This material is derived from Daniel S. Kleinberger, "Delaware's Implied Contractual Covenant of Good Faith and "Sibling Rivalry" Among Equity Holders," a paper presented at the 21st Century Commercial Law Forum: 15th International Symposium in Beijing, at Tsinghua University's School of Law, November 1, 2015 (all footnotes and most citations omitted).

Delaware's Implied Contractual Covenant of Good Faith and Fair Dealing

Introduction

An obligation of good faith and fair dealing is implied in every common law contract[1] and is codified in the Uniform Commercial Code ("U.C.C").[2] The terminology differs: Some jurisdictions refer to an "implied covenant;"[3] others to an "implied contractual obligation;"[4] still others to an "implied duty."[5] But whatever the label, the concept is understood by the vast majority of U.S. lawyers as a matter of commercial rather than entity law.[6] And, to the vast majority of corporate lawyers, "good faith" does not mean contract law but rather conjures up an important aspect of a corporate director's duty of loyalty.

Nonetheless, Delaware's "implied contractual covenant of good faith and fair dealing"[7] has an increasingly clear and important role in Delaware "entity law" –

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[1] Restatement (Second) of Contracts § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.")

[2] *See* U.C.C § 1-304 (Obligation of Good Faith). The pre-eminent commercial law statute in the U.S., the U.C.C is the joint product of the Uniform Law Conference and the American Law Institute and its most important provisions have been adopted with at most minor variations in 49 states and the District of Columbia.

[3] *E.g.,* Bike Fashion Corp. v. Kramer, 202 Ariz. 420, 423, 46 P.3d 431, 434 (Ct. App. 2002)

[4] *E.g.,* Uniform Limited Liability Company Act (2006) (Last Amended 2013) ("ULLCA (2013)") § 409(d); Uniform Limited Partnership Act (2001) (Last Amended 2013) ("ULPA (2013)") § 409(d); Uniform Partnership Act (2006) (Last Amended 2013) ("UPA (2013)") § 409(d).

[5] *E.g.,* O'Reilly v. Physicians Mut. Ins. Co., 992 P.2d 644, 646 (Colo. App. 1999)

[6] At one time, this phrase would have been "corporate law," but today formations of new limited liability companies far outpace the formation of new corporations. By overwhelming numbers, corporations remain the principal structure for publicly traded entities, but, also by overwhelming numbers, most U.S. business organizations are closely held.

[7] This phrase appears in Delaware's partnership and limited liability company statutes, Del. Code tit. 6, § 17-1101(d) (providing *inter alia* that "the partnership agreement may

i.e., the law of unincorporated business organizations (primarily limited liability companies and limited partnerships) as well as the law of corporations.[8]

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not eliminate the implied contractual covenant of good faith and fair dealing"); Del. Code tit. 6, § 18-1101(c) "providing *inter alia* that "the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing"), and is invariably used by Delaware courts. On October 13, 2015, a Westlaw search for *("implied covenant of good faith" "implied contractual covenant of good faith") /s ("limited partnership" "limited liability company")* in the Delaware database found 38 cases.

[8] Although most U.S. limited liability companies – like most U.S. corporations – are closely held, publicly traded limited partnerships are well known and several score of public traded limited liability companies exist as well. *See* Corwin v. KKR Fin. Holdings LLC, No. 629, 2014, 2015 WL 5772262, at *1 n. 3 (Del. Oct. 2, 2015) (noting that "this case involves a merger between a limited partnership and a limited liability company, … both … whose ownership interests trade on public exchanges").

In most circumstances, a publicly traded limited partnership or limited liability company is taxed as a corporation (i.e., subject to "double taxation" – the corporation pays tax on its profits, with no deduction for distributions made to shareholders, and shareholders then pay tax on distributions received). Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW (Warren Gorham & Lamont, 1994; Supp. 2015-1), ¶ 16.01.

The non-cognoscenti might wonder, "If the interests are going to be publicly traded, what's the point in using a limited partnership or a limited liability company? Why not just use a corporation?" The answer is twofold. First, as discussed in Part V, Delaware's law of limited partnerships and limited liability companies allows deal makers far more latitude in "sculpting" fiduciary duty than does Delaware corporate law. Second, a publicly traded limited partnership or limited liability company can retain pass-through taxation (no tax at the entity level; profits, whether or not distributed, taxed to the owners) if the business is confined to certain fields that the Internal Revenue Code selects for advantageous treatment. ." *Id.* (stating that Internal Revenue Code "does not prescribe corporate tax treatment for publicly traded partnerships and LLCs whose incomes are primarily passive"). *See also* Kevin Mahn, "What You Need to Know about MLPs and Investing In Energy," Forbes.com (September 30, 2014), available at http://www.forbes.com/sites/advisor/2014/09/30/what-you-need-to-know-about-mlps-and-investing-in-energy/, last visited October 13, 2015 (stating that "[t]o qualify for [pass-through taxation], MLPs [master limited partnerships] must earn at least 90% of their income from 'qualified sources' as per the guidelines published by the Internal Revenue Service, such as natural resources"). The same is true for publicly traded limited liability companies. Most publicly traded limited partnerships invest in the oil and gas industry, particularly in pipelines. Phil DeMuth, "You Haven't Really Considered MLPs, Have You?," Forbes.com (August 27, 2013), available at http://www.forbes.com/sites/phildemuth/2013/08/27/you-havent-really-considered-mlps-have-you/, last visited October 13, 2015 ("[P]ublicly traded partnerships … typically earn

