative business forms such as LLCs).

¹¹⁰ See Kahan & Kamar, *supra* note 3, at 1210–12.

¹¹¹ See *infra* notes 112–161 and accompanying text.

¹¹² See Kamar, *supra* note 8, at 1923; see also Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774–89 (1995) (discussing the network externalities and learning effects of corporate law generally). Although some will use “network effects” and “network externalities” interchangeably, the term “network externalities” adds the implication that a network effect is causing some sort of market inefficiency. See Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CALIF. L. REV. 479, 482 n.5 (1998). Because this Article is not expressly concerned with any inefficiencies caused by network effects, it avoids the use of the term “network externalities.”

¹¹³ See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 725–27 (1997); Klausner, *supra* note 112, at 779, 786–89. Although network effects and learning effects are distinct phenomena, this Article, for the sake of readability, sometimes refers to both the network effects and learning effects of Delaware corporate and LLC law as “network effects.”

¹¹⁴ See Kamar, *supra* note 8, at 1924; see also Klausner, *supra* note 112, at 786–89.

charters, Delaware today enjoys a vast and instructive body of case law, broader than that of any other state.¹¹⁵ As a result of its breadth, Delaware offers case law applying to a variety of factual scenarios, giving corporations the perception of certainty and predictability as to the law.¹¹⁶

In contrast to learning effects, network effects are forward-looking and reflect Delaware's existing popularity among corporations.¹¹⁷ So, for example, because of the number of corporations currently domiciled in Delaware, matters of Delaware corporate law are frequently litigated.¹¹⁸ The judicial opinions that result from frequent litigation benefit all members of the Delaware network, because such opinions provide firms with interpretive guidance on matters of Delaware corporate law. Likewise, because of its widespread use, legal and financial advisors are already familiar with and have developed expertise in Delaware corporate law.¹¹⁹ This familiarity and expertise reduces the costs of professional services to all firms incorporated in Delaware.¹²⁰ Because Delaware offers the broadest network, its corporate law appears more attractive to firms than the law of its rival states.¹²¹ And, as more firms join Delaware's corporate network, the more network effects benefit all Delaware corporations.¹²²

In the LLC context, Delaware's learning effects and network effects are less obvious. Because the LLC form is relatively new and has only recently emerged as a popular alternative to the corporate form, no state—Delaware included—offers learning effects or network effects for LLC law comparable to Delaware's corporate network. But, even in this context, Delaware's law product could offer LLCs certain unique advantages.

¹¹⁵ Kahan & Kamar, *supra* note 3, at 1212; Kamar, *supra* note 8, at 1924; Romano, *supra* note 42, at 274.

¹¹⁶ Kahan & Kamar, *supra* note 3, at 1212; Kamar, *supra* note 8, at 1924; Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 484 (1987); Romano, *supra* note 42, at 274.

¹¹⁷ Kamar, *supra* note 8, at 1924. Although distinct phenomena, network effects and learning effects are related in that "a product widely used in the past is often still widely used in the present." *Id.*

¹¹⁸ See Bebchuk & Hamdani, *supra* note 8, at 586–87; Klausner, *supra* note 112, at 845; Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 723 (1987); Romano, *supra* note 42, at 277.

¹¹⁹ See Bebchuk & Hamdani, *supra* note 8, at 587; Kahan & Kamar, *supra* note 3, at 1212; Kamar, *supra* note 8, at 1924; Klausner, *supra* note 112, at 846.

¹²⁰ See Kahan & Kamar, *supra* note 25, at 725; Kahan & Kamar, *supra* note 3, at 1212; Kamar, *supra* note 8, at 1924; Klausner, *supra* note 112, at 846; Romano, *supra* note 118, at 723; Romano, *supra* note 42, at 274–75.

¹²¹ Kamar, *supra* note 8, at 1924.

¹²² See Klausner, *supra* note 112, at 772 (describing network effects generally).

Consider first learning effects. Although no state currently offers a particularly rich breadth of LLC case law, Delaware does, as a result of its apparent popularity as a domicile for LLCs, offer a relatively robust body of LLC case law.¹²³ And, given Delaware's popularity as a domicile for LLCs, this body of case law is likely only to grow.¹²⁴ This existing

¹²³ Consider, for example, the number of new LLC opinions generated by the Delaware Court of Chancery relating to various LLC matters in recent years. *See generally, e.g., In re Atlas Energy Res., LLC*, No. 4589-VCN, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010) (deciding the applicability of fiduciary duties to contractual provisions in an LLC agreement purporting to modify such duties); *Related Westpac LLC v. JER Snowmass LLC*, No. 5001-VCS, 2010 WL 2929708 (Del. Ch. July 23, 2010) (deciding various LLC-related claims, including claims based on the implied contractual covenant of good faith and fair dealing, unjust enrichment, and breach of fiduciary duties); *Kuroda v. SPJS Holdings, LLC*, No. 4030-CC, 2010 WL 925853 (Del. Ch. Mar. 16, 2010) (deciding various LLC-related claims, including claims based on the implied contractual covenant of good faith and fair dealing and the applicability of fiduciary duties); *PT China LLC v. PT Korea LLC*, No. 4456-VCN, 2010 WL 761145 (Del. Ch. Feb. 26, 2010) (addressing the Delaware courts' personal jurisdiction over an LLC manager); *Kelly v. Blum*, No. 4516-VCP, 2010 WL 629850 (Del. Ch. Feb. 24, 2010) (deciding various LLC-related claims, including claims based on the implied contractual covenant of good faith and fair dealing and the applicability of fiduciary duties); *Lola Cars Int'l Ltd. v. Krohn Racing, LLC*, Nos. 4479-CVN, 4886-VCN, 2009 WL 4052681 (Del. Ch. Nov. 12, 2009) (deciding LLC-based claims for dissolution, demand futility and breach of the implied contractual covenant of good faith and fair dealing); *R & R Capital, LLC v. Merritt*, No. 3989-CC, 2009 WL 2937101 (Del. Ch. Sept. 3, 2009) (interpreting the removal provision of an LLC governing agreement); *Mickman v. Am. Int'l Processing, L.L.C.*, No. 3869-VCP, 2009 WL 2244608 (Del. Ch. July 28, 2009) (interpreting LLC members' inspection rights under the terms of an LLC governing agreement); *In re Nextmedia Investors, LLC*, No. 4067-VCS, 2009 WL 1228665 (Del. Ch. May 6, 2009) (interpreting the amendment provision of an LLC governing agreement); *In re Arrow Inv. Advisors, LLC*, No. 4091-VCS, 2009 WL 1101682 (Del. Ch. Apr. 23, 2009) (interpreting the business purpose provision of an LLC governing agreement); *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. 3658-VCS, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009) (interpreting the implied contractual covenant of good faith and fair dealing and breach of fiduciary duty claims in the LLC context); *Kuroda v. SPJS Holdings, LLC*, 971 A.2d 872 (Del. Ch. 2009) (deciding various claims, including LLC-related claims based on the implied contractual covenant of good faith and fair dealing); *Spellman v. Katz*, No. 1838-VCN, 2009 WL 418302 (Del. Ch. Feb. 6, 2009) (interpreting the dissolution provision of an LLC governing agreement and the pleading requirements for bringing a derivative claim); *Fisk Ventures, LLC, v. Segal*, No. 3017-CC, 2009 WL 73957 (Del. Ch. Jan. 13, 2009) (interpreting the statutory provision permitting judicial dissolution of an LLC); *R & R Capital, LLC v. Buck & Doe Run Valley Farms, L.L.C.*, No. 3803-CC, 2008 WL 3846318 (Del. Ch. Aug. 19, 2008) (holding LLC members may, pursuant to the terms of the LLC governing agreement, waive their statutory right to seek dissolution of the LLC); *Fisk Ventures, L.L.C. v. Segal*, No. 3017-CC, 2008 WL 1961156 (Del. Ch. May 7, 2008) (deciding issues relating to Delaware courts' personal jurisdiction over an LLC member, the interpretation of an LLC governing agreement, and the implied contractual covenant of good faith and fair dealing).

¹²⁴ *See* Jack B. Jacobs, *Entity Rationalization: A Judge's Perspective*, 58 BUS. LAW. 1043, 1044 (2003) (noting the recent proliferation of litigation in Delaware in the context of LLCs and other non-corporate business entities); Larry E. Ribstein, *Making Sense of Entity Rationalization*, 58 BUS. LAW. 1023, 1031 (2003) ("[I]n recent years hundreds of LLC cases have

case law, and whatever is sure to accumulate going forward, would ostensibly provide LLC managers, investors, and attorneys with the same kind of interpretive guidance and certainty that their corporate counterparts have long valued.

Even if firms find Delaware's existing body of LLC case law lacking, Delaware LLCs can effectively tap into Delaware's vast and instructive body of corporate case law to capture the learning effects that that body of law offers. For example, consider again Fortress Investment Group. Fortress's governing agreement,¹²⁵ which delineates the terms of the firm's internal governance, is the LLC analog to a corporate certificate of incorporation and bylaws. Like other Delaware LLCs,¹²⁶ Fortress's governing agreement effectively mimics the corporate form by organizing the LLC's internal governance structure to mirror that of a Delaware corporation.¹²⁷ The LLC governing agreement vests the authority to manage the business and affairs of Fortress in a board of directors, akin to a corporate board of directors.¹²⁸ Like a corporate board of directors, the Fortress board may in turn appoint and delegate its authority to company officers to oversee the day-to-day business of the firm.¹²⁹ And, like corporate shareholders, Fortress's shareholders are entitled to basic voting rights, including the right to vote for the annual election of directors and on certain fundamental transactions.¹³⁰ Indeed, beyond simply mimicking the superficial governance structure of a corporation, Fortress's governing agreement provides:

Except as otherwise expressly provided in this Agreement (i) the duties and obligations owed to the Company by the Officers and Directors shall be the *same* as the duties and obligations owed to a corporation organized under [Delaware General Corporation Law] by its officers and directors, respectively, and (ii) the duties and obligations owed to the Mem-

shown the power of new forms in attracting judicial decision in a relatively short amount of time."); Walsh & Gattuso, *supra* note 10, at 11 ("The rapid deployment of [Delaware] LLCs by the business community has naturally led to an uptick in LLC litigation. That litigation has resulted in steady development of the case law surrounding and construing the Delaware Limited Liability Company Act.").

¹²⁵ See generally FORTRESS LLC AGREEMENT, *supra* note 99.

¹²⁶ See *infra* note 241 (comparing significant terms of the LLC governing agreements of Fortress Investment Group and Och-Ziff Capital Management and noting the similarities between the two).

¹²⁷ See Manesh, *supra* note 10, at 485–86 (summarizing the significant terms of the governing agreements of Fortress and Och-Ziff Capital Management and noting the similarities to the corporate governance structure).

¹²⁸ FORTRESS LLC AGREEMENT, *supra* note 99, § 5.1.

¹²⁹ *Id.* §§ 5.1, 5.22.

¹³⁰ *Id.* §§ 5.3, 10.3.

bers by the Officers and Directors shall be the *same* as the duties and obligations owed to the shareholders of a corporation under [Delaware General Corporation Law] by its officers and directors, respectively.¹³¹

Provisions like these effectively allow Delaware LLCs to capture all of the learning effects offered by Delaware corporate law.¹³² By referencing Delaware's corporate law, Fortress's LLC governing agreement incorporates every precedent of Delaware's vast body of corporate case law, as well as all of the interpretive guidance, certainty, and predictability that body of law may offer.

Consider next the network effects associated with Delaware LLC law. Provisions like the one found in Fortress's governing agreement allow Fortress and other Delaware LLCs to capture not only the learning effects associated with Delaware corporate law, but also the network effects derived from Delaware's corporate law network. Because the duties of Fortress's officers and directors are the "same as the duties" of officers and directors under Delaware corporate law, such duties will evolve as Delaware corporate law evolves. Every new Delaware case adjudicating the duties and obligations of corporate officers and directors will provide additional meaning and interpretive guidance to Fortress's governing agreement. And, because legal and financial advisors already closely follow Delaware corporate law, Fortress would seemingly also enjoy the same efficient and expert professional advice that Delaware's corporate law network provides.

In addition to leveraging the network effects of its corporate law, Delaware offers LLCs a rapidly growing, independent network for LLC law. Recall that network effects are forward-looking. The more users, the greater the network effects. Today, as the number of LLCs formed in Delaware outpaces the number of corporations by nearly three to one,¹³³ Delaware's LLC network is expanding faster than its corporate network. This rapid expansion suggests that Delaware is poised to offer the same kinds of network benefits to LLCs that it currently offers to

¹³¹ *Id.* § 5.23.

¹³² Note, however, that Delaware LLCs are not required to adopt all of the provisions of Delaware's corporate law wholesale in order to capture corporate law learning effects. To the extent an LLC disfavors any provision of Delaware corporate law, it may modify, waive, or supersede that provision in the LLC's governing agreement. *See infra* notes 188–193 and accompanying text. Indeed, Fortress does just that. *See* Manesh, *supra* note 10, at 488–91 (describing how Fortress's governing agreement modifies the traditional fiduciary duties under corporate law). Thus, Delaware LLCs are permitted to pick and choose which provisions of Delaware corporate law to adopt and therefore which learning effects to capture.

¹³³ *See supra* notes 68–69 and accompanying table (Table 3) and text.

corporations. As more LLCs form in Delaware, more LLC litigation and judicial precedents will accumulate.¹³⁴ And, as this burgeoning body of LLC law develops, it would seemingly benefit all members of the Delaware LLC network by providing LLCs and their managers and advisors with valuable guidance on matters of LLC governance and statutory interpretation. Indeed, the growth of the Delaware LLC network is reflected in the marketing materials of many national law firms. As more and more of their LLC clients elect to domicile in Delaware, such firms are required to inform themselves and keep abreast of the developments in Delaware law. Today, national law firms regularly publish client advisories, bulletins, and similar publications, tracking significant developments and marketing their expertise in Delaware LLC law.¹³⁵ As lawyers develop this expertise, Delaware's growing LLC network, like its established corporate network, would ostensibly reduce the cost and enhance the quality of legal services for all of its members.

In sum, to the extent corporations value Delaware's learning and network effects, similar considerations would seemingly lead LLCs to choose Delaware as well.¹³⁶ Delaware's ability to leverage the existing network effects of its corporate law, coupled with its rapidly expanding independent network for LLC law, suggests that Delaware LLC law would enjoy the same competitive advantage with respect to learning and network effects that its corporate law has long enjoyed.

¹³⁴ See sources cited *supra* note 124.

¹³⁵ See, e.g., *Implied Contractual Covenant of Good Faith and Fair Dealing—Kelly v. Blum, Kuroda v. SPJS Holdings, L.L.C. and Nemeo v. Shrader, KNOWLEDGE CTR.* (Richards, Layton & Finger, Wilmington, Del.), Apr. 26, 2010, available at <http://www.rlf.com/KnowledgeCenter/EAlertsNewsletters?find=14807>; *Client Alert: Managers and Members of a Delaware LLC May Be Subject to "Traditional Fiduciary Duties,"* CORP. GOVERNANCE GROUP (Milbank, Tweed, Hadley & McCloy LLP, New York, N.Y.), Apr. 8, 2010, at 1–4, available at http://www.milbank.com/NR/rdonlyres/23D08746-9A76-44C6-A22A-07AA7D237113/0/040810_Kelly_v_Blum.pdf; *2009 Amendments to Delaware LLC, LP and GP Acts* (Skadden, Arps, Slate, Meagher & Flom LLP, New York, N.Y.), July 9, 2009, at 1–8, available at http://www.skadden.com/content/Publications/Publications1830_0.pdf; *Proposed Amendments to Delaware's LLC, Limited Partnership and Partnership Statutes*, CORP. & SECURITIES LAW ALERT (Pepper Hamilton LLP, Philadelphia, Pa.), May 13, 2009, available at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=1490; *Ability to Restrict Dissolution Filings Upheld Under Delaware LLC Act*, McDERMOTT NEWSLETTERS (McDermott, Will & Emery, Chicago, Ill.), Sep. 18, 2008, available at http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/7e22ec16-8feb-46b8-a584-fd8885a2150b.cfm.

¹³⁶ As noted above, Professors Ribstein and Kobayashi have raised doubts about the importance of network effects in the competition among business forms—namely the LLC versus LLP. See Ribstein & Kobayashi, *supra* note 14, at 82 (noting that the authors' data "enables a focus on the role of network externalities in the choice of form"). The discussion here concerns the importance of network effects in the jurisdictional competition among states. To the extent their skepticism about network effects applies more broadly to the jurisdictional competition among states, see *supra* note 14.

B. *Judicial Expertise and Experience*

In the corporate context, Delaware benefits from the reputation of its judges, who are widely considered to be experts in resolving business disputes in a quick and efficient fashion.¹³⁷ This expertise is a result of the long history and frequent exposure of the Delaware courts—particularly, the Delaware Court of Chancery—in adjudicating corporate disputes.¹³⁸ The chancery court, which has original jurisdiction over most corporate matters¹³⁹ but otherwise limited subject matter jurisdiction, decides most cases without juries, ensuring that its caseload is limited and concentrated on corporate matters that can be resolved quickly.¹⁴⁰ Due to their experience and expertise, Delaware judges, particularly Delaware chancellors, have developed a national reputation for providing quality adjudication in corporate matters and, today, are among the most highly regarded corporate adjudicators in the country.¹⁴¹

Of course, the same Delaware judges that adjudicate corporate matters are assigned to adjudicate LLC matters. Like corporate directors,¹⁴² the Delaware chancery court has personal jurisdiction over the managers of domestic LLCs.¹⁴³ Likewise, the chancery court has subject

¹³⁷ See, e.g., Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. L. Rev. 542, 589–90 (1990); Kahan & Kamar, *supra* note 25, at 708; Kamar, *supra* note 8, at 1925.

¹³⁸ Kamar, *supra* note 8, at 1925–26.

¹³⁹ See DEL. CODE ANN. tit. 8, § 111 (West, Westlaw through 2010 legislation).

¹⁴⁰ Kahan & Kamar, *supra* note 25, at 708; Kahan & Kamar, *supra* note 3, at 1212; see also Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 903 (1990) (noting that 75% of the chancery court's pending cases involve corporate matters).

¹⁴¹ See, e.g., Fisch, *supra* note 3, at 1077–78; Kurt M. Heyman, *Expedited Proceedings in the Delaware Court of Chancery: Things of the Past?*, 23 DEL. J. CORP. L. 145, 145 (1998); Kahan & Kamar, *supra* note 3, at 1212; Kamar, *supra* note 8, at 1921–26.

¹⁴² DEL. CODE ANN. tit. 10, § 3114 (2005 & Supp. 2009); see also Kahan & Kamar, *supra* note 25, at 714.

