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Delaware's Implied Contractual Covenant of Good Faith and "Sibling Rivalry" Among Equity Holders

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Abstract

An obligation of good faith and fair dealing is implied in every common law contract and is codified in the Uniform Commercial Code ("U.C.C"). The terminology differs: Some jurisdictions refer to an "implied covenant;" others to an "implied contractual obligation;" still others to an "implied duty." 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. 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" has an increasingly clear and important role in Delaware "entity law" – i.e., the law of unincorporated business organizations (primarily limited liability companies and limited partnerships) as well as the law of corporations. This essay addresses the effect of Delaware's implied covenant on what might be termed "sibling rivalry" – i.e., entity restructurings that benefit one set of equity holders to the detriment of another set. Such restructurings are typically "zero sum games" – one sibling will win; the other will necessarily lose.

Delaware's implied covenant is a powerful but narrow concept, and the meaning of "good faith" varies with the context. Accordingly, much of this essay is in the nature of a lemma – i.e., "an auxiliary proposition used in the demonstration of another proposition." Put another way: building blocks.

Keywords

Covenant, Good faith, Fair dealing, Delaware, UCC, Uniform Commercial Code

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Part I - Introduction

An obligation of good faith and fair dealing is implied in every common law contract[2] and is codified in the Uniform Commercial Code ("U.C.C").[3] The terminology differs: Some jurisdictions refer to an "implied covenant;"[4] others to an "implied contractual obligation;"[5] still others to an "implied duty."[6] 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.[7] 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"[8] has an increasingly clear and important role in Delaware "entity

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[2]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.")

[3] *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.

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

[5] *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).

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

[7] 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.

[8] 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 not eliminate the implied contractual covenant of good faith and fair dealing"); Del. Code

law" – i.e., the law of unincorporated business organizations (primarily limited liability companies and limited partnerships) as well as the law of corporations.[9]

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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.

[9] 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 90% or more of their income from natural resource activities. Think "pipelines" and you

This essay addresses the effect of Delaware's implied covenant on what might be termed "sibling rivalry" – *i.e.,* entity restructurings that benefit one set of equity holders to the detriment of another set.[10] Such restructurings are typically "zero sum games" – one sibling will win; the other will necessarily lose.[11]

Delaware's implied covenant is a powerful but narrow concept, and the meaning of "good faith" varies with the context.[12] Accordingly, much of this essay is in the nature of a lemma – *i.e.*, "an auxiliary proposition used in the demonstration of another proposition."[13] Put another way: building blocks.

Because this essay addresses the application of Delaware's implied covenant, the most important building block is the meaning of "good faith and fair dealing" with respect to the covenant. Part II provides that building block. Because to the unitiated "good faith" can be frustratingly polysemous,[14] Part II begins by explaining what the implied covenant's "good faith" is *not*,

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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.").

[10] Professor Mitchell has described this type of conflict as "horizontal." Lawrence E. Mitchell, The Puzzling Paradox of Preferred Stock (and Why We Should Care About It), 51 Bus. Law. 443, 449 (1996).

[11] "A situation in which a gain by one person or side must be matched by a loss by another person or side." American Heritage Dictionary of the English Language 5th ed. 2011).

[12] Restatement (Second) of Contracts § 205, cmt. b (1981) ("The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context."); ULLCA (2013) § 105(c)(7), cmt. ("The term 'bad faith' has multiple meanings, and the context determines which meaning applies.").

[13] http://www.merriam-webster.com/dictionary/lemma, last visited October 9, 2015.

[14] 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.

distinguishing the covenant from: (i) managerial duties of loyalty; (ii) the "acts or omissions not in good faith" as referred in Delaware's famous "director exculpation" statute – Section 102(B)(7);[15] (iii) the obligation of good faith and fair dealing contemplated by the Uniform Commercial Code; and (iv) express contractual requirements of "good faith."

Part III discusses how Delaware law uses the fiduciary duty of loyalty to deal with sibling rivalry, explaining how the nature of the rivalry determines which standard applies – the very demanding "entire fairness" testor the very deferential business judgment rule. Part III is a necessary building block, because the duty of loyalty has been the traditional manner of addressing "sibling rivalry" issues.

Using the background thus established, Parts IV and V examine the implied covenant's role in three important cases. Part IV considers *Nemec v. Shrader*, a corporate case in which the Delaware Supreme Court rejected fiduciary duty claims and used the implied covenant to resolve a "zero sum game" that pitted the interests of one class of shareholders against the interests of the other.[16]

Part V examines the sibling rivalry issue in the context of two publicly traded Delaware limited partnerships. Part V first explains the power of a

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[15] The phrase appears in Del. Code. Ann. tit. 8, § 102(b)(7)(ii) as an exception to the range of director conduct subject to exculpation. For the pertinent part of section 102(b)(7), see the text at n. 24.

[16] Nemec v. Shrader, 991 A.2d 1120 (Del. 2010).

partnership or limited liability company ("LLC") agreement[17] to restrict or eliminate fiduciary duties[18] and examines how using that power affects the scope and efficacy of the implied covenant. Part V then analyzes *Gerber v. Enter. Products Holdings, LLC*[19] and *In re Kinder Morgan, Inc. Corporate Reorganization Litig.*[20] Each case concerned a "sibling rivalry" dispute pertaining to a publicly traded limited partnership. In the former case, an implied covenant claim succeeded. In the latter, the implied covenant claim failed because the

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[17] Although most LLC statutes use "operating agreement" as the term of art for the foundational agreement among members, formally, at least, "limited liability company agreement" is the term of art under Delaware law. "Until 2002, the Delaware LLC Act eschewed the more commonly used term 'operating agreement,' although some Delaware LLCs nonetheless used that term."
Carter G. Bishop & Daniel S. Kleinberger, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW, ¶ 14.02[1] (Warren Gorham & Lamont, 1994; Supp. 2015-1) (citing Walker v. Resource Dev. Co. Ltd., LLC (DE), No. Civ. A. 1843-S, 2000 WL 1336720 (Del. Ch., Aug. 29, 2000) and Lusk v. Elliott, No. Civ. A. 16326, 1999 WL 644739 (Del. Ch., Aug. 13, 1999)). Today, the definition of "limited liability company agreement" includes the phrase "whether referred to as a limited liability company agreement, operating agreement or otherwise." Del. Code tit. 6, § 18-101(7) (2015).

[18] For criticism of the extent of this power, see Sandra K. Miller & Karie Davis-Nozemack "Toward Consistent Fiduciary Duties for Publicly-Traded Entities," 68 FLA. L. REV., publication pending, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2586218 at p. 4 (arguing that investors in publicly-traded limited partnerships and LLCs are significantly disadvantaged because such entities enjoy exemptions from independence requirements under SEC listing rules, fail to provide truly independent conflicts committee members, are subject to one-sided contractual terms that are highly protective of management and which are often difficult to challenge because the implied covenant of good faith and fair dealing is very narrow in scope); Leo E. Strine Jr. & J. Travis Laster, "The Siren Song of Unlimited Contractual Freedom," Research Handbook on Partnerships, LLCs and Alternative Forms Of Business Organizations (Robert W. Hillman and Mark J. Loewenstein eds. 2015).

[19] Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400, 420 (Del. 2013), overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013)

[20] In re Kinder Morgan, Inc. Corporate Reorganization Litig., No. CV NO. 10093-VCL, 2015 WL 4975270 (Del. Ch. Aug. 20, 2015) judgment entered sub nom. In re Kinder Morgan, Inc. (Del. Ch. Aug. 24, 2015).

limited partnership agreement discounted sibling rights in favor of a vague preference for the interests of the limited partnership.[21]

Part VI offers concluding thoughts as to: (i) the meaning and scope of the implied covenant; (ii) the effect on the implied covenant of the presence or preclusion of a loyalty claim; and (iii) what the implied covenant can and cannot do in "sibling rivalry" cases for those who invest in preferred stock of a Delaware corporation or in publicly traded Delaware partnerships or limited liability companies.

Part II – Delineating Delaware's Implied Contractual Covenant

A. Clearing Away the Underbrush

In the 1990s, the Uniform Law Conference replaced its 1914 Uniform Partnership Act with what came to be colloquially called the Revised Uniform Partnership Act or RUPA.[22] The relevance to this essay is that: (i) RUPA was the first uniform business organizations act to codify an obligation of good faith and

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[21] *Id.*, at *8.

[22] The revised version was first adopted in 1992 and then amended in 1993, 1994, 1996, and 1997. RUPA's formal name is Uniform Partnership Act (1997). *See* UPA (1997), *Uniform Partnership Act—Quick Chronology*. A new version exists, harmonized with the seven other uniform business entity acts. The new version's formal name is UPA (1997) (Last Amended 2013).

fair dealing among an entity's owners;[23] but (ii) the codification did nothing to add clarity to the concept. To the contrary, the relevant official comment states:

> The meaning of "good faith and fair dealing" is not firmly fixed under present law. "Good faith" clearly suggests a subjective element, while "fair dealing" implies an objective component. It was decided to leave the terms undefined in the Act and allow the courts to develop their meaning based on the experience of real cases.[24]

In addition, the comment quoted a law review article that characterized "good faith" as "a phrase with no general meaning or meanings of its own," noting that "[i]t is hard to get this point across to persons used to thinking that every word must have one or more general meanings of its own – must be either univocal or ambiguous."[25]

In 2015, the Uniform Law Conference revised this official comment, and the revised version takes a very different and far more definite view.[26] But the fact remains that "good faith" has multiple meanings in U.S. jurisprudence and

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[23] UPA (1997) § 409(d) states, "A partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing." *See also id.*, cmt. 4 (stating that Section 409(b) is "new").