Because to the uninitiated "good faith" can be frustratingly polysemous,[9] the following section "clears away the underbrush" by explaining what Delaware's implied covenant's "good faith" is *not*.

A Couple of Major "Nots"

1. *Not the Looser Approach of the UCC*

The Uniform Commercial Code codifies the common law obligation of good faith and fair dealing for matters governed by the Code: "Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement."[10] The Code defines "good faith" as "mean[ing] [except for letter of credit matters] honesty in fact and the observance of reasonable commercial standards of fair dealing."[11] An official comment elaborates:

> [T]he definition of "good faith" in this section … is to be interpreted …as including both the subjective element of honesty in fact and the objective element of the observance of reasonable commercial standards of fair dealing. As a result, both the subjective and objective elements are part of the standard of "good faith" …. [T]he definition of "good faith" in this section requires not only honesty in fact but also "observance of reasonable commercial standards of fair dealing." Although "fair dealing" is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed.[12]

The UCC standard thus incorporates facts far beyond the words of the contract at issue and furthers a value (fairness) which in the entity context is usually the

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90% or more of their income from natural resource activities. Think "pipelines" and you have it in a nutshell. The biggest share of the 120 MLPs in existence today are involved in the distribution of oil or natural gas through pipelines.").

[9] I am grateful to Eric Lipman for teaching me this word, which means "having multiple meanings." http://www.merriam-webster.com/dictionary/polysemy, last visited October 12, 2015.

[10] UCC § 1-304 (Obligation of Good Faith).

[11] UCC § 1-201(b)(20).

[12] *Id.*, cmt.

province of fiduciary duty.[13] The UCC definition provides some constraint by referring to "reasonable commercial standards," but "[d]etermining . . . unreasonableness inter se owners of an organization is a different task than doing so in a commercial context, where concepts like 'usages of trade' are available to inform the analysis."[14]

In any event, the Delaware Supreme Court has flatly rejected the U.C.C. approach for Delaware unincorporated businesses. "This Court has never held that the UCC definition of good faith applies to limited partnership agreements. The UCC applies to specific kinds of contracts, but not to limited partnerships."[15] The holding applies to LLC operating agreements as well.[16]

2. *Not the Corporate Good Faith of* Disney, Stone v. Ritter, *and* Caremark

An obligation to act in good faith has long been part of a corporate director's duty under Delaware law,[17] but the concept became ever more important

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[13] See text at nn. 94-96.

[14] ULLCA (2013) § 105(e), cmt.

[15] DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 109 (Del. 2013). However, "[i]f the parties wanted to use the UCC definition of good faith, they could have so provided in the [limited partnership agreement] or incorporated it as a defined term by reference." *Id.*

[16] Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW (Warren Gorham & Lamont, 1994; Supp. 2015-1) ¶ 14.01[2] n. 14 ("Delaware courts consider the two statutes to be reciprocally precedential. Attractions and Dangers of the Delaware LLC Act") (citing cases). The Delaware statute refers to an LLC's all-important, foundational document in the alternative – as "limited liability company agreement" and "operating agreement." *Id.* ("Delaware Code Annotated, title 6, § 18-101(7) [defines "limited liability company agreement" as "any agreement (*whether referred to as a limited liability company agreement, operating agreement or otherwise*) written, oral, or implied of the member or members as to the affairs of the limited liability company and the conduct of its business." Until 2002, the Delaware LLC Act eschewed the more commonly used term "operating agreement," although some Delaware LLCs nonetheless used that term. A 2007 amendment made clear that a Delaware LLC "shall" have an LLC agreement (however labeled by the members).") (emphasis added; footnotes omitted).