¹⁴³ DEL. CODE ANN. tit. 6, § 18-109(a) (2005); see also *PT China L.L.C.*, 2010 WL 761145, at *7–8 (holding the court has personal jurisdiction over a manager under DEL. CODE ANN. tit. 6, § 18-109 despite the manager's claims to the contrary). Interestingly, although almost all provisions of the Delaware LLC Act provide default rules from which the LLC parties may deviate by the terms of the LLC's governing agreement, see *infra* notes 188–195 and accompanying text, an LLC member “may not waive its right to maintain a legal action or proceeding in the courts of the State of Delaware with respect to matters relating to the organization or internal affairs of a limited liability company.” DEL. CODE ANN. tit. 6, § 18-109. As Chancellor William B. Chandler III has explained, this provision of the Delaware LLC Act “ensures that Delaware retains ultimate jurisdiction over its limited liability companies,” *R & R Capital, L.L.C.*, 2008 WL 3846318, at *5, meaning that this provision has the effect of ensuring that Delaware LLC litigation can always be brought before Delaware courts. This not only accelerates the creation of the Delaware LLC case law, but also affords Delaware judges the opportunity to develop and publicly demonstrate their expertise in LLC matters.

matter jurisdiction over issues of basic LLC internal governance, including the election, appointment, and removal of LLC managers,¹⁴⁴ as well as the interpretation, application, and enforcement of LLC governing agreements.¹⁴⁵ Given that the same judges handling Delaware corporate law matters also handle Delaware LLC matters, the Delaware chancery court's reputation for quality adjudication in the corporate context should readily translate to the LLC context. Even if the experience and expertise of the Delaware judges in substantive corporate law do not translate into LLC law, the growing popularity of Delaware LLCs suggests that the Delaware judges will have frequent exposure to LLC disputes and will develop comparable experience and expertise in such matters. Thus, to the extent corporations place value on the Delaware judiciary when deciding to incorporate in Delaware, the same consideration would ostensibly lead LLCs to make the same decision.

C. *Proficient Administrative Services*

In the corporate context, firms value Delaware's administrative bureaucracy, which is considered to provide modern and efficient filing, certification, and registration services.¹⁴⁶ Although such services may at first seem trivial, in the fast-paced world of corporate mergers and takeovers, expedient administrative services can be critical.¹⁴⁷ Today, Delaware's Department of State, Division of Corporations, which handles filings, registrations, and certifications for the state, offers not only expedited twenty-four hour and same-day filing services, but for a premium fee, also offers priority two-hour and even one-hour services.¹⁴⁸ And these expedited services are in high demand: in 2009 alone, expedited service revenue exceeded \$18 million for the state.¹⁴⁹ Indeed, Delaware's dominant market share for corporate charters may mean that Delaware enjoys a unique economy of scale that contributes to its responsiveness and efficiency in administrative matters.¹⁵⁰

¹⁴⁴ DEL. CODE ANN. tit. 6, § 18-110 (2005 & Supp. 2008).

¹⁴⁵ *Id.* § 18-111 (2005 & Supp. 2008).

¹⁴⁶ Kahan & Kamar, *supra* note 3, at 1213; *see also* Romano, *supra* note 42, at 274 n.70.

¹⁴⁷ *See* Alva, *supra* note 140, at 901-02.

¹⁴⁸ The fees currently charged by the Delaware Secretary of State, Division of Corporations, for one-hour and two-hour expedited services are available at <http://corp.delaware.gov/Aug09feesch.pdf>.

¹⁴⁹ 2009 DELAWARE ANNUAL REPORT, *supra* note 30, at 2. This figure is down from 2007, where expedited service revenue exceeded \$24 million for the state, representing a twenty percent increase from 2006. 2007 DELAWARE ANNUAL REPORT, *supra* note 68, at 2.

¹⁵⁰ Kahan & Kamar, *supra* note 3, at 1213 n.32.

Of course, the Delaware Department of State, Division of Corporations, also serves LLCs.¹⁵¹ The same expedited filing, registration, and certification services available to Delaware corporations are available to Delaware LLCs, and for the same fees.¹⁵² Moreover, lawyers and paralegals in the corporate practice, through their repeated interactions with Delaware's bureaucratic machinery, have developed a certain familiarity and trust in its operations. Thus, Delaware, because of its longtime popularity among corporations, is in a unique position to leverage this existing trust and familiarity into the world of LLCs. To the extent Delaware's efficient administrative services bureaucracy is a source of market power for attracting corporate charters, the same bureaucracy should provide Delaware with similar market power for attracting LLC charters.

D. Delaware's Credible Commitment

Finally, in the corporate context, Delaware is perceived to be uniquely committed to corporate needs.¹⁵³ Because incorporation fees and franchise taxes represent such a large portion of Delaware's annual budget, Delaware is, unlike any other state, under constant pressure to ensure this revenue stream continues.¹⁵⁴ Firms value Delaware's dependence on incorporation fees and franchise taxes because it means Delaware is less likely to adopt any law that its corporate taxpayers will disfavor.¹⁵⁵

To be sure, Delaware's revenue from LLC taxes is not currently as substantial as its revenue from corporate franchise taxes. Recall, between 2005 and 2009, 15.3% to 16.7% of Delaware's annual state income derived from corporate franchise taxes.¹⁵⁶ Although Delaware's revenue from LLC taxes during that same period was not as substantial, such taxes still represented a significant and steadily increasing portion of Delaware's annual revenue, doubling from 2.0% of its total revenue in 2005 to 4.0% in 2009.¹⁵⁷

More importantly, two facts loom over Delaware's future. First, although the corporate franchise tax has and continues to make a critical

¹⁵¹ See, e.g., DEL. CODE ANN. tit. 6, § 18-206 (West, Westlaw through 2010 legislation) (designating the Secretary of State as the governmental office responsible for receiving and handling filings related to Delaware LLCs).

¹⁵² See *supra* note 148.

¹⁵³ Kahan & Kamar, *supra* note 3, at 1213; see Kamar, *supra* note 8, at 1927; Romano, *supra* note 118, at 721-22.

¹⁵⁴ See Kahan & Kamar, *supra* note 3, at 1213; Kamar, *supra* note 8, at 1927; Romano, *supra* note 118, at 721-22.

¹⁵⁵ Macey & Miller, *supra* note 116, at 490-91; see Kahan & Kamar, *supra* note 3, at 121.

¹⁵⁶ See *supra* note 34 and accompanying table (Table 1).

¹⁵⁷ See *supra* note 79 and accompanying table (Table 5).

contribution to Delaware's annual revenue stream, that contribution has been virtually flat for some time.¹⁵⁸ Second, revenue from LLC taxes has during this same period steadily grown, and this growth is projected to only accelerate in the coming years.¹⁵⁹

No doubt, the growth trend in Delaware's LLC tax revenue can be largely attributed to the sheer volume of new LLCs being formed in Delaware. Rather than increasing its revenue by increasing the rate of the LLC tax, Delaware has been able to simply rely upon a growing LLC taxpayer base.¹⁶⁰ To achieve similar growth in its corporate franchise tax would require Delaware to increase the rate of the franchise tax, something that Delaware did in 2009.¹⁶¹ Otherwise, if these recent trends were to continue, the LLC tax would eventually eclipse the corporate franchise tax as a source of Delaware's revenue.

In sum, to Delaware, LLC taxes matter. LLC taxes already represent an important portion of Delaware's annual budget. And the rate at which Delaware LLC formations outpace corporate formations suggests that in the future, LLC taxes will matter even more. Thus, to the extent firms believe that Delaware's dependence on corporate franchise taxes forces Delaware to be credibly committed to corporate needs, the data regarding LLC taxes suggest Delaware would show a comparable commitment to LLCs.

III. CONTRACTIBILITY AND INDETERMINACY UNDER LLC LAW

The foregoing discussion showed that in the competition for LLC charters, Delaware seems to offer the same competitive advantages that have long afforded it market power in the competition for corporate charters. This Part now explains how the importance of two of those advantages may be substantially diminished under LLC law.

¹⁵⁸ See *supra* note 34 and accompanying table (Table 1) (showing that between 2005 and 2009, the revenue generated from corporate franchise taxes as a percentage of Delaware's total annual revenue has remained within a range of 15.3% and 16.7%).

¹⁵⁹ See *supra* note 79 and accompanying table (Table 5) (showing that revenue generated from LLC taxes between 2005 and 2009 has doubled from 2.0% to 4.0%).

¹⁶⁰ Delaware last increased its LLC franchise tax from \$200 to \$250 annually in 2008. See Act of Jan. 1, 2008, 76 Del. Laws ch. 287 (codified as amended at DEL. CODE ANN. tit. 6, § 18-1107 (2001 & Supp. 2009)). This increased tax became effective as of January 1, 2008. Since then, Delaware's annual revenue from the LLC tax has continued to increase and is projected to continue doing so in 2010 and 2011. See *supra* note 79 and accompanying table (Table 5). This actual and projected increase in revenue, thus, is attributable to the growth in the number of Delaware LLCs, rather than an increase in the rate of the LLC tax.

¹⁶¹ See Act of Jan. 1, 2009, 77 Del. Laws ch. 78, § 57 (codified as amended at DEL. CODE ANN. tit. 8, § 503 (2001 & Supp. 2009)) (increasing the rate and maximum amount of the franchise tax).

Specifically, this Part describes how the high level of contractibility and the resulting reduction in legal indeterminacy offered by LLC law diminish the importance of Delaware's network effects and its expert judiciary. In short, because contractibility means that not all LLCs will be governed by the same legal rules, contractibility limits compatibility and, therefore, the linkage within Delaware's LLC network. Likewise, reduced indeterminacy eliminates the need for Delaware's interpretive LLC network while also marginalizing Delaware's judicial advantage. In each instance, contractibility and reduced indeterminacy diminish the relative value of Delaware's LLC law product when compared to its rivals. This is because contractibility and reduced indeterminacy provide a benefit that Delaware's law product shares with several states, but marginalize competitive advantages unique to Delaware.

This Part elaborates on these claims as follows. First, it explains how, in the competition for corporate charters, the legal indeterminacy pervasive in Delaware corporate law enhances Delaware's advantages over rival states.¹⁶² Second, it describes how the high level of contractibility offered by Delaware LLC law allows firms to substantially reduce and altogether avoid the kind of indeterminacy found in Delaware corporate law.¹⁶³ Finally, it argues that heightened contractibility and the resulting reduction in legal indeterminacy actually diminish the value of two of Delaware's traditional competitive advantages, namely its network effects and its expert judiciary. With these two advantages diminished, in the market for LLC law, Delaware does not have the same competitive strength and, therefore, may not have the kind of market power that it has long enjoyed for corporate charters.¹⁶⁴

A. *The Role of Legal Indeterminacy in Delaware Corporate Law*

The pervasive indeterminacy of Delaware corporate law is well known in academic circles.¹⁶⁵ Delaware judges even admit it.¹⁶⁶ Dela-

¹⁶² See *infra* notes 165–187 and accompanying text.

¹⁶³ See *infra* notes 188–230 and accompanying text.

¹⁶⁴ See *infra* notes 231–257 and accompanying text.

¹⁶⁵ See, e.g., Bebchuk & Hamdani, *supra* note 8, at 601–02; Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 92–100 (1990); Carney & Shepherd, *supra* note 29, at 11–48; Fisch, *supra* note 3, at 1074–84; Kahan & Kamar, *supra* note 3, at 1233–41; Kamar, *supra* note 8, at 1914–18; Mohsen Manesh, *Indeterminacy and Self Enforcement: A Defense of Delaware's Approach to Director Independence in Derivative Litigation*, 6 J. BUS. & SEC. L. 177, 185–95 (2006); Faith Stevelman, *Regulatory Competition, Choice of Forum and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 123–26 (2009); see also David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 137–55 (1997) (arguing that the unanimity norm on the Delaware Supreme Court leads to doctrinal cycling and instability).

ware corporate law, and in particular its judge-made law of fiduciary duties, tends to favor contextual, fact-intensive standards over bright-line rules.¹⁶⁷ As a result, each Delaware precedent tends to have a narrow breadth, particularized to a specific set of facts with limited predictive value for other factual scenarios.¹⁶⁸ For its critics, the indeterminacy in Delaware's corporate law creates unpredictability. Vague, open-

¹⁶⁶ See, e.g., *Lonegran v. EPE Holdings L.L.C.*, No. 5856-VCL, 2010 WL 3987173, at *8 (Del. Ch. Oct. 11, 2010) (“[E]x post fiduciary review inherently produces some degree of uncertainty.”); *Hollinger, Inc., v. Hollinger Int’l, Inc.*, 858 A.2d 342, 378 (Del. Ch. 2004) (conceding that the case law interpreting section 271 of the Delaware General Corporation Law “provides less than ideal certainty” and that “certain decisions . . . appear to deviate from the statutory language in a marked way”); *In re Gen. Motors Class H S’holders Litig.*, 734 A.2d 611, 623 (Del. Ch. 1999) (noting that the judicial interpretation of section 271 of the Delaware General Corporation Law “eschew[s] a definitional approach” focusing on the statutory text “in favor of a contextual approach” requiring any lawyer attempting to interpret the statute to proceed “with extreme caution”); see also William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 898 (1997) [hereinafter *Ambiguity in Corporation Law*] (noting that the “fiduciary concept [under corporate law] adds ambiguity”); William B. Chandler, III & Anthony A. Rickey, *Manufacturing Mystery: A Response to Professors Carney and Shepherd’s “The Mystery of Delaware Law’s Continuing Success,”* 2009 ILL. L. REV. 95, 98 (“Delaware law is far from perfect or entirely determinate.”); Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 BUS. L. 1, 11 (2005) (“Because of the high degree of fact-specificity inherent in fiduciary-duty adjudication, corporate law judges are less bound by principles of res judicata and stare decisis than judges in other areas of law.”); Myron T. Steele & J. W. Verret, *Delaware’s Guidance: Ensuring Equity for the Modern Witenagemot*, 2 VA. L. & BUS. REV. 189, 193–94 (2007) (“Granted, [Delaware’s] standards are not exact. The predictability of judicial response to each permutation of a certain deal measure or structure is not absolute.”); Strine, *supra* note 4, at 1265 (“[I]n many ways Delaware corporation law is less than optimally clear.”); Leo E. Strine, Jr., “Mediation-Only” Filings in the Delaware Court of Chancery: Can New Value Be Added by One of America’s Business Courts?, 53 DUKE L.J. 585, 587 (2003) (“[C]orporation law has eschewed bright-line rules . . . and instead has deployed the more contextual, standards-based tool of fiduciary duty review to keep corporate managers faithful.”) E. Norman Veasey, *Juxtaposing Best Practices and Delaware Corporate Jurisprudence*, 18 INSIGHTS 5, 7 (2004) (acknowledging that Delaware’s corporate law “may be somewhat indeterminate”); E. Norman Veasey & Christine T. Di Gulielmo, *What Happened in Delaware Corporate Law and Governance from 1992–2004?: A Perspective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1413 (2005) (confirming that the corporate law of fiduciary duties is “inherently and usefully indeterminate”); William T. Allen, *Modern Corporate Governance and the Erosion of the Business Judgment Rule in Delaware Corporate Law* 3 (Comparative Research in Law & Political Econ., Paper No. 06, 2008) [hereinafter *The Erosion of the Business Judgment Rule*], available at <http://www.ssrn.com/abstract=1105591> (“In lieu of detailed instructions . . . [corporate] law provides . . . vague generalities . . .”); *id.* at 4 (“Never has it been less clear exactly what is required to meet one’s responsibilities” as a corporate director). See generally Symposium, *The Next Century of Corporate Law*, 25 DEL. J. CORP. L. 1, 72 (1999) (quoting then Vice Chancellor William Allen that the “breadth of ambiguity” in Delaware corporate law is “breathtaking”).

¹⁶⁷ See, e.g., *Bebchuk & Hamdani, supra* note 8, at 601; *Fisch, supra* note 3, at 1075–76; *Kahan & Kamar, supra* note 3, at 1236; *Kamar, supra* note 8, at 1914–15.

¹⁶⁸ See, e.g., *Fisch, supra* note 3, at 1076; *Kahan & Kamar, supra* note 3, at 1239; *Kamar, supra* note 8, at 1915–18.

ended standards and narrow precedents make the ex ante prediction of legal outcomes difficult.¹⁶⁹ Legal uncertainty, in turn, complicates business planning and promotes costly litigation.¹⁷⁰

Indeterminacy, thus, would seem to reduce the value of Delaware's corporate law. Professor Kamar, however, has pointed out that indeterminacy actually benefits Delaware by enhancing its traditional advantages in the jurisdictional competition for corporate charters.¹⁷¹ It does so in at least two ways.

First, indeterminacy allows Delaware to exclude rival states from the network effects of its corporate law, giving Delaware corporations the exclusive benefit of Delaware's corporate law network.¹⁷² Because Delaware corporate law is highly indeterminate, it is difficult for other states to achieve compatibility with Delaware.¹⁷³ If Delaware corporate law were more determinate, meaning that it could be accurately captured by a defined set of bright-line rules, other states could easily adopt such rules wholesale in order to link into Delaware's corporate law network.¹⁷⁴ By doing so, such states would achieve compatibility with Delaware law and could thus offer the same network effects offered by Delaware.¹⁷⁵ Because, however, Delaware's corporate law is indeterminate, its contents cannot be captured by a definitive set of rules.¹⁷⁶ Instead, Delaware courts must give the law meaning piecemeal.¹⁷⁷ In this way, indeterminacy not only intensifies the network effects of Delaware's law by increasing the value of judicial interpretations, but it also makes Delaware's law inseparable from its courts.¹⁷⁸

¹⁶⁹ See, e.g., Bebchuk & Hamdani, *supra* note 8, at 601; Fisch, *supra* note 3, at 1076; Kamar, *supra* note 8, at 1919.

¹⁷⁰ See, e.g., Bebchuk & Hamdani, *supra* note 8, at 601; Kahan & Kamar, *supra* note 3, at 1240–41; Kamar, *supra* note 8, at 1919, 1947; see also Carney & Shepherd, *supra* note 29, at 43–47 (noting the litigation costs associated with the indeterminacy of Delaware corporate law). But see Allen, *Ambiguity in Corporation Law*, *supra* note 166, at 898 (noting that although “[c]lear, ‘hard and fast’ legal rules reduce uncertainty and allow business people to contract relatively efficiently,” the ambiguity of corporate law is necessary to guard against corporate mismanagement); Fisch, *supra* note 3, at 1081–85 (espousing the value of indeterminacy); Jens Dammann, *Regulatory Competition and Legal Determinacy in Corporate Law* 55 (Univ. of Tex. Sch. of Law, Law & Econ. Research Paper No. 166, 2009), available at <http://ssrn.com/abstract=1491864> (arguing that, when compared to the corporate law of Germany and the United Kingdom, Delaware corporate law does not appear to be excessively indeterminate).

¹⁷¹ See Kamar, *supra* note 8, at 1927–35.

¹⁷² *Id.* at 1929.

¹⁷³ *Id.* at 1927–28.

¹⁷⁴ *Id.* at 1929.

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ Kamar, *supra* note 8, at 1929.

¹⁷⁸ *Id.* at 1928–29, 1930 n.83.