[24] *Id.*

[25] *Id.* (quoting Robert S. Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 262 (1968)). The RESTATEMENT (SECOND) OF CONTRACTS § 205, cmt d. (1981) reflects this point of view: "A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."

[26] *See* UPA (2013) § 409(d), cmt., discussed *infra*, at n. 41.

the meanings vary both with jurisdiction and context.[27] It is useful, therefore, to approach the definition of Delaware's implied contractual covenant of good faith and fair dealing by explaining what the covenant's good faith is not.

1. 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,[28] but the concept became ever more important following the landmark case of *Smith v. Van Gorkom*.[29] The Delaware Supreme Court held directors liable for gross negligence in approving a merger transaction,[30] a holding that "shocked the corporate world."[31] Before *Van Gorkom*:

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[27] *See* n. 12. Adding to the complexity under Delaware law, Delaware courts have sometimes "defined the characteristic of good faith by its opposite characteristic—bad faith." DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago, 75 A.3d 101, 110 (Del. 2013).

[28] *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 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).

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

[30] *Id.* At 874.

[31] 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

> 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.[32]

Spurred by the Delaware corporate bar, the Delaware legislature , amended Delaware's corporate statute.[33] 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:

> 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.[34]

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").

[32] 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)

[33] 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)).

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

In effect, the provision authorizes exculpation from damages arising from claims of director negligence,[35] 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,"[36] 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.[37] Eventually, in *Stone v. Ritter*, the court made clear that in this context "good faith" is an aspect of the duty of loyalty:

> [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

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

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

[37] 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).

> 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.”[38]

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.*,[39] 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.[40]

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[38] 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).

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

[40] 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.[41] The difference is fundamental and involves both different legal questions and different temporal foci.[42]

2. Not the Looser Approach of the Uniform Commercial Code

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."[43] 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."[44] 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

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[41] 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)).

[42] 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).

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

[44] UCC § 1-201(b)(20).

> 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.[45]

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 province of fiduciary duty.[46] 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."[47]

In any event, the Delaware Supreme Court has flatly rejected the U.C.C. approach for 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."[48] The holding applies to LLC operating agreements as well.[49]

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[45] *Id.*, cmt.

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

[47] ULLCA (2013) § 105(e), cmt.

[48] 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.*

[49] 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

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.[50] 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.[51] 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."[52]

The rejected notion arose from on an overbroad reading of *Nemec v. Shrader*[53] – namely that "under *Nemec*, the implied covenant is merely a 'gap

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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).

[50] *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.")

[51] 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)

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

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

filler' that by its nature must always give way to, and be trumped by, an 'express' contractual right that covers the same subject matter."[54] Invoking Section 1101(d) of the Delaware Revised Uniform Limited Partnership Act,[55] 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.'"[56]

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

[55] 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).

[56] *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

Some agreements contain express good faith provisions but omit to define the concept.[57] Such omissions render the agreement ambiguous[58] and impose on the courts an interpretative task that involves looking not only to other, related provisions in the agreement[59] but also to the negotiations, if any, and other circumstances that led up to the agreement being made.[60] A few Delaware cases

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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.

[57] *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").

[58] 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").

[59] *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").

[60] 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

have even resorted to the corporate fiduciary duty concept of good faith.[61] 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.

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,[62] and

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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).

[61] 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.

[62] 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.").

Delaware's limited partnership and limited liability company acts have expressly recognized the covenant since 2004.[63] However, the contents of the implied covenant have not always been crystal clear.[64]

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 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.[65]

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[63] 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").

[64] 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.")

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

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."[66] The broader the frame of reference, the more likely is the covenant to become "a judge's roving commission for determining fairness."[67]

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

[67] 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, 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

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.[68]

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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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)).

[68] 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.[69]

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."[70] 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*.[71]

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[69] 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*).

[70] *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").

[71] 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

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.[72] 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.[73] *Expressio unius est exclusio alterius*.[74] There is no gap.

But inevitably gaps will exist:[75]

> 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

§ 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).

[72] 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.").

[73] *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.").

[74] "[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).

[75] 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.

> so fundamental that they did not need to negotiate about those expectations.[76]

For example, suppose that: (i) a limited partnership agreement authorizes the general partner to restructure the organization as the general partner sees fit 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.[77] 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."[78] 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."[79]

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[76] 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).

[77] 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).

[78] 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.

[79] 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

In this respect, the implied covenant analysis resembles the analysis for determining whether a party's contractual duties are discharged by supervening impractically. "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."[80] 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"[81] means that only a condition that is egregious or at least extreme is capable of revealing a gap to be remedied by the implied covenant.[82]

Part III – A Director's Duty of Loyalty and "Sibling Rivalry"

A. The Classic Aspects of a Delaware Director's Duty of Loyalty

A director's duty of loyalty is fundamental to Delaware corporate law, and some early cases even viewed directors as "trustees."[83] In 1939, in *Guth v. Loft,*

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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."

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

[81] See n. 66.

[82] 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)).

[83] Bovay v. H. M. Byllesby & Co., 27 Del. Ch. 381, 392-94, 38 A.2d 808, 813 (1944).

Inc., the Delaware Supreme Court implicitly rejected that view as technically incorrect,[84] but the opinion nonetheless described a director's duty of loyalty in strong, uncompromising, and now famous words:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[85]

A director's duty of loyalty has both a subjective and objective aspect. The subjective aspect pertains to the director's state of mind when she or he acts or omits to act and is sometimes referred to in terms of good faith. "At a

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[84] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del.1939). The case is considered Delaware's "seminal loyalty case." Carsanaro v. Bloodhound Technologies, Inc., 65 A.3d 618, 637 (Del. Ch. 2013).

[85] *Id. See also, e.g.,* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) decision modified on reargument, 636 A.2d 956 (Del. 1994) (stating that, "[i]n exercising [their] powers, directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act in the best interests of its shareholders"); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (stating that, "[i]n carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders"), overruled on other ground by Gantler v. Stephens, 965 A.2d 695 (Del. 2009); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (referring to "certain fundamental fiduciary obligations [of directors] to the corporation and its shareholders"), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

minimum, good faith requires that the decision-maker act 'honestly and without pretext'"[86] *i.e.,* – "in the honest belief that the action taken was in the best interests of the company."[87] *A fortiori*, actual malice breaches the subjective aspect of the duty of loyalty.[88]

The duty's objective aspect pertains to situations in which a director's self-interest is necessarily at odds with the best interests of the corporation or in some cases the corporation's shareholders. The three classic situations are usurpation of a corporate opportunity, acting as or for a party adverse to the corporation (or in some circumstances, the shareholders of the corporation), and competing with the corporation:

- <u>usurpation of a corporate opportunity</u>

> [I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able

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[86] In re Dole Food Co., Inc. Stockholder Litig., No. CV 8703-VCL, 2015 WL 5052214, at *39 (Del. Ch. Aug. 27, 2015) (quoting Joseph K. Leahy, A Decade After Disney: A Primer on Good and Bad Faith, 83 U. Cin. L. Rev. 859, 864 (2015)).

[87] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000). *See also* In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006) ("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation.") (quoting In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005)); Guttman <u>v. Huang</u>, 823 A.2d 492, 506 (Del. Ch. 2003) ("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."). It is this aspect of the duty of loyalty which the Delaware Supreme Court used to deal with the "not in good faith" exception of Del. Code., tit. 8, § 102(b)(7)(iii). Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006). See Part II-A-1

[88] *See* In re Dole Food Co., Inc. Stockholder Litig., No. CV 8703-VCL, 2015 WL 5052214, at *39 (Del. Ch. Aug. 27, 2015) ("In its most extreme form, it involves 'the conscious doing of a wrong because of dishonest purpose or moral obliquity' or 'a state of mind affirmatively operating with furtive design or ill will.'") (quoting McGowan v. Ferro, 859 A.2d 1012, 1036 (Del. Ch.2004)).

to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.[89]

- acting as or for a party adverse to the corporation

> Most severely constrained are dealings between a corporate fiduciary and the corporation itself, where the fiduciary stands on both sides of the transaction, implicating the fiduciary's duty of loyalty. Early common law prevented corporate directors from transacting business with a corporation for which they served.[90]

- competing with the corporation

> Inherent in a director's duty of loyalty to the corporation is a proscription against entering into a business that directly competes with the corporation to which the duty is owed. If the fiduciary's competing business causes injury to, or has a substantial detrimental effect on, the primary corporation, the fiduciary has breached his or her duty of loyalty.[91]

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[89] Guth v. Loft, Inc., 23 Del. Ch. 255, 272-73, 5 A.2d 503, 511 (1939)

[90] In re Cornerstone Therapeutics Inc. Stockholder Litig., No. CIV.A. 8922-VCG, 2014 WL 4418169, at *6 (Del. Ch. Sept. 10, 2014) rev'd on other grounds sub nom. In re Cornerstone Therapeutics Inc, Stockholder Litig., 115 A.3d 1173 (Del. 2015). *See also* Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701 (1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."); Marciano v. Nakash, 535 A.2d 400, 405 (Del. 1987) (considering an "entire fairness" claim pertaining to loans made to a corporation by one of its two 50/50 shareholders; affirming the trial court determination that the loan obligee had satisfied the entire fairness test).