[17] *See, e.g.,* Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 135, 32 A.2d 148, 151-52 (1943) (stating that "[t]here is a presumption that the judgment of the governing body of a corporation, whether at the time it consists of directors or majority stockholders, is formed in good faith and inspired by a bona fides of purpose."); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule "is a presumption that

following the landmark case of *Smith v. Van Gorkom*.[18] The Delaware Supreme Court held directors liable for gross negligence in approving a merger transaction,[19] a holding that "shocked the corporate world."[20]

Before *Van Gorkom*:

> The search for cases in which directors of industrial corporations have been held liable … for negligence uncomplicated by self-dealing [was] a search for a very small number of needles in a very large haystack. Few are the cases in which the stockholders do not allege conflict of interest, still fewer those among them which achieve even such partial success as denial of the defendants' motion to dismiss the complaint.[21]

Spurred by the Delaware corporate bar, the Delaware legislature , amended Delaware's corporate statute.[22] The amendment permits Delaware corporations to essentially opt out of the *Van Gorkom* rule. The now famous Section 102(b)(7) authorizes a Delaware certificate of incorporation to include:

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in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company"), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). *See also* Smith v. Van Gorkom, 488 A.2d 858, 875 (Del. 1985) (holding that under Delaware corporate statute, directors are protected for "good faith, not blind, reliance" on specified types of information), overruled on other grounds by Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

[18] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), overruled on other grounds by Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

[19] *Id.* At 874.

[20] Stephen A. Radin, The Director's Duty of Care Three Years After Smith v. Van Gorkom, 39 Hastings L.J. 707 (1988). *See also* Julian Velasco, A Defense of the Corporate Law Duty of Care, 40 J. Corp. L. 647, 657 (2015) (noting that "[t]he fact that the directors were held liable in the Van Gorkom case sent shock waves throughout the corporate world"); David B. Fischer, Bank Director Liability Under FIRREA: A New Defense for Directors and Officers of Insolvent Depository Institutions - - or A Tighter Noose?, 39 UCLA L. Rev. 1703, 1737 (1992) (referring to "The Van Gorkom Shock Waves").

[21] Joseph W. Bishop, Jr., Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers, 77 Yale L.J. 1078, 1099 (1968)

[22] In re Cornerstone Therapeutics Inc, Stockholder Litig., 115 A.3d 1173, 1185 (Del. 2015) (explaining the background to the adoption of Section 102(b)(7)).

> [a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [pertaining to the liability of directors for the unlawful payment of a dividend or unlawful purchase or redemption of stock]; or (iv) for any transaction from which the director derived an improper personal benefit.[23]

In effect, the provision authorizes exculpation from damages arising from claims of director negligence,[24] but for some time the exception "for acts or omissions not in good faith" was controversial. Where plaintiffs could not allege breach of the duty of loyalty, they sought to equate "not in good faith" with extreme negligence.

The Delaware Supreme Court inadvertently encouraged this approach by referring to "the triads of [director] fiduciary duty—good faith, loyalty [and] due care,"[25] Notably, the meaning of "not in good faith" was pivotal in the lengthy and costly litigation arising from the Disney corporation's termination of Michael Ovitz. However, the Supreme Court's decision in *In re Walt Disney Co. Derivative Litig.* left the issue murky.[26] Eventually, in *Stone v. Ritter*, the court made clear that in this context "good faith" is an aspect of the duty of loyalty:

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[23] Del. Code Ann., tit. 8, § 102(b)(7).

[24] Malpiede v. Townson, 780 A.2d 1075, 1093 (Del. 2001).

[25] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) decision modified on reargument, 636 A.2d 956 (Del. 1994)

[26] In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52-5, 67 (Del. 2006). Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 and n. 29 (Del. 2006) ("It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case…. [W]hether a violation of the duty to act in good faith is a basis for the direct imposition of liability, was expressly left open in Disney. We address that issue here.") (citation omitted).

> [The correct] view of a failure to act in good faith results in two … doctrinal consequences. First, although good faith may be described colloquially as part of a "triad" of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman,* "[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."[27]

The Court then equated a lack of this type of good faith with a director's utter failure to attend to his or her oversight obligations. Referring to *In re Caremark Int'l Inc. Deriv. Litig.*,[28] a 1996 decision from the Court of Chancery, the Supreme Court stated:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[29]

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[27] Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (footnotes omitted) (quoting Guttman v. Huang, 823 A.2d 492, 506 n. 34 (Del.Ch.2003) (brackets in the original).

[28] In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del.Ch.1996).

[29] Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (footnotes omitted).