Even though indeterminacy lowers the value of Delaware law, so long as it lowers the value of rival laws relative to Delaware, indeterminacy allows Delaware to retain an advantage over its rival states.¹⁷⁹

Second, legal indeterminacy accentuates Delaware's judicial advantage over rival states.¹⁸⁰ Laws based on determinate rules delineate the rights and obligations of parties *ex ante*, minimizing the role of the court in the interpretation and application of such laws.¹⁸¹ If Delaware were to adopt determinate rules-based law, it would marginalize the role of its judges in deciding cases.¹⁸² Indeterminate laws, in contrast, entail open-ended standards that are valuable only when applied by a proficient court.¹⁸³ Because Delaware's corporate law favors open-ended standards, it increases the importance of the Delaware judges applying those standards. Even if other states could achieve compatibility with Delaware's corporate law network, indeterminacy allows Delaware to retain a competitive advantage by accentuating the importance of its expert judiciary.¹⁸⁴

In both instances, indeterminacy may reduce the actual value of Delaware's corporate law product, but it reduces the value of rival states' law products even more.¹⁸⁵ In this way, indeterminacy, even though it may be an unintentional, even inherent feature of Delaware corporate law,¹⁸⁶ serves to increase the relative value of Delaware's corporate law product when compared to its rival states.¹⁸⁷

¹⁷⁹ *Id.* at 1930.

¹⁸⁰ *Id.* at 1928.

¹⁸¹ *See id.* at 1914 ("Rules delineate the law *ex ante*. Their application in court requires determination only of whether their pre-set conditions were met."); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992) (distinguishing between determinate rules, which "entail an advance determination of what conduct is permissible, leaving *only* factual issues for the adjudicator," and indeterminate standards, which "leav[e] both specification of what conduct is permissible *and* factual issues for the adjudicator") (emphasis added)).

¹⁸² *See* Kamar, *supra* note 8, at 1914.

¹⁸³ *See id.* at 1933.

¹⁸⁴ *See id.* ("Corporate law is transferable, as the convergence of other states' laws to the Delaware model demonstrates. Judicial quality, by contrast, is relatively fixed.")

¹⁸⁵ *Id.* at 1930–31, 1933–34.

¹⁸⁶ Although Professor Kamar argues that indeterminacy enhances Delaware's competitive position, he also points out that it is unlikely that Delaware law was designed to be intentionally indeterminate. *Id.* at 1939. More recently, in distinguishing corporate law from so-called "unincorporate" law, Professor Ribstein has argued that indeterminacy may be an inherent feature of corporate law. *See* Larry E. Ribstein, *The Unincorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 132–33. Whether indeterminacy is intentional, accidental, or inherent does not affect the arguments made in this Article.

¹⁸⁷ Kamar, *supra* note 8, at 1933.

B. *The Contractual Nature of LLC Law*

Unlike Delaware corporations, which are regarded as “creatures of state law,” created and, therefore, subject to regulation by the state, Delaware LLCs are regarded as “creatures of contract,” representing a voluntary, contractual relationship among private parties.¹⁸⁸ As the Delaware Chancery Court has explained, “contractual language defines the scope, structure and personality of limited liability companies.”¹⁸⁹ Indeed, the Delaware LLC Act—like the LLC statutes of various rival states¹⁹⁰—explicitly provides that its principal policy is “to give the maximum effect to the principle of freedom of contract.”¹⁹¹ Consistent with this policy, virtually all of the default provisions specified in the Delaware LLC Act may be superseded or otherwise contractualized by the terms of an LLC’s governing agreement.¹⁹² As a result, many of the

¹⁸⁸ See Manesh, *supra* note 10, at 476–77; see also *In re Atlas Energy Res., L.L.C.*, No. 4589-VCN, 2010 WL 4273122, at *6 (Del. Ch. Oct. 28, 2010) (“Limited Liability Companies are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.’”) (quoting *R & R Capital, L.L.C. v. Buck & Doe Run Valley Farms, LLC*, No. 2803-CC, 2008 WL 3846318, at *4 (Del. Ch. Aug. 19, 2008)); *Mickman v. Am. Int’l Processing, L.L.C.*, No. 3869-VCP, 2009 WL 2244608, at *2 (Del. Ch. July 28, 2009) (“LLC agreements are creatures of contract, which should be construed like other contracts. The construction of an LLC agreement, therefore, begins with the language of the agreement.”); *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 880–81 (Del. Ch. 2009) (“Limited liability companies are creatures of contract, and the parties have broad discretion to use an LLC agreement to define the character of the company and the rights and obligations of its members.”); *Fisk Ventures, L.L.C. v. Segal*, No. 3017-CC, 2008 WL 1961156, at *8 (Del. Ch. May 7, 2008) (“In the context of limited liability companies, which are creatures not of the state but of contract, [any] duties or obligations must be found in the LLC agreement . . .”).

¹⁸⁹ *Fisk Ventures, L.L.C.*, 2008 WL 1961156, at *1.

¹⁹⁰ See, e.g., ARK. CODE ANN. § 4-32-1304 (2001); COLO. REV. STAT. § 7-80-108(4) (2009); CONN. GEN. STAT. ANN. § 34-242(a) (West 2005); GA. CODE ANN. § 14-11-1107(b) (2003 & Supp. 2010); KAN. STAT. ANN. § 17-76,134(b) (2007); KY. REV. STAT. ANN. § 275.003 (West, Westlaw through 2010 legislation); LA. REV. STAT. ANN. § 12:1367(B) (2010); ME. REV. STAT. ANN. tit. 31, § 753(1) (1996 & Supp. 2009); MISS. CODE ANN. § 79-29-1201(2) (2009); MO. REV. STAT. § 347.081(2) (2001 & Supp. 2010); NEV. REV. STAT. § 86.286(4)(b) (2010); N.H. REV. STAT. ANN. § 304-C:78(II) (2005); N.J. STAT. ANN. § 42:2B-66(a) (West 2004); N.M. STAT. ANN. § 53-19-65(A) (LexisNexis 1978 & Supp. 2003); N.C. GEN. STAT. ANN. § 57C-10-03(c) (2009); OKLA. STAT. ANN. tit. 18, § 2058(D) (West 1999 & Supp. 2010); UTAH CODE ANN. § 48-2c-1901 (LexisNexis 2007); VA. CODE ANN. § 13.1-1001.1(C) (2006); WASH. REV. CODE ANN. § 25.15.800(2) (West 2005); WIS. STAT. ANN. § 183.1302(1) (West 2002).

¹⁹¹ DEL. CODE ANN. tit. 6, § 18-1101(b) (West, Westlaw through 2010 legislation) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”).

¹⁹² See, e.g., DEL. CODE ANN. tit. 6, § 18-008 (2005) (relating to indemnification of LLC managers and members); *id.* § 18-107 (2005) (relating to transactions between an LLC and its members or managers); *id.* § 18-209(b) (West, Westlaw through 2010 legislation) (relating to the approval of a merger by LLC members); *id.* § 18-210 (West, Westlaw through 2010 legislation) (relating to contractual appraisal rights of LLC members); *id.* § 18-302(a)

mandatory and indeterminate provisions that are imposed under Delaware corporate law—including the judge-made law of fiduciary duties—may be contractually waived, modified or clarified under Delaware LLC law.¹⁹³

The high level of contractibility offered by Delaware LLC law has two significant consequences. First, contractibility means that all Delaware LLCs, unlike Delaware corporations, are not necessarily bound by

(2005 & Supp. 2009) (relating to the relative rights, powers and duties of classes or groups of LLC members); *id.* § 18-302(b) (relating to the voting rights of LLC members); *id.* § 18-302(c) (relating to notice, quorum and proxy voting requirements in connection with a meeting of LLC members); *id.* § 18-302(d) (relating to the manner of a meeting of LLC members and action by written consent of the members); *id.* § 18-302(e) (relating to requirements for amending an LLC governing agreement); *id.* § 18-305(a) (2005 & Supp. 2009) (providing that an LLC member's inspection rights may be subject to such reasonable standards as may be set forth in an LLC governing agreement); *id.* § 18-402 (2005) (relating to the management of the LLC, the appointment and removal of LLC managers, and the LLC managers' and members' authority to bind the LLC); *id.* § 18-404(a) (2005 & Supp. 2008) (relating to the relative rights, powers and duties of classes or groups of LLC managers); *id.* § 18-404(b) (relating to the voting rights of LLC managers); *id.* § 18-404(c) (relating to notice, quorum and proxy voting requirements in connection with a meeting of LLC managers); *id.* § 18-404(d) (relating to the manner of a meeting of LLC managers and action by written consent of LLC managers); *id.* § 18-702 (West, Westlaw through 2010 legislation) (relating to the assignment and redemption of LLC interests); *id.* § 18-801(a) (2005) (relating to the dissolution of an LLC); *id.* § 18-1101(c) (relating to the expansion, restriction or elimination of any duties (including fiduciary duties) owed by LLC managers or members at law or in equity); *id.* § 18-1101(e) (relating to the limitation or elimination of liability for the breach of any duties (including fiduciary duties) owed by LLC managers or members). Even where a provision in the Delaware LLC statute does not explicitly provide that the default rule may be superseded or otherwise contractualized by an LLC governing agreement, see for example *id.* tit. 6 § 18-802 (2005) (regarding the rights of LLC members and managers to seek judicial dissolution of the LLC), Delaware courts have held that such default rules may nonetheless be superseded by the terms of the LLC governing agreement. See, e.g., *R & R Capital, L.L.C.*, 2008 WL 3846318, at *6–8.

¹⁹³ See, e.g., *Fisk Ventures, L.L.C.*, 2009 WL 73957, at *3 (“Delaware’s LLC Act . . . allows LLC members to ‘arrange a manager/investor governance relationship’; the LLC Act provides defaults that can be modified by contract.”); *Sutherland v. Sutherland*, No. 2399-VCC, 2009 WL 857468, at *4 (Del. Ch. Mar. 23, 2009) (noting that although a provision limiting the fiduciary duty of loyalty “is permissible under the Delaware Limited Liability Company Act . . ., where freedom of contract is the guiding and overriding principle, it is expressly forbidden by the [Delaware corporate statute]”); *Kahn v. Portnoy*, No. 3515-CC, 2008 WL 5197164, at *3 (Del. Ch. Dec. 11, 2008) (“LLC agreements are contracts that are enforced according to their terms, and all fiduciary duties, except for the implied contractual covenant of good faith and fair dealing, can be waived in an LLC agreement.”); *R & R Capital, L.L.C.*, 2008 WL 3846318, at *6 (“[T]he LLC Act expressly encourages ‘made-to-order’ structuring of limited liability companies” and “offers explicit assurance that contractual arrangements will be given effect to the fullest permissible extent”); *Walsh & Gattuso*, *supra* note 10, at 11 (“Delaware’s statutory scheme affords members virtually unlimited discretion to define the terms of their relationship in the operating agreement. Indeed, the [Delaware LLC statute] contains a host of fundamental provisions that are subject to modification by the members.”). See generally EDWARD P. WELCH ET AL., *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 18-1101.3 (5th ed. Supp. 2010).

the same mandatory provisions of internal governance. Although Delaware's LLC statute and the judge-made law of fiduciary duties serve as legal defaults, these defaults are never mandatory for LLCs.¹⁹⁴ Instead, the default provisions prescribed by Delaware law are subject to and limited by the contractual provisions of an LLC's governing agreement.¹⁹⁵

Second, contractibility means that Delaware LLCs may avoid the costs and uncertainty associated with certain of the mandatory provisions imposed under Delaware corporate law.¹⁹⁶ Unlike Delaware corporations, which are subject to various indeterminate, fact-intensive standards imposed by corporate law, Delaware LLCs may opt for contractual clarity, or bright lines, in the provisions of their governing agreements. Such provisions can be drafted to be determinate yet still flexible enough to use in relational contexts, like those involving business associations.¹⁹⁷ This latter point need not be speculative or abstract.

¹⁹⁴ See, e.g., *Related Westpac L.L.C. v. JER Snowmass L.L.C.*, No. 5001-VCS, 2010 WL 2929708, at *8 (Del. Ch. July 23, 2010) ("When . . . parties [to an LLC agreement] cover a particular subject in an express manner, their contractual choice governs and cannot be supplanted by the application of inconsistent fiduciary duty principles that might otherwise apply as a default."); *Kelly v. Blum*, No. 4516-VCP, 2010 WL 629850, at *10 (Del. Ch. Feb. 24, 2010) ("[I]n the absence of a contrary provision in the LLC agreement, LLC managers and members owe traditional fiduciary duties of loyalty and care to each other and to the company. Thus, unless the LLC agreement . . . explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties . . ."); *Bay Ctr. Apartments Owner, L.L.C. v. Emery Bay PKI, L.L.C.*, No. 3658-VCS, 2009 WL 1124451, at *8 (Del. Ch. Apr. 20, 2009) (noting that "[t]he Delaware LLC Act gives members of an LLC wide latitude to order their relationships, including the flexibility to limit or eliminate fiduciary duties," but that "in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties"); see also *Walsh & Gattuso*, *supra* note 10, at 12 ("Delaware courts typically imply the existence of traditional fiduciary duties [in LLC matters] as a default mechanism in the absence of an express, unambiguous provision in the [LLC] operating agreement eliminating those duties.").

¹⁹⁵ See Ribstein, *supra* note 186, at 150.

¹⁹⁶ Cf. *id.* at 142–44 (arguing that the contractibility permitted under the law of LLCs and other noncorporate entities is one of the key features that reduces the indeterminacy of so-called "uncorporate" law when compared to corporate law); Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 29 (2007) (arguing that one of the benefits of contractually-based governance under LLC law is increased certainty of business parties as to their legal rights and obligations).

¹⁹⁷ See Gold, *supra* note 67, at 151 (arguing in the context of LLC and LP governing agreements that although "[i]t is certainly true that long-term relational contracts cannot explicitly address every future contingency . . . [p]arties can contractually pre-commit themselves to an outcome even where they have difficulty predicting future disputes"); Kahan & Kamar, *supra* note 3, at 1241 ("Even where Delaware law retain[s] flexible standards, the standards could be rendered more determinate by employing presumptions or safe harbors or by limiting or prioritizing the criteria to their application."); Kamar, *supra* note 8, at 1920 ("Not all rules are so rigid so as to preclude their use in . . . relational context[s] For instance, procedural and structural rules that stipulate how decisions should be made in the firm without dictating their content can be both determinate and

Consider, for example, the standard used under Delaware corporate law to determine whether a transaction constitutes a sale of “all or substantially all” assets. This standard is critical to Delaware corporations because one of the mandatory provisions imposed by Delaware corporate law is that any transaction that constitutes a sale of “all or substantially all” of a corporation’s assets requires the approval of the corporation’s shareholders.¹⁹⁸ If a transaction does not constitute a sale of “all or substantially all” assets, then the transaction may be approved by the corporation’s board of directors, without a shareholder vote.¹⁹⁹ Like other provisions of Delaware corporate law, this provision cannot be modified, clarified or otherwise waived by the terms of a corporation’s governing documents.²⁰⁰

Whether a transaction involves “all or substantially all” of a corporation’s assets is the sort of question that begs for a quantitative analysis. Delaware courts have, however, adopted a standard that reflects both a quantitative and open-ended qualitative analysis under *Gimbel v. Signal Cos.*,²⁰¹ a 1974 decision by the Delaware Court of Chancery and affirmed by the Delaware Supreme Court.²⁰² Under the *Gimbel* standard, a court asks whether the “sale is of assets quantitatively vital to the operation of the corporation *and* is out of the ordinary *and* substantially affects the existence and purpose of the corporation.”²⁰³ Using the open-ended *Gimbel* standard has led Delaware courts to a number of seemingly inconsistent and, therefore, unhelpful precedents.²⁰⁴ In 1996, in *Thorpe v. CERBCO, Inc.*, the Delaware Supreme Court determined that the sale of stock constituting 68% of the company’s assets and the primary source of the company’s income is a sale of “substantially all” of the company’s assets.²⁰⁵ In the 1991 case *Oberly v. Kirby*, however, the Delaware Supreme Court ruled the sale of stock compris-

flexible.”). Even the Chief Justice of the Delaware Supreme Court has argued that an LLC governing agreement “can easily be structured to carve out safe harbors for self-dealing by managers, where the parties, fully informed about the scope of those safe harbors, agree in writing.” Steele, *supra* note 196, at 5.

¹⁹⁸ DEL. CODE ANN. tit. 8, § 271(a) (West, Westlaw through 2010 legislation).

¹⁹⁹ *Id.*

²⁰⁰ Though other provisions of Delaware’s General Corporation Law may expressly provide that they are subject to contrary terms in the corporations certificate of incorporation, see for example DEL. CODE ANN. tit. 8, § 233(a) (West, Westlaw through 2010 legislation), conspicuously, § 271(a) does not.

²⁰¹ 316 A.2d 599 (Del. Ch.), *aff’d*, 316 A.2d 619 (Del. 1974).

²⁰² See generally WELCH ET AL., *supra* note 193, § 271.2.1.

²⁰³ 316 A.2d at 606 (emphasis added).

²⁰⁴ One need not search hard to find these seemingly contradictory precedents. Rather, the cases that follow are conveniently collected by Vice Chancellor Strine in *In re General Motors Class H Shareholders Litigation*, 734 A.2d 611, 623 n.10 (Del. Ch. 1999).

²⁰⁵ 676 A.2d 436, 444 (Del. 1996).

ing 80% of a foundation's assets is not a sale of "substantially all" assets because the foundation was in the "business of holding investment securities and donating its profits to charity."²⁰⁶ In 1981, the Delaware Court of Chancery in *Katz v. Bergman* found that a sale of assets constituting 51% of the company's total assets and contributing 52% of the company's pre-tax operating income is a sale of "substantially all" assets.²⁰⁷ In the 1984 case *Bacine v. Scharffenberger*, however, the Delaware Court of Chancery ruled that the sale of assets responsible for 53% of the company's net income is not a sale of "substantially all" assets because, among other things, the net income figure seemed attributable to a bad year in the company's other businesses.²⁰⁸

The *Gimbel* test is thus perhaps a textbook example of a legally indeterminate standard.²⁰⁹ Lawyers and their clients cannot use the *Gimbel* test to ascertain their legal obligations *ex ante*. A sale of 68% of a company's assets requires a shareholder vote; a sale of 80% does not. A sale of assets contributing 52% of a company's income requires a shareholder vote; a sale of assets contributing 53% does not. And, because the provision interpreted in *Gimbel* is mandatory under Delaware corporate law, a corporation cannot avoid this indeterminacy by simply clarifying the standard in the terms of its governing documents.

Now, consider how the *Gimbel* standard could be contractually clarified in the provisions of an LLC governing agreement. Most obviously, one could definitively settle the question by drafting a provision authorizing an LLC's managers to sell "all or substantially all" of the LLC's assets without prior shareholder approval. Such a provision is, however, unlikely to be palatable to most investors. Instead, a more evenhanded and determinate provision could rest on a purely quantitative test. For example, the board of directors is not required to obtain shareholder approval for a transaction if, after giving effect to the transaction, (i) the LLC retains at least 25% of its total assets *and* 25%

²⁰⁶ 592 A.2d 445, 454, 464 (Del. 1991).

²⁰⁷ 431 A.2d 1274, 1275–76 (Del. Ch. 1981).

²⁰⁸ Nos. 7862, 7866, 1984 WL 21128, at *2–3 (Del. Ch. Dec. 11, 1984).

