“Package Deal”: The Curious Relationship Between Fiduciary Duties and the Implied Covenant of Good Faith and Fair Dealing in Delaware Limited Liability Companies

Monica E. White
“PACKAGE DEAL”: THE CURIOUS RELATIONSHIP BETWEEN FIDUCIARY DUTIES AND THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING IN DELAWARE LIMITED LIABILITY COMPANIES

MONICA E. WHITE*

ABSTRACT

Since 1977, the popularity of the limited liability company (“LLC”) has grown tremendously, overtaking the corporation and the partnership as the preferred business structure in many jurisdictions. Amidst this growth in popularity, a legal debate has sparked concerning the existence, nature, and extent of the fiduciary and contractual duties owed in the LLC context.

Drafters of LLC agreements can adjust fiduciary “norms” through limitation or, in certain jurisdictions like Delaware, through complete elimination of fiduciary duties. However, the implied contractual covenant of good faith and fair dealing (the “Implied Covenant” or the “Covenant”) remains and cannot be waived by the parties. This delicate balance between waivable duties and an unwaivable covenant begs two key questions: What, if any, is the relationship between fiduciary duties and the Implied Covenant, and where is the boundary between the two? Further, how is the scope of the Implied Covenant affected when an LLC agreement eliminates fiduciary duties? The answers to these questions are critical in separating permissible acts under an LLC agreement from acts giving rise to causes of action for breach of contract.

The relationship between fiduciary duties and the Implied Covenant is marked by an inherent tension that the Delaware courts have yet to properly resolve. Rather, these courts have structured an extremely narrow view of the Covenant, and have sometimes conflated the Covenant with fiduciary duties, thereby reducing the effectiveness of the Covenant as an independent means of enforcing behavioral norms arising from contractual relationships. Consequently, parties to LLC agreements have been left to question whether the Implied Covenant has any significance independent of fiduciary duties. This Article attempts to shed light on this dilemma, but cautions that, in this unique context, protection under the Covenant appears to be illusory when fiduciary duties are no longer in play.

* Associate (Corporate), Baker Botts L.L.P.; J.D., magna cum laude, University of Houston Law Center (2012); B.S., Economics and Political Science, summa cum laude, University of Houston (2009). Many thanks to Professor Douglas Moll for his invaluable insight and comments. Thanks also to the editors of the University of Miami Business Law Review for their efforts in preparing this Article for publication.
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I. INTRODUCTION

Until the late twentieth century, long-term business relationships were generally either structured as partnerships or corporations. Each of these structures came with distinct benefits and disadvantages. For example, the partnership structure was easy to form, but had the potential to expose some or all of the partners to unlimited personal liability for the obligations of the partnership; the corporate structure shielded shareholders, directors and officers from personal liability, but resulted in double taxation on the corporation’s profits and dividends. However, in 1977, a hybrid entity structure known as the limited liability company (“LLC”) was introduced in Wyoming, arguably creating a business organization possessing the best features of the partnership and corporate forms. Among other benefits, LLCs shielded the personal assets of their members and managers from liability, and offered partnership-style, pass-through taxation. Since 1977, the popularity of the LLC has grown tremendously, overtaking the corporation and the partnership as the preferred business structure in many jurisdictions. However, amidst this growth in popularity, a legal debate has sparked concerning the existence,
nature, and extent of the fiduciary and contractual duties owed by LLC members and managers to each other, and to the LLC itself.\(^7\)

In the partnership and corporate contexts, the common law firmly established the significance of fiduciary duties as mechanisms to ensure the first priority of the interests of the individuals or entities to whom these duties were owed.\(^8\) Later, statutory developments modified the extent to which the fiduciary duties would regulate certain conduct.\(^9\) Now, ample precedent and statutory guidance endow the creators of partnerships and corporations with reasonable expectations regarding whether certain actions will violate standards of fiduciary conduct.\(^10\)

In contrast, LLCs are considered “creatures of contract”\(^11\)—the drafters of LLC agreements can adjust fiduciary “norms” through limitation or, in certain jurisdictions like Delaware, through complete elimination of fiduciary duties.\(^12\) However, the implied covenant of good faith and fair dealing (the “Implied Covenant” or the “Covenant”) remains and cannot be waived by the parties.\(^13\) This delicate balance between waivable duties and an unwaviable covenant begs two key questions: What, if any, is the relationship between fiduciary duties and the Implied Covenant, and where is the boundary between the two? Further, how is the scope of the Implied Covenant affected when an LLC agreement eliminates fiduciary duties? The answers to these questions are not entirely clear, but they are critical in separating permissible acts under

\[^{8}\text{See discussion infra Part II.}\n
\[^{9}\text{See discussion infra Part II.}\n
\[^{10}\text{See discussion infra Part II.}\n
\[^{11}\text{E.g., REVISED UNIF. LTD. LIAB. CO. ACT § 110 cmt. (2006).}\n
\[^{12}\text{See DEL. CODE ANN. tit. 6, § 18-1101(c) (2005) (providing for the contractual elimination of member and manager fiduciary duties); Sandra K. Miller, Legal Realism, the LLC, and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing, 45 WAKE FOREST L. REV. 729, 729–30 (2010); Szto, supra note 1, at 65–70.}\n
\[^{13}\text{Miller, supra note 12, at 730; e.g., tit. 6, § 18-1101(c).}\n
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an LLC agreement from acts giving rise to causes of action for breach of contract.

Delaware is one jurisdiction in which the boundary between fiduciary duties and the Implied Covenant is not readily apparent. For decades, Delaware has had a preeminent reputation with respect to the formation of incorporated, unincorporated, and “alternative” business entities (including LLCs). In particular, its LLC statute is favored among parties who value its flexibility, tax benefits, and minimal disclosure requirements. In addition, Delaware’s vast business-law precedent and chancery court system are added benefits should disputes arise.

However, even in this sophisticated business-law state, the relationship between optional fiduciary duties and the mandatory Covenant is far from settled. Curiously, as a result of the tension inherent in this relationship, a strange dilemma has developed. Rather than attempting to resolve the tension, the Delaware courts have instead structured a very narrow view of the Implied Covenant, and have conflated the Covenant with fiduciary duties, thereby reducing the effectiveness of the Covenant as an independent means of enforcing behavioral norms arising from contractual relationships. Consequently, parties to LLC agreements have been left to question whether the Implied Covenant has any significance independent of fiduciary duties. This Article attempts to shed light on this dilemma by unwinding the intricacies that link and differentiate these two classes of obligations.

Part II explores the contours of fiduciary duties as they have developed from Judge Cardozo’s iconic and open-ended pronouncement in Meinhard v. Salmon to the more defined boundaries of fiduciary duties in the uniform acts and corporate statutes. This Part also discusses the emergence of LLCs and the fiduciary law that applies to these entities.

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14 See Frank H. Easterbrook & Daniel R. Fischel, Contract and Fiduciary Duty, 36 J.L. & Econ. 425, 438 (1991) (characterizing the relationship between fiduciary duties and the Implied Covenant as “a blur . . . not a line”); Ladig, supra note 7 (summarizing recent Delaware precedent and noting that the relationship between fiduciary duties and contract rights is yet to be clarified by the Delaware courts).