This fiduciary, *Caremark* good faith is *not* the good faith and fair dealing the implied covenant requires.[30] The difference is fundamental and involves both different legal questions and different temporal foci.[31]

3. *Not Whatever is Meant by a Contractual Provision Invoking "Good Faith"*

Some limited partnership and operating agreements expressly refer to "good faith" and define the term.[32] As the Delaware Supreme Court held in *Gerber v. Enter. Products Holdings, LLC* (*Gerber*), such "express good faith provisions" do not affect the implied covenant.[33] In *Gerber*, the Court rejected the notion that "if a partnership agreement eliminates the implied covenant de facto by creating a conclusive presumption that renders the covenant unenforceable, the presumption remains legally incontestable."[34]

The rejected notion arose from on an overbroad reading of *Nemec v. Shrader*[35] – namely that "under *Nemec*, the implied covenant is merely a 'gap filler' that by its nature must always give way to, and be trumped by, an 'express' contractual right

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[30] See ULLCA (2013) § 409(d), cmt. "The contractual obligation of 'good faith' has nothing to do with the corporate concept of good faith that for years bedeviled courts and attorneys trying to understand: (i) Delaware's famous corporate law exoneration provision; and (ii) that provision's exception 'for acts or omissions not in good faith.' Del. Code Ann., tit. 8, § 102(b)(7) (2012). In that context, good faith is an aspect of the duty of loyalty.") (citing Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369-70 (Del. 2006)).

[31] ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440-42 (Del. Ch. 2012), rev'd. on other grounds, 68 A.3d 665 (Del. 2013) (distinguishing an implied covenant claim from a fiduciary claim both in terms of different temporal focus and different legal issues involved).

[32] *E.g.,* DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 109 (Del. 2013) (stating that, "[i]f the parties wanted to use the UCC definition of good faith, they could have so provided in the [limited partnership agreement] or incorporated it as a defined term by reference."); In re El Paso Pipeline Partners, L.P. Derivative Litig., No. CIV.A. 7141-VCL, 2014 WL 2768782, at *17 (Del. Ch. June 12, 2014) ("In this case, the LP Agreement supplies a definition of 'good faith' that governs whether the defendants have complied with provisions of the LP Agreement that utilize that term.")

[33] Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400 (Del. 2013), overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013)

[34] *Id.*, at 420, n. 48.

[35] Nemec v. Shrader, 991 A.2d 1120 (Del. 2010). *Nemec* is analyzed in Part IV.

that covers the same subject matter."[36] Invoking Section 1101(d) of the Delaware Revised Uniform Limited Partnership Act,[37] the *Gerber* opinion stated: "That reasoning does not parse. The statute explicitly prohibits any partnership agreement provision that eliminates the implied covenant. It creates no exceptions for contractual eliminations that are 'express.'"[38]

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[36] *Gerber*, 67 A.3d at 420, n. 48.

[37] Del. Code., tit.6, § 17-1101(d). The subsection has been amended since then but the relevant language is unchanged: "the agreement may not eliminate the implied contractual covenant of good faith and fair dealing." Unlike the uniform partnership, limited partnership, and limited liability company acts, the Delaware statutes do not authorize a partnership or operating agreement to "prescribe the standards, if not manifestly unreasonable, by which the performance of the [implied contractual] obligation [of good faith and fair dealing] is to be measured." UPA (2013) § 105(c)(6); ULPA (2013) § 105(c)(6); ULLCA § 105(c)(6) (identical wording in each).

[38] *Gerber*, 67 A.3d at 420, n. 48. *See also* In re El Paso Pipeline Partners, L.P. Derivative Litig.:

> The defendants … try to defeat the implied covenant claim by arguing that the LP Agreement expressly defines the term "good faith," leaving no room for the implied covenant. According to the defendants, the implied covenant does not apply because the LP Agreement makes "good faith" the standard for evaluating whether the Conflicts Committee validly gave Special Approval and further defines "good faith" as subjective good faith. The defendants argue that when the parties have "agreed how to proceed under a future state of the world" (i.e., in the face of a conflict transaction), their bargain (i.e., the LP Agreement) "naturally controls." The Delaware Supreme Court has rejected similar arguments.

No. CIV.A. 7141-VCL, 2014 WL 2768782, at *16 (Del. Ch. June 12, 2014) (citing and quoting Gerber v. Enter. Prods. Hldgs., LLC, 67 A.3d 400, 418 (Del.2013), overruled in part on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del.2013) and DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chi., 75 A.3d 101, 109 (Del.2013) (recognizing that the agreement's "contractual duty [of good faith] encompasses a concept of 'good faith' that is different from the good faith concept addressed by the implied covenant of good faith and fair dealing")) (parentheticals in the original).

The *El Paso* opinion further explained: "In this case, the LP Agreement supplies a definition of 'good faith' that governs whether the defendants have complied with provisions of the LP Agreement that utilize that term. The definition is not a means of implying terms to fill contractual gaps, and the implied covenant does not turn on whether the counterparty acted in subjective good faith." *El Paso.,* at *17.