²⁰⁹ See, e.g., *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d at 623 (noting that the contextual approach reflected by the *Gimbel* test requires "[a]ny wise counselor [to] approach the question of whether a disposition . . . involve[s] a sale of 'substantially all' of a company with extreme caution"); *Hollinger, Inc.*, 858 A.2d at 378 (conceding that the case law interpreting and applying the *Gimbel* test "provides less than ideal certainty" and that "certain decisions . . . appear to deviate from the statutory language in a marked way"); Carney & Shepherd, *supra* note 29, at 32–33; see also *id.* at 33 n.180 ("Experienced practitioners have observed that there is a broad area, probably involving asset sales of between 25% and 75% of assets, where predicting whether a shareholder vote is required in Delaware is extremely difficult."). But see Chandler & Rickey, *supra* note 166, at 122–23 (contesting the assertion that the *Gimbel* test is overly indeterminate).

of its gross revenues from continuing operations, (ii) measured in each case as of the end of the LLC's last fiscal year, (iii) as determined by the LLC's outside auditors.²¹⁰ Such a provision would not abolish the right of shareholders to approve certain significant transactions, but it would provide a rules-based safe harbor for managers struggling with the indeterminate *Gimbel* test.²¹¹ The point here is not that 25% is a better or more accurate threshold for measuring the "all or substantially all" assets test but that LLCs can draft contractual provisions that are reasonable and determinate, without resorting to an open-ended ex post inquiry that is required under the mandatory provisions imposed under corporate law.

At the risk of belaboring this point, consider another example: the test used under Delaware corporate law to determine whether a board of directors has met its so-called *Revlon* duty. In 1986, the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, announced that directors have a special fiduciary duty in the event of a corporate sale to get the best price for the stockholders.²¹² Like other fiduciary duties, the *Revlon* duty is mandatory and cannot be waived, modified, or otherwise clarified by the terms of a corporation's governing documents.²¹³ But Delaware judges have assiduously declined to give any further guidance on how to fulfill this duty.²¹⁴ In trying to fulfill their *Revlon* duty, boards have tried everything from conducting a public auction, to discreetly soliciting other potential acquirers (a so-called "market check"), to simply relying on "an impeccable knowledge of the market."²¹⁵ Yet, because the *Revlon* standard is so indeterminate, courts can always find facts that suggest a board breached its *Revlon* du-

²¹⁰ This rule is largely based on the safe harbor set forth in section 12.02 of the Model Business Corporation Act. See MODEL BUS. CORP. ACT § 12.02 (2002).

²¹¹ Cf. Kamar, *supra* note 8, at 1921 (noting that Delaware corporate law could be more determinate if, like federal securities law, Delaware provided rules-based safe harbors, "compliance with which would preclude judicial review and reduce uncertainty").

²¹² *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009) (paraphrasing and interpreting *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986)). See generally WELCH ET AL., *supra* note 193, § 141.2.5.1.

²¹³ Other than the fiduciary duty of care, which may be exculpated under Delaware corporate law, DEL. CODE ANN. tit. 8, § 102(b)(7) (West, Westlaw through 2010 legislation), corporations are not permitted to exculpate or contractually modify common law fiduciary duties. See, e.g., *Sutherland*, 2009 WL 857468, at *4 ("While . . . a provision [limiting the fiduciary duty of loyalty] is permissible under the Delaware [LLC] Act . . . , where freedom of contract is the guiding and overriding principle, it is expressly forbidden by the [Delaware corporate statute].").

²¹⁴ See, e.g., *Lyondell Chem. Co.*, 970 A.2d at 242 ("No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control.").

²¹⁵ *Id.* at 243.

ty. So, for example, in a pair of recent cases decided by the same chancellor just three months apart, one company's board breached its *Revlon* duty, although it had conducted a private auction among financial bidders before entering into a definitive agreement;²¹⁶ in contrast, the *Revlon* process of another company's board was affirmed, even though that board had failed to conduct any kind of pre-signing auction or market check before entering into an acquisition agreement.²¹⁷ Indeed, the *Revlon* standard is so indeterminate that even after nearly twenty-five years since the doctrine was first announced, the Delaware Supreme Court still finds that Delaware chancellors—the reputed experts on matters of corporate law—apply it incorrectly.²¹⁸

Now, consider how the *Revlon* question could be contractualized in the provisions of an LLC governing agreement. Again, one could imagine a contract term providing that a pre-signing auction or market check is never required. But such a one-sided provision is unlikely to be palatable to investors. Instead, one could resort to another quantitative test based on objective measures. For example, a board of directors is not required to engage in a pre-signing auction or market check in the event the LLC receives an acquisition offer that represents (i) a premium of fifty percent or greater on the market value of the LLC's then-outstanding securities (ii) as measured based on the average closing price of the LLC's securities for the last one-year period. Such a rule does not abolish the requirement for a pre-signing auction or market check but simply provides a safe harbor under which a board could elect to forgo such a process. Such a safe harbor would bring relative clarity to the current disarray reflected in Delaware's *Revlon* jurisprudence.

The two foregoing examples demonstrate that, as creatures of contract, Delaware LLCs may avoid the cost and uncertainty associated with

²¹⁶ *In re Netsmart Techs. Inc. S'holders Litig.*, 924 A.2d 171, 197–99 (Del. Ch. 2007). In *Netsmart*, Vice Chancellor Strine reasoned that the private auction process was insufficient because micro-cap companies, like the one at issue in the case, are unlikely to attract significant market attention and are, therefore, expected to make a “material effort at salesmanship” to attract potential strategic bidders. *Id.* at 197–98.

²¹⁷ *In re Lear Jet Corp. S'holders Litig.*, 926 A.2d 94, 118–23 (Del. Ch. 2007). In *Lear*, Vice Chancellor Strine was persuaded that a pre-signing auction was not required under *Revlon* because, among other reasons, (i) the company at issue had, by eliminating its poison pill, signaled publicly that it was interested in unsolicited bids, *id.* at 118, (ii) an auction could result in the company losing its one existing bid, *id.* at 119, (iii) the deal protection provisions in the acquisition agreement did not preclude a rival bid after the agreement was signed, *id.*, and (iv) the valuation analyses considered by the company's board provided a reasonable basis for accepting the existing bid without an auction, *id.* at 122.

²¹⁸ See, e.g., *Lyondell Chem. Co.*, 970 A.2d at 243 (“The trial court decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell directors did not discharge that ‘known set of *Revlon* duties.’ But, as noted, there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties.”).

certain mandatory provisions imposed under Delaware corporate law. Admittedly, doing so will require firms to invest costly time and resources into the drafting of their LLC governing agreements.²¹⁹ And not every firm will. For such firms, “fiduciary duties [still] loom in the background, ready to flow into any gap left by the contract.”²²⁰ But large, publicly traded firms, the type that most value chartering in Delaware,²²¹ are also the most able to afford and most likely to invest in such resources.²²² And there is evidence to suggest that such firms actually do invest the necessary time and resources to draft provisions contractualizing and clarifying their managers’ rights and duties in order to avoid the indeterminate standards and fiduciary duties of corporate law.²²³

Of course, even if such firms invest the necessary resources to carefully draft clear, determinate provisions in their LLC governing agreement, contract law subjects Delaware LLCs to certain mandatory, un-

²¹⁹ To be sure, the relative determinacy of rules-based contract provisions over the kind of open-ended standards that pervade corporate law depends upon lawyers drafting precise provisions. But where lawyers do draft precise, determinate provisions in LLC governing agreements, Delaware courts strictly enforce and assiduously refuse to read ambiguity into such provisions. *See, e.g., Related Westpac L.L.C.*, 2010 WL 2929708, at *6–8 (refusing to imply a reasonableness qualifier to a contractual provision regarding an LLC member’s right to withhold its consent to certain actions, where the provision expressly omitted a reasonableness qualifier and other provisions in the LLC agreement did not); *Kuroda v. SPJS Holdings, L.L.C.*, No. 4030-CC, 2010 WL 925853, at *11 (Del. Ch. Mar. 16, 2010) (declining to impute confidentiality obligations on a member, based on theories of common law, fiduciary law, or contractual intentions, where “the LLC Agreement specifically excluded any duties relating to confidentiality”); *Kelly*, 2010 WL 629850, at *8 (declining to nullify “unambiguous [provisions in an LLC agreement] that explicitly allow for delivery of notice by confirmed fax and commercial delivery service”); *R & R Capital, L.L.C.*, 2009 WL 2937101, at *4 (refusing to read a material adverse effect qualification into a L.L.C. governing agreement provision regarding the removal of the LLC manager); *In re Nextmedia Investors, L.L.C.*, No. 4067-VCS, 2009 WL 1228665, at *4–6 (Del. Ch. May 6, 2009) (declining to read ambiguity into the amendment provision of an LLC governing agreement); *In re Arrow Inv. Advisors, L.L.C.*, No. 4091-VCS, 2009 WL 1101682, at *3–4 (Del. Ch. Apr. 23, 2009) (declining to narrowly construe an explicitly broad business purpose provision set forth in an LLC agreement); *Spellman v. Katz*, No. 1838-VCN, 2009 WL 418302, at *3 (Del. Ch. Feb. 6, 2009) (refusing to consider parol evidence where the dissolution provision of an LLC governing agreement is unambiguous); *Fisk Ventures, L.L.C.*, 2008 WL 1961156, at *9 (declining “to follow [the defendant’s] invitation to turn an expressly exculpatory provision [in an LLC governing agreement] into an all encompassing and seemingly boundless standard of conduct”).

²²⁰ Ribstein, *supra* note 186, at 165.

²²¹ *See Kahan & Kamar, supra* note 3, at 1225–28 (arguing that public companies place a higher value than nonpublic companies on incorporation in Delaware and that “among public corporations, the value of incorporation in Delaware increases with the size of the company”).

²²² *See Ribstein, supra* note 186, at 165 (noting that only the “largest and most sophisticated unincorporations” may benefit from the ability to avoid indeterminacy under LLC law).

²²³ For two examples of publicly traded LLCs that have contractually clarified the fiduciary duties of their managers, see Manesh, *supra* note 10, at 488–91.

waivable provisions as well, including most significantly the implied contractual covenant of good faith and fair dealing.²²⁴ This implied covenant binds all parties to a contract and may not be modified or waived by the express terms of the contract.²²⁵ Upon first impression, the implied contractual covenant appears to be the kind of open-ended, standards-based obligation that could wreak the same kind of indeterminacy in LLC law as fiduciary duties have under corporate law.²²⁶ To date, however, the Delaware courts have made clear that the implied contractual covenant is doctrinally distinct and substantially narrower than the open-ended fiduciary duties imposed by corporate law.²²⁷ Importantly, Delaware courts have repeatedly noted that the implied contractual covenant may never be applied to contradict the express terms of an LLC's governing agreement.²²⁸ Moreover, some De-

²²⁴ DEL. CODE ANN. tit. 6, § 18-1101(c), (e) (West, Westlaw through 2010 legislation).

²²⁵ See, e.g., *Kahn*, 2008 WL 5197164, at *3 (“[A]ll fiduciary duties, except for the implied contractual covenant of good faith and fair dealing, can be waived in an LLC agreement.”); *R & R Capital, L.L.C.*, 2008 WL 3846318, at *7 (“It is the *unwaivable* protection of the implied covenant that allows the vast majority of the remainder of the LLC Act to be so flexible.”) (emphasis added)); Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469, 1480 (2005).

²²⁶ See *infra* notes 266–272 and accompanying text.

²²⁷ *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008) (“The implied covenant of good faith and fair dealing is a creature of contract, distinct from the fiduciary duties [of corporate law].”); *Lonegran*, 2010 WL 3987173, at *7–8 (“The implied covenant is not a substitute for fiduciary analysis To use the implied covenant to replicate fiduciary review would ‘vitiolate the limited reach of the concept of the implied duty of good faith and fair dealing.’”); *Kuroda*, 2010 WL 925853, at *10 (“[R]ather than constituting a free floating duty imposed on a contracting party, the implied covenant can only be used conservatively to ensure the parties reasonable expectations are fulfilled Consistent with its narrow purpose, the implied covenant is only rarely invoked successfully.”) (quoting *Kuroda*, 971 A.2d at 888); see also *Steele*, *supra* note 196, at 29 (arguing that the implied contractual covenant of good faith and fair dealing is “relatively clear . . .[,] defined and workable within known parameters,” whereas the “alleged fiduciary duty of good faith is . . . neither defined clearly . . . nor even imaginably workable as a predictable, clear and consistent standard of conduct”); *Walsh & Gattuso*, *supra* note 10, at 13 (“[A]s a practical matter, claims asserting breach of the implied covenant [of good faith and fair dealing] are difficult to sustain in Delaware because the doctrine is construed narrowly.”).

²²⁸ See, e.g., *Nemec v. Shrader*, 991 A.2d 1120, 1127 (Del. 2010) (“The implied covenant will not infer language that contradicts a clear exercise of an express contractual right.”); *Related Westpac L.L.C.*, 2010 WL 2929708, at *6 (holding that the implied contractual covenant of good faith and fair dealing “cannot imply an obligation inconsistent with the parties’ express agreement”); *Kuroda*, 2010 WL 925853, at *10 (“The implied covenant cannot be invoked to override the express terms of the contract”) (quoting *Kuroda*, 971 A.2d at 888); *Kelly*, 2010 WL 629850, at *13 (“[T]he implied covenant is ‘only rarely invoked successfully’ and may ‘not be invoked to override the express terms of the contract.’”); *Lola Cars Int’l Ltd. v. Krohn Racing, L.L.C.*, Nos. 4479-VCN, 4886-VCN, 2009 WL 4052681, at *8 (Del. Ch. Nov. 12, 2009) (“The Court . . . may not substitute its own notions of fairness for the terms of the agreement . . . and will therefore only invoke the implied cove-

laware courts have even begun applying a heightened pleading standard for an alleged breach of the implied covenant,²²⁹ further limiting the doctrine's reach. Thus, at least under current Delaware law,²³⁰ the implied contractual covenant of good faith and fair dealing seems unlikely to render the same kind of chaos that has been wrought by the broad, indeterminate standards pervading Delaware corporate law.

C. *The Role of Contractibility and Reduced Indeterminacy in Delaware LLC Law*

In the competition for corporate charters, legal indeterminacy enhances Delaware's competitive advantages. But, as the following discussion shows, in the competition for LLC charters, the heightened contractibility and the resulting reduction in legal indeterminacy offered by Delaware LLC law ironically serve to diminish the value of Delaware's competitive advantages relative to its rival states.

Contractibility diminishes the value of Delaware's LLC law product because it allows each LLC to draft its own contract terms to override virtually all of the default provisions of Delaware LLC law. As a result, even though Delaware may have the largest, broadest LLC network, the diversity of contractual provisions within the network limits linkage and, therefore, the network effects that would result from Delaware LLC law.

Reduced indeterminacy further diminishes the value of Delaware's LLC network, but in a distinct way. Reduced indeterminacy diminishes the value of Delaware's LLC network by eliminating the need for an interpretive network of judicial opinions in the first instance. Moreover, reduced indeterminacy neutralizes Delaware's judicial advantage by marginalizing the role of Delaware's judges in the adjudication of LLC disputes.

In this regard, the heightened contractibility and reduced indeterminacy reflected in LLC law pose a problem for Delaware. On the

nant when the contract does not expressly address the subject at issue."); *Fisk Ventures, L.L.C.*, 2008 WL 1961156, at *10 (confirming that the implied contractual covenant "cannot be invoked where the contract itself expressly covers the subject at issue"); *Altman & Raju*, *supra* note 225, at 1479–80.

²²⁹ See, e.g., *Kuroda*, 2010 WL 925853, at *10 ("General allegations of bad faith conduct are not sufficient. Rather, defendants must allege a specific implied contractual obligation and allege how the violation of that obligation denied them the fruits of the contract."); *Kelly*, 2010 WL 629850, at *13 ("Because general allegations of bad faith do not satisfy these elements, to state a cognizable claim a plaintiff must allege a *specific implied contractual obligation* and allege how the violation of that obligation denied the plaintiff the fruits of the contract.").

²³⁰ For a discussion of how the implied contractual covenant may evolve in future cases, see *infra* notes 258–325 and accompanying text.

one hand, contractibility and reduced indeterminacy likely enhance the value of Delaware's LLC law by making it appear more attractive to firms. Indeed, this value is reflected in the fact that so many states have, like Delaware, legislatively embraced an expansive freedom of contract in their LLC laws.²³¹ But this is precisely the problem for Delaware: contractibility also enhances the value of many other states' LLC law product. Yet contractibility and reduced indeterminacy harm Delaware alone by marginalizing the network and judicial advantages that are unique to the state. With these two competitive advantages diminished, Delaware is less able to distinguish itself from its rivals. In the competition for LLC charters, contractibility levels the playing field.

1. Contractible Law Limits Compatibility and Linkage Within Delaware's Network

Although the high level of contractibility offered by Delaware LLC law may be desirable to business managers and investors, it has a pernicious effect on Delaware's LLC network. Because each Delaware LLC is free to adopt contract provisions specifically tailored for its circumstances, it is likely that LLCs will adopt disparate, or incompatible, provisions regarding matters of internal governance.²³² Even where an LLC appears to adopt the default provisions of Delaware LLC law, the terms of the LLC's governing agreement may provide specifically tailored exceptions or limitations for these defaults.²³³ As a result, a Delaware

²³¹ See *supra* note 190.

²³² Cf. Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1564 (1989) (noting, in the context of corporate law, that "[i]n a regime of contractual freedom, it is likely that different charter terms will proliferate"). In the corporate context, Professor Gordon has argued that if expansive freedom of contract prevailed over the mandatory rules imposed by corporate law, the addition of customized terms by more firms will over time lead to disintegration of the standard form. Thus, although firms are better off collectively if the standard form is maintained, incentives for individual firms to deviate from the standard form will eventually undermine it. *Id.* at 1567.

²³³ For example, although the Fortress governing agreement noted above includes a provision specifying that the LLC's directors and officers shall have the same duties and obligations as corporate directors and officers under corporate law, that provision importantly begins with the qualification "[e]xcept as otherwise expressly provided in this Agreement." *Supra* text accompanying note 131. Unsurprisingly, Fortress's governing agreement includes provisions elsewhere that substantially modify and limit the fiduciary duties that would otherwise be applicable to corporate officers and directors. See Manesh, *supra* note 10, at 488–91. For another example of this, consider *Kahn*, 2008 WL 5197164, at *4, where the LLC agreement at issue similarly provided that the "authority, powers, functions and duties (including fiduciary duties)" of the LLC's board of directors shall be identical to those of a board of directors of a Delaware corporation, "unless otherwise *specifically provided for in the LLC agreement.*" *Id.* (emphasis added). As the chancellor in that case

court's interpretation of a provision in one LLC's governing agreement may have little or no benefit for other LLCs because other LLCs may have different, incompatible provisions in their governing agreements. Put differently, the judicial interpretation of one Delaware LLC's governing agreement may have no network effects for other Delaware LLCs.²³⁴ Likewise, because not all Delaware LLCs will have the same provisions in their governing agreements, lawyers and other professionals are unable to achieve the kind of familiarity and expertise in LLC law matters that they have developed in the corporate context, eliminating any efficiencies in the cost of professional services. In this way, contractibility substantially reduces the network effects of Delaware LLC law. Even though Delaware may have the largest, broadest network of LLC law, contractibility limits compatibility and therefore linkage among LLCs within the network—that is, unless all LLCs adopt the same contract provisions.²³⁵

Of course, some LLCs will adopt identical provisions in their governing agreements. Lawyers and business managers do not work in vacuums. They often share, admire, and copy each other's contracts. And various professional and commercial sources provide model contract provisions,²³⁶ which lawyers often use to reduce costs, time, and mistakes. Moreover, the default provisions prescribed by Delaware's statutory and judge-made law may themselves become the source of standardization among some LLC governing agreements.²³⁷ Indeed, network effects alone encourage some degree of uniformity among contract terms.²³⁸ So, although Delaware LLC law prescribes few mandatory provisions that will universally apply to all firms, some degree of uniformity among LLC governing agreements may exist. But not all LLCs will adopt the same contract provisions. And even LLCs that do adopt substantially identical provisions may vary the language in ways that limit or eliminate network effects for other LLCs.

noted, "the LLC Agreement makes several modifications to the duties owed by the directors of a Delaware corporation." *Id.*

²³⁴ This is true for network effects as well as learning effects. *See supra* notes 113–117. The adjudication of a specific provision in the terms of one Delaware LLC's governing agreement will have no learning effects for other Delaware LLCs that do not include an identical provision in the terms of their governing agreement.