15 Manesh, supra note 6, at 218–19. The term “alternative entity” typically denotes “unincorporated business entities providing limited liability to their owners.” Miller, supra note 12, at 729 n.1.

16 Id. at 252–53.

17 See id. at 215, 217–19.

18 See In re Emerging Commc’ns, Inc. S’holders Litig., No. 16415, 2004 Del. Ch. LEXIS 70, at *142 n.184 (Del. Ch. May 3, 2004) (stating that the corporate directors were liable for breaching their “dut[ies] of loyalty and/or good faith,” and conceding that “the Delaware Supreme Court has yet to articulate the precise differentiation between the duties of loyalty and of good faith”).

19 See discussion infra Parts III–VI.
focusing special attention on Delaware—a jurisdiction that allows not only modification of fiduciary duties, but also elimination of these duties in alternative-entity agreements.

Part III discusses the meaning, scope, and application of the Implied Covenant as it relates to fiduciary duties. Seeking to clarify the role of the Covenant, this Part proposes a model for analyzing the relationship between fiduciary duties and the Covenant with an eye towards determining the contexts in which certain conduct would theoretically be permitted as falling within provisions waiving fiduciary duties, but prohibited as violating the Implied Covenant.

Part IV argues that Delaware’s approach to the Implied Covenant skews the relationship between the Covenant and fiduciary duties, and discusses the effect of Delaware’s tort- and contract-based strands of good-faith jurisprudence on Covenant inquiries in the alternative-entity context. Through detailed analysis of key cases arising in this context, this Part also examines the importance of certain non-contractual factors in contributing to the narrow scope of the Implied Covenant, and illustrates that fiduciary waivers further reduce the Covenant’s influence in Delaware.

Part V, drawing on the precedent discussed in Part IV, predicts that Delaware’s approach to the Implied Covenant will not adequately accommodate the expectations of parties in the average LLC when fiduciary duties are eliminated. Part VI admits what the Delaware courts have yet to concede—namely, that all indicators in Delaware suggest that the Implied Covenant has no practical role when fiduciary duties have been foreclosed by contract. Finally, Part VII cautions that fiduciary waivers in this unique context risk leaving LLC parties with no recourse should disputes arise under agreements that rely on the Implied Covenant as their sole protective device.

II. The Evolution of Fiduciary Duties

Because LLCs are hybrid entities combining select features from partnerships and corporations, it is useful to briefly examine the evolution of fiduciary duties, first in the partnership and corporate contexts, and then in the context of alternative entities.

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20 Cain & Garrison, supra note 4, at 52–53.
A. The Starting Point: Fiduciary Duties in the Partnership Context

A fiduciary duty is a “duty of utmost good faith trust, confidence, and candor owed by a fiduciary . . . to [a] beneficiary.”21 This duty mandates that the fiduciary “act with the highest degree of honesty and loyalty toward [the beneficiary] and in [their] best interests.”22 Unlike many other legally imposed duties, the relevance of fiduciary duties is not limited to discrete transactions. Rather, fiduciary duties concern the governance of certain status relationships, and reflect broad, equitable principles premised on trust, stewardship, and agency.23

The common law set an extremely high bar for the execution of fiduciary duties. In Meinhard v. Salmon,24 the seminal case addressing fiduciary duties, then-Judge Cardozo made the following iconic pronouncement:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arms’ length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular expectations. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.25

The Meinhard standard is virtually, and perhaps intentionally, boundless. By failing to draw a clear line between acceptable and objectionable conduct of a fiduciary, Meinhard provided an incentive for fiduciaries to “aim high” in structuring their conduct to avoid findings that they had breached their fiduciary duties.26 Although Meinhard clearly...

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21 BLACK’S LAW DICTIONARY 581 (9th ed. 2009).
22 Id.
23 See Szto, supra note 1, at 61.
25 Id. at 546.
26 See Tolal & Riley, supra note 7, at 276 (noting the difficulty in drafting agreements when the common law is unclear on the boundaries of fiduciary duty).
established a caliber of conduct that would ensure that the beneficiaries of fiduciary relationships were adequately protected, it also constituted a “non-standard” that was difficult for courts to grasp and apply. Due to Meinhard’s lack of clarity, courts responded by raising the fiduciary duty “floor” in an attempt to meet Meinhard’s unbending demands. One commentator coined the term “galloping Meinhardism” to connote this “continuing extension of heightened, expansive, judicially-imposed fiduciary duties.”

Like the common law, the Uniform Partnership Act (“UPA”), which predated Meinhard, failed to define specific fiduciary duties owed by one partner to another, or by partners to the partnership itself. In fact, the term “fiduciary” only appears in the title of UPA section 21. However, UPA section 18 does list partners’ rights and duties in relation to the partnership—including information, disclosure, and accounting—none of which can be modified via contract. Rather than labeling section 18 as a discrete list of fiduciary duties, the drafters of UPA left the courts to determine the outer limits of fiduciary duties on a case-by-case basis.

Until 1997, UPA operated in a majority of jurisdictions in conjunction with an accumulating common law gloss that refined UPA’s scope and application. As did the common law, UPA exemplified the expansive view that fiduciary duties encompassed a notion of fairness that surpassed the four corners of the partnership agreement. However, in most states, UPA and Meinhard-influenced common law notions of fiduciary duties were soon overtaken by increasingly contractarian conceptions of partnerships. Nothing exemplifies this trend more than the

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27 Samuel J. Samaro, The Case for Fiduciary Duty as a Restraint on Employer Opportunism Under Sales Commission Agreements, 8 U. PA. J. LABOR & EMP. L. 441, 486 (2006) (“The extent to which Judge Cardozo’s soaring rhetoric [in Meinhard] is or in fact ever was a correct statement of law is unclear. For many years, lawyers, judges and scholars have debated what [Cardozo’s] pretty language means ‘on the ground.’” (footnote omitted)).

28 Toal & Riley, supra note 7, at 276.


31 See Toal & Riley, supra note 7, at 278 (grouping UPA together with the common-law fiduciary duty regime). See generally UNIF. P’SHP ACT (1914).

32 See UNIF. P’SHP ACT § 21.

33 Id. § 18.


35 See UNIF. P’SHP ACT § 21.
widespread enactment of the 1997 Revised Uniform Partnership Act ("RUPA"). In 1986, the first signs of disfavor with UPA emerged in an American Bar Association Business Law Section report hinting that UPA needed to be overhauled.36 Between 1989 and 1997, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") formulated multiple working drafts of RUPA, and in 1997, RUPA emerged in its final form and was subsequently adopted by a majority of the states.37

Generally, it can be said that RUPA introduced a heavy dose of contractarianism into the fiduciary-duty framework, and stripped away the effectiveness of the common-law gloss that had accumulated with respect to UPA. Under RUPA, fiduciary duties became exclusively statutory obligations that were capable of being reasonably modified by the partnership agreement.38 Where UPA and the common law failed to set a limit on the expansiveness of fiduciary duties, RUPA section 404 announced that “[t]he only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care.”39 This language stopped the unbounded expansion of the scope of fiduciary duties that characterized the common law.40 Rather, if a court wanted to enforce a standard of conduct that surpassed section 404’s statutory “floor,” the agreement of the parties would be the sole means of establishing that standard.41 Therefore, RUPA effectively converted fiduciary duty analysis from one solely based on status to one based, in part, on contract. Only RUPA section 103(b) saves fiduciary duties from complete elimination.42

Notably, the drafters of RUPA were fundamentally troubled with the term “fiduciary” because it was “subject to abuse in the hands of judges, academics, and others whose flow of satisfactions [was] derived in far too large part from imposing their personal values on the more productive...