Some agreements contain express good faith provisions but omit to define the concept.[39] Such omissions render the agreement ambiguous[40] and impose on the courts an interpretative task that involves looking not only to other, related provisions in the agreement[41] but also to the negotiations, if any, and other circumstances that led up to the agreement being made.[42] A few Delaware cases

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[39] *E.g.,* DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 107 (Del. 2013); Allen v. Encore Energy Partners, L.P., 72 A.3d 93, 105 n.44 (Del. 2013) (referring to "the undefined term 'bad faith' in the LPA's exculpation provision"); Norton v. K-Sea Transp. Partners L.P., 67 A.3d 354, 362 (Del. 2013) (noting that (i) "the LPA broadly exculpates all Indemnitees … so long as the Indemnitee acted in 'good faith;'" but (ii) "the LPA regrettably does not define 'good faith' in this context").

[40] DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 107 (Del. 2013) (noting that the failure of a limited partnership agreement to define the term resulted in "ambiguity").

[41] *See, e.g.,* Norton v. K-Sea Transp. Partners L.P., 67 A.3d 354, 362 (Del. 2013) (noting that "the LPA broadly exculpates all Indemnitees … so long as the Indemnitee acted in 'good faith' [but] regrettably does not define 'good faith' in this context;" dealing with "the parties' insertion of a free-standing, enigmatic standard of 'good faith' by construing the term to be consistent with another, related provision; stating that "[i]n this LPA's overall scheme, 'good faith' cannot be construed otherwise").

[42] The ambiguity precludes application of the parol evidence rule. Schwartz v. Centennial Ins. Co., No. CIV. A. 5350 (1977), 1980 WL 77940, at *5 (Del. Ch. Jan. 16, 1980) (stating that "[t]he parol evidence rule is unavailable to plaintiffs to bar the admission of [defendant's] evidence to show the true meaning of the ambiguous term"). In the Delaware Court of Chancery, the other circumstances may even include common drafting practices within the informal community of (mostly Delaware) lawyers whose practices regularly involve negotiating and drafting very sophisticated partnership and LLC agreements. *See* In re El Paso Pipeline Partners, L.P. Derivative Litig., No. CIV.A. 7141-VCL, 2014 WL 2768782, at *22 (Del. Ch. June 12, 2014) ("[P]recedent suggests that if the drafters intended for a disclosure obligation to exist, they would have included specific language. A recent decision by this court interpreted a limited partnership agreement that utilized a similar structure for conflict-of-interest transactions, with four contractual alternatives including Special Approval. The language authorizing the Special Approval route stated that it would be effective 'as long as the material facts known to the General Partner or any of its Affiliates regarding any proposed transaction were disclosed to the Conflicts Committee at the time it gave its approval.' The inclusion of this condition in [that other] agreement indicates that without this language, a general partner and its affiliates would not have an obligation to disclose information.") (citation and footnote omitted).

have even resorted to the corporate fiduciary duty concept of good faith.[43] In any event, if, as held in *Gerber*, an agreement that expressly defines "good faith" cannot affect the implied covenant, *a fortiori* neither can an agreement that uses the term but omits to define it.

[43] DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 110 (Del. 2013) ("In our recent opinion in Brinckerhoff v. Enbridge Energy Company, Inc. [67 A.3d 369, 373 (Del.2013)], we defined the characteristic of good faith by its opposite characteristic – bad faith. We applied a traditional common law definition of the business judgment rule to define a limited partnership agreement's good faith requirement. We used the formula describing conduct that falls outside business judgment protection, namely, an action 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.' That definition of good faith, as set forth in Brinckerhoff, is appropriately applied in this case as well."). Thus, no single definition exists for the meaning of "good faith" when a limited partnership or LLC agreement expressly includes the term. The meaning depends first on what, if any, definition the agreement provides. In the absence of a definition, uncertainty is initially inevitable; the term means whatever the court determines the term to mean. In contrast, it is certain that the implied covenant is not a fallback definition for an undefined express good faith provision. Opinions dealing with such provisions never use the implied covenant even as a frame of reference. See, e.g., DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 107 (Del. 2013); Allen v. Encore Energy Partners, L.P., 72 A.3d 93, 105 n.44 (Del. 2013); Norton v. K-Sea Transp. Partners L.P., 67 A.3d 354, 362 (Del. 2013). Moreover, using the implied covenant as a fallback definition would render the undefined provision duplicative, because the implied covenant exists in every limited partnership or LLC agreement as a matter of law.

B. Delaware's Implied Contractual Covenant of Good Faith and Fair Dealing

Delaware case law applying the implied contractual covenant of good faith and fair dealing to a limited partnership dates back to at least 1993,[44] and Delaware's limited partnership and limited liability company acts have expressly recognized the covenant since 2004.[45] However, the contents of the implied covenant have not always been crystal clear.[46]

A passage from a 2000 Chancery Court decision is illustrative:

> The implied covenant of good faith requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the contract. This doctrine emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party. The parties' reasonable expectations at the time of contract formation

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[44] Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199, 1207 (Del. 1993) ("Desert Equities alleges that the defendants breached their implied covenant of good faith and fair dealing when they, in bad faith, breached the Partnership Agreement.").