²³⁵ Interestingly, because several other states have also adopted an expansive policy of freedom of contract with respect to LLCs, see *supra* note 190, network and learning effects may form among specific contractual provisions that are widely adopted among LLCs formed in various states, rather than the substantive LLC law of a specific state.

²³⁶ *See, e.g.,* SARGENT & SCHWIDETZKY, *supra* note 77, apps. AL–WI, at 191–1218 (providing form LLC governing agreements tailored for the specific laws of various states).

²³⁷ *See* Klausner, *supra* note 112, at 827–29.

²³⁸ *See* Kahan & Klausner, *supra* note 113, at 729.

Again, this last claim need not be speculative or abstract. Consider the governing agreements of two publicly traded Delaware LLCs, Och-Ziff Capital Management²³⁹ and the now-familiar Fortress Investment Group.²⁴⁰ Upon first inspection, the similarities between the two governing agreements seem substantial.²⁴¹ These similarities would suggest that Fortress and Och-Ziff's governing agreements would enjoy a high-degree of network compatibility or, put differently, that the judicial interpretation of a provision in either LLC's governing agreement would have network effects for the other LLC. A closer examination, however, shows that this is not always the case. Consider in particular the right that a manager has to indemnification from the LLC in the course of performing any actions or obligations on behalf of the LLC. Och-Ziff's governing agreement includes limitations on a manager's right to indemnification, in the event the manager acts "in a manner . . . constituting fraud, gross negligence or willful misconduct."²⁴² Fortress's governing agreement, although it includes a nearly identical indemnification provision, does not have limitations for actions "constituting fraud, gross

²³⁹ OCH-ZIFF CAPITAL MANAGEMENT GROUP LLC, SECOND AMENDED AND RESTATED LIMITED LIABILITY COMPANY AGREEMENT, *in* Annual Report (Form 10-K), exhibit 3.2 (Nov. 13, 2007) [hereinafter OCH-ZIFF LLC AGREEMENT], *available at* <http://www.sec.gov/Archives/edgar/data/1403256/000119312508064885/dex32.htm>.

²⁴⁰ FORTRESS LLC AGREEMENT, *supra* note 99.

²⁴¹ Many of the most important provisions in the two agreements feature almost identical language. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 1.1, *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 1.1 (defining "Conflicts Committee"). *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 1.1 (defining "Special Approval"), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 1.1. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 4.3 (regarding distributions to record holders), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 4.3. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.1 (regarding the power and authority of the board of directors), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.1. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.3 (regarding the election of directors), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.3. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.4 (regarding the removal of directors), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.4. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.19(b) (regarding the restriction of any duties and liabilities existing at law or in equity), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.19(b). *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.20 (regarding the approval of conflicted transactions), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.20. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.23 (regarding the duties of officers and directors), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.23. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 5.24 (regarding a director's outside business interests and activities), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.24. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, Art. IX (regarding amendments to the LLC agreement), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, art. IX. *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, §§ 10.1, 10.2 (regarding the approval process for a merger or conversion), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, §§ 10.1, 10.2; *Compare* FORTRESS LLC AGREEMENT, *supra* note 99, § 11.1 (regarding the meetings of members), *with* OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 12.1.

²⁴² OCH-ZIFF LLC AGREEMENT, *supra* note 239, § 5.19(a).

negligence or willful misconduct.”²⁴³ Thus, if a Delaware court adjudicated a dispute regarding whether certain of Och-Ziff’s managers committed gross negligence for indemnification purposes, this ruling would have no network benefit for Fortress. The question of gross negligence is, under the terms of Fortress’s governing agreement, simply moot.²⁴⁴

The picture that emerges from this analysis is that of a disjointed Delaware LLC network offering limited value. In contrast to Delaware’s corporate law network where firms are involuntarily linked by the mandatory provisions imposed under Delaware corporate law, Delaware’s LLC law network does not impose mandatory linkage. So, where all Delaware corporations are subject to the same, indeterminate *Revlon* duties, each LLC is subject to the specific terms of its own governing agreement. Although some LLCs will share similar provisions in their governing agreements and will thus be linked within Delaware’s LLC network, many LLCs will employ idiosyncratic and therefore incompatible provisions that are tailored to the specific needs of the firm. Such firms, although Delaware LLCs in name, will be isolated from others within Delaware’s LLC network. Thus, the size and breadth of Delaware’s LLC network becomes irrelevant because contractibility limits the linkage within it.

2. Determinate Law Eliminates the Need for Delaware’s Interpretive Network

The foregoing analysis suggested that heightened contractibility limits the linkage within Delaware’s LLC law network and thus diminishes its value. Reduced indeterminacy further diminishes the value of Delaware’s LLC network by eliminating the need for an interpretive network of judicial opinions in the first instance.

Judicial interpretations of legal doctrine are only beneficial when the underlying law is indeterminate and requires clarification.²⁴⁵ Determinate rules-based law, however, does not require judicial interpretation to give its content meaning.²⁴⁶ Thus, the value of an interpretive

²⁴³ FORTRESS LLC AGREEMENT, *supra* note 99, § 5.19(a).

²⁴⁴ Note that Och-Ziff will thus also suffer from an absence of network effects in this respect.

²⁴⁵ See Klausner, *supra* note 112, at 775–77 (arguing in the context of network effects that “[t]he benefit of judicial interpretation lies in the reduction of uncertainty”); Lemley & McGowan, *supra* note 112, at 572 (“The case for interpretive [network] effects . . . rests on the value of possible future clarification of less precise terms . . .”); Ribstein & Kobayashi, *supra* note 14, at 112 (noting that network effects are “most important where terms are open-ended or complex enough to require clarification”).

²⁴⁶ See Kamar, *supra* note 8, at 1914 (“Rules delineate the law *ex ante*. Their application in court requires determination only of whether their pre-set conditions were met.”); Kap-

network is substantial under indeterminate law and less so under determinate law.

For corporations, an interpretive network of judicial opinions is important because of the pervasive indeterminacy in corporate law.²⁴⁷ Because Delaware offers the broadest network, corporations flock to Delaware.²⁴⁸

For LLCs, however, an interpretive network is not as significant. Because Delaware LLC law allows firms to contractualize virtually all of the provisions of internal governance, Delaware LLCs can effectively avoid the indeterminate standards imposed under Delaware corporate law. Instead, Delaware LLCs may opt for determinate contractual provisions that resemble bright-line rules, delineating the rights and obligations of the LLC parties *ex ante*. To the extent LLCs take advantage of this contractual freedom by drafting clear, determinate provisions into their governing agreements, they will face less uncertainty regarding the rights and obligations of managers and shareholders. And, the less uncertainty LLCs face with respect to their legal rights and obligations, the less such firms will need an interpretive network of case law for guidance.

The result is that, even when firms are, as a consequence of sharing identical contract provisions, linked within Delaware's LLC network, that linkage has less value where freedom of contract allows firms to avoid indeterminacy. In lieu of an interpretive network to deal with indeterminacy, firms may rely on contractual clarity. And, because Delaware is merely one of several states that offers an expansive freedom of contract under its LLC law,²⁴⁹ it offers no particular advantage to firms seeking contractual clarity.

3. Determinate Law Marginalizes Delaware's Judicial Advantage

Reduced indeterminacy not only diminishes the need for an interpretive network of law, it also marginalizes Delaware's judicial advantage by limiting the role and importance of Delaware's judges in the interpretation of the law. In the corporate context, indeterminacy accentuates Delaware's judicial advantage over its rival states because in-

low, *supra* note 181, at 559–60 (“[Rules-based law] entail[s] an advance determination of what conduct is permissible, leaving only factual issues for the adjudicator.”); *cf.* Lemley & McGowan, *supra* note 112, at 572 (“Relatively specific provisions will by definition have relatively little value to gain through possible clarification by litigation . . . because the process of interpretation would have little to add to the clarify of such terms . . .”).

²⁴⁷ See *supra* note 165 and accompanying text.

²⁴⁸ See Kamar, *supra* note 8, at 1924.

²⁴⁹ See *supra* note 190 and accompanying text.

determinacy grants Delaware's expert judges greater discretion in applying the law.²⁵⁰ Under indeterminate corporate law, and in particular the indeterminate law of fiduciary duties, Delaware's judges are required to give the law meaning *ex post*, using their discretion and notions of equity.²⁵¹ And, in doing so, Delaware judges are afforded the opportunity to develop and publicly demonstrate their expertise in adjudicating corporate matters.²⁵²

Under determinate rules-based law, however, the discretion of Delaware's judges is constrained. The role of Delaware's judges is reduced to mere fact-finder because determinate rules-based law has meaning *ex ante*; it entails an advance determination of what conduct is permitted or proscribed.²⁵³

The example provisions described in Part III.B above illustrate the kind of determinate rules-based law that may govern LLCs. Consider the provision proposed in Part III.B for a transaction constituting a sale of "all or substantially all" assets. Under Delaware corporate law's indeterminate *Gimbel* test, a court is required to both interpret a legal standard (i.e., the qualitative and quantitative determination of what constitutes "substantially all assets") *and* make a factual determination (i.e. do the facts of a particular case satisfy that legal standard). The legal standard is broad, fact-intensive, and open-ended, requiring Delaware courts to give it meaning *ex post*, on a case-by-case basis. In contrast, the rule proposed in Part III.B requires the court to make only a factual determination (i.e., whether an independent auditor has determined that the LLC would retain at least 25% of its total assets and continuing operations constituting 25% of its gross revenues). The rule provides an advance determination of what would constitute "all or substantially all" assets. Under such a rule, a Delaware court need not engage in a contextual inquiry to interpret the meaning of an open-ended legal standard.²⁵⁴ Instead, the court would need to determine only whether certain pre-set conditions were met.

²⁵⁰ See Kamar, *supra* note 8, at 1932–34.

²⁵¹ See Fisch, *supra* note 3, at 1076 ("Standards apply general principles that judges must use to evaluate transactions from an *ex post* perspective . . . [S]tandards, in comparison to rules, increase judicial discretion."); Kahan & Kamar, *supra* note 3, at 1236; see also Kamar, *supra* note 8, at 1914–15; Kaplow, *supra* note 181, at 560 (noting that standards-based law "leav[es] both specification of what conduct is permissible and factual issues for the adjudicator").

²⁵² See Kamar, *supra* note 8, at 1935.

²⁵³ See Kaplow, *supra* note 181, at 559–60.

²⁵⁴ Cf. *In re Nextmedia Investors, L.L.C.*, 2009 WL 1228665, at *1 (noting that where the parties' rights are explicitly delineated in the LLC governing agreement, those rights are an inappropriate "after-the-fact matter for judicial determination"); *id.* at *7 (noting that the adjudication of the members' rights *ex post* "would leave investors subject to *ad hoc*

As this example illustrates, determinate contractual provisions substantially limit the discretion of Delaware's judges in the adjudication of LLC matters. Instead of interpreting and applying a broad, indeterminate standard to specific facts to reach an equitable result, Delaware's judges are left to enforce explicit contractual provisions. Thus, the reduced indeterminacy achievable under LLC law substantially diminishes the need for an expert judiciary. Open-ended, contextual standards may be best applied by a proficient court like Delaware's, but any state court can ably interpret and apply determinate contractual provisions.

D. *Explaining Delaware's LLC Tax*

The foregoing discussion shows that contractibility and reduced indeterminacy may actually weaken Delaware's competitive position in the market for LLC charters. And this may help explain Delaware's relatively meager LLC taxes.

With Delaware's network and judicial advantages diminished, the two remaining advantages traditionally attributed to Delaware's law product—the proficiency of Delaware's administrative services and Delaware's credible commitment to LLCs—may be insufficient to meaningfully differentiate Delaware in the market for LLC law.²⁵⁵ Instead, Delaware appears to be merely one of many states willing to enforce the determinate provisions of an LLC governing agreement and give maximum effect to freedom of contract.²⁵⁶ As a result, Delaware may simply be unable to command a substantial premium for its LLC law product. Although firms are willing to pay an extraordinary premium for a Delaware corporate charter, in the market for LLC charters, Delaware's competitive position is substantially weaker.

decisions about their substantive rights, whereas the purpose of an LLC agreement, like all agreements, is to define the rules of the game so that all parties know what to expect”).

²⁵⁵ With respect to Delaware's administrative services, it should be noted that other states have attempted to match Delaware's proficiency. Consider, for example, Nevada, which by many accounts is Delaware's leading competitor in the corporate context. Kahan & Kamar, *supra* note 25, at 693. Today, Nevada's Secretary of State Office, like Delaware's, offers expedited one-hour, two-hour and next-day filing services for LLC documents, all for premium fees comparable to Delaware's. NEV. SEC'Y OF STATE, *Limited Liability Company Fee Schedule* (July 1, 2008), available at <http://nvsos.gov/Modules/ShowDocument.aspx?documentid=1047>. With respect to Delaware's credible commitment to LLCs, revenue from Delaware's LLC tax, even though substantial and growing, still represents less than one-third of the revenue levels that have theoretically secured Delaware's credible commitment to corporations. Moreover, to the extent the growth of revenues from the LLC tax is a recent phenomenon, firms may feel it is too early to consider Delaware irreversibly dependent on such taxes.

²⁵⁶ See *supra* note 190 (identifying other states that, like Delaware, have statutorily confirmed the freedom of contract under LLC law).

To be sure, there may be other explanations for Delaware's failure to charge a premium or discriminatory price for its LLC law. As noted above,²⁵⁷ the absence of premium or discriminatory pricing does not necessarily foreclose the possibility that Delaware has market power for LLC charters. And that market power may be sufficient to allow Delaware to charge more than it currently does in the market for LLC law. But Delaware does not, and contractibility and indeterminacy may explain why.

IV. IMPLICATIONS

Part III shows that contractibility and the reduced indeterminacy achievable under Delaware LLC law substantially diminish the importance of two of Delaware's traditional competitive advantages, namely its network effects and its expert judiciary. Although heightened contractibility and reduced legal indeterminacy enhance the value of Delaware's LLC law product, the value of contractibility and reduced indeterminacy is a benefit offered by several other states.

This Article now concludes by briefly touching on four important implications of the foregoing analysis. First, if the analysis in this Article is correct, then a variety of incentives suggest that Delaware will increase the level of indeterminacy reflected in its LLC law going forward.²⁵⁸ Second, in addition to the legal advantages of contractibility and reduced indeterminacy offered by LLC law, the difference between Delaware's corporate franchise and LLC taxes suggests that firms have a purely economic incentive to choose the LLC form over the corporate form.²⁵⁹ Third, like Delaware's corporate franchise tax, the LLC tax may be a good candidate for reform to better align Delaware's incentives with the maximization of shareholder value.²⁶⁰ Finally, the relatively meager fees and taxes charged for LLC charters by Delaware and its rival states raise questions about the very existence of a vigorous competition among states for LLC charters.²⁶¹

A. *Future Indeterminacy Through the Implied Covenant of Good Faith and Fair Dealing*

Because of the high level of contractibility afforded under Delaware LLC law, Delaware LLCs are subject to less legal indeterminacy

²⁵⁷ See *supra* notes 94–97 and accompanying text.

²⁵⁸ See *infra* notes 262–325 and accompanying text.

²⁵⁹ See *infra* notes 326–333 and accompanying text.

²⁶⁰ See *infra* notes 334–342 and accompanying text.

²⁶¹ See *infra* notes 343–349 and accompanying text.

than their corporate cousins. Going forward, however, Delaware faces several incentives to create corporate-like indeterminacy in its LLC law. Indeterminacy could allow Delaware to re-create in the LLC context the same competitive advantages that afford it market power in the corporate context. Moreover, increased indeterminacy may satisfy interest group pressures within Delaware. Finally, increased indeterminacy would afford Delaware the ability to forestall federal intervention in an era of increasing business regulation and consumer protection.

1. Re-creating the Corporate Model

For Delaware to re-create in the LLC context the competitive advantages it has long enjoyed for corporate charters, the analysis of the Article suggests that Delaware would need to modify its substantive LLC law in two respects, so that it more closely resembles its substantive corporate law. First, rather than permit virtually unlimited contractibility, Delaware LLC law would need to include more mandatory provisions. Mandatory provisions would apply to all Delaware LLCs, forcing compatibility and therefore linkage within the Delaware LLC network. Second, Delaware would need to increase the level of indeterminacy in its LLC law. Indeterminacy would enhance the importance of Delaware's interpretive network and expert judges in the interpretation and application of the law.

Note, however, that either of these moves could actually hurt Delaware in the competition for LLC charters. As noted above, it is likely that high contractibility and reduced indeterminacy enhance the value of Delaware's LLC law. Indeed, it may be that high contractibility and reduced indeterminacy are the *reason* for Delaware's existing popularity among LLCs. The problem for Delaware, however, is that the benefit of high contractibility and reduced indeterminacy is shared with several other states that have, like Delaware, adopted LLC statutes explicitly giving maximum effect to the freedom of contract. Yet, the negative effects of high contractibility and reduced indeterminacy harm Delaware alone. If Delaware were to eliminate the high contractibility available under its substantive law without offering some other compelling, countervailing advantages, LLCs would simply avoid Delaware in favor of a rival state.

For now, any such moves by Delaware seem unlikely. Delaware's legislature has explicitly confirmed the state's commitment to the freedom of contract under LLC law,²⁶² and recent legislative amendments

²⁶² DEL. CODE ANN. tit. 5, § 18-1101(b) (West, Westlaw through 2010 legislation).

to the Delaware LLC Act have only reaffirmed this commitment.²⁶³ Moreover, the Delaware courts have followed the legislature in this regard, strictly enforcing the contractual provisions of LLC governing agreements without imputing implied or open-ended corporate-like provisions.²⁶⁴ As a result, Delaware LLC law seems unlikely to develop the kind of indeterminacy found in its corporate law any time soon.