37 Powell, supra note 34, at 147–48.
38 REVISED UNIF. P’SHP ACT §§ 103, 404 (1997).
39 Id. § 404 (emphasis added).
41 See REVISED UNIF. P’SHP ACT § 103(a) (“Except as otherwise provided . . . relations among the partners and between the partners and the partnership are governed by the partnership agreement.”).
42 See id. § 103(b).
members of society." 43 Perhaps it was this line of reasoning that caused RUPA to rarely use the term “fiduciary” explicitly. 44 After all, RUPA fundamentally altered the types of conduct that would satisfactorily execute fiduciary duties, and therefore, indirectly changed the definition of fiduciary duty itself.

For example, self-interested conduct—the very antithesis of conduct becoming a fiduciary under UPA and the common law45—was no longer strictly prohibited under RUPA.46 In spite of the fact that RUPA’s duty of loyalty provision provides that partners must “refrain from dealing with the partnership . . . as or on behalf of a party having an interest adverse to the partnership,” RUPA section 404(e) states that a “partner does not violate a duty of obligation under [this Act] or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest,” and RUPA section 404(f) states that a “partner may lend money to and transact other business with the partnership.”47 In addition, RUPA completely eliminated fiduciary duties during the phases prior to the partnership’s formation and after the partnership’s dissolution.48 Further, the parties’ ability to agree, after-the-fact, that certain activities would not breach fiduciary duties remained as it did under UPA and the common law, providing yet another escape valve for parties wishing to weaken these duties.49

RUPA’s fiduciary duty provisions proved to be controversial at best. RUPA satisfied most contractarians by supporting freedom of contract principles and deferring to the intent of the parties forming the

44 The vast majority of RUPA’s explicit references to fiduciary duty are in the commentary, not in RUPA’s main sections. Compare REVISED UNIF. P’SHP ACT §§ 404 cmt. 1, 405 cmt. 1, 603 cmt. 2, 803 cmt. 6, 807 cmt. 3, with REVISED UNIF. P’SHP ACT § 404(a) (providing that the only fiduciary duties owed are the duties of loyalty and care).
46 REVISED UNIF. P’SHP ACT § 404(a).
47 Id. § 404(b)(2), (e)–(f).
48 See id. § 404(b)(3) (“A partner’s duty of loyalty to the partnership and the other partners is limited to the following: . . . to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.” (emphasis added)).
49 Vestal, *supra* note 7, at 559.
partnership.\textsuperscript{50} However, some contractarians argued that RUPA was overly paternalistic and did not go far enough in honoring partnership agreements.\textsuperscript{51} In contrast, RUPA outraged traditionalists who thought that fiduciary duties should not be governed by black-letter rules and bright-line tests, but should evolve based on morals, fairness, and societal context. One commentator contended that RUPA’s reformulation of fiduciary duties was “pinched and almost mean spirited.”\textsuperscript{52} Regardless, RUPA’s push to transform fiduciary duties from a general manner of conduct to a discrete set of amendable defaults had an influence on the duties that would apply in the context of non-partnership entities.\textsuperscript{53}

At bottom, RUPA contained the free-floating fog that was fiduciary duty under the UPA–common-law regime. This containment eliminated duties previously considered fiduciary in nature, and therefore opened a gap between the “old” and “new” conceptions of fiduciary duty by treating the partnership as a conglomeration of contracts rather than a unique type of relationship.\textsuperscript{54} This gap—which RUPA allowed to be expanded and contracted by the parties—arguably created a trap for the unsophisticated or inadequately represented. This void would later be widened by the uniform LLC Acts, and various state LLC statutes.\textsuperscript{55}

\textbf{B. The Corporate Fiduciary Standard}

The corporate context has its own unique fiduciary duty paradigm. Broadly speaking, corporate directors and officers, like partners in a partnership, owe two fiduciary duties to the corporation—the duties of care and loyalty.\textsuperscript{56} The duty of care is bifurcated into two separate


\textsuperscript{51} Id. at 81; see also id. at n.3 (citing Professor Larry Ribstein, a leading contractarian in this arena, who stated that RUPA “change[d] decades of prior law under the UPA,” by explicitly making fiduciary duties mandatory among partners).

\textsuperscript{52} Vestal, supra note 40, at 280 & n.40 (citing Letter from Melvin A. Eisenberg to The Commissioners on Uniform State Laws, at 1 (July 27, 1992)).


\textsuperscript{54} Powell, supra note 34, at 165.

\textsuperscript{55} See discussion infra Part II.C.

contexts. In the oversight context, directors and officers of a corporation must discharge their duties in good faith as ordinary prudent people would under similar circumstances and in like positions.\(^{57}\) In the decisionmaking context, directors and officers of a corporation must make the types of substantive and procedural decisions that prudent directors or officers would make under similar circumstances.\(^{58}\)

However, this decisionmaking duty is tempered by the business judgment rule—a standard of review that validates the decisions of directors and officers as long as those decisions were made in good faith and according to a reasonable decisionmaking process free of bias or conflicts of interest.\(^{59}\) The business judgment rule is the most lenient standard of review used by courts in assessing the propriety of business decisions.\(^{60}\) The rule is often phrased as a presumption that “sound business judgment” was exercised if the decision “can be attributed to any rational business purpose.”\(^{61}\) The business judgment rule is not derived from the parties’ contract. Rather, it is based on the idea that some degree of risk-taking is desirable in commercial enterprise, and that judges should not scrutinize honest business decisions out of market context.\(^{62}\)

In addition, other protections may be found in some corporate statutes which contain exculpatory provisions that shield directors from liability for violating the duty of care.\(^{63}\) Even though exculpation statutes and the business judgment rule are not available for violations of loyalty or good faith,\(^ {64}\) these protections do for directors and officers what RUPA does for partners accused by traditionalists of breaching their fiduciary duties—they narrow the scope of conduct that is considered objectionable under a duty of care analysis.

C. Fiduciary Duties in the LLC

The rise of the LLC created an entirely new framework for the application and analysis of fiduciary and contractual duties. The LLC

\(^{57}\) See id. at 916–21.

\(^{58}\) See id.

\(^{59}\) See, e.g., Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000) (articulating the fundamentals of the business judgment rule).


\(^{61}\) Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (emphasis added).

\(^{62}\) Tarbert, supra note 60, at 652.