[45] 74 Del. Laws, c. 265, §15 (revising Del. Code tit. 6, § 17-1101(d) to provide *inter alia* that "the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing"). The same change was made to the limited liability company act by 74 Del. Laws, c. 275, § 13 (revising Del. Code tit. 6, § 18-1101(c) to provide *inter alia* that "the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing").

[46] Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (stating that "[t]he articulation of the standard for implying terms through application of the covenant of good faith and fair dealing represents an evolution from previous Delaware case law" and that "Delaware Supreme Court jurisprudence is developing along the general approach that implying obligations based on the covenant of good faith and fair dealing is a cautious enterprise"). *See also, e.g.,* Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199, 1207 (Del. 1993) (reversing the Chancery Court's dismissal on the pleadings of plaintiff's implied covenant claim; accepting the seemingly redundant notion that bad faith breach of the partnership agreement could breach the implied covenant; and suggesting the general partner may have acted in bad faith by "act[ing] unreasonably"). For a decision that addresses the redundancy issue, see Painewebber R & D Partners, L.P. v. Centocor, Inc., No. C.A. 96C-04-194, 1998 WL 109818, at *4 (Del. Super. Feb. 13, 1998) ("The Court is satisfied that the payment obligations of Centocor are encompassed by the express terms of the PPA and, as a matter of law, cannot be the subject of any implied covenant.")

> determine the reasonableness of the challenged conduct. [C]ases invoking the implied covenant of good faith and fair dealing should be rare and fact-intensive. Only where issues of compelling fairness arise will this Court embrace good faith and fair dealing and imply terms in an agreement.[47]

This formulation was correct as far as it went, but it omitted the all-important frame of reference. In the "fact-intensive" inquiry, what types of facts matter? Where does the court look to determine "the agreed common purpose" and "the justified expectations of the [complaining] party"? What evidence is admissible to prove the expected "fruits of the bargain"?

The answers to these questions determine whether "implying obligations based on the covenant of good faith and fair dealing [remains] a cautious enterprise."[48] The broader the frame of reference, the more likely is the covenant to become "a judge's roving commission for determining fairness."[49]

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[47] Cont'l Ins. Co. v. Rutledge & Co., 750 A.2d 1219, 1234 (Del. Ch. 2000) (internal quotations and footnotes omitted).

[48] Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998).

[49] Daniel S. Kleinberger, Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity, 14 Fordham J. Corp. & Fin. L. 445, 469 (2009) (first presented as the keynote address at the 2lst Century Commercial Law Forum – Seventh International Symposium 2007 – sponsored by School of Law, Tsinghua University, Beijing, People's Republic of China). *See also* Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010) ("Crafting, what is, in effect, a post contracting equitable amendment that shifts economic benefits from [one set of shareholders to another] would vitiate the limited reach of the concept of the implied duty of good faith and fair dealing…. 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."); Lonergan v. EPE Holdings, LLC, 5 A.3d 1008, 1019 (Del. Ch. 2010) (criticizing and rejecting attempts to "re-introduce fiduciary review through the backdoor of the implied covenant" of good faith and fair dealing). This point is precisely what divided the majority and dissent in *Nemec.* The core of the dissent is this statement: "[U]nder Delaware case law, a contracting party, even where expressly empowered to act, can breach the implied covenant if it exercises that contractual power arbitrarily or unreasonably." *Nemec*, at 1131 (Jacobs, J. dissenting). The statement does not recognize that the frame of reference must be the words of the contract. *Cf.* ULLCA (2013) § 409(d), cmt. (stating that "the purpose of the contractual obligation of good faith and fair dealing is to protect the arrangement the members have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it"). *But cf.* HB Korenvaes Inv., L.P. v. Marriot Corp., Del. Ch., C.A. No. 12922, Mem. Op. at 11, Allen, C., (June 9,

Fortunately, over the past five years the Court of Chancery and the Delaware Supreme Court have provided both clarity and context. The frame of reference is confined to the actual words of the agreement; the reasonable expectations must be gleaned from those words.[50]

Thus, the actual words of the agreement control the application of the implied covenant, both as to "fair dealing" and "good faith":

> "Fair dealing" is not akin to the fair process component of entire fairness, *i.e.,* whether the fiduciary acted fairly when engaging in the challenged transaction as measured by duties of loyalty and care …. It is rather a commitment to deal "fairly" in the sense of consistently with the terms of the parties' agreement and its purpose. Likewise, "good faith" does not envision loyalty to the contractual counterparty, but rather faithfulness to the scope, purpose, and terms of the parties' contract. Both necessarily turn