[91] Balotti and Finkelstein's Delaware Law of Corporations and Business Organizations § 4.16[C], available at 2006 WL 2450303, last visited October 5, 2015. *See also* Thorpe by Castleman v. CERBCO, Inc., 676 A.2d 436, 442 (Del. 1996) (referring to "[t]he fundamental proposition that directors may not compete with the corporation").

The same three duties exist under agency law, partnership law, and the law of limited liability companies.[92]

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[92] For example:

Agency law

> "An agent has a duty not to acquire a material benefit from a third party in connection with transactions conducted or other actions taken on behalf of the principal or otherwise through the agent's use of the agent's position." RESTATEMENT (THIRD) OF AGENCY §§ 8.02 (Material Benefit Arising out of Position). "An agent has a duty not to deal with the principal as or on behalf of an adverse party in a transaction connected with the agency relationship." 8.03 (Acting as or on Behalf of an Adverse Party). "Throughout the duration of an agency relationship, an agent has a duty to refrain from competing with the principal and from taking action on behalf of or otherwise assisting the principal's competitors." § 8.04 (Competition)

Partnership law

> The fiduciary duty of loyalty of a general partner [in a limited partnership] includes the duties: (1) to account to the limited partnership and hold as trustee for it any property, profit, or benefit derived by the general partner: (A) in the conduct or winding up of the partnership's activities and affairs; (B) from a use by the general partner of the partnership's property; or (C) from the appropriation of a partnership opportunity; (2) to refrain from dealing with the partnership in the conduct or winding up of the partnership's activities and affairs as or on behalf of a person having an interest adverse to the partnership; and (3) to refrain from competing with the partnership in the conduct or winding up of the partnership's activities and affairs. ULPA (2013) § 409 (b). The uniform act pertaining to general partnerships has the same language, except that the duty not to compete ends when the partnership dissolves. UPA (2013) § 409(b)

The law of limited liability companies.

> ULLCA (2013) § 409(b) contains essentially the same language as UPA (2013) § 409(b).

B. The Duty of Loyalty in "Sibling Rivalry" Transactions

1. Where a Controller Shareholder is one of the "Siblings"

A director's duty of loyalty also applies when a controlling shareholder's interest in a transaction are adverse to (in conflict with) minority shareholders and the controlling shareholder effects a transaction that requires approval by the board of directors. A "going private" transaction is a prime example, including a parent-subsidiary merger which eliminates minority shareholders. Such transactions are a type of "sibling rivalry" – *i.e.,* an entity restructuring that benefits one set of equity holders (the controlling shareholder) to the detriment of another set (the minority shareholders).

Delaware case law is replete with rulings that such transactions rebut the presumption of the director-friendly business judgment rule[93] and subject the transaction to the far more demanding "entire fairness" test.

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[93] *See, e.g,* Quadrant Structured Products Co., Ltd. v. Vertin, 115 A.3d 535, 549 n. 22 (Del. Ch. 2015) (citing cases); Lake Treasure Holdings, Ltd. v. Foundry Hill GP LLC, No. CIV.A. 6546-VCL, 2014 WL 5192179, at *10 (Del. Ch. Oct. 10, 2014) (conflict of interest rebuts the business judgment rule; partnership case); In re Tele-Commc'ns, Inc. Shareholders Litig., No. CIV.A. 16470, 2005 WL 3642727, at *6 (Del. Ch. Dec. 21, 2005) (business judgment rule rebutted "[i]n transactions where directors stand 'on both sides of a transaction'"); Khanna v. McMinn, No. CIV.A. 20545-NC, 2006 WL 1388744, at *25 n. 201(Del. Ch. May 9, 2006) (holding that "compliance with [Del. Code., tit. 8] § 144(a) [partial safe harbor for conflict of interest transactions] does not guarantee the benefit of the presumption of the business judgment rule").

For a concise statement of the business judgment rule, see In re Crimson Exploration Inc.Stockholder Litig., No. CIV.A. 8541-VCP, 2014 WL 5449419, at *9 (Del. Ch. Oct. 24, 2014) ("The business judgment rule is a principle of prudence and discretion that operates to preclude a court from imposing itself unreasonably on the business and affairs of a corporation. The rule in effect provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good

As explained in the seminal case of *Weinberger v. UOP, Inc.*, entire fairness is a demanding test with two aspects – fair process and fair price:

> The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts…. The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. [94]

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faith to meet their duty. The rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be attributed to any rational business purpose.") (internal quotation marks and footnotes omitted) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360, 361 (Del.1993), which in turn was quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del.1971)). *See also* Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052–53 (Del. Ch.1996)).

[94] Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983). *See also* Lake Treasure Holdings, Ltd. v. Foundry Hill GP LLC, No. CIV.A. 6546-VCL, 2014 WL 5192179, at *10 (Del. Ch. Oct. 10, 2014) ("Entire fairness is Delaware's most onerous standard of review."); In re Crimson Exploration Inc. Stockholder Litig., No. CIV.A. 8541-VCP, 2014 WL 5449419, at *9 (Del. Ch. Oct. 24, 2014) ("Practically, the business judgment rule means that litigants challenging a board's decision face an uphill battle.").

"A fair process usually results in a fair price," Americas Mining Corp. v. Theriault, 51 A.3d 1213, 1244 (Del. 2012), but the contrapositive is not necessarily true. Sometimes a fair price results from an unfair process. In such circumstances, plaintiffs cannot recover damages (for, by definition, they have not been damaged), but the directors may be liable for plaintiffs' attorney's fees. In re Nine Sys. Corporation Shareholders Litig., No. CIV.A. 3940-VCN, 2014 WL 4383127, at *1, 3 (Del. Ch. Sept. 4, 2014) ("Here, the Court concludes that a price that, based on the only reliable valuation methodologies, was more than fair does not ameliorate a process that was beyond unfair. At least doctrinally, stockholders may be entitled to more than merely a fair price, but the difficulty arises in quantifying the value of that additional entitlement. A more challenging question thus arises: what damages may stockholder plaintiffs receive where the transaction at issue was approved and implemented at a fair price?…. That said, the Plaintiffs are granted leave to petition the Court for an award of attorneys' fees and costs.")

A controlling shareholder can escape the "entire fairness" test by subjecting the conflict of interest transaction to mechanisms appropriate to negate the conflict. In *Kahn v. M & F Worldwide Corp.* (*Kahn*), the Supreme Court stated that "business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders."[95]

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[95] Kahn v. M & F Worldwide Corp., 88 A.3d 635, 645 (Del. 2014). Earlier decisions can be read to preclude the resurrection of the business judgment rule. Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1240 (Del.2012) ("[E]ven when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or a well-functioning committee of independent directors, an entire fairness analysis is the only proper standard of review."); Carsanaro v. Bloodhound Technologies, Inc., 65 A.3d 618, 660 (Del. Ch. 2013) ("Because of the controller's influence, entire fairness has been held to apply ab initio, and the use of a single procedurally protective mechanism, such as a special committee or majority of the minority vote, does not restore the business judgment rule.') (citing Ams. Mining Corp. v. Theriault, 51 A.3d 1213, 1240 (Del.2012)). *Kahn* cites *Americas Mining*, but without reference to the case's "even when" language. *Kahn* describes *Americas Mining* as a case in which "it was not possible to make a pretrial determination that the independent committee had negotiated a fair price." *Kahn*, 88 A.3d a 645. *See also* Kahn v. Lynch Commc'n Sys., Inc. ("*Lynch*"), 638 A.2d 1110, 1117 (Del. 1994) (noting the importance of "careful judicial scrutiny of a special committee's real bargaining power before shifting the burden of proof on the issue of entire fairness"). *Kahn* describes *Lynch* as follows:

> Almost two decades ago, in *Kahn v. Lynch*, we held that the approval by either a Special Committee or the majority of the noncontrolling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff. Lynch did not involve a merger conditioned by the controlling stockholder on both procedural protections. The Appellants submit, nonetheless, that statements in Lynch and its progeny could be (and were) read to suggest that even if both procedural protections were used, the standard of review would remain entire fairness. However, in *Lynch* and the other cases that Appellants cited, *Southern Peru* and *Kahn v. Tremont*, the controller did not give up its voting power by agreeing to a non-waivable majority-of-the-minority condition. That is the vital distinction

More particularly, the Court held:

> [I]n controller buyouts, the business judgment standard of review will be applied if and only if: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.[96]

2. Where No Controlling Shareholder Influence is Involved

In general, the deferential business judgment rule applies when independent, disinterested directors take lawful action that prefers one set of equity holders over another. As stated in *In re Gen. Motors Class H Shareholders Litig.* ("*In re General Motors*"): "An allegation that properly motivated directors, for no improper personal reason, advantaged one class of stockholders over the

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> between those cases and this one. The question is what the legal consequence of that distinction should be in these circumstances.