\(^{64}\) E.g., id.
structure originated in Germany in 1892, and LLCs soon began to appear in other civil law countries around the world.\(^{65}\) The emergence of the LLC in the United States occurred relatively late, but response to the LLC grew stronger as it became clearer how the LLC would fit into the established framework of business entities. The immense popularity of the LLC structure can be traced to favorable tax laws promulgated by the Internal Revenue Service (IRS) and the needs of businesses in an increasingly globalized economy.\(^{66}\)

In 1977, the first American LLC statute was enacted in Wyoming, in response to an oil company’s need to assume a structure similar to the Latin American LLC equivalent.\(^{67}\) The Wyoming LLC statute was a patchwork of provisions from the Wyoming corporate statute, the Uniform Limited Partnership Act, and UPA.\(^{68}\) However, due to the IRS’s initial treatment of LLCs, this business structure was not an immediate success. Until 1997, the IRS imposed corporate-style taxation on LLCs if these entities possessed a “preponderance of corporate characteristics”—continuity of life, centralized management, limited liability, and free transferability of interests.\(^{69}\) Conversely, LLCs were taxed as partnerships if they possessed a preponderance of partnership characteristics.\(^{70}\) Further, the IRS proposed that LLCs would be taxed as corporations if their members were not personally liable for LLC debts.\(^{71}\) The lack of clarity and simplicity in LLC tax policy complicated LLC formation and stunted the popularity of the LLC structure.\(^{72}\)

In 1997, the IRS streamlined the taxation of LLCs by instituting a “check-the-box” regime whereby an LLC could elect to be taxed as a partnership without regard to the number of corporate characteristics it possessed.\(^{73}\) Three years earlier, the Uniform Limited Liability Company Act (“ULLCA”) was promulgated.\(^{74}\) However, the IRS’s unpredictable treatment of LLCs prior to 1997 meant that, in response, most states had

\(^{65}\) Szto, supra note 1, at 63–65.

\(^{66}\) Id.

\(^{67}\) Id. at 64.


\(^{72}\) Szto, supra note 1, at 64–65.

\(^{73}\) See 26 C.F.R. §§ 301.7701-1 to -4.

\(^{74}\) Buck, supra note 53, at 718.
already enacted and amended their own LLC statutes by the time ULLCA reached its final form. Therefore, unlike partnerships under state-adopted versions UPA and RUPA, LLCs are largely a product of uniquely tailored state law.

Nevertheless, a brief look at ULLCA and the Revised Uniform Limited Liability Company Act ("RULLCA") is helpful as a baseline against which to compare the Delaware LLC statute. Fiduciary duties are implicated with respect to managers in an LLC, and ULLCA largely mirrors RUPA's narrow formulation of fiduciary defaults—the only duties owed by an LLC member–manager to other members and the company are the duties of care and loyalty. As under RUPA, these duties are subject to reasonable modification by the parties under ULLCA. Non-manager members are not subject to any fiduciary constraints under ULLCA, yet are given virtually unrestricted access to company information. Disclosure obligations remain non-fiduciary in nature, as under RUPA. However, ULLCA was not widely adopted.

In 2006, NCCUSL took another bite at the apple by enacting RULLCA. Interestingly, RULLCA reverted to a UPA-type conception of fiduciary duties—one that included, but was not limited to the duties of loyalty and care. Therefore, RULLCA provided direction with regard to LLC fiduciary duties without hindering the development of the common law. Nevertheless, like ULLCA, RULLCA does not impose fiduciary duties on non-manager members. However, unlike ULLCA, RULLCA does subject non-manager members to the obligation of good faith and fair dealing.

Due to the limited adoption of ULLCA and RULLCA, individual state LLC statutes carry more weight in the analysis of fiduciary duties in the LLC setting. Because limited partnerships are alternative entities that

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75 Id. at 717–18.
76 See id.
79 See id. § 103(b)(2)(i).
82 See supra text accompanying notes 74–76.
84 Callison & Vestal, supra note 80, at 186.
85 Id.
are analogous to LLCs for purposes of this Article, two Delaware statutes merit attention—the Delaware Limited Liability Company Act (“DLLCA”) and the Delaware Limited Partnership Act (“DRULPA”). Both statutes are founded on strong contractarian policy, with a joint aim to “give the maximum effect to the principle of freedom of contract and to the enforceability of [LLC and limited partnership] agreements.”

When alternative entities became popular in Delaware, courts were forced to make significant doctrinal adjustments to accommodate the DLLCA and DRULPA frameworks. However, these adjustments did not come naturally—after decades of developing partnership and corporate law, the Delaware courts were accustomed to defaulting to fiduciary duties given that these duties are mandatory, in some degree, in both the partnership and corporate contexts.

One example of this tendency to default to fiduciary norms in the context of limited partnerships is the Delaware Supreme Court’s decision in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.* In that case, a series of transactions proposed to Hallwood’s board of directors were at issue. The transactions were contingent on financing via the purchase of units generated in the transaction by Hallwood’s corporate parent. Gotham, a limited partner unitholder in Hallwood, brought action against Hallwood’s general partner, alleging that the general partner breached its fiduciary duties. When *Gotham* was decided, DRULPA allowed partnership agreements to expand or restrict partner duties, but did not explicitly provide for the elimination of fiduciary duties. Although traditional fiduciary duties would have applied in the absence of explicit contractual provisions to the contrary, the parties in *Gotham* contracted to allow the conduct that the plaintiffs later claimed had breached the limited partnership’s fiduciary duty to its unitholders. On this contractual basis, the chancery court rejected Gotham’s fiduciary duties.

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87 DEL. CODE ANN. tit. 6, §§ 18-1101(b), 17-1101(c) (2005) (emphasis added).
90 Id. at 164–65.
91 Id. at 164, 166.
92 DEL. CODE ANN. tit. 6, § 17-1101(d)(2) (2000) (amended 2004) (“[T]he partner’s or other person’s duties and liabilities may be expanded or restricted by provisions in the partnership agreement.”).
93 See id. at 24 (noting that the partnership agreement “occup[ied] all the territory traditionally covered by fiduciary duty doctrine”).
duty claims. However, in a surprising turn of events on appeal, the Delaware Supreme Court reverted to an “adherence to fiduciary duties . . . normally expected,” even though such adherence ran contrary to the contractual and applicable statutory language. Although the court conceded that the partnership agreement “became the sole source of protection for [Gotham],” the court was clearly uncomfortable with the concept of abandoning a corporate-style fiduciary duty analysis in favor of a statutory regime that allowed parties to govern their own conduct apart from the pronouncements of the common law: “[W]e note the historic cautionary approach of the courts of Delaware that efforts by a fiduciary to escape a fiduciary duty, whether by a corporate director or officer or other type of trustee, should be scrutinized searchingly.” Therefore, the court insisted that the parties’ status took precedence over the parties’ contract as an “underlying general principle in [Delaware] jurisprudence.”

After seeing that the Delaware Supreme Court was not recognizing the legislative intent behind DRULPA, the Delaware legislature amended DRULPA and preemptively amended DLLCA to expressly permit the complete contractual elimination of fiduciary duties. These amendments gave rise to a unique and challenging issue. Now, with the blessing of the Delaware legislature, parties could avoid unfavorable court treatment when they eliminated fiduciary duties. However, it was unclear what meaningful protections would remain once the possibility of fiduciary liability was foreclosed. Although the Implied Covenant remained mandatory, the Delaware courts retained the power to determine whether specific conduct would violate the Covenant, and thereby retained the power to define the general scope of the Covenant’s application. Thus far, these courts have chosen to exercise this power to significantly reduce the Covenant’s significance.