But the latent seeds of indeterminacy may be already present in Delaware LLC law, waiting to germinate. Although Delaware LLC law allows for virtually unlimited contractibility, the Delaware LLC Act makes clear that all LLCs are still subject to the implied contractual covenant of good faith and fair dealing.²⁶⁵

Others have already noted the similarities between the implied contractual covenant and the fiduciary duties imposed under corporate law.²⁶⁶ Like fiduciary duties under corporate law, the implied contractual covenant is both mandatory and universal, implied into every contract.²⁶⁷ And, like fiduciary duties under corporate law, the implied contractual covenant cannot be waived.²⁶⁸ Finally, like the fiduciary duties of corporate law, the substantive content of the obligation entailed by the implied contractual covenant is not determinable at the outset of the contract, but instead evolves and is shaped by subsequent developments in the relationship.²⁶⁹ These similarities—universality, unwaivability, and contextual evolution—suggest that the implied contractual covenant is well-suited to serve as a doctrinal substitute for the fiduciary duties of corporate law,²⁷⁰ to deal with the ongoing relational context of LLCs,²⁷¹ and to ensure equitable results.²⁷²

²⁶³ See Altman & Raju, *supra* note 225, at 1472–74 (discussing the 2004 amendments to the Delaware LLC Act, which confirm that even the judge-made law of fiduciary duties is fully contractible).

²⁶⁴ See *supra* note 219.

²⁶⁵ DEL. CODE ANN. tit. 6, § 18-1101(c), (e).

²⁶⁶ See *HB Korenvaes Invs., L.P. v. Marriott Corp.*, No. 12922, 1993 WL 205040, at *6 (Del. Ch. June 9, 1993) (“Indeed the contract doctrine of an implied covenant of good faith and fair dealing may be thought in some ways to function analogously to the fiduciary concept.”); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1653–64 (1989).

²⁶⁷ See Coffee, *supra* note 266, at 1653–54.

²⁶⁸ *Id.* at 1654.

²⁶⁹ *Id.*

²⁷⁰ See *id.*

²⁷¹ See *Amirsaleh v. Bd. of Trade of the City of N.Y.*, No. 2822-CC, 2009 WL 3756700, at *5 (Del. Ch. Nov. 9, 2009) (“[T]he implied covenant of good faith and fair dealing is particularly important in contracts that defer a decision at the time of contracting and empower one party to make that decision later.”); *cf.* Coffee, *supra* note 266, at 1654 (noting that, like fiduciary duties under corporate law, the duties created by the implied contractual covenant of good faith and fair dealing are not “wholly determinable at the time of

Even so, the Delaware courts have made clear that the implied contractual covenant of good faith and fair dealing is doctrinally distinct from, and substantially narrower than, the indeterminate fiduciary duties of corporate law.²⁷³ And, as a result, Delaware courts have seldom affirmed a claim based on the implied contractual covenant.²⁷⁴

contracting . . . [but instead are] shaped and affected by postcontracting developments”). *But see* Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager After More Than a Decade of Experimentation?*, 32 J. CORP. L. 565, 606–10 (2007) (arguing that the implied contractual covenant “is not well-suited to addressing the relational contract that unfolds when LLC members conduct a business enterprise over time”).

²⁷² See *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, No. 3803-CC, 2008 WL 3846318 at *7 (Del. Ch. Aug. 19, 2008) (“There is no threat to equity in allowing members to waive their right[s], because there is no chance that some members will be trapped in a limited liability company at the mercy of others acting unfairly and in bad faith.”); Coffee, *supra* note 266, at 1664 (noting that if “[p]roperly interpreted, the [implied contractual] duty of good faith could largely” achieve the principal that “distributive fairness should remain a constraint on the pursuit of efficiency”).

²⁷³ See *supra* note 227 and accompanying text.

²⁷⁴ See, e.g., *Nemec v. Shrader*, 991 A.2d 1120, 1128 (Del. 2010) (affirming the dismissal of claims based on the implied contractual covenants, reasoning in part that “Delaware’s implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not . . . [R]ather the covenant is a limited and extraordinary legal remedy”); *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008) (holding that the implied contractual covenant must be based on contractual obligations and, therefore, does not apply to the plaintiff’s claims based upon alleged breaches of fiduciary duties); *Related Westpac LLC v. JER Snowmass LLC*, No. 5001-VCS, 2010 WL 2929708, at *6 (Del. Ch. July 23, 2010) (granting a motion to dismiss a claim based on the implied contractual covenant of good faith and fair dealing where the claim would require the court to “imply an obligation inconsistent with the parties’ express agreement”); *Kuroda v. SPJS Holdings, LLC*, No. 4030-CC, 2010 WL 925853, at *10–11 (Del. Ch. Mar. 16, 2010) (granting a motion to dismiss claims based on the implied contractual covenant in the context of an LLC governing agreement because “any use of the implied covenant to insert a contractual duty of confidentiality into the LLC Agreement would be an override of the express terms of that agreement”); *Kelly v. Blum*, No. 4516-VCP, 2010 WL 629850, at *14 (Del. Ch. Feb. 24, 2010) (granting a motion to dismiss a claim based on the implied contractual covenant in the context of an LLC governing agreement because the plaintiff failed to connect “any alleged violations of the implied covenant [with] a specific implied obligation in the contract”); *Amirsaleh*, 2010 WL 177681, at *9 (holding after a bench trial that the defendants’ conduct did not breach the implied contractual covenant in the context of a merger agreement); *Kuroda v. SPJS Holdings, LLC*, 971 A.2d 872, 888 (Del. Ch. 2009) (granting a motion to dismiss claims based on the implied contractual covenant in the context of an LLC governing agreement because, among other reasons, “the complaint fails to draw a sufficient connection between the alleged violations of the implied covenant and a specific implied obligation in the contract”); *Fisk Ventures, LLC v. Segal*, No. 3017-CC, 2008 WL 1961156, at *10–11 (Del. Ch. May 7, 2008) (granting a motion to dismiss a claim based on the implied contractual covenant in the context of an LLC governing agreement because “the mere exercise of one’s contractual rights, without more, cannot constitute a breach of the implied covenant”). *But see* *Lola Cars Int’l Ltd. v. Krohn Racing, LLC*, Nos. 4479-CVN, 4886-VCN, 2009 WL 4052681, at *9 (Del. Ch. Nov. 12, 2009) (denying a motion to dismiss a claim based on a breach of the implied contractual covenant in the context of an LLC agreement without

Yet, as Delaware judges,²⁷⁵ lawyers,²⁷⁶ and scholars²⁷⁷ alike have all acknowledged, the implied contractual covenant of good faith and fair dealing is an inherently contextual, standards-based, and, therefore, indeterminate doctrine. To illustrate this point, one need not look any further than the recent Delaware Supreme Court opinion, *Nemec v. Shrader*, decided in 2010.²⁷⁸ *Nemec* is unusual because it was a 3–2 split decision. For a court accustomed to unanimous opinions,²⁷⁹ *Nemec* features a rare, and forceful, dissent.²⁸⁰

The three-justice majority in *Nemec* rejected the plaintiff's claims that the defendants had breached their implied contractual covenant of good faith and fair dealing under the contractual terms of a stock incentive plan.²⁸¹ In reaching this conclusion, the majority reasoned that "Delaware's implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract. Rather the covenant is a limited and extraordinary legal remedy."²⁸² Thus, the majority preferred to strictly enforce the contract in question, without intervening:

A party does not act in bad faith by relying on contract provisions for which that party bargained where doing so simply limits advantages to another party. We cannot reform a con-

providing substantial analysis for the ruling); *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, Nos. 4479-VCN, 4886-VCN, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009) (denying a motion to dismiss a claim based on upon a breach of the implied contractual covenant in the context of an LLC agreement, but conceding that even at this early procedural stage, "[t]his is a close question").

²⁷⁵ See, e.g., *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) ("This quasi-reformation, however, should be a rare and *fact-intensive exercise, governed solely by issues of compelling fairness.*") (emphasis added); *Amirsaleh*, 2009 WL 3756700, at *4 ("[T]he exact contours of the implied covenant of good faith and fair dealing are not always easily discernable in the case law. This is partly driven by the *fact-intensive* nature of the doctrine.") (emphasis added)).

²⁷⁶ See, e.g., *Altman & Raju*, *supra* note 225, at 1478 (noting that the implied contractual covenant under Delaware law is "not clear" and that courts apply the implied covenant "by fashioning standards on an ad hoc factual basis," which "is indicative of the arguably nebulous . . . [and] fact-intensive nature of the doctrine").

²⁷⁷ See, e.g., *Gold*, *supra* note 67, at 135 ("The content of contractual good faith has not been easy to define in the abstract, in part because context is so significant to its application."); *Lemley & McGowan*, *supra* note 112, at 587 ("The implied covenant is an open-ended term that effectively establishes a totality of the circumstances test, which by definition produces different outcomes in different circumstances . . .").

²⁷⁸ 991 A.2d 1120 (Del. 2010).

²⁷⁹ See *Skeel*, *supra* note 165, at 129, 132.

²⁸⁰ See 991 A.2d at 1131–35 (Jacobs, J., dissenting).

²⁸¹ *Id.* at 1127–28 (majority opinion).

²⁸² *Id.* at 1128.

tract because enforcement of the contract as written would raise moral questions. The policy underpinning the implied duty of good faith and fair dealing does not extend to post contractual rebalancing of the economic benefits flowing to the contracting parties.²⁸³

The two-justice dissent, however, argued that “Delaware law does not support, let alone mandate, such a narrow construction of the implied covenant.”²⁸⁴ Under the dissent’s reasoning, a contracting party may breach the implied covenant, even where it is expressly empowered to act, if it exercises its contractual power unreasonably or arbitrarily.²⁸⁵ Consequently, unlike the majority, the dissenting justices were prepared to perform an ex post review of the reasonableness of the defendant’s actions.²⁸⁶ *Nemec* thus illustrates the sharp disagreement among Delaware’s justices on the role that the implied covenant should play in the courts’ ex post review of contractual disputes.

Although the justices of the Delaware Supreme Court disagree about the scope of ex post review permissible under the implied contractual covenant of good faith and fair dealing, several reasons suggest the Delaware chancellors would be particularly receptive to seeing the implied contractual covenant devolve into a broad, fiduciary-like standard allowing for expansive ex post review. Aside from the simple lure of applying a familiar equitable framework,²⁸⁷ indeterminacy in the application of the implied contractual covenant would reassert the centrality of the Delaware chancellors in the resolution of business disputes.²⁸⁸ As noted above,²⁸⁹ determinate rules-based law marginalizes the role of the judge in the adjudication of a dispute. Indeterminate law, in contrast, places judges in the center of the dispute, accentuating the role and importance of Delaware’s chancellors in the adjudication and development of business law. Moreover, increased indeterminacy under the implied contractual covenant of good faith and fair dealing would allow

²⁸³ *Id.*

²⁸⁴ *Id.* at 1131 (Jacobs, J., dissenting).

²⁸⁵ *Id.* at 1132–34.

²⁸⁶ *Nemec*, 991 A.2d at 1135.

²⁸⁷ See Steele, *supra* note 196, at 19; see also Ribstein, *supra* note 186, at 164 (cautioning that past Delaware cases “show that the judicial tendency to apply corporate rules [in cases involving unincorporated entities] is always lurking and that courts have not yet completely severed unincorporate cases from corporate indeterminacy”).

²⁸⁸ See Kamar, *supra* note 8, at 1940 (“Delaware’s judges may . . . be inclined toward legal indeterminacy as a consequence of their own preference for wide judicial discretion.”).

²⁸⁹ See *supra* notes 250–254 and accompanying text.

the Delaware chancellors the ability to wring equitable results in cases where LLC governing agreements otherwise impose harsh realities.²⁹⁰

So, even while the Delaware legislature professes its fealty to the freedom of contract under LLC law, the implied contractual covenant of good faith and fair dealing lurks, enshrined in Delaware's LLC statute, ready as a doctrinal vehicle for Delaware courts to apply mandatory and indeterminate provisions onto all Delaware LLCs.²⁹¹ Delaware courts, pressed by the repeated challenges of aggrieved investors and compelling fact patterns, may eventually be forced to broaden the standards defining the implied contractual covenant to achieve equitable results in otherwise unjust circumstances, even though the indeterminacy that would result could hurt Delaware in the competition for LLC charters.

2. Interest Group Pressures

In addition to the desires of Delaware's judges to achieve equity in LLC cases, Delaware's lawyers may also be interested in seeing an increase in the level of indeterminacy present in Delaware LLC law. In the corporate context, Professors Jonathan Macey and Geoffrey Miller have posited an interest group theory of Delaware law, arguing that Delaware could raise its franchise tax if it provided a more determinate, less litigation-intensive corporate law.²⁹² Under this theory, the indeterminacy that pervades Delaware's corporate law reflects the influence of the state's corporate bar.²⁹³ Unlike corporate franchise taxes, which benefit all of Delaware's citizens equally, indeterminate law benefits Delaware's lawyers specifically because it generates demand for their services.²⁹⁴ Because firms view exposure to litigation and franchise taxes as components of the total costs of incorporating within the state, if Delaware reduced the former, it would be able to increase the latter

²⁹⁰ This seems especially true in the context of publicly traded LLCs, where the Delaware Chancery has already expressed a wariness about the elimination of traditional fiduciary duties. *See In re Atlas Energy Res., LLC*, No. 4589-VCN, 2010 WL 4273122, at *7 (Del. Ch. Oct. 28, 2010).

²⁹¹ *Cf.* Ribstein, *supra* note 186, at 163 (noting that any "indeterminacy problem [in Delaware] may lie in the courts rather than the legislature. . . . [given] the legislature's strong incentive to respond to its business constituency").

²⁹² *See* Macey & Miller, *supra* note 116, at 491–92, 497–98, 504–05; *see also* Skeel, *supra* note 165, at 156–62 (applying Professors Macey and Miller's interest group theory of Delaware corporate law to the Delaware Supreme Court).

²⁹³ *See* Macey & Miller, *supra* note 116, at 503–05. Professor Kamar's view that legal indeterminacy also benefits Delaware in the competition for corporate charters is consistent with this interest group theory. *See* Kamar, *supra* note 8, at 1939–40.

²⁹⁴ *See* Macey & Miller, *supra* note 116, at 491–93.

without increasing the total costs to its chartered corporations.²⁹⁵ Responding to interest group pressures from the local corporate bar, however, Delaware has adopted a relatively indeterminate corporate law at the expense of increased revenues from higher franchise taxes.²⁹⁶

Delaware's low LLC tax can be viewed as consistent with this interest group theory. Delaware's apparent popularity with LLCs coupled with the higher taxes and fees charged by other states suggests that Delaware could charge a higher LLC tax without risking a decline in its LLC chartering business.²⁹⁷ Doing so would cause Delaware to reap more of the direct benefits of its chartering business and minimize the indirect benefits that are captured primarily by the lawyers within the state.²⁹⁸ Responding to pressure from these lawyer interest groups, however, Delaware has chosen to keep its LLC tax artificially low.²⁹⁹ Keeping LLC taxes low has two effects that benefit Delaware's lawyers: first, low taxes attract more LLCs to the state; second, low taxes mean firms are prepared to pay more of the indirect cost of organizing in Delaware to the state's lawyers.³⁰⁰

Under Professors Macey and Miller's theory, however, Delaware's lawyers stand to reap benefits from LLCs charters only if Delaware provides an indeterminate, litigation-intensive LLC law that would require the services of local lawyers.³⁰¹ Thus, Professors Macey and Miller's interest group theory suggests another incentive for Delaware to increase the level of indeterminacy found in its LLC law.³⁰² If this interest group theory of Delaware LLC law is correct, one would expect to see indeterminate cracks eventually appear in Delaware LLC law.³⁰³

But the Delaware legislature, the body most likely to be susceptible to interest group pressures, has shown little interest in developing

²⁹⁵ *See id.*

²⁹⁶ *See id.* at 498, 503–05.

²⁹⁷ The fact that several states charge an annual LLC tax higher than Delaware's \$250 LLC tax suggests that Delaware could at least increase its annual LLC tax to higher than its current levels.

²⁹⁸ *Cf.* Macey & Miller, *supra* note 116, at 491–93, 503–05 (making the same assertion with respect to Delaware's corporate franchise tax).

²⁹⁹ *Cf.* Kahan & Kamar, *supra* note 3, at 1229–30 (arguing that interest group pressure from the local corporate bar has restrained Delaware from increasing its relatively modest franchise tax for large corporations).

³⁰⁰ *Cf.* Macey & Miller, *supra* note 116, at 492–93 (claiming, in the corporate context, that from the perspective of the firm the direct and the indirect costs of Delaware incorporation are interchangeable).

³⁰¹ *Cf. id.* at 503–05 (making the same assertion regarding Delaware corporate law).

³⁰² *See id.*

³⁰³ Indeed, *Nemec* may be the first sign of these indeterminate cracks. *See supra* notes 278–286 and accompanying text.

open-ended, indeterminate LLC law. As noted above,³⁰⁴ Delaware's legislature has explicitly enshrined and only recently reaffirmed the state's commitment to the freedom of contract under its LLC law. Thus, again, the most likely source for legal indeterminacy may be Delaware's judiciary. Although interest group theory is usually applied to explain legislative behavior, Delaware's judges may also be responsive to interest group pressures.³⁰⁵ Through the judicial selection process and an intricate web of personal and professional contacts, there are several reasons to believe that Delaware judges would be sympathetic or at least predisposed to the interests of the Delaware bar.³⁰⁶ Under Professors Macey and Miller's theory, Delaware's judges, responding to pressures from the Delaware bar, may be inclined to create indeterminacy in Delaware LLC law, most obviously through the broadened interpretation and application of the implied contractual covenant of good faith and fair dealing, as described above.

Note, however, that interest group pressures could also work in the opposite direction, in favor of predictable, determinate LLC law. Although Professors Macey and Miller suggest that Delaware lawyers prefer indeterminate, litigation-intensive law,³⁰⁷ this may only be true for litigators and not for transactional attorneys, who may prefer determinate law to ensure their contracting is enforced. Likewise, if high contractibility and reduced indeterminacy are part of what makes LLC law valuable, then other Delaware interest groups—for example, LLC managers and the service firms that provide Delaware LLCs operating out-of-state with filing and registered agent services—would prefer predictable, determinate law. To the extent that Delaware LLC law does not evolve in the direction of indeterminacy, it suggests that Professors Macey and Miller's interest group theory fails to account adequately for these opposing interest groups.

3. Threat of Federal Intervention

The threat of federal intervention may give Delaware yet another incentive to create indeterminacy in its LLC law. In the corporate context, Professors Bebchuck and Hamdani have argued that legal inde-

³⁰⁴ See *supra* note 262–263 and accompanying text.

³⁰⁵ See Macey & Miller, *supra* note 116, at 501–02; Skeel, *supra* note 165, at 155–62; Strine, *supra* note 4, at 1270–71 (conceding that the Delaware “courts are also responsive to ‘constituent pressures’” from corporate practitioners). *But see* Fisch, *supra* note 3, at 1092–95 (arguing that Delaware's judges “enjoy an unusual degree of political independence” and are “subject to less political influence than its legislature”).

³⁰⁶ See Macey & Miller, *supra* note 116, at 502; Skeel, *supra* note 165, at 158–59.