Kahn, 88 A.3d at 642 (footnotes omitted).

[96] *Id.* For a textbook example of how not to use a special committee, see In re Dole Food Co., Inc. Stockholder Litig., No. CV 8703-VCL, 2015 WL 5052214, at *2 (Del. Ch. Aug. 27, 2015) (finding that a special committee and its advisors functioned diligently and well, "[b]ut what the Committee could not overcome, what the stockholder vote [a majority of the minority] could not cleanse, and what even an arguably fair price does not immunize, is fraud" by the controlling shareholder and his chief assistant; holding that "[u]nder these circumstances, assuming for the sake of argument that the $13.50 price still fell within a range of fairness, the stockholders are not limited to a fair price [but rather] are entitled to a fairer price designed to eliminate the ability of the defendants to profit from their breaches of the duty of loyalty"). *See also* In re Emerging Commc'ns, Inc. Shareholders Litig., No. CIV.A. 16415, 2004 WL 1305745, at *28-38 (Del. Ch. May 3, 2004) (providing a painstaking analysis of the defects in the special committee's process).

other in apportioning transactional consideration does not state a claim for breach of the duty of loyalty."[97]

In particular, in allocating merger consideration between preferred and common shareholders, no duty of loyalty compels directors to allocate to the preferred shareholders any more than their contractual rights. To the contrary, "it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred."[98] Moreover, "[i]t is a well-settled principle that where a

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[97] In re Gen. Motors Class H Shareholders Litig., 734 A.2d 611, 618 (Del. Ch. 1999). *See also* Gilbert v. El Paso Co., 575 A.2d 1131, 1147 (Del. 1990) (stating that "[i]n attempting to fulfill their fiduciary duties to the shareholders, directors may have to make difficult decisions involving the competing interests of various shareholder groups;" holding the directors "entitled to the protections of the business judgment rule"). *See also* Freedman v. Rest. Associates Indus., Inc., No. CIV.A. 9212, 1987 WL 14323, at *10 (Del. Ch. Oct. 16, 1987) ("It is easy to say that a director's duty runs to the corporation and all of its shareholders, but such a statement gives faint guidance to a director when conflicts among shareholder constituencies arise, as they do. For example, when merger considerations must be apportioned between Class A and Class B stock directors are inevitably faced with a conflict among classes of stock and, in most such instances, such directors will themselves own more of one class than another. Does such fact alone deprive such directors of the presumptions ordinarily accorded to their good faith decisions and require them to establish the intrinsic fairness of the apportionment? And, if so, do different directors have different burdens depending upon which class of stock they happen to own more of. It is not my impression that that is the law.") (citing MacFarlane v. North American Cement Corp., Del.Ch., 157 A. 396 (1928)); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789, 794 (Del. Ch. 1967) ("What … would be a fair allocation [of the consideration involved in a parent-subsidiary merger]? …. [P]laintiff makes no suggestion. The obvious reason for his failure to do so is that it is impossible, as between parent and subsidiary, to set fair standards for allocation agreements.... The question, then, is reduced to one of business judgment with which the court should not interfere absent a showing of 'gross and palpable overreaching.' No such showing is here made.").

[98] LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 452 (Del. Ch. 2010). *See also* Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) ("While the facts out of which this dispute arises indisputably entail the imposition by the board of (or continuation of) economic risks upon the preferred stock which the holders of the preferred did not want, and while this board action was taken for the benefit largely of the

dispute arises from obligations that are expressly addressed by contract, that dispute will be treated as a breach of contract claim. In that specific context, any fiduciary claims arising out of the same facts that underlie the contract obligations would be foreclosed as superfluous."[99]

3. Determining Whether a Director is Independent and Disinterested

Under both *Kahn* and *In re General Motors*, it is essential to determine whether the directors approving a "sibling rivalry" transaction are each independent and disinterested. In a related context, the Court of Chancery has recently stated: "Determining whether a plaintiff has pled facts supporting an inference that a director cannot act independently of an interested director for

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common stock, those facts do not constitute a breach of duty. While the board in these circumstances could have made a different business judgment, in my opinion, it violated no duty owed to the preferred in not doing so. The special protections offered to the preferred are contractual in nature. The corporation is, of course, required to respect those legal rights. But … generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock-as the good faith judgment of the board sees them to be-to the interests created by the special rights, preferences, etc., of preferred stock, where there is a conflict.") (citation and footnote omitted). An exception to this general rule exists "[w]hen … there is no objective contractual basis for treatment of the preferred." In that circumstance, "the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred." LC Capital Master Fund, Ltd. v. James, 990 A.2d at 445-449 (citing, explaining, and distinguishing Jedwab v. MGM Grand Hotels, Inc.,509 A.2d 584 (Del.Ch.1986) and In re FLS Holdings, Inc. Shareholders Litigation, 1993 WL 104562 (Del.Ch. Apr. 2, 1993)).

[99] Nemec v. Shrader, 991 A.2d 1120, 1129 (Del. 2010) (citing Blue Chip Capital Fund II Ltd. P'ship v. Tubergen, 906 A.2d 827, 833 (Del. Ch.2006); Gale v. Bershad, 1998 WL 118022, at *5 (Del.Ch. Mar. 4, 1998)).

purposes of demand excusal under *Aronson* [473 A.2d 805 (Del.1984)] can be difficult."[100] The same is true for purposes of *Kahn* and *In re General Motors*.

However, at least two guideposts exist. First, the fact that a director owns equity in one of the siblings does not by itself disqualify the director. "To hold that independent directors are disabled from the protections of the business judgment rule when addressing a merger because they own common stock, and not the corporation's preferred stock, is not … something that should be done lightly" and indeed should not be done at all – at least according to the Court of Chancery.[101]

The Delaware Supreme Court has made much the same statement in a case involving tender offers. *Gilbert v. El Paso Co.* involved the El Paso Company, plaintiff shareholders of the company, who had tendered their shares in response to a first offer (the December offer) from an unrelated party, and the alleged liability of the El Paso directors, who had agreed to the withdrawal of the

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[100] Delaware Cnty. Employees Ret. Fund v. Sanchez, No. 702, 2014, 2015 WL 5766264, at *1 (Del. Oct. 2, 2015). There is also the related question of when the involvement of one interested director taints the otherwise disinterested members of the board. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 364 (Del. 1993), decision modified on reargument, 636 A.2d 956 (Del. 1994) ("This Court has generally and consistently refrained from adopting a bright-line rule for determining when a director's breach of duty of independence through self-interest translates into evidence sufficient to rebut the business judgment presumption accorded board action…. [T]he question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case.").

[101] LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 452 (Del. Ch. 2010). *See also* Solomon v. Armstrong, 747 A.2d 1098, 1118 (Del. Ch. 1999) aff'd, 746 A.2d 277 (Del. 2000) ("Directors must often resolve conflicts among classes of stock, and the fact that a majority of the directors own more of one class than another does not necessarily implicate the directors' good faith or loyalty.") (footnote omitted).

December offer and to a substitute offer (the January offer) less beneficial to the plaintiffs.[102] The Court categorically rejected "plaintiffs' assertion that the actions of the El Paso directors are not entitled to the protections of the business judgment rule because their interests as shareholders indisputably conflicted with the plaintiffs' interests in having their shares accepted under the December offer."[103]

Second, even assuming a very significant advantage to the "sibling" equities owned by a director, the director remains disinterested absent specific allegations and (eventually) a showing that "the director's interest is material to *that* director."[104] Thus:

> To show that a …director's independence was compromised by her ownership of greater amounts of [an advantaged class of stock], the plaintiffs must plead that the amount of such holdings and the predominance of such holdings over [the director's] holdings [of the disadvantaged class of stock] was of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties to the … shareholders [of the disadvantaged class of stock] without being influenced by her

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[102] Gilbert v. El Paso Co., 575 A.2d 1131 (Del. 1990).

[103] *Id.*, at1147 (Del. 1990). The Court also stated: "As to the plaintiffs' contention that self-dealing can be inferred from the El Paso directors' role in arranging the January offer, into which the board could tender their own El Paso shares, it is undisputed that El Paso's directors did not stand on both sides of the transaction. By tendering into the January offer, no board member received any special benefit which was not also extended to all shareholders." *Id.*, at 1146.

[104] Solomon v. Armstrong, 747 A.2d 1098, 1118 (Del. Ch. 1999) (footnote omitted; emphasis added) (referring to the point as "well established"), aff'd, 746 A.2d 277 (Del. 2000).

> overriding personal interest in the performance of the [advantaged] shares.[105]

These two guideposts narrow the range of circumstances in which plaintiffs can effectively allege that a director is interested or lacks independence.