95 Gotham, 817 A.2d at 167.
96 Id. at 171.
97 Id. at 168.
98 Id. at 167.
100 See discussion infra Parts IV–V.
III. The Role of the Implied Covenant of Good Faith and Fair Dealing

“Good faith and fair dealing” is one of the most commonly used phrases in the legal lexicon, yet the conceptual framework behind it is incredibly abstract and has yet to be precisely defined. After all, “attempt[s] to capture in a set of normally necessary and sufficient conditions some characteristic or characteristics common to all things that are or could be called ‘good faith’ is doomed to failure.” Whereas fiduciary duties are defined in positive terms, the Implied Covenant is generally defined in negative terms. For example, in Meinhard, then-Judge Cardozo set a high, albeit vague, standard of “undivided loyalty” and the “punctilio of an honor most sensitive;” UPA section 18 creates a basic framework of partnership rights and duties upon which courts have built; and RUPA section 404 provides, as a default matter, that the fiduciary duties of loyalty and care are owed in the partnership context. In contrast, the Implied Covenant lacks an established general meaning, and courts have routinely defined good faith as something akin to “not bad faith,” rather than set specific standards of conduct that would satisfy the Covenant’s boundaries. To complete the circular reasoning, case law has often defined bad faith as a lack of good faith.

Nevertheless, at bottom, the Implied Covenant seeks to give effect to the contemplations and intentions of the parties. On one hand, the parties can promote private expectations during the negotiation phase of contract formation. On the other hand, once that agreement is reached, good faith and fair dealing mandates that the parties adhere to the bargain that was struck and refrain from taking opportunistic advantage of fellow parties. In general, the Implied Covenant requires parties to

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104 See UNIF. P'SHIP ACT § 18 (1914); REvised UNIF. P'SHIP ACT § 404(a)–(c) (1997).
105 Summers, supra note 102, at 820.
107 Steele, supra note 88, at 16.
109 See Allied Capital Corp. v. GC–Sun Holdings, L.P., 910 A.2d 1020, 1024 (Del. Ch. 2006) (suggesting that it is the parties’ responsibility to extract substantive rights during contract negotiations).
110 Gold, supra note 108, at 134.
avoid “arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the [contract’s] fruits.”\textsuperscript{111}

These principles are fairly straightforward. However, when the analysis of a dispute involves both fiduciary duties and the Implied Covenant in a hybrid entity like the LLC, the relationship between the two obligations becomes highly complex because neither obligation is conducive to discrete measurement.\textsuperscript{112}

\textbf{A. How Does the Implied Covenant Relate to Fiduciary Duties?}

While outlining the contours of fiduciary duties has been made easier with the development of the Uniform Acts and state statutes,\textsuperscript{113} defining the Implied Covenant in a vacuum is a much more challenging endeavor with little practical significance.\textsuperscript{114} Worse still, attempting to glean a relationship between fiduciary duties and the Implied Covenant is almost impossibly abstract.\textsuperscript{115} Nevertheless, whether “some portion of traditional fiduciary duties [can] be preserved through the enforcement of good faith duties”\textsuperscript{116} is a question that the Delaware courts have generally answered in the negative. Therefore, if an LLC agreement eliminates fiduciary duties, it is important to determine what types of conduct will or will not violate the Implied Covenant in spite of this elimination. In order to make this determination, an analysis of the relationship between fiduciary duties and the Implied Covenant is critical.

There are a number of approaches to fiduciary duties in the alternative entities. The fiduciary duties of care and loyalty can be mandatory, or these duties can be treated as defaults that can be altered but not eliminated.\textsuperscript{117} Alternatively, a more contract-based approach treats the duties of loyalty and care as fiduciary defaults that can be altered or

\textsuperscript{111} Wilgus v. Salt Pond Inv. Co., 498 A.2d 151, 159 (Del. Ch. 1985) (interpreting Restatement (Second) of Contracts § 205 (1981)).

\textsuperscript{112} DeMott, supra note 45, at 879; Summers, supra note 102, at 827.

\textsuperscript{113} See discussion supra Part II.A.

\textsuperscript{114} John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 COLUM. L. REV. 1618, 1654 (1989); Manesh, supra note 6, at 244.

\textsuperscript{115} See Gold, supra note 108, at 135 (emphasizing the importance of context in defining contractual good faith obligations).

\textsuperscript{116} Id. at 126.

\textsuperscript{117} E.g., N.Y. L.I.T.D. L.I.A.B. C.O. L.A.W § 417 (McKinney 2011) (allowing for alteration, but not elimination, of fiduciary duties); see Miller, supra note 12, at 732–33; Miller, supra note 30, at 600 (noting that “a significant number of states now prevent the elimination of fiduciary duties”); see also Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del. 2002) (taking this approach prior to the 2004 DLLCA
eliminated. \footnote{Miller, supra note 12, at 732–33. A more extreme contractarian view (yet to be adopted by the courts) assumes that the fiduciary duties of loyalty and care are not defaults at all, but rather must be affirmatively contracted for by the parties. \textit{Id.} at 733.} Delaware takes this latter approach. A Delaware court will presume that “traditional” fiduciary duties of loyalty and care will govern the relationship between the parties unless the parties’ agreement provides otherwise. \footnote{Auriga Capital Corp. v. Gatz Properties, 40 A.3d 839, 853 (Del. Ch. 2012); \textit{see Del. Code Ann. tit. 6, § 18-1101 (2005).} The contractual elimination of fiduciary duties, known as “fiduciary waiver” or “fiduciary opt-out,” is subject to a fairly high standard of review by the Delaware courts. \textit{See, e.g.,} R.S.M. Inc. v. Alliance Capital Mgmt. Holdings, 790 A.2d 478, 497 (Del. Ch. 2001) (noting that fiduciary waiver will be judicially recognized only in circumstances when a contract clearly disclaims the applicability of fiduciary defaults, and the court’s application of these defaults “would intrude upon the contractual rights or expectations” of the parties).}

Before parties contemplate a fiduciary opt-out, however, it is critical that they consider the types of conduct that might breach the Implied Covenant. As a general matter, to successfully argue that the defendant breached the Implied Covenant, a plaintiff must prove that the defendant acted in bad faith by conducting themselves “arbitrarily or unreasonably” such that the plaintiff was prevented from reaping the benefits of the contract. \footnote{Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010).} For example, courts have found that bad faith conduct includes “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.” \footnote{Restatement (Second) of Contracts § 205 cmt. d (1981); \textit{see, e.g.,} \textit{In re Walt Disney Co. Derivative Litig.}, 825 A.2d 275 (Del. Ch. 2003) (suggesting that willful abdication of corporate responsibilities is indicative of bad faith).}

Given this basic landscape, a few observations can be made regarding the Implied Covenant as it relates to fiduciary duties. Fiduciary duties and the Implied Covenant are close relatives. \footnote{Gale v. Bershad, No. CIV. A. 15714, 1998 WL 118022, at *5 (Del. Ch. Mar. 4, 1998) (“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 . . . .”); Easterbrook & Fischel, supra note 14, at 426–27 (“A fiduciary relation is a contractual one . . . .”); see also id. at 438 (characterizing the relationship as nonlinear, but arguing that the Implied Covenant best approximates the contours of fiduciary duties).} After all, “both types of duties seek to prevent opportunism where a contract is silent,” and can therefore be characterized as mere “variations on a theme.” \footnote{Gold, supra note 108, at 134; \textit{see also} Larry E. Ribstein, \textit{Fencing Fiduciary Duties}, 91 B.U. L. Rev. 899, 909 (2011) (suggesting that good faith and fiduciary duty may be synonymous).} However, what differentiates fiduciary duties from the Implied Covenant is their scope of amendment); \textit{supra} text accompanying notes 89–99 (discussing \textit{Gotham} and the 2004 amendment in greater detail).
application. At most, the Implied Covenant merely “binds the parties to an agreement.”\(^\text{124}\) In contrast, a fiduciary is required to act affirmatively to put the interests of the beneficiary ahead of his own interests, even if neither individual’s interests were considered in an explicit contractual reference.\(^\text{125}\) Moving from good faith and fair dealing towards fiduciary duties, the relationship between the parties evolves from strictly contractual to status-based, the applicable standard of conduct is raised, and courts become more likely to impose liability.