³⁰⁷ See Macey & Miller, *supra* note 116, at 504–05.

terminacy benefits Delaware by allowing the state to disguise certain deficiencies in its law—specifically, what they view as Delaware corporate law’s bias in favor of managers over shareholders:³⁰⁸

[I]ndeterminacy always leaves some chance . . . that Delaware’s chancery court will intervene in favor of shareholders. Even a few isolated decisions against managers might be sufficient to disguise and make less conspicuous the managerial favoritism that is actually at work. Furthermore the flexibility of the open-ended standards enables Delaware case law to develop in directions that are responsive to the fear of federal intervention without the visible change in course that would be involved in a legislative amendment.³⁰⁹

By disguising this managerial bias, Delaware reduces the likelihood that the federal government would intervene in state corporate law.³¹⁰

The relative absence of indeterminacy in Delaware LLC law may be harmful in this regard. In the corporate context, Delaware courts have used the indeterminate law of fiduciary duties as a backstop to prevent egregious cases of managerial abuse and disloyalty.³¹¹ And, because fiduciary duties cannot be waived or limited under corporate law, this doctrinal tool is always available. Under Delaware LLC law, however, this is not always the case because firms may limit or even eliminate the traditional fiduciary duties that would otherwise bind LLC managers.³¹² And the implied contractual covenant of good faith and fair dealing—the one obligation that cannot be modified or eliminated under LLC law—has yet to develop as a meaningful doctrinal check on allegations of managerial abuse.³¹³

Thus, unlike corporate law, under LLC law, Delaware courts may be unable to camouflage the harshness of its results on LLC sharehold-

³⁰⁸ See Bebchuk & Hamdani, *supra* note 8, at 603–05.

³⁰⁹ *Id.* at 603.

³¹⁰ See *id.* at 603–04.

³¹¹ In the same vein as Professors Bebchuk and Hamdani, Professor Griffith has suggested that the Delaware courts developed an intentionally “flexible” fiduciary duty of good faith in part to fend off the threat of further federal intervention into state corporate law. See Sean J. Griffith, *Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence*, 55 DUKE L.J. 1, 53–68 (2005). Specifically, he argues that the fiduciary duty of good faith under corporate law “can support scrutiny in one case and deference in the next.” *Id.* at 68. “When federal preemption looms large, as in periods of scandal and crisis, corporate law judges manipulate doctrine to increase management accountability in hopes of quieting calls for federal intervention.” *Id.* at 57.

³¹² See *supra* notes 186–187 and accompanying text.

³¹³ See *supra* notes 272–273 and accompanying text.

ers.³¹⁴ Stripped of the judicial discretion afforded by legal indeterminacy, Delaware judges are forced to simply enforce the contractual provisions of LLC governing agreements without considerations of equity or public policy. The potential harshness of this consequence is echoed in the Delaware chancery court's view that LLC law reflects a policy of *caveat emptor*: investors beware.³¹⁵ As Vice Chancellor Donald F. Parsons has explained, "[b]ecause of [the] statutorily-granted discretion [under Delaware LLC law], investors in the LLC context should be 'on notice that fiduciary duties may be altered' and that they should, therefore, read carefully the LLC agreement before becoming members."³¹⁶ The Delaware Supreme Court has even gone further, suggesting that Delaware courts should not shirk from the harshness of enforcing explicit contractual provisions even when the results "would raise 'moral questions.'"³¹⁷

In this regard, Delaware's policy under LLC law seems to stand in somewhat stark contrast to the recent zeal for business regulation at the federal level, where Congress and the Obama administration have recently proposed and enacted a variety regulatory reforms, including changes in the regulation of financial institutions,³¹⁸ corporate governance,³¹⁹ consumer credit cards,³²⁰ asset-backed securities,³²¹ securities

³¹⁴ Cf. *Lonegran v. EPE Holdings LLC*, No. 5856-VCL, 2010 WL 3987173, at *8 (Del. Ch. Oct. 11, 2010) (noting in the analogous LP context that "[w]hen parties exercise the authority provided by [Delaware law] to eliminate fiduciary duties, they take away the most powerful of a court's remedial . . . powers").

³¹⁵ See, e.g., *Kelly*, 2010 WL 629850, at *10 n.67.

³¹⁶ *Id.*

³¹⁷ See *Nemec*, 991 A.2d at 1128.

³¹⁸ See, e.g., Binyamin Appelbaum, *Obama Administration Pushing for Regulatory Reform on Many Fronts*, WASH. POST, Sept. 23, 2009, at A25; Binyamin Appelbaum & David M. Herszenhorn, *Financial Overhaul Signals Shift on Deregulation*, N.Y. TIMES, July 15, 2010, at A1, available at <http://www.nytimes.com/2010/07/16/business/16regulate.html>; Peter Baker, *Obama Issues Sharp Call for Reforms on Wall Street*, N.Y. TIMES, Apr. 22, 2010, <http://www.nytimes.com/2010/04/23/business/economy/23prexy.html>; Brady Dennis, *Congress Passes Financial Reform Bill*, WASH. POST, July 16, 2010, at A1.

³¹⁹ See, e.g., Tara Siegel Bernard, *Voting Your Shares May Start to Matter*, N.Y. TIMES, Mar. 6, 2010, at B1, B4; Jessica Holzer & Dennis Berman, *Investors Gain New Clout: SEC Votes To Boost Power Over Boards; GOP Member Calls Move 'Fatally Flawed'*, WALL ST. J., Aug. 26, 2010, at A1.

³²⁰ See, e.g., Yan Q. Mui, *Fed Proposes Limits on Credit Card Penalty Fees in Final Phase of Reform Legislation*, WASH. POST, Mar. 4, 2010, at A16; Yan Q. Mui, *Liberal Senators Propose to Cap Interest Rates Paid by Credit-Card Holders*, WASH. POST, May 1, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/04/30/AR2010043002327.html>; *New Credit Card Rules in Effect Monday*, CHI. TRIB. REDEYE, Feb. 22, 2010, at 3.

³²¹ See, e.g., Zachary A. Goldfarb, *SEC Targets Securities that Helped Fuel Crisis*, WASH. POST, Apr. 8, 2010, at A16; Edward Wyatt, *S.E.C. Moves to Tighten Rules on Bonds Backed by Consumer Loans*, N.Y. TIMES, Apr. 8, 2010, at B3.

disclosures,³²² stock and insurance brokers,³²³ and executive compensation,³²⁴ all with the overall aim of creating greater investor protections. To the extent Delaware's policy of caveat emptor and freedom of contract continues to diverge from the federal mood for increased business regulation, the more likely federal regulators will become interested in regulating Delaware entities directly.

Of course, Delaware could forestall any such moves at the federal level by simply creating indeterminacy, and thus judicial flexibility, in its LLC law. Like indeterminacy in the corporate context, indeterminacy in the LLC context would give Delaware courts the flexibility necessary to protect shareholders when equity (or political constraints) demands.³²⁵ Thus, the threat of federal intervention provides yet another incentive for Delaware to create indeterminacy in Delaware LLC law, most obviously through the broadened interpretation and application of the implied contractual covenant of good faith and fair dealing.

B. *Delaware Corporations and the LLC "Discount"*

This Article has largely focused on the regulatory competition among states. An analysis of Delaware's LLC tax, however, also has implications on the regulatory competition among business forms within Delaware.

The discrepancy between Delaware's corporate franchise tax and LLC tax structures is likely a vestige of history. When compared to the corporate form, LLCs are a relatively new entity. Until only recently, LLCs were considered arcane investment vehicles, suitable only for small or closely held entities, negotiated by sophisticated investors. Most publicly held firms were, and indeed today continue to be, organized as corporations,³²⁶ subject to Delaware's corporate franchise tax.

Recently, however, LLCs have assumed increased prominence in American business.³²⁷ Today, publicly traded LLCs, like Fortress, with

³²² See, e.g., *S.E.C. Approves Tougher Rules on Executive Pay: Rules Would Require Banks To Share in Risks, Offer More Disclosure*, N.Y. TIMES, Dec. 16, 2009, at B1.

³²³ See, e.g., Tara Siegel Bernard, *Struggling Over a Rule for Brokers*, N.Y. TIMES, Feb. 16, 2010, at B1.

³²⁴ See, e.g., David Cho et al., *U.S. Targets Excessive Pay for Top Executives: Compensation Czar to Oversee Firms at Heat of Crisis*, WASH. POST, June 11, 2009, at A1; Eric Dash, *Washington Turns Focus to Bank Pay*, N.Y. TIMES, Jan. 13, 2010, at B1; Tomoch Murakami Tse, *Firms Not Following Treasury Pay Advice: New Standard for CEOs Sought*, WASH. POST, Apr. 1, 2010, at A1.

³²⁵ Cf. Griffith, *supra* note 311, at 57 (arguing, in the context of Delaware corporate law, that the Delaware courts can manipulate the flexible fiduciary duty of good faith to "increase management accountability" as necessary to "quiet[] calls for federal intervention").

³²⁶ See Chrisman, *supra* note 10, at 462; Manesh, *supra* note 10, at 503–504.

³²⁷ See *supra* note 10 and accompanying text.

multi-million dollar market capitalizations, are not uncommon.³²⁸ And, going forward, the inherent legal advantages of the LLC form over the corporate form—namely contractibility and the resulting reduction in legal indeterminacy—suggest that such LLCs will become only more common.³²⁹

Given this context, Delaware's meager LLC tax creates one more, purely economic advantage for the LLC form over the corporate form. For all but the smallest firms, Delaware's corporate franchise tax would be higher than the LLC tax.³³⁰ And for larger firms, the difference in tax may be as great as \$179,750 annually.³³¹ Thus, in addition to the inherent legal advantages of contractibility and reduced indeterminacy, the LLC "discount" offered by Delaware in the form of its low LLC tax presents one more reason to believe that the LLC form will challenge the continued viability and dominance of the corporate form in Delaware.

Of course, if many business planners do elect to organize as Delaware LLCs in lieu of corporations, it will almost certainly mean the end of a flat \$250 LLC tax. Simply put, Delaware cannot afford to give every large firm incorporated in the state the up to \$179,750 "discount" that would result if the firm organized as an LLC instead. To Delaware, the revenue generated from the corporate franchise tax is too important.³³² If this revenue were to dwindle, Delaware would be forced to raise the cash elsewhere, and the LLC tax would seem to be the most viable option.

But to replace the revenues from lost franchise taxes, Delaware would need to reform its LLC franchise tax because under its current structure, all Delaware LLCs are subject to the same \$250 annual tax, regardless of the LLC's size, profitability, or any other metric. Akin to what it has long used in the corporate context, it seems likely that De-

³²⁸ For a list of publicly traded LLCs that had their IPO in recent years, see Appendix A, *infra*.

³²⁹ See Connaway, *supra* note 69, at 817 (noting that the ability to contractualize duties and liabilities in LLCs and LPs "suggest[s] that the present trend in public unincorporated entities will continue and could likely increase"); Manesh, *supra* note 10, at 502–05 (arguing that the ability of LLCs and LPs to mimic the corporate structure while contractualizing the rights and duties of their managers means that these types of noncorporations will likely overtake the corporate form for publicly traded entities). Of course, to the extent the Delaware judiciary acts on the incentives outlined in Part IV.A to interpret the implied contract covenant of good faith and fair dealing broadly, thereby creating indeterminacy in Delaware LLC law, the advantages of contractibility and reduced indeterminacy under LLC law would be reduced or even wholly eliminated.

³³⁰ See *supra* Table 7.

³³¹ See *id.*

³³² See *supra* notes 34–38 and accompanying text and table (Table 1) (showing the importance of corporate franchise taxes as a percentage of Delaware's annual revenue).

laware would opt for a scalable tax structure, charging firms in accordance with their ability to pay. The discussion that follows considers one such tax proposal that would also align Delaware's incentives with those of LLC shareholders.³³³

C. Possible Tax Reforms

In the corporate context, Professor Michal Barzuza has recently observed that Delaware's corporate franchise tax is not structured in a way that promotes the maximization of shareholder value.³³⁴ More specifically, Professor Barzuza argues that the current franchise is based on metrics that are irrelevant to a firm's value or performance.³³⁵ Recall that the franchise tax is based on either the number of authorized shares or the gross value of the firm's assets.³³⁶ The number of authorized shares, of course, has no correlation to a firm's value or performance.³³⁷ And a firm's gross assets may have little relation to the firm's value or performance because "[f]irms that perform better may, for instance, distribute dividends to shareholders rather than buy assets to hold in the corporation's name."³³⁸ Because the franchise tax is not structured to reward Delaware for increases in shareholder value, the tax provides Delaware with no incentive to adopt laws that would maximize shareholder value.³³⁹ To address this problem, Professor Barzuza proposes that Delaware reform its corporate franchise tax so that it is at least partially based on some metric of a firm's performance.³⁴⁰ By doing so, the franchise tax would better incentivize Delaware to adopt corporate law designed to maximize shareholder value.³⁴¹

Professor Barzuza's analysis can be applied with equal force to Delaware's LLC tax. Because the LLC tax is the same for all LLCs, irrespective of the firm's value or performance, the LLC tax incentivizes Delaware to maximize only the number of LLCs chartered by the state. The tax does not create any incentive for Delaware to provide LLC laws that would maximize shareholder value. If, however, Delaware were to

³³³ Note, however, that if Delaware lacks the necessary market power to charge a premium and discriminatory price for its LLC law product, then there is a limit to how much Delaware could raise its LLC price before firms begin to form elsewhere.

³³⁴ Michal Barzuza, *Delaware's Compensation*, 94 VA. L. REV. 521, 535-36 (2008).

³³⁵ See *id.* at 536-37.

³³⁶ See *supra* notes 44-48 and accompanying text; see also Barzuza, *supra* note 334, at 536-37.

³³⁷ Barzuza, *supra* note 334, at 537.

³³⁸ *Id.*

³³⁹ See *id.* at 535-41.

³⁴⁰ *Id.* at 550-54.

³⁴¹ *Id.* at 550-51, 555.

amend its LLC tax so that it was at least partially based on some metric of an LLC's performance, the tax would incentivize Delaware to adopt laws and policies that would maximize shareholder value.

The LLC context, however, folds some additional wrinkles into Professor Barzuza's analysis. First, if, as this Article has argued, LLC law marginalizes two of Delaware's traditional competitive advantages and, thus, limits Delaware's ability to differentiate itself in the nascent competition for LLC charters, then Delaware may be even more hesitant to disturb the existing structure of the LLC tax because any change that is viewed negatively by LLC managers and investors will threaten Delaware's lucrative and growing LLC chartering business. With several available substitutes in the market for LLC law, LLCs may be more inclined to simply charter elsewhere. Second, and conversely, because Delaware's LLC tax is relatively new and still a smaller portion of Delaware's total budget than the corporate franchise tax, Delaware may be more open to amending the LLC tax in novel ways.³⁴² Thus, in this respect at least, the LLC tax may be a better candidate for the types of reforms that Professor Barzuza proposes.

D. *The Myth of State Competition in LLC Law?*

This Article has largely focused on Delaware's position in the jurisdictional competition for LLC charters. But the findings of this Article also have significant implications for the competition itself. Appendix B demonstrates that, when compared to the other 49 states and the District of Columbia, Delaware's LLC tax does not represent a substantial premium. Appendix B, however, also demonstrates a second, perhaps more significant point: that all states—Delaware included—actually have little to gain from attracting LLC charters. This latter finding raises serious questions about the very existence of a jurisdictional competition for LLC charters.

Traditional regulatory competition theory suggests that states would compete to provide the best LLC law product with the primary aim of securing the revenue associated with LLC charters.³⁴³ But the meager sums that the states charge for LLC charters puts this whole theory in doubt. No state stands to make any substantial marginal revenue by attracting additional LLC charters. California, the state with the

³⁴² *Cf. id.* at 558–59 (noting that Delaware may be reluctant to reform its corporate franchise tax because the states' lawmakers are risk averse and unlikely to "deviate[] from past precedents").

³⁴³ Kahan & Kamar, *supra* note 25, at 687.

most to make from securing an additional LLC charter,³⁴⁴ would only make \$800 per year for each additional LLC charter that it attracts.³⁴⁵ Delaware itself only stands to make \$250 per year in marginal revenue for each LLC that it attracts.³⁴⁶

Thus, the findings of this Article suggest that states have little direct incentive to vigorously compete to attract LLC charters. Every state has structured its LLC taxes and fees in ways that would not generate substantial marginal revenues from attracting additional LLCs.³⁴⁷ To put it slightly differently, the minimal revenue that states stand to earn from attracting additional LLC charters may itself reflect the fact that states do not expect to attract a significant number of LLCs from other states.³⁴⁸ Whatever the reason for this expectation, it is borne out by recent findings by Professors Ribstein and Kobayashi, which, when compared to data in the corporate context, suggest that LLCs are substantially less likely to charter outside of their home state than corporations.³⁴⁹ The relative dearth of LLCs forming outside of their home state, coupled with the meager marginal revenue states would earn for

³⁴⁴ In some instances, Tennessee could earn more than California—up to \$3000 per year—through the filing fee charged in connection with the filing of an LLC’s annual report. The amount of the filing fee, however, is based on the number of LLC members and could be as low as \$300 per year. *See* Appendix B, *infra*.

³⁴⁵ *See* Appendix B, *infra*. Eight hundred dollars is the minimum revenue that California would receive from an LLC that is organized under California law but does not otherwise do any business within the state. California would earn additional tax revenue from an LLC that does business within the state; however, that additional revenue is unrelated to the fact that the LLC is chartered in the state.

³⁴⁶ *See* Appendix B, *infra*.

³⁴⁷ *Cf.* Kahan & Kamar, *supra* note 25, at 687–92 (making the same claim in the context of competition for corporate charters).

³⁴⁸ *Cf.* Bebchuk & Hamdani, *supra* note 8, at 585 (making the same claim in the context of competition for corporate charters).

³⁴⁹ Professor Kobayashi and Ribstein’s data show that of 9588 LLCs studied (namely LLCs that reported their state of formation and employed 50 or more persons), only 1189, or 12.4%, formed outside of the state in which the firm was headquartered. *See* Kobayashi & Ribstein, *supra* note 9, at 32–33. In comparison, Professors Bebchuk and Hamdani have collected data showing that, of the 6530 corporations studied, almost 67.3% were incorporated outside of the state in which the firm was headquartered. *See* Bebchuk & Hamdani, *supra* note 8, at 568–72. The discrepancy in these findings can be, at least partially, explained by the fact that though Professors Bebchuk and Hamdani’s study was limited to publicly traded corporations, Professors Kobayashi and Ribstein’s data was limited to private LLCs with more than fifty employees, which is relatively few by large firm standards. *See id.* Professors Dammann and Schündeln’s study, which gives arguably better insight into the chartering decisions of larger LLCs, namely those with more than one thousand employees, still shows that less than 47% formed outside of their home state. *See* Dammann & Schündeln, *supra* note 9, at 8; *see also* Miller, *supra* note 10, 374, 387–88, 413 (reporting the results of a survey showing that only 24.5% of practitioners frequently use LLCs formed outside of their home state instead of a corporation).

attracting additional LLCs, together suggest that states have little incentive to vigorously compete for LLC charters.

CONCLUSION

This Article stems from one simple observation: that the price Delaware charges for LLC charters is curiously different than the price it charges for corporate charters. Unlike the market for corporate charters, in which Delaware charges firms a premium, discriminatory price, in the nascent market for LLC charters, Delaware does neither.