Part IV – *Nemec v. Shrader* and the Implied Contractual Covenant

As discussed in Part III, the duty of loyalty provides no recourse for plaintiffs in a "sibling rivalry" dispute so long as: (i) the challenged transaction is not accomplished by or at the behest of a controlling shareholder; and (ii) the directors approving the transaction are independent and disinterested.[106] A director is not disinterested merely because she or he owns more stock in the advantaged class of equities than in the disadvantaged class.[107] Moreover, when the advantaged class comprises preferred stock, except in extraordinary situations, contract law displaces the duty of loyalty.[108]

Contract law of course includes the implied covenant of good faith and fair dealing, and in 2010, the Delaware Supreme Court brought the implied covenant to bear on a "sibling rivalry" dispute within a Delaware corporation. In

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[105] In re Gen. Motors Class H Shareholders Litig., 734 A.2d 611, 617 (Del. Ch. 1999). *See also* Lee v. Pincus, No. CV 8458-CB, 2014 WL 6066108, at *13 (Del. Ch. Nov. 14, 2014) (quoting In re General Motors, 734 A.2d at 617).

[106] Even when the first condition is not met, *Lynch* provides a blueprint for displacing loyalty's "entire fairness" test with the business judgment rule. See n. 95.

[107] See Part III-B-C.

[108] See text at n. 112.

Nemec v. Shrader ("*Nemec*"). The Court split 3-2, holding that no breach had occurred.[109] The majority opinion educed a "thoughtful dissent."[110]

The key facts were straightforward. The corporation, Booz Allen, sold half of its business to a third party, The Carlyle Group. Before closing the transaction, the Booz Allen board of directors had to decide how to allocate the sale proceeds between a class of preferred shareholders (retired principals of the firm) and the owners of common stock (the current principals, who would be continuing to run the remaining business in a new corporation). The decision was necessary because the corporation had an option to call the preferred shares at book value, a price significantly less than the price the preferred shareholders would receive if they still owned their shares when the transaction closed.

The board decided to have the corporation call the preferred shares before the transaction closed, which caused the common shareholders to receive approximately $60 million more than they would have if the corporation had not exercised its call right.[111] The "sibling rivalry" being a zero sum game, that $60 million was a lost opportunity for the preferred shareholders. The preferred shareholders sued the board members for breach of fiduciary duty (loyalty) and the corporation for breach of the implied contractual covenant.

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[109] Nemec v. Shrader, 991 A.2d 1120 (Del. 2010).

[110] *Id.*, at 1127 (majority opinion).

[111] *Id.*

The majority opinion quickly dispatched the loyalty claims, primarily on the grounds that, with preferred stock, contract law displaces fiduciary duty law:

> [T]he fiduciary duty claim … arises from a dispute relating to the exercise of a contractual right—the Company's right to redeem the shares of retired nonworking stockholders. That right was not one that attached to or devolved upon all the Company's common shares generally, irrespective of a contract. Rather, that right was solely a creature of contract, and attached only to those shares that retired stockholders acquired under the Stock Plan. As a consequence, the nature and scope of the Directors' duties when causing the Company to exercise its right to redeem shares covered by the Stock Plan were intended to be defined solely by reference to that contract. Any separate fiduciary duty claims that might arise out of the Company's exercise of its contract right, therefore, were foreclosed.[112]

The majority also noted that – the displacement issue aside – no loyalty breach existed because the plaintiffs had not alleged facts showing that the directors were interested: "The fact that some directors were in the group of working stockholders who received a pro rata share of the $60 million did not make it an interested transaction because those director stockholders received the same pro rata benefit as all other stockholders similarly situated."[113]

On the implied covenant claim, the majority reasoned straightforwardly that: (i) "[t]he implied covenant will not infer language that contradicts a clear exercise of an express contractual right;"[114] and (ii) the outcome plaintiffs complained of was a natural result of what the plaintiffs had bargained for. As to

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[112] *Id.*, at 1129. For a general discussion of this point of law, see the text at n. 112.

[113] *Id.*, at 1127. For a general discussion of this point of law, see text at nn. 101-103.

[114] *Nemec*, 991 A.2d at 1127.

the latter point, the majority opinion stated that "[c]ontractually negotiated put and call rights are intended by both parties to be exercised at the time that is most advantageous to the party invoking the option."[115]

The majority characterized the dissent as seeking to re-write the parties' deal. "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."[116] The majority also rejected the dissent's assertion that bad faith had been alleged because the decision to call the preferred shares served no legitimate purpose:

> Our colleagues' thoughtful dissent suggests that we neglect to note that the challenged conduct (redeeming the retired stockholders shares) must "*further a legitimate interest of the party relying on the contract*" [emphasis supplied by the dissent]. The Company's directors, at the time of the decision to redeem owed fiduciary duties to the corporation and its stockholders. The redemption would not affect the Company directly. However, a failure to redeem the now retired stockholders' shares consistent with the Company's right under the stock plan would directly reduce the working stockholders' distribution by $60 million. If the Company's directors had not exercised the Company's absolute contractual right to redeem the retired stockholders [sic] shares, the working stockholders had a potential claim against the directors for

[115] *Id.* (quoting the Chancellor's decision} (footnote omitted). *See also id.* at 1128 (stating that "[t]hese plaintiff-appellants got the benefit of their actual bargain" and "[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"). *Cf.* ULPA (2013) § 409(d), cmt. ("[T]he purpose of the contractual obligation of good faith and fair dealing is to protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.").

[116] *Id.* (footnote omitted).

> favoring the retired stockholders to the detriment of the working stockholders.[117]

The dissent viewed the majority as taking a far too narrow approach to the implied covenant,[118] and the dissenting opinion depends on the assertion that, if "the Company's redemption of the plaintiffs' shares prejudiced the plaintiffs while serving no legitimate interest of the Company…, the redemption would have been arbitrary and unreasonable, for which reason the complaint stated a cognizable claim for breach of the implied covenant."[119]

Rejecting the notion that the directors had obligations to the holders of common stock,[120] the dissent reiterated:

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[117] *Id.*, at 1127 (emphasis and brackets in the original). The majority certainly has the better of this part of the argument. Call rights on preferred stock often (if not typically) work to the benefit of other stockholders.

[118] *Id.*, at 1134 (Jacobs, J., dissenting) (rejecting the majority characterization of the dissent's view as overly expansive: stating that "it is the majority's view of the doctrine's reach that is unduly crabbed").

[119] *Id.*, at 1131.

[120] At *id.*, 1135, the dissent states:

> First, the majority cites no authority, nor articulates any reasoning, to support its conclusory statement that the working stockholders would have a valid claim for breach of fiduciary duty against the directors for not redeeming the plaintiffs' shares. If that is so, then it is equally arguable that the plaintiffs would have had an identical fiduciary duty claim against the directors for causing their shares to be redeemed for the sole benefit of the working stockholders. Second, and more fundamentally, even if the working stockholders arguably had a legitimate economic interest in not being deprived of the $60 million the plaintiffs would otherwise have received, that is an interest that pertains only to the working stockholders—not the Company. Only by conflating the interest of the working shareholders with that of the Company is the majority then able to posit a legitimate corporate interest that the Company then became entitled (indeed, required) to further. This attribution of the working stockholders' interest to Booz Allen magically puts a second rabbit into the same hat.

> The Company's decision whether or not to redeem was discretionary, in the sense that Booz Allen, as the right holder was not *obligated* to redeem the shares at the time it chose to do that. Exercising a contractual right under circumstances detrimental to the counterparty and where the right holder has nothing to gain, is arguably not in good faith, unless the contract expressly allows the exercise for any (or even no) reason.[121]

Nemec may well have been the Court's first step in, or at least may have foreshadowed, the clarification process described in Part II-B. Without using the phrase "frame of reference," the majority decision implied a narrow frame for identifying the fruits of the bargain. For example, the majority rejected (almost scoffed at) the dissent's use of a comment by Booz Allen's chairman and CEO as relevant to the implied covenant analysis:

> On March 10, 2008, Ralph Shrader, Booz Allen's chairman and CEO, told Nemec [one of the plaintiffs] that allowing both Nemec and Wittkemper to retain their Booz Allen stock until the Carlyle transaction closed was an "easy moral decision." The Dissent construes this comment on "morality" as an indication of the parties' legal intent during contractual bargaining and signing 30 years earlier.[122]

Likewise, without using the phrase, the dissent assumes a far broader, more flexible frame of reference.[123]

Although the majority may not have cited it, authority did exist. *See* n. 98 . By the same token, the dissent omitted to cite any of the "roving commissioner" cases identified at the end of note 67.

[121] *Id.* at 1132, n. 44 (emphasis in original).

[122] *Nemec*, 991 A.2d at 1125 n. 6. Recall the comparison to the Corbin approach to the parol evidence rule, discussed in note 68.

[123] The assertion just discussed evidences this approach. More generally, the dissent suggests no guidelines for (let alone constraints on) the facts relevant to an implied covenant analysis.

The practical "take away" from *Nemec* is that "sibling rivalry" may well exist between owners of preferred stock and owners of common stock, but if in the given transaction:

- no extraordinary circumstances exist;[124]
- the allocation of consideration does not breach the contract rights of the preferred;[125] and
- as a practical, financial matter, those rights do not consume the lion's share of the consideration;.[126]

then the rivalry's outcome is preordained. The owners of common stock win financially, and a lawsuit by owners of the preferred stock will be to no avail.