Because the Implied Covenant exists in all contracts and cannot be waived, the Covenant lies at the core of all contractual relationships. Even statutes that allow for the modification or elimination of fiduciary duties leave the Implied Covenant untouched. For example, DLLCA and DRULUPA allow the expansion and contraction of fiduciary duties provided that the Implied Covenant is not eliminated.\(^\text{126}\) However, even though the Implied Covenant is indispensable, it is narrower in scope than are fiduciary duties, which encompass a broad notion of fairness governing certain status relationships “characterized by unusually high costs of specification and monitoring.”\(^\text{127}\) Further, it is easier to breach a fiduciary duty than to breach the Implied Covenant.\(^\text{128}\) Fiduciary duties often seek to prevent parties from placing their own interests ahead of the interests of the individual or entity to whom the fiduciary duty is owed.\(^\text{129}\) In contrast, this is not the fundamental goal of the Implied Covenant.\(^\text{130}\) Rather, “the key question is abuse, not benefit to the actor.”\(^\text{131}\)


\(^{125}\) See D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399, 1409–10 (2002) (“In the fiduciary context, the duty of loyalty requires the fiduciary to adjust her behavior on an ongoing basis to avoid self-interested behavior that wrongs the beneficiary. By contrast, the implied obligation of good faith and fair dealing requires loyalty to the other contracting party only to the extent that the terms of the contractual relationship reasonably contemplate the actions in question.”).


\(^{131}\) DeMott, *supra* note 45, at 900.
Therefore, because fiduciary duties impose more exacting standards of behavior, they are more easily breached. This suggests that fiduciary duties lie on the outskirts of the Implied Covenant and are, therefore, more “accessible” under the theory that “inequitable action does not become permissible simply because it is legally possible.”

B. The Nested-Sphere Model: A Way to Conceptualize the Relationship Between the Implied Covenant and Fiduciary Duties

In light of the observations made above, this Article suggests building a “nested-sphere” model—an analytical model of the relationship between fiduciary duties and the Implied Covenant that interlocks these two classes of obligations together. One can graphically represent this model as a sphere within a sphere, where the Implied Covenant occupies the innermost sphere, fiduciary duties occupy the outer sphere, and a nearly infinite range of permissible conduct surrounds both spheres. In a purely contractual relationship, the outer sphere of fiduciary duties is not at issue, thereby expanding the scope of a party’s permissible conduct. This means that although the inner core of good faith and fair dealing always remains, it is somewhat more difficult to breach.

Nevertheless, when a party unilaterally attempts to recoup an opportunity that was relinquished during contract formation, that party may have breached the Implied Covenant. If a party breaches the inner core of good faith, a court, in theory, should hold that party liable if the contract suggests that, had the parties envisioned the breach, they would have negotiated express terms covering the disputed conduct. If the parties have a fiduciary relationship, any breach of the Implied Covenant would theoretically satisfy the requirements of a breach of fiduciary duty claim simultaneously. In other words, commonly cited conduct constituting bad faith—for example, “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

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133 See infra app. A.
failure to cooperate in the other party’s performance”—would breach fiduciary duties, because all of these behaviors necessarily run counter to the broad, external fairness norms that these duties seek to impose. In spite of this overlap, the Covenant is designed to provide a separate avenue of relief.

Thus, the nested-sphere model sets the initial framework for discussing a dispute involving fiduciary duties and the Implied Covenant. In order to further clarify the Covenant’s role and application, the next step is to determine how much territory the Covenant covers within the nested sphere, as well as the effect, if any, of a fiduciary opt out on the Covenant’s scope. This determination will assist in predicting the chances of a plaintiff’s success on an Implied Covenant claim.

IV. Reality Is More Complicated Than Theory: The Nested-Sphere Model in Action

At a minimum, the Implied Covenant cannot be used to revive or re-strengthen fiduciary duties that were partially or completely relinquished during contract negotiation. In addition, a plaintiff cannot bring a de facto fiduciary duty action under the guise that the defendant breached the Implied Covenant. These points are noncontroversial, and are supported by the nested-sphere model.

However, in Delaware, the joint operation of fiduciary duties and the Implied Covenant is not as straightforward in practice as the nested-sphere model would initially suggest. Two distinct patterns that alter the nested-sphere model are apparent in Delaware. First, the Delaware courts have given rise to a growing body of alternative-entity case law that mixes contractualism with various external factors to account for the very narrow initial scope of the Implied Covenant. Second, there are

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137 Restatement (Second) of Contracts § 205 cmt. d (1981).
138 See supra Part II (discussing the contours of fiduciary duties). For example, “lack of diligence and slacking off” would likely give rise to duty of care claims, and “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” would likely give rise to duty of loyalty claims. In addition, fiduciaries are presumably not allowed to breach contracts with the beneficiaries of their fiduciary duties because this action would harm the beneficiary.
139 See Bay Cit., 2009 WL 1124451, at *5.
141 Lonergan v. EPE Holdings, 5 A.3d 1008, 1016 (Del. Ch. 2010).
142 See infra apps. A, C.
143 See supra Part III.B.2–3.
144 See infra Part IV.A–B; app. B.
indications that, in situations where Delaware parties eliminate fiduciary duties by contract, the scope of the Implied Covenant will be narrowed even further, thereby rendering the Covenant functionally meaningless.145

The overall result of the courts’ hesitancy to trigger the Covenant is that fiduciary duties and the Implied Covenant have essentially become a “package deal”—neither obligation can apply without the other in situations where fiduciary duties were originally available to regulate the parties’ relationship: First, when fiduciary duties are maintained between the parties, they necessarily operate in conjunction with the Covenant given that the Covenant inheres in every contract.146 Second, because contract claims based solely on the Implied Covenant are rarely successful, and because Delaware has indicated that these claims would be deemed superfluous if fiduciary duties have not been eliminated by the parties,147 the Implied Covenant has little to no significance as an independent remedial tool.148

A. Incorporating Fairness, Contract, or Both?: The Role of Conflicting Strands of Implied Covenant Analysis in Contributing to the Covenant’s Narrow Initial Scope in Delaware

While it is clear is that the Implied Covenant is derived from the notion that, in commercial dealings, a certain level of conduct should be expected from the parties,149 what is not as clear is whether this level of...
conduct should be established only through reference to the parties’ contract (thereby rendering the Covenant a tool for contract interpretation), or whether this level of conduct should be set with any reference to external fairness norms (thereby rendering the Covenant a tool for governing the parties’ relationship). Whether a court chooses to incorporate fairness considerations into its inquiry affects the initial scope of the Covenant within the nested-sphere model—if fairness is incorporated, the Covenant’s scope is wider than if the court does not consider fairness because a fairness inquiry in a Covenant case would necessarily align the Covenant more with the equitable objectives of fiduciary duties.  