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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.") (quoted in Gale v. Bershad, No. CIV. A. 15714, 1998 WL 118022, at *5 n. 24(Del. Ch. Mar. 4, 1998); Gale v. Bershad, No. CIV. A. 15714, 1998 WL 118022, at *5 ("The function of the implied covenant of good faith and fair dealing in defining the duties of parties to a contract, is analogous to the role of fiduciary law in defining the duties owed by fiduciaries."); Blue Chip Capital Fund II Ltd. P'ship v. Tubergen, 906 A.2d 827, 832 (Del. Ch. 2006) (stating that "[t]he court [in Gale v. Bershad] explained that the implied covenant of good faith and fair dealing defines the duties of parties to a contract and is analogous to the role of fiduciary law in defining the duties owed by fiduciaries") (citing Gale v. Bershad, No. CIV. A. 15714,.1998 WL 118022 at *5, (Del.Ch. Mar. 3, 1998)).

[50] These points are analogous to Professor Williston's four corners approach to determining ambiguity for the purposes of the parol evidence rule. *See, e.g.,* Wallace v. 600 Partners Co., 86 N.Y.2d 543, 548, 658 N.E.2d 715, 717 (1995) (stating that "[t]he question whether a writing is ambiguous is one of law to be resolved by the courts" and that "excursion beyond the four corners of the document" is warranted only when the wording is not "clear and complete") (citing Williston, 4 Williston, Contracts, § 610A, at 513 [3d ed.]). The "roving commission" notion resembles Professor Corbin's approach to the ambiguity question. "According to Corbin, the court cannot apply the parol evidence rule without first understanding the meaning the parties intended to give the agreement. To understand the agreement, the judge cannot be restricted to the four corners of the document." Taylor v. State Farm Mut. Auto. Ins. Co., 175 Ariz. 148, 153, 854 P.2d 1134, 1139 (1993) (citation omitted). Delaware takes the Williston approach. GMG Capital Investments, LLC v. Athenian Venture Partners I, L.P., 36 A.3d 776, 781-84 (Del. 2012) Schwartz v. Centennial Ins. Co., No. CIV. A. 5350 (1977), 1980 WL 77940, at *5 (Del. Ch. Jan. 16, 1980) (stating that "parol evidence may not be used to show an ambiguity in the first place").

> on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.[51]

When a court considers a fiduciary claim, the "court examines the parties as situated at the time of the [alleged] wrong. … [and] determines whether the defendant owed the plaintiff a duty, considers the defendant's obligations (if any) in light of that duty, and then evaluates whether the duty was breached."[52] In contrast, because the actual words of the agreement control the application of the implied covenant:

> An implied covenant claim ... looks to the past. It is not a free-floating duty unattached to the underlying legal documents. It does not ask what duty the law should impose on the parties given their relationship at the time of the wrong, but *rather what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting*.[53]

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[51] Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400, 418-19 (Del. 2013) (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440–42 (Del. Ch. 2012), aff'd in part, rev'd in part on other grounds, 68 A.3d 665 (Del. 2013)) (footnotes omitted) (citations omitted) (internal quotations omitted without ellipsis by *Gerber*).

[52] *Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400, 418 (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440–42 (Del. Ch. 2012), aff'd in part, rev'd in part on other grounds, 68 A.3d 665 (Del. 2013)) Del. 2013)*. *Gerber* was overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013). *See also* Gilbert v. El Paso Co., 575 A.2d 1131, 1142-43 (Del. 1990) (enforcing express conditions pertaining to a tender offer; stating that "[a]lthough an implied covenant of good faith and honest conduct exists in every contract … such subjective standards cannot override the literal terms of an agreement").

[53] Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440–42 (Del. Ch. 2012), aff'd in part, rev'd in part on other grounds, 68 A.3d 665 (Del. 2013)) (emphasis added) (footnotes omitted) (citations omitted) (internal quotations omitted without ellipsis by *Gerber*). In this respect, the implied covenant parallels the contract law doctrine of unconscionability. *See* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981) (stating that the unconscionability analysis addresses whether "a contract or term thereof is unconscionable *at the time the contract is made*") (emphasis added); UCC § 2-302 (stating that the doctrine applies only if "the court finds the contract or any clause of the contract to have been unconscionable *at the time it was made*") (emphasis added).

A successful implied covenant claim depends on finding a gap in the contractual language; therefore, an implied covenant claim cannot override an express contractual provision.[54] For example, if a limited partnership agreement creates options for limited partners under specified circumstances and not otherwise, the implied covenant will not extend the option right to circumstances not specified.[55] *Expressio unius est exclusio alterius*.[56] There is no gap.