Part V – "Sibling Rivalry" in the Domain of Delaware Unincorporated Entities

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[124] For example, it would be an extraordinary circumstances the designation of the rights of the preferred stock provided no objective basis for determining the payout for the preferred shares. LC Capital Master Fund, Ltd. v. James, 990 A.2d 435, 445-449 (Del. Ch. 2010) (stating that an exception exists to the general rule of no loyalty duty "[w]hen … there is no objective contractual basis for treatment of the preferred;" holding that, in that circumstance, "the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred") (citing, explaining, and distinguishing Jedwab v. MGM Grand Hotels, Inc.,509 A.2d 584 (Del.Ch.1986) and In re FLS Holdings, Inc. Shareholders Litigation, 1993 WL 104562 (Del.Ch. Apr. 2, 1993)).

[125] See text at n. 98.

[126] Preferred shareholders will sue only if their contractual rights disadvantage them *viz-à-viz* the common shareholders. If the reverse is true, the common will suffer the disadvantage. For example, assume that a corporation has: 100 shares of preferred shares outstanding, each with a payout right of $50 per share in a "Covered Transaction" as well as 1000 outstanding shares of common stock. If a buyer in a Covered Transaction pays a total of $75,000 in consideration, each preferred share receives $50; each common share receives $25. If the preferred payout right is only $25, then the situation is reversed.

A. How The Power of a Partnership or Limited Liability Company Agreement to Restrict or Eliminate Fiduciary Duties Affects the Scope and Power of the Implied Covenant

In many important respects, the law applicable to Delaware limited partnerships and Delaware limited liability companies ("LLCs") differs fundamentally from the law applicable to Delaware corporations. The Delaware Supreme Court has very recently emphasized this reality:

> We wish to make a point. We are keenly aware that this case involves a merger between a limited partnership and a limited liability company, albeit both ones whose ownership interests trade on public exchanges. But, it appears that both before the Chancellor, and now before us on appeal, the parties have acted as if this case was no different from one between two corporations whose internal affairs are governed by the Delaware General Corporation Law and related case law. We have respected the parties' approach to arguing this complex case, but felt obliged to note that we recognize that this case involved alternative entities, and that in cases involving those entities, distinctive arguments often arise due to the greater contractual flexibility given to those entities under our statutory law.[127]

Delaware's case law on LLCs is replete with statements that "limited liability companies are creatures of contract."[128] Although such statements have

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[127] Corwin v. KKR Fin. Holdings LLC, No. 629, 2014, 2015 WL 5772262, at *1 n. 3(Del. Oct. 2, 2015)

[128] On October 9, 2015, a Westlaw search for *"creature of contract" /s "limited liability company"* in the Delaware database found 18 cases. The most recent opinion was CSH Theatres, LLC v. Nederlander of San Francisco Associates, No. CV 9380-VCP, 2015 WL 1839684, at *11 (Del. Ch. Apr. 21, 2015) (stating that "[l]imited liability companies are creatures of contract"). At least two cases go even further. In re Seneca Inv. LLC, 970 A2d 259, 261 (Del. Ch. 2008) (stating that "[a]n LLC is *primarily* a creature of contract") (emphasis added); Fisk Ventures, LLC v. Segal, No. Civ. A. 3017-CC, 2008 WL

only rarely appeared in cases pertaining to limited partnerships,[129] both the LLC and limited partnership statutes exalt freedom of contract in essentially the same language. "It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of [partnership] [limited liability company] agreements."[130] Moreover, "Delaware courts consider [case law pertaining to each of] the two statutes to be reciprocally precedential."[131]

Absent a contrary agreement, those who govern a limited partnership or limited liability company[132] owe the same duties of loyalty to the entity and its owners as directors owe to the corporation and its shareholders.[133] Thus, for

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1961156, at *8 (Del. Ch., May 7, 2008) (stating that "limited liability companies…are creatures not of the state but of contract"). The statement in *Fisk Ventures* is quite remarkable, given that it is the Delaware LLC statute that both provides for the existence Delaware LLCs and establishes the all-import liability shield. *See* In re Carlisle Etcetera LLC, No. CV 10280-VCL, 2015 WL 1947027, at *11 (Del. Ch. Apr. 30, 2015) ("[A]n LLC agreement is not an exclusively private contract among its members precisely because the LLC has powers that only the State of Delaware can confer. Those powers affect the rights of third parties, who at a minimum must take into account the LLC's separate legal existence and its members' limited liability shield.")

[129] On October 9, 2015, a Westlaw search for *"creature of contract" /s "limited partnership"* in the Delaware database found only one case, and the reference to the concept was oblique. Twin Bridges Ltd. P'ship v. Draper, No. CIV.A. 2351-VCP, 2007 WL 2744609, at *20, n. 123 (Del. Ch. Sept. 14, 2007) (citing Myron T. Steele, Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 Del. J. of Corp. L. 1, 5, 9-13, 29-32 (2007) as referring to the limited "as a creature of contract").

[130] Del. Code tit. 6, §§17-1101(c) (limited partnership act), 18-1101(b) (limited liability company act) (2015).

[131] 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.

[132] *I.e.,* the general partner(s) of a limited partnership, the manager(s) or managing member(s) of a limited liability company.

[133] *See, e.g.,* Kelly v. Blum, No. CIV.A. 4516-VCP, 2010 WL 629850, at *1 (Del. Ch. Feb. 24, 2010) ("[E]ven though contracting parties to an LLC agreement have the freedom to expand, restrict, or eliminate fiduciary duties owed by managers to the LLC

present purposes, the most important aspect of Delaware's "Contract is God" approach[134] is the power of a limited partnership or limited liability company agreement to restrict or even eliminate fiduciary duty.[135] As with the freedom of contract provision, the limited partnership and LLC statutes use essentially the same language. Section 18-1101(c) of the LLC act provides:

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and its members and by members to each other, in the absence of a provision explicitly altering such duties, an LLC's managers and controlling members in a manager-managed LLC owe the traditional fiduciary duties that directors and controlling shareholders in a corporation would."); Boxer v. Husky Oil Co., 429 A.2d 995, 997 (Del. Ch. 1981) ("The duty of the general partner in a limited partnership to exercise the utmost good faith, fairness, and loyalty is required both by statute and common law. This fiduciary duty of partners is often compared to that of corporate directors.") (citing Miller v. Schweickart, S.D.N.Y., 405 F.Supp. 366 (1975)). *See also* Twin Bridges Ltd. P'ship v. Draper, No. CIV.A. 2351-VCP, 2007 WL 2744609, at *20 n. 123 (Del. Ch. Sept. 14, 2007) ("In the 2004 amendments to [the Delaware limited partnership statute] … the Legislature made clear that absent contractual modification of fiduciary duties, a limited partnership formed under Delaware law is presumed to incorporate those duties in its governance structure. Specifically, the Legislature, consistent with the underlying policy of giving maximum effect to the principle of freedom of contract, stated that to the extent that 'a partner or other person has duties (including fiduciary duties) to a limited partnership,' the duties may be expanded or restricted in the partnership agreement, provided that it does not eliminate the implied contractual covenant of good faith and fair dealing.") (quoting Del. Code tit. 6, § 17-1101(d) (as amended by 74 Del. Laws 265 (2004)).

[134] "Is the 'Contract is God' State Subverting the Law of Contracts: Seepage from the Delaware Law of Unincorporated Business Organizations," lecture presented at the Third International Conference on Contracts, South Texas College of Law (February 23-24, 2007).

[135] An empirical study by Professor Horton indicates the extent to which publicly traded limited partnerships and limited liability companies exercise this power:

> [O]ver 87% of publicly traded non-corporate business associations present their investors with a unique susceptibility to going-private freeze-outs – a susceptibility that is beyond that experienced by investors in publicly traded corporations. It also must be noted that, while the danger is high for those that invest in publicly traded LLCs (58.82% make use of either a special approval or fiduciary elimination provision), it is even higher for those investing in publicly traded LPs (94.20% make use of either a special approval or fiduciary elimination provision).

Brent J. Horton, "The Going Private Freeze-out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations, 38 Del. J. Corp. Law 53, 60-61 (2013).

> To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement….[136]

Section 17-1101(d) is identical, except for differences necessary to apply the language to partners, partnership agreements, and limited partnerships rather than to members, managers, limited liability company agreements, and limited liability companies.[137]

The power to "restrict or eliminate" has at least two consequences for the implied covenant. The more a limited partnership or LLC agreement makes use of that power, the more important the implied covenant becomes and the more confined is its scope.[138]

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[136] Del. Code, tit. 6, §18-1101(c) (2015).

[137] Del. Code tit. 6, §17-1101(d) (2015).