Because good faith comes into play in both the contractual and tort contexts, the obligation takes on different characteristics accordingly. In Delaware, there is authority supporting a fairness-tinged interpretation of the Implied Covenant, and there is authority supporting a contractual interpretation of the Covenant. Further, some of Delaware’s contract cases confuse the issue by using language from Covenant cases in the tort context, thereby conflating the contractual analysis of the Covenant with the fairness inquiry of fiduciary duties.


In the tort context, many case-law inquiries into good faith and fair dealing are concentrated in the insurance and employment arenas. Because tort law necessarily concerns the imposition of external standards of equitable conduct, these cases naturally inquire into the fairness of the defendant’s conduct in light of the special, or quasi-fiduciary relationship between the plaintiff and the defendant. In contrast, in a purely contractual good faith and fair dealing inquiry, only the parties’ contract should influence the outcome of the dispute.

("Although the duties implied under the covenant of good faith and fair dealing are derived from the particular contract, they nonetheless reflect social standards of fair conduct . . . .") See generally Peter H. Huang, Trust, Guilt, and Securities Regulation, 151 U. Pa. L. Rev. 1059, 1061–62 (2003) (discussing the power of law in compelling parties to comply with social norms).

150 See supra Parts II, III.A (noting the role of fairness in fiduciary inquiries).


152 See generally David G. Owen, Expectations in Tort, 43 Ariz. St. L.J. 1287, 1311 (2011) ("[T]ort law is and ought to be grounded in the fair expectations of actors, victims, and broader society.").

153 See, e.g., Fink, supra note 172.

While plaintiffs’ purely contractual Implied Covenant claims are rarely successful,\(^{155}\) this is not the case in the tort arena. For example, in the insurance tort context, the “special relationship” between the insurer and the insured has given rise to liability under the Implied Covenant more often than any other context\(^{156}\) because courts imply a high level of trust into insurance contracts, and because the relationship between the parties deemed “quasi-fiduciary.”\(^{157}\)

*Dunlap v. State Farm Fire & Casualty Co.* is illustrative of the tort-law approach to the Implied Covenant. In *Dunlap*, after suffering injuries in a car accident, the plaintiff sued her insurer, claiming that the insurer acted in bad faith by refusing to guarantee that it would continue its coverage of the plaintiff even if she settled with the alleged tortfeasor.\(^{158}\) State Farm moved to dismiss the complaint for failure to state a claim, and the trial court granted the motion.\(^{159}\)

In the prelude to its partial reversal, the Delaware Supreme Court outlined the 300-plus year history of the Implied Covenant in the insurance context.\(^{160}\) Characterizing the application of the Covenant as “quasi-reformation,” the court emphasized that such an application “governed solely by issues of compelling fairness.”\(^{161}\) The question in *Dunlap* was whether or not such issues existed.

The court concluded that the plaintiff may have had a cognizable Implied Covenant claim.\(^{162}\) Interestingly, the court rejected the notion that a finding of lack of good faith on the part of the defendant necessarily meant that the defendant acted in bad faith.\(^{163}\) Rather, a lack of good faith encompassed a broader range of conduct, according to the *Dunlap* court.\(^{164}\) If State Farm had simply improperly failed or refused to pay the plaintiff’s insurance claim, this conduct would have constituted bad
faith. However, because the conduct in question was State Farm’s failure to pay in reliance on a provision in the insurance contract requiring the plaintiff to exhaust remedies provided in other insurance policies before obtaining underinsurance benefits from State Farm, a pure bad faith analysis would not have covered State Farm’s conduct. Nevertheless, in the court’s view, State Farm’s actions could have fallen within the Implied Covenant’s boundaries under a “lack of good faith” analysis. Therefore, the court reversed the lower court’s granting of State Farm’s motion to dismiss and remanded on the question of whether State Farm violated the Implied Covenant.

2. Good Faith in the Contractual Context.

In contrast with the tort-law approach to the Implied Covenant, the Seventh Circuit’s decision in Kham & Nate’s Shoes No. 2, Inc. v. First Bank is illustrative of a purely contractual conception of the Implied Covenant (i.e., one that does not consider external notions of fairness to resolve the dispute). In that case, the debtor (a shoe corporation) and a bank entered into a loan agreement that established a $300,000 line of credit and allowed creditors to draw on letters of credit. When the debtor entered bankruptcy, creditors began drawing on the letters of credit and the debtor failed to repay the bank in full. Subsequently, the bank discontinued all advances to the debtor. Under a fourth plan of reorganization under Chapter 11 of the Bankruptcy Code, the debtor proposed that the bank be demoted to unsecured creditor status. The bankruptcy judge confirmed the proposed plan under the theory that the bank’s conduct was inequitable.

The Seventh Circuit vacated the bankruptcy court’s decision. Judge Easterbrook delivered the opinion of the court, and his contractarian

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165 Id.
166 Id. at 437.
167 Id. at 442.
168 Id. at 442–43.
169 Id. at 445.
170 Kham & Nate’s Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990).
171 Id. at 1353–54.
172 Id. at 1354.
173 Id.
174 Id.
175 Id.
176 Id. at 1363.
philosophy was apparent:\textsuperscript{177} "Good faith" is a \textit{compact} reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith—such as the UCC’s standard of honesty in fact and the reasonable expectations of the trade . . . —fill the gap. They do not block use of terms that actually appear in the contract.\textsuperscript{178}

When tort claims are not at issue, \textit{Kham} makes the Covenant’s role clear. It is merely a contractual gap-filler, where the contract itself controls whether a court can locate gaps in the first place. Further, Judge Easterbrook’s reference to good faith as “compact” reinforces the notion that good faith is conceptually narrower than fiduciary duty. The philosophy of Judge Posner, Judge Easterbrook’s colleague on the Seventh Circuit, further supports this idea: “Contract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother’s keeper. That philosophy may animate the law of fiduciary obligations but parties to a contract are not each other’s fiduciaries.”\textsuperscript{179}

3. Delaware’s Contractual Approach to the Implied Covenant as Influenced by Tort-Law Precedent.

The approach of the Delaware courts is similar to that of the \textit{Kham} court.\textsuperscript{180} Because Delaware’s alternative-entity statutes explicitly label the Implied Covenant as “contractual” in nature,\textsuperscript{181} Delaware courts have taken a contractualist tack, emphasizing that the Implied Covenant is not a “free-floating duty unattached to the underlying legal documents,” and that the Covenant is “best understood as a way of implying terms in [an]
agreement.” In other words, independent fairness considerations play no role.

However, even though Delaware’s overall approach to the Implied Covenant is contractual, some Delaware cases addressing the contractual Implied Covenant have imported language from good faith and fair dealing cases in the tort context, and this language often references external notions of fairness. For example, multiple non-tort cases in Delaware have cited Dunlap (or similar cases) for the proposition that Implied Covenant cases should be governed solely by “issues of compelling fairness.” However, the use of this tort language is highly problematic in the contractual setting: If a court believes that the Implied Covenant should not involve fairness considerations, then the use of language from tort cases (that consider fairness) as a standard against which the parties’ conduct should be evaluated necessarily hinders a plaintiff’s ability to succeed on a purely contractual claim based on the Covenant. This approach may also cause courts to permanently associate the Covenant with tort- or fiduciary duty-like fairness inquiries, leading to increased hesitancy to trigger the Covenant, especially when parties contractually eliminate fiduciary duties.