But inevitably gaps will exist:[57]

> No contract, regardless of how tightly or precisely drafted it may be, can wholly account for every possible contingency. Even the most skilled and sophisticated parties will necessarily fail to address a future state of the world ... because contracting is costly and human knowledge imperfect. In only a moderately complex or extend[ed] contractual relationship, the cost of attempting to catalog and negotiate with respect to all possible future states of the world would be prohibitive, if it were cognitively possible. And parties occasionally have understandings or expectations that were so fundamental that they did not need to negotiate about those expectations.[58]

For example, suppose that: (i) a limited partnership agreement authorizes the general partner to restructure the organization as the general partner sees fit

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[54] 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.").

[55] *See* Aspen Advisors LLC v. United Artists Theatre Co., 843 A.2d 697, 707 (Del. Ch.) aff'd, 861 A.2d 1251 (Del. 2004) ("By specific words, the parties to the Stockholders Agreement and the Warrants identified particular transactions that would provide the Warrantholders with the right to receive the same consideration paid to common stockholders (e.g., in mergers involving United Artists) and the right (if they had exercised their Warrants) to tag along (i.e., in certain change of control transactions). Similarly, the parties also (by omission) defined the freedom of action other parties to those contracts (such as United Artists, the UA Holders, and Anschutz) had to engage in transactions without triggering rights of that nature.").

[56] "[T]o express or include one thing implies the exclusion of the other." EXPRESSIO UNIUS EST EXCLUSIO ALTERIUS, Black's Law Dictionary (10th ed. 2014).

[57] However, whether a gap matters depends on whether a party's conduct makes the gap apparent – i.e., whether one party's conduct exposes an issue on which the parties would have agreed had the issue arisen when the deal was being made.

[58] Allen v. El Paso Pipeline GP Co., L.L.C., No. CIV.A. 7520-VCL, 2014 WL 2819005, at *11 (Del. Ch. June 20, 2014) (internal quotations and citations omitted).

provided a competent expert provides a "fairness opinion" stating that the restructuring is fair to the limited partners; (ii) a competent expert furnishes the opinion; but (iii) the expert omits to consider the value of certain contingent assets of the limited partnership, namely the value of pending derivative litigation.[59] Because the limited partnership agreement "[does] not specify whether the fairness opinion [has] to consider the value of derivative litigation," the expert's omission reveals "a gap for the implied covenant to fill."[60] The gap is filled with what the court concludes "the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting."[61]

In this respect, the implied covenant analysis resembles the analysis for determining whether a party's contractual duties are discharged by supervening impracticably. "In order for a supervening event to discharge a duty …, the non-occurrence of that event must have been a 'basic assumption' on which both parties made the contract."[62] For impracticability or a breach of the implied covenant to exist, the situation at issue must have been fundamentally important to the deal and yet unaddressed by the deal documents. Put another way: the notion of a "cautious enterprise"[63] means that only a condition that is egregious or

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[59] In simplified form, this example reflects one of the transactions – the 2010 merger – addressed in Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400 (Del. 2013), overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013).

[60] Allen v. El Paso Pipeline GP Co., L.L.C., No. CIV.A. 7520-VCL, 2014 WL 2819005, at *14 (Del. Ch. June 20, 2014). The opinion refers to the omission "creating a gap," *id.* but the author respectfully disagrees. The gap existed *ab initio*. It remained hidden until revealed by the expert's omission.

[61] Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (quoting ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC, 50 A.3d 434, 440–42 (Del. Ch. 2012), aff'd in part, rev'd in part on other grounds, 68 A.3d 665 (Del. 2013)) (emphasis added) (footnotes omitted) (citations omitted) (internal quotations omitted without ellipsis by *Gerber*). It might be more consistent with actual practice to revise the quoted language so that the sentence read: "The gap is filled with what the court concludes the now complaining party would have insisted on as a condition to going forward with the deal, if the party had then considered the issue in the party's original bargaining position at the time of contracting."

[62] RESTATEMENT (SECOND) OF CONTRACTS § 261, cmt. b (1981)

[63] See n. 66.

at least extreme is capable of revealing a gap to be remedied by the implied covenant.[64]

[64] In this respect, the implied covenant is similar to the unconscionability doctrine of contract law. *See* RESTATEMENT (SECOND) OF CONTRACTS § 208. cmt. b (1981) ("Traditionally, a bargain was said to be unconscionable in an action at law if it was 'such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other….") (quoting Hume v. United States, 132 U.S. 406 (1889), which in turn was quoting Earl of Chesterfield v. Janssen, 2 Ves.Sen. 125, 155, 28 Eng.Rep. 82, 100 (Ch.1750)).