[138] Arguably, there is a third consequence – namely, increased efforts to broaden the concept and breadth of the implied covenant. discussion *Cf.* ULLCA (2013), *Prefatory Note to ULLCA (2006)*, *Noteworthy Provisions of the 2006 Act* (stating constraining fiduciary duty puts "inordinate pressure on the concept of 'good faith and fair dealing'"); Daniel S. Kleinberger & Carter G. Bishop, "The Next Generation: The Revised Uniform Limited Liability Company Act, 62 BUS. LAW. 515, 551 n. 49 (2007) ("[W]e are already seeing pressure in the courts on the duty of good faith and fair dealing. When you say there are no other fiduciary duties and courts for hundreds of years have looked to fiduciary duties as a policing mechanism that they can develop, if you say you can't have fiduciary duties, they will go to good faith. And, in fact, I had a conversation with ... [t]he judge of North Carolina's business court [who] said, if you stop us on fiduciary duty, we will just go to good faith.") (quoting remarks of Co-Reporter Kleinberger at the 2006 Annual Meeting of the Uniform Law Conference). For the moment, however, in Delaware such efforts have been turned away. See Part II-B.

The second consequence may not be intuitively obvious. The implied covenant means the same thing regardless of whether the entity involve is incorporated.[139] But the implied covenant defers to express contractual provisions, and the reach of such provisions is far greater in the unincorporated context than in the corporate one.

For example, consider an express provision X, which negates the aspect of the duty of loyalty pertaining to self-dealing.[140] X will be ineffective as against public policy in a certificate of incorporation, but will be entirely effective in a partnership or operating agreement.[141] As a result, a shareholder prejudiced by X will not need to invoke the implied covenant. In contrast, in the context of a partnership or operating agreement, the implied covenant will have to defer to the

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[139] Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. Civ. A. 3658-VCS, 2009 WL 1124451, at *7 (Del. Ch., Apr. 20, 2009) (understanding the implied covenant of good faith in an LLC agreement in part with reference to corporate case law; noting how in that context the covenant "functions to protect stockholders' expectations that the company and its board will properly perform the contractual obligations they have under the operative organizational agreements");

[140] The example uses self-dealing, because Delaware corporate law permits at least the partial waiver of the duty not to usurp corporate opportunities. "Every corporation created under this chapter shall have power to … [r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders." Del. Code tit. 8, § 122(17) (2015).

[141] The latter point assumes that X is well drafted, an assumption not always justified in practice. *See* Daniel S. Kleinberger, "Careful What You Wish For – Freedom of Contract and the Necessity of Careful Scrivening," XXIV PUBOGRAM 19 (October 2006) (Committee on Partnerships and Unincorporated Business Organizations of the ABA Business Law Section).

words of X, except to the extent that an egregious or extreme situation reveals a gap in those words.[142]

B. *Gerber v. Enter. Products Holdings, LLC:* Circumstances Sufficiently Egregious or Extreme

The facts in *Gerber v. Enter. Products Holdings, LLC* ("*Gerber*") were very complicated, because the restructuring had a very complicated background.[143] For present purposes, it is sufficient to know generally that:

- The case involved a "sibling rivalry" within Enterprise GP Holdings, L.P ("EPE"), a publicly traded limited partnership.[144]
- At all relevant times before the completion of the restructuring:
  - EPE was controlled by Dan L. Duncan through "a Duncan affiliate." [145]
  - EPE's general partner was EPE Holdings, LLC, "a privately-held Delaware limited liability company owned by a Duncan affiliate."[146] The decision refers to the limited liability company as "Enterprise Products GP."

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[142] See text at nn. 80-82.

[143] Gerber v. Enter. Products Holdings, LLC, 67 A.3d 400, 418-421 (Del. 2013), overruled on other grounds by Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013).

[144] *Id.*

[145] *Id.*

[146] *Id.*

- Under the limited partnership agreement ("LPA") "'protections were minimal' and 'did not provide EPE's public investors with anything resembling the protections available at common law."[147]
- The plaintiff, Joel Gerber, was a public investor acting on behalf of two classes of fellow public investors.[148]
- In essence, the "sibling rivalry" was between the public investors and Mr. Duncan.
- In his complaint, Mr. Gerber made *inter alia* an implied covenant claim pertaining to the two principal parts of the restructuring:
    - a 2009 sale of some of EPE's assets through a transaction in which the person controlling EPE had a conflict of interest (the "2009 Sale");[149] and
    - a 2010 merger which displaced the public investors (the "2010 Merger").[150]
- The defendants asserted that the express language of the LPA precluded both claims.

In particular, as to the implied covenant claim:

[147] *Id.*, at 422 n. 32 (quoting Gerber v. Enterprise Prods. Hldgs., LLC, 2012 WL 34442 (Del.Ch. Jan. 6, 2012); *Id.*, at 422 (stating that, due to the LPA, the public investors "forewent the protections available under common law fiduciary principles").

[148] *Id.*, at 418-421.

[149] *Id.*

[150] *Id.*

- The LPA expressly allowed for the 2009 Sale and the 2010 Merger and barred any claims based on any duty, express or implied, provided that each transaction was approved through the use of any one of four safe harbors.[151]
- The Defendants asserted *inter alia* that the safe harbor known as "Special Approval" applied to each transaction and thereby precluded any implied covenant claim [152]
- The Special Approval provision required approval by independent and disinterested decision makers but did not otherwise specify how the decision making should proceed.[153]
- The plaintiff's' implied covenant claim with regard to the 2009 Sale asserted that the decision makers had relied on a Morgan Stanley fairness opinion that did not assess the consideration received for the Sale but rather assessed the total consideration received for the Sale and another transaction.[154]
- The plaintiff's implied covenant claim with regard to the 2010 Merger alleged that:

[151] *Id.*

[152] *Id.*

[153] *Id.*

[154] *Id.*

    - a principal purpose of the Merger was to extinguish unliquidated derivative claims the limited partnership had arising from the 2009 Sale and a 2007 transaction; and
    - in giving Special Approval to the Merger, the decision makers relied on a Morgan Stanley fairness opinion that accorded no value to those claims.[155]
- The Court of Chancery had dismissed both implied covenant claims on the pleadings.[156]

The Supreme Court's analysis was also complex, but, for present purposes, the key parts are simply stated:

- As discussed above,[157] the Court held that it is impossible for any contract to make the implied covenant inapplicable.[158]
- The Court reversed the dismissal of the implied covenant claims.[159]
- With regard to the 2009 Sale, the Court stated:

> When Gerber purchased EPE LP units, he agreed to be bound by the LPA's provisions, which conclusively deemed Enterprise Products GP's contractual fiduciary duty to be satisfied, if Enterprise Products GP relied upon the opinion of a qualified expert. *At the time of contracting, however, Gerber could hardly have anticipated that Enterprise*

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[155] *Id.*

[156] *Id.*, at 423.

[157] See text at nn. 51-56.

[158] *Gerber*, 67 A.3d at 418-421.

[159] *Id.*, at 425.

> *Products GP would rely upon a fairness opinion that did not fulfill its basic function—evaluating the consideration the LP unitholders received for purposes of opining whether the transaction was financially fair*.[160]

- With regard to the 2010 Merger, the Court stated:

> *Gerber could not fairly be charged with having anticipated that Enterprise Products GP would merge EPE for the purpose of eliminating EPE's derivative claims, but then rely on a fairness opinion that did not even consider those claims' value.* Although [the LPA] does not explicitly so require, we conclude that the parties would certainly have agreed, at the time of contracting, that any fairness opinion contemplated by that provision would address the value of derivative claims where (as here) terminating those claims was a principal purpose of a merger.[161]

Gerber thus illustrates the type of egregious or extreme circumstances necessary to trigger application of the implied covenant.[162]

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[160] *Id.,* at 422 (emphasis added).

[161] *Id.,* at 422-23. (emphasis added) (quotation marks and footnote omitted; first set of brackets in original).

[162] Also, as discussed in Part V-B, *Gerber* substantially clarified the meaning and reach of the implied covenant.

C. In re Kinder Morgan, Inc. Corporate Reorganization Litigation: The Implied Covenant Cannot Re-Write an Express, Pivotal Deal Point

The facts needed to understand *in re Kinder Morgan, Inc. Corporate Reorganization Litigation* ("*Kinder Morgan*")[163] are somewhat less complicated than the facts needed to understand *Gerber*. In particular:

- The case involved a complicated set of restructurings that involved a going private merger for each of two affiliated, publicly traded, Delaware entities:
    - a so-called "master limited partnership,"[164] Kinder Morgan Energy Partners, L.P.; and
    - a limited liability company, Kinder Morgan Management, LLC, to which had been delegated the management rights of the general partner of the master limited partnership.

  The *Kinder Morgan* opinion refers to these two entities as respectively the "Partnership" and the "GP Delegate" and to the mergers as respectively the "MLP Merger" and the "GP Delegate Merger."

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[163] In re Kinder Morgan, Inc. Corporate Reorganization Litig., No. CV NO. 10093-VCL, 2015 WL 4975270 (Del. Ch. Aug. 20, 2015) judgment entered sub nom. In re Kinder Morgan, Inc. (Del. Ch. Aug. 24, 2015).

[164] A master limited partnership is publicly traded limited partnership controlled, either directly or through affiliates, by a person or small group of persons.