B. Examining Delaware Precedent to Further Explain the Implied Covenant’s Narrow Scope

Even though Delaware courts often claim to merely extrapolate from the spirit of the contract when deciding whether to imply a covenant into a contract, in reality, their Implied Covenant analyses do not always strictly interpret the contents of the parties’ contract. Rather, Delaware courts also appear to use a combination of contractual, relational, and motivational factors to place these contracts in context, and to reduce the territory that the Implied Covenant can cover. These factors can be used to organize relevant case law and to obtain a better understanding of

182 Lonergan v. EPE Holdings, 5 A.3d 1008, 1017 (2010) (quoting Dunlap, 878 A.2d at 441) (internal quotation marks omitted). This strict contractual approach is likely attributable to the stark change of direction imposed on the courts by the Delaware legislature in the wake of Gotham. See supra text accompanying notes 89–99.

183 E.g., Nemec v. Shrader, 991 A.2d 1120, 1126 n.16 (Del. 2010); Lonergan, 5 A.3d at 1018; In re Broadstripe, LLC, 435 B.R. 245, 263 & n.73 (Bankr. D. Del. 2010).

184 See discussion infra Part IV.C.


186 See infra app. B.
the reasoning behind the Delaware’s narrow reading of the Implied Covenant.

1. Sophistication of the Parties.

Among the nuanced factors that differentiate one Implied Covenant case from another, the sophistication of the parties arguably plays the biggest role. A general guideline emerges: The more sophisticated the parties are, the less likely they are to prevail under an Implied Covenant theory because sophisticated parties will theoretically have difficulty arguing that a court should imply one or more terms into a contract that appears to have been designed to cover all reasonably foreseeable contingencies.187

To shed light on this generalization, it helps to revisit the cases that influenced Delaware’s Implied Covenant jurisprudence. Many of the cases that jumpstarted Delaware’s conception of the Implied Covenant addressed disputes in the employment and insurance contexts—arenas in which courts deem a “special relationship” to exist between the parties.188 These relationships are marked by inherently unequal bargaining power, and this inequality provides a convenient basis for triggering the Implied Covenant.189 However, when equally-sophisticated parties negotiate an agreement on mutually-agreeable terms, no such inequality is presumed to exist, meaning that a plaintiff’s Implied Covenant claim is less likely to succeed.

This principle was illustrated in Airborne Health, Inc. v. Squid Soap, LP.190 In that case, Squid Soap, counseled by Vinson & Elkins, and Airborne, counseled by Weil, Gotshal & Manges, entered into an asset purchase agreement providing for potential earn-out payments to Squid Soap under which Airborne agreed to purchase $1 million of Squid Soap’s assets, Squid Soap’s brand name, goodwill and intellectual property upon the achievement of certain sales and marketing goals.191 The agreement obligated Airborne to transfer the purchased assets back to Squid Soap if Airborne stopped selling or marketing Squid Soap products at any time, or did not incur $1 million in advertising and marketing costs and obtain $5

188 See Steele, supra note 88, at 14–15.
191 Id. at 132.
million in net sales of Squid Soap products.192

After the agreement was signed, Airborne failed to meet these benchmarks and suffered significant setbacks with respect to its consumer credibility including a class action lawsuit. Squid Soap learned of the pending class action and claimed that Airborne and Weil were aware of the lawsuit at the time Airborne signed the agreement with Squid Soap.193 As part of its “damage control” efforts, Airborne sought to return the purchased assets to Squid Soap.194 However, Squid Soap refused to accept the assets.195

When Airborne sought a declaratory judgment that it was not liable under the asset purchase agreement, Squid Soap counterclaimed against Airborne under a variety of theories, including the Implied Covenant.196 Its Implied Covenant claim centered on Airborne’s failure to disclose the pending lawsuit against it to Squid Soap, and Airborne’s failure to meet the marketing, advertising, and sales targets set forth in the agreement.197 However, the Delaware Chancery Court swiftly rejected Squid Soap’s Covenant claim. Characterizing this claim as a “fall[ ] back” that merely “recast[ ] . . . Squid Soap’s basic complaints,” the court reasoned that the Implied Covenant would not apply to impose liability on Airborne because the asset purchase agreement expressly covered the subject of the dispute—namely, the marketing, advertising, and sales goals, and Airborne’s representation regarding litigation.198 However, the court conceded that “Squid Soap understandably question[ed] what it obtained under the [asset purchase agreement] if Airborne had no obligation actually to expend resources” under the agreement’s marketing and advertising provisions.199

If there ever was an agreement that would presumably fit within the Implied Covenant’s specific criteria, it was the Airborne–Squid Soap agreement. First, the provisions of the agreement setting forth the specific targets that Airborne would have to meet in order to retain the Squid Soap assets provided a basis for gleaning and interpreting the parties’ intentions. By signing the agreement, was Squid Soap implicitly agreeing

192 Id.
193 Id. at 134.
194 Id. at 135.
195 Id.
196 Id. at 136.
197 Id. at 145.
198 Id.
199 Id. at 146.
that Airborne could arbitrarily fail to promote Squid Soap’s products and
deny Squid Soap the earn-out payments? Squid Soap argued, reasonably, that it did not.\textsuperscript{200} Second, the Implied Covenant does not apply if the
agreement addresses the subject of the dispute. Here, the agreement did
not address the subject of the dispute because it did not oblige Airborne
to expend resources to market Squid Soap’s products.\textsuperscript{201} The question was
whether the court could—or would be willing to—imply a covenant by
finding a strong enough connection between the agreement’s explicit
provisions and its lack of clarity regarding Airborne’s role in executing
these provisions.

Under the plain language of the agreement, Airborne had complete
discretion to either expend or fail to expend its resources for the benefit of
Squid Soap. Airborne was not under an explicit obligation to expend
resources. Rather, it had the option to return the assets to Squid Soap if it
chose not to market Squid Soap’s products; Airborne attempted to
exercise this option in lieu of marketing the assets. However, in
discretion-type cases, the party exercising discretion must not do so in bad
faith or arbitrarily to the detriment of the other party. The \textit{Airborne}
court recognized that this principle has support in Delaware law.\textsuperscript{202} Squid Soap
may have had a plausible argument that Airborne acted in bad faith by
failing to market the products simply because it was in the midst of a
corporate crisis and it wanted to conserve its resources. However, the
court contended that Squid Soap mistakenly failed to specifically allege
bad faith or arbitrariness on Airborne’s part.\textsuperscript{203}

Certainly, Squid Soap did not bring its strongest case to court.
However, the facts and the merits of the court’s holding in \textit{Airborne} are
less important than the reasoning behind the holding. The court’s
characterization of Squid Soap as a sophisticated party was key:

Squid Soap’s position is also undercut by the ease with which
Squid Soap could have insisted on specific contractual
commitments from Airborne regarding the expenditure of
resources, or some form of “efforts” obligation for Airborne.
These provisions are familiar to any transactional lawyer, and