Taking this one observation, this Article has explored the possibility that, in the competition for LLC charters, Delaware lacks the kind of market power that it has long enjoyed for corporate charters. Specifically, this Article has shown that, by marginalizing two of Delaware's traditional competitive advantages, the heightened contractibility and reduced legal indeterminacy available under LLC law limit Delaware's ability to differentiate itself from its rivals in the nascent competition for LLC charters. Although contractibility and reduced legal indeterminacy may be attractive to firms, Delaware LLC law is not unique in that regard. Yet, contractibility and reduced indeterminacy also harm Delaware uniquely by diminishing the importance of two of Delaware's traditional competitive advantages. Without its valuable network effects and expert judiciary, in the market for LLC law, Delaware does not have the same competitive strength and, therefore, may not have the kind of market power that it has long enjoyed for corporate charters.

If this analysis is correct, then several important implications follow for Delaware, the indeterminacy in its LLC law, the regulatory competition between the corporate and LLC forms, and the regulatory competition among states for LLC charters. All of which goes to show one simple observation can have profound implications.

APPENDIX A: UNITED STATES LLC IPOs AND IPO REGISTRATIONS
MARCH 31, 2004–MARCH 31, 2010 ³⁵⁰

	Company	IPO Date (Registration Date)	Market	Ticker Symbol	State of Organization	Total Assets as of Dec. 31, 2009 (in millions)
1	Niska Gas Storage Partners LLC	(Feb. 22, 2010)	(NYSE)	NKA	Delaware	\$2147.4
2	Ellington Financial LLC	(July 14, 2009)	(NYSE)	EFC	Delaware	\$102.9
3	Och-Ziff Capital Management Group LLC	Nov. 14, 2007	NYSE	OZM	Delaware	\$2206.4
4	Vanguard Natural Resources, LLC	Oct. 24, 2007	NYSE Arca	VNR	Delaware	\$210.7
5	Golub Capital Partners, LLC	(May. 14, 2007)	(NASDAQ GM)	–	Delaware	\$484.7 ³⁵¹
6	Atlas Industries Holdings LLC	(May. 4, 2007)	(NASDAQ GM)	–	Delaware	\$338.1 ³⁵²
7	Fortress Investment Group LLC	Feb. 9, 2007	NYSE	FIG	Delaware	\$1660.2
8	Atlas Energy Resources, LLC	Dec. 13, 2006	NYSE	ATN	Delaware	\$2208.8
9	Stewart & Stevenson, LLC	(Nov. 24, 2006)	NYSE	–	Delaware	\$570.4 ³⁵³
10	Constellation Energy Partners LLC	Nov. 15, 2006	NYSE Arca	CEP	Delaware	\$708.3
11	NuStar GP Holdings, LLC	July 14, 2006	NYSE	NSH	Delaware	\$593.2
12	Linn Energy, LLC	Jan. 13, 2006	NASDAQ GS	LINE	Delaware	\$4340.3
13	KKR Financial Holdings LLC	Jun. 24, 2005 ³⁵⁴	NYSE	KFN	Delaware	\$10,300.0

³⁵⁰ The information in this Appendix was collected from the Hoover's IPO Reports database available on LexisNexis. Information regarding each firm's state of organization and asset value was collected from the firm's public securities filings with the U.S. Securities and Exchange Commission. This Appendix excludes any LLC that converted (or intended to convert) into a corporation immediately prior to its initial public offering. For firms that registered but never completed an IPO, the date shown in parentheses is the date the firm filed its first registration statement with the U.S. Securities and Exchange Commission to conduct an IPO, and the market name shown in parentheses is the market on which the registration statement indicates the firm's securities were to be listed.

³⁵¹ This figure is reported as of December 31, 2006.

³⁵² This figure is unaudited and reported as of June 30, 2007.

³⁵³ This figure is unaudited and reported as of October 31, 2009.

³⁵⁴ KKR Financial Holdings, LLC had its initial public offering as a corporation, under the name "KKR Financial Corp." on June 24, 2005. Thereafter, on May 4, 2007, it effected a restructuring, pursuant to which the corporation was converted into an LLC. LLC membership inter-

14	Macquarie Infrastructure Company LLC ³⁵⁵	Dec. 16, 2004	NYSE	MIC	Delaware	\$2339.2
15	Copano Energy, LLC	Nov. 9, 2004	NASDAQ GS	CPNO	Delaware	\$1867.4

est was registered under the Securities Act on Form S-4, and the corporation's shareholders became members of the LLC. See KKR Fin. Holdings, LLC (Form 10-K), at 4 (Mar. 1, 2010), available at <http://www.sec.gov/Archives/edgar/data/1386926/000104746910001648/a2196605z10-k.htm>.

³⁵⁵ Macquarie Infrastructure Company completed an initial public offering as a Delaware statutory trust, with the trust shares corresponding to shares of an LLC subsidiary. On June 25, 2007, the statutory trust was effectively converted into a Delaware LLC and the publicly traded securities are now LLC interests. Macquarie Infrastructure Co. LLC (Form 10-K), at 105 (Feb. 25, 2010), available at http://www.sec.gov/Archives/edgar/data/1289790/000114420410009813/v174182_10k.htm.

**APPENDIX B: LLC INITIAL FILING FEES, PERIODIC REPORTING FEES AND
ENTITY-LEVEL TAXES CHARGED BY THE VARIOUS STATES** ³⁵⁶

Group I States*				
	State	Initial Filing Fee	Annual/Biennial Report Fee ³⁵⁷	Annual Entity-Level Tax
1	Alaska	\$250	\$100 (biennially)	None
2	Arizona	\$50	None	None
3	Colorado	\$50	\$10 (annually)	None
4	Florida	\$125 ³⁵⁸	\$138.75 (annually)	None
5	Georgia	\$100	\$30 (annually)	None
6	Hawaii	\$50	\$15 (annually)	None
7	Idaho	\$100	None	None
8	Indiana	\$90	\$20 (biennially) ³⁵⁹	None
9	Iowa	\$50	\$45 (biennially)	None
10	Louisiana	\$75	\$25 (annually)	None
11	Maine	\$175	\$85 (annually)	None ³⁶⁰
12	Maryland	\$100	\$300 (annually)	None
13	Massachusetts	\$500	\$500 (annually)	None
14	Mississippi	\$50	None	None
15	Missouri	\$105	None	None
16	Montana	\$70	\$15 (annually) ³⁶¹	None
17	Nebraska	\$110	None	None
18	Nevada	\$200 ³⁶²	\$125 (annually)	None
19	New Mexico	\$50	None	None
20	North Carolina	\$125	\$200 (annually)	None

³⁵⁶ The information presented in this Appendix was collected through a variety of existing sources and the author's independent research. The information reported under the columns titled "Initial Filing Fee" and "Annual/Biennial Report Fee" is taken from the Limited Liability Company Guide (CCH) ¶ 18,610, available on LexisNexis. The information under the column titled "Annual Entity Level Tax" is reported in MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK, §§ 3:111, :120 (2009–2010 ed. 2009) available on Westlaw, and supplemented by the author's independent research during May 2010.

³⁵⁷ Many states charge a lower fee for electronic filings. For these states, this Appendix lists the lower electronic filing fee.

³⁵⁸ The \$125 represents the sum of \$100 for filing articles of organization and \$25 for a registered agent fee.

³⁵⁹ LLCs paying the biennial fee using Indiana state's proprietary system are charged \$20; LLCs paying using a credit card are charged \$22.44. See *Business Entity Report Filing*, IN.gov, <http://www.in.gov/ai/appfiles/sos-berf/> (last visited Jan. 13, 2011).

³⁶⁰ LLCs that qualify as "financial institutions" under state law are subject to a franchise tax based on the LLC's tax income and assets attributable to the state. ME. REV. STAT. ANN. tit. 36, § 5206 (West, Westlaw through 2010 legislation). Otherwise, no entity-level tax applies to LLCs.

³⁶¹ LLCs filing their annual report before April 15 of the calendar year are charged \$15; LLCs filing after April 15 are charged \$30. See *Business Forms*, MONT. SECRETARY STATE, <http://sos.mt.gov/Business/Forms/index.asp#lledomestic> (last visited Jan. 13, 2011).

³⁶² The \$200 represents the sum of \$75 for filing articles of organization and \$125 for filing the initial list of members and managers.

21	North Dakota	\$135	\$50 (annually)	None
22	Oklahoma	\$100	None	None
23	Oregon	\$50	\$50 (annually)	None
24	South Carolina	\$110	None	None
25	South Dakota	\$150	\$50 (annually)	None
26	Utah	\$52	\$12 (annually)	None
27	Virginia	\$100	\$50 (annually)	None

* States listed above charge domestic and foreign LLCs no entity-level tax. Other than the one-time initial filing fee and recurring annual/biennial report fee, these states have nothing to gain, in terms of direct revenue, from attracting LLCs to organize in the state.

Group II States*						
	State	Initial Filing Fee	Annual/Biennial Report Fee	Annual Entity-Level Tax	Entity-Level Tax Base	Applicable Min/Max for Entity-Level Tax
1	D.C.	\$150	\$150 (biannually)	Variable ³⁶³ →	Taxable income	No min No max
2	Illinois	\$500	\$250 (annually)	Variable ³⁶⁴ →	Net income	No min No max
3	Kansas	\$165	\$50 (annually)	Variable ³⁶⁵ →	Net capital account	No min \$20,000 max
4	Michigan	\$50	\$25 (annually)	Variable ³⁶⁶ →	Business income and modified gross receipts	No min No max
5	Minnesota	\$160	None	Variable ³⁶⁷ →	Property, payroll, and sales	No min \$5000 max
6	New Hampshire	\$100	\$100 (annually) ³⁶⁸	Variable ³⁶⁹ →	Income and enterprise value	No min No max
7	New Jersey	\$125	\$50 (annually)	Variable ³⁷⁰ →	Number of members and net income	No min No max
8	Ohio	\$125	None	Variable ³⁷¹ →	Gross receipts	No min ³⁷² No max

³⁶³ All LLCs, domestic and foreign, are charged a tax on income derived from district sources, subject to a minimum tax of \$100. *See* D.C. CODE § 47-1808.03 (LexisNexis 2001 & Supp. 2010). The \$100 minimum tax does not, however, apply to LLCs with less than \$12,000 gross income derived from district sources. *See id.* § 47-1805.02(6) (LexisNexis 2001 & Supp. 2010). LLCs are also subject to a “ballpark fee,” ranging from \$5500 to \$16,500, but this fee is limited to LLCs that have at least \$5 million in income from district sources. *See id.* § 47-2762.

³⁶⁴ *See* 35 ILL. COMP. STAT. 5/201(c)–(d), 5/205(b) (West 2005 & Supp. 2010).

³⁶⁵ *See* KAN. STAT. ANN. § 79-5401(a)(2) (1997 & Supp. 2009) (repealed Dec. 31, 2010). This tax will no longer apply after December 31, 2010. *Id.* § 79-5401(g).

³⁶⁶ *See* MICH. COMP. LAWS ANN. §§ 208.1201, .1203 (West 2010).

³⁶⁷ *See* MINN. STAT. ANN. § 290.0922(1)(b) (West 2007).

³⁶⁸ LLCs are charged \$100 for an annual report filed before April 1 of the calendar year or \$150 for an annual report filed after April 1. *See* N.H. REV. STAT. ANN. § 304-C:81(I)(d) (West 2000 & Supp. 2009).

³⁶⁹ *Id.* §§ 77-A:2 (business profits tax), -E:2 (business enterprise tax).

³⁷⁰ LLCs deriving income from state sources that have two or more members are charged a filing fee of \$150 per member per year, up to a maximum of \$250,000. *See* N.J. STAT. ANN. § 54A:8-6(b)(2) (West 2002 & Supp. 2010). In addition, a tax of 6.37% to 9% on net income apportioned to the state is allocated to nonresident members. *See id.* § 54:10A-15.11.

³⁷¹ *See* OHIO REV. CODE ANN. §§ 5751.02–.03 (West 2007).

³⁷² LLCs with more than \$150,000 in gross receipts attributable to the state are subject to a “commercial activity tax,” *see id.* § 5751.02, the minimum payment for which is \$150, *see id.* § 5751.03(B). LLCs with no income (or income less than \$150,000 annually) sourced to the state, however, are not subject to this tax or the minimum payment due thereunder. *See id.* § 5751.01(E) (defining “taxpayer” to exclude “excluded persons”).

9	Pennsylvania	\$125	None ³⁷³	Variable ³⁷⁴ →	Capital stock value	No min No max
10	Texas	\$300	None	Variable ³⁷⁵ →	Revenue; revenue minus cost of goods sold; or revenue minus compensation	No min No max
11	Washington	\$190 ³⁷⁶	\$69 (annually) ³⁷⁷	Variable ³⁷⁸ →	Gross income	No min No max
12	Wisconsin	\$130	\$25 (annually)	Variable ³⁷⁹ →	Net income	No min \$9800 max

* The states listed above charge both domestic and foreign LLCs an annual entity-level tax based on some measure of the LLC's business in that state. For these states, the LLC tax is a charge for the privilege of doing business in the state, rather than a charge for organizing in the state. Because domestic and foreign LLCs are taxed equally, so far as the state is concerned, it makes no difference whether an LLC is organized in that state. Thus, like the Group I States, Group II States have nothing to gain, in terms of direct revenue, from attracting LLCs to organize in the state, other than a one-time initial filing fee and a recurring annual/biennial report fee.

³⁷³ Pennsylvania charges certain restricted professional service LLCs a per member fee; this fee, however, does not apply to all LLCs generally. *See* 15 PA. CONS. STAT. ANN. § 8998(b) (West 2001).

³⁷⁴ *See* 72 PA. CONS. STAT. ANN. § 7602(a)–(b) (West 2001 & Supp. 2010).

³⁷⁵ *See* TEX. TAX CODE ANN. §§ 171.001, .002 (West 2008).

³⁷⁶ The \$190 represents the sum of \$180 for filing articles of organization and \$10 for filing an initial annual report. Fees were increased to these prices as of January 1, 2009.

³⁷⁷ The \$69 represents the sum of a \$59 annual license fee and a \$10 annual report fee.

³⁷⁸ *See* WASH. REV. CODE § 82.04.220 (West 2004 & Supp. 2010).

³⁷⁹ LLCs that derive income from business in the state and have aggregate annual gross receipts of more than \$4 million are subject to a recycling surcharge. WIS. STAT. ANN. § 77.93(3) (West 2004). The minimum surcharge is \$25 and the maximum is \$9800, *id.* § 77.94(1)(b); LLCs that derive no income from the state, however, are not subject to the surcharge, *id.* § 77.93(3).

Group III States*						
	State	Initial Filing Fee	Annual / Biennial Report Fee	Annual Entity-Level Tax	Entity-Level Tax Base	Applicable Min/Max for Variable Tax
1	Alabama	\$75 ³⁸⁰	None	Variable ³⁸¹ →	Net worth	\$100 min \$15,000 max
2	Arkansas	\$50	None	\$300 ³⁸²	n/a	n/a
3	California	\$70	\$20 (biennially)	Variable ³⁸³ →	Gross income	\$800 min \$12,790 max
4	Connecticut	\$60	\$10 (annually)	\$250 ³⁸⁴	n/a	n/a
5	Delaware	\$90	None	\$250 ³⁸⁵	n/a	n/a
6	Kentucky	\$40	\$15 (annually)	Variable ³⁸⁶ →	Gross receipts or gross profits	\$175 min No max
7	New York	\$200	\$9 (biennially)	Variable ³⁸⁷ →	Gross receipts	\$25 min \$4500 max
8	Rhode Island	\$150	\$50 (annually)	\$500 ³⁸⁸	n/a	n/a
9	Tennessee	\$300 - \$3000 ³⁸⁹	\$300-\$3000 (annually) ³⁹⁰	Variable ³⁹¹ →	Net earnings and net worth	\$100 No max
10	Vermont	\$100	\$25 (annually)	\$250 ³⁹²	n/a	n/a
11	West Virginia	\$100	\$25 (annually)	Variable ³⁹³ →	Capital	\$50 min No max

³⁸⁰ The \$75 represents the sum of \$40 for filing articles of organization and a \$35 probate judge fee.

³⁸¹ See ALA. CODE § 40-14A-22 (LexisNexis 2003).

³⁸² See ARK. CODE ANN. § 26-54-104(8) (LexisNexis 2008).

³⁸³ All LLCs are subject to an annual minimum tax of \$800. See CAL. REV. & TAX. CODE § 17941(b) (West 2004 & Supp. 2010). In addition, LLCs with annual income in excess of \$250,000 derived from state sources are charged a second tax based on such income, ranging from \$900 (minimum) to \$11,790 (maximum). *Id.* § 17942.

³⁸⁴ See CONN. GEN. STAT. ANN. § 12-284b(a) (2), (b) (West 2008).

³⁸⁵ See DEL. CODE ANN. tit. 5, § 18-1107(b) (LexisNexis 2005 & Supp. 2008).

³⁸⁶ See KY. REV. STAT. ANN. § 141.0401(2)(a) (LexisNexis 2001 & Supp. 2009).

³⁸⁷ See N.Y. TAX LAW § 658(c) (3) (McKinney 2006 & Supp. 2010).

³⁸⁸ See Regulation CT 98-14: Limited Liability Companies, 60-1-131:1 R.I. CODE R. (LexisNexis 2010), available at <http://www.tax.state.ri.us/regulations/other/ct98-14.php>.

³⁸⁹ The fee for filing articles of organization is equal to \$50 per LLC member, with a minimum of \$300 and a maximum of \$3000.

³⁹⁰ The fee for filing annual reports is equal to \$50 per LLC member, with a minimum of \$300 and a maximum of \$3000.

³⁹¹ LLCs with business in the state are subject to both an excise tax and a franchise (or privilege) tax. See TENN. CODE ANN. §§ 67-4-2007 (LexisNexis 2006 & Supp. 2010) (excise tax), 67-4-2106 (franchise tax). The excise tax is based on an LLC's net earnings and requires no minimum. *Id.* § 67-4-2007(a). The franchise tax, however, is based on an LLC's net worth and provides for a minimum tax of \$100. *Id.* § 67-4-2119 (LexisNexis 2006).

³⁹² See VT. STAT. ANN. tit. 32, § 5921 (LexisNexis 2008).

³⁹³ See W. VA. CODE § 11-23-6 (LexisNexis 2010).

12	Wyoming	\$100	None. ³⁹⁴	Variable. ³⁹⁵ →	Capital, property and assets	\$50 min No max
<p>* The states listed above charge domestic LLCs a flat or minimum annual tax, regardless of the amount of the LLC's business in the state. Each of these states, thus, charges firms simply on the basis of organizing in the state. Five states within this last group—Arkansas, Connecticut, Delaware, Rhode Island and Vermont—charge all domestic LLCs a flat tax, regardless of the amount of the size or business of the LLC within or without the state. The remaining seven—Alabama, California, Kentucky, New York, Tennessee, West Virginia and Wyoming—charge both domestic and foreign LLCs based on some measure of the LLC's business in that state, subject to a minimum tax. Because domestic LLCs with no business in the state would not otherwise be subject to the minimum tax, the minimum tax represents a surcharge for simply organizing in the state.</p>						

³⁹⁴ Wyoming charges an "annual report license tax" payable with an LLC's annual report. The tax is reflected in the "Annual Entity Level Tax" column of this chart.

³⁹⁵ See WYO. STAT. ANN. §§ 17-15-132, 17-16-1630 (LexisNexis 2009).