- Richard D. Kinder effectively controlled each of the entities principally involved in the restructuring.[165]

- The "sibling rivalry" at issue was between the persons owning limited partner units in the Partnership and persons who owned membership interests in the GP Delegate.[166] Directly or beneficially, Mr. Kinder owed both.

- The case was a lawsuit brought by owners of the limited partner units against Mr. Kinder and various affiliated individuals and entities, alleging *inter alia* a breach of the implied covenant in the approval of the MLP Merger.

- The defendants asserted that the MLP Merger had received "Special Approval," which under the express terms of the limited partnership agreement ("LPA") immunized the Merger from any attack.[167]

- The LPA "defined Special Approval as 'approval by a majority of the members of the Conflicts and Audit Committee.' The [LPA] in turn defined the Conflicts and Audit Committee (the "Committee") as 'a committee of the Board of Directors of the General Partner composed

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[165] *Kinder Morgan* at *1.

[166] For reasons not explained, the *Kinder Morgan* opinion refers to these persons as "shareholders."

[167] *Id.* at *2.

entirely of one or more directors who are neither officers nor employees of the General Partner or its Affiliates.'"[168]

- In support of the implied covenant claim, the plaintiff alleged that:
    - The Committee "never challenged the … insistence [of Mr. Kinder through an affiliated entity] that GP Delegate stockholders and the Partnership's common unitholders receive the same consideration, notwithstanding the historical discount on the GP Delegate's shares or the tax-free treatment that the GP Delegate's stockholders would receive" and the tax liability the unit holders would necessarily incur.[169]
    - The Committee:

> [b]y agreeing to a taxable transaction for the Partnership … effectively transferred a deferred tax benefit from holders of common units to Parent. Yet the Committee accepted in return taxable consideration at a level such that, after paying taxes, the average Partnership public unitholder received *less* than the Partnership's pre-transaction trading price. In addition, the Committee anticipated that the dividends which former unitholders would receive after the MLP Merger as stockholders of Parent would be lower than the distributions they would have received from the Partnership absent the MLP Merger. Not only that, but the distributions would be taxable.[170]

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[168] *Id.* at *2 (citations to the LPA omitted).

[169] *Kinder Morgan* at *3. "As Kinder wanted, holders of the GP Delegate's shares received the same value as holders of the Partnership's common units, and they received it in a tax-free exchange." *Id.* Presumably the GP Delegate was taxed as a corporation, permitting the tax free exchange.

[170] *Id.* (emphasis in the original).

- The defendants sought dismissal on the pleadings, invoking the LPA's Special Approval provision.

The Court of Chancery granted the motion,[171] despite recognizing that the plaintiffs had raised "fair concerns" about the Committee's basic negotiation position, ineffective bargaining, and an outcome highly prejudicial to the unit holders.[172] Supreme Court precedent dictated the interpretation of the relevant provisions of the LPA,[173] and that interpretation limited the plaintiffs to claiming breach of contract and confined the Court of Chancery Court to an "analysis [that was] solely contractual."[174]

That analysis doomed the plaintiffs' implied covenant claim, because the Special Approval provision relieved the Committee from considering the interests of the unit holders:

> [T]he members of the Committee did not have to believe that the MLP Merger was in the best interests of the limited partners. They rather had to believe in good faith that the MLP Merger was in the best interests of the Partnership. The Complaint's allegations do not provide a basis to question the Committee's decision from the standpoint of the Partnership. Indeed, if the Complaint's allegations

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171 *Id.* at *12.

172 *Id.* at *2

173 *Id.* at *5 ("The pertinent provisions of the LP Agreement are identical to those interpreted by the Delaware Supreme Court in Norton [v. K–Sea Transportation Partners, L.P., 67 A.3d 354, 360 (Del.2013)]; the only distinction is that the provisions of the limited partnership agreement in Norton appeared in Article VII, while the provisions of the LP Agreement appear in Article VI. The Delaware Supreme Court's construction of those provisions is controlling.")

174 *Kinder Morgan* at *5.

> are credited, the Partnership faced a looming crisis because of its increasing cost of capital. The inference that the Complaint's allegations actually support is that the Committee acted reasonably and in the best interests of the Partnership by agreeing to the MLP Merger and solving the Partnership's cost-of-capital conundrum.[175]

The Chancery Court left no doubt as to what its ruling would have been if the Special Approval standard included consideration of the limited partners' interests:

> If the applicable standard required that the members of the Committee determine that the MLP Merger was in the best interests of the limited partners, then the Complaint's allegations would support a pleading-stage inference that the members of the Committee did not act in good faith. It is reasonably conceivable, based on the facts alleged, that the members of the Committee approved the terms of the MLP Merger to accommodate Parent, rather than because they believed they were in the best interests of the limited partners. Although poor negotiating alone is not enough, that factor can combine with others to support the requisite inference. In this case, the factors include a pattern of

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[175] *Id.* at *8. The LPA's Special Approval provision stated: "Any conflict of interest and any resolution of such conflict of interest shall be conclusively deemed fair and reasonable to the Partnership if such conflict of interest or resolution is … approved by Special Approval." *Id.* at *6. A related provision stated: "Any standard of care[,] any duty imposed by this Agreement or under the Delaware Act or any applicable law, rule or regulation shall be modified, waived or limited as required to permit the General Partner to act under this Agreement or any other agreement contemplated by this Agreement and to make any decision pursuant to the authority prescribed in this Agreement *so long as such action is reasonably believed by the General Partner to be in, or not inconsistent with, the best interests of the Partnership*." *Id.* at *5 (emphasis added). *See also* Allen v. El Paso Pipeline GP Co., L.L.C., No. CIV.A. 7520-VCL, 2014 WL 2819005, at *8 (Del. Ch. June 20, 2014) ("The second aspect of the contractual test that deserves additional discussion is the referent for the Conflicts Committee's good faith belief, namely that the conflict-of-interest transaction is in the best interests of the Partnership. The contractual standard does not require the Conflicts Committee to make a determination regarding the best interests of the limited partners as a class."); Sonet v. Timber Co., 722 A.2d 319, 325 (Del. Ch.1998) ("In any event, pursuant to § 6(b) of the agreement, in situations where the General Partner is authorized to act according to its own discretion, there is no requirement that the General Partner consider the interests of the limited partners in resolution of a conflict of interest.") (emphasis in original).

> concessions, a blind-eye towards contradictory market evidence, the transfer of significant value in the form of tax benefits from the limited partners to the controller, and substantial opposition from disinterested unitholders. That is not the only inference, nor necessarily the better inference, but it is reasonably conceivable, making it possible that the plaintiffs could establish a set of facts after taking discovery on which they could prevail at trial.[176]

Kinder Morgan thus illustrates how in the unincorporated context the implied covenant can be so much narrower in scope than in the corporate context.

The Court of Chancery also left no doubt as to what its ruling would been if the plaintiffs had been able to claim a breach of fiduciary duty: "If the LP Agreement had not eliminated fiduciary duties, and if the plaintiffs had plead a claim for breach of fiduciary duty (as they doubtless would have), then I would have held that the complaint stated a claim for breach under the Rule 12(b)(6) standard."[177]

Kinder Morgan thus also illustrates what freedom of contract can do to "sibling rivalry" disputes in the realm of Delaware limited partnerships and limited liability companies.

Part VI – Concluding Thoughts

Under Delaware law, the implied covenant of good faith is not the duty of loyalty in disguise. The implied covenant is not only "a cautious enterprise"[178] but also an enterprise tethered to the actual words of the contract at issue. It is

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[176] *Id.* (footnotes omitted).

[177] *Id.* at *5 (Laster, V.C.).

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

those words that must imply the sought-after term; the only extrinsic factor is the egregiousness of the result if the term is not discovered.

However, the duty of loyalty does affect the application of the implied covenant. When present, the duty typically puts any implied covenant claim into the "backseat" of the case. When the duty is eliminated and any loyalty claim precluded – as is permitted under Delaware's limited partnership and LLC statutes – the implied covenant is often the sole recourse for a complaining investor. But at the same time, the elimination of the duty of loyalty increases substantially the permissible range of express provisions, which, if clearly drafted, render the implied covenant inapposite.

In one respect, the same situation exists under Delaware corporate law, because, except in extraordinary circumstances, corporate directors owe no duty of loyalty to the owners of preferred stock. Neither the corporate statute nor the cases speak of "elimination" or waiver, but the cases are emphatic that the rights of preferred shareholders are solely contractual.

Whether the implied covenant can help equity owners disadvantaged by a "sibling rivalry" transaction depends on two factors: how clear and precise is the relevant contractual language and how egregious or "unthinkable" is the result being contested. If the plaintiff cannot invoke the latter factor, an implied covenant claim should fail. The stronger the defendant's case on the former factor, the less likely an implied covenant claim is to prevail.[179]

[179] If a limited partnership or operating agreement were to clearly and specifically empower a controlling equity owner to decimate the interests of the minority holders, would an implied covenant claim fail nonetheless? The question makes an interesting hypothetical. Given that such agreements are contracts of adhesion, in such extreme circumstances even a Delaware court might invoke the doctrine of unconscionability. As any good transactional lawyer knows, "Pigs get fat and hogs get slaughtered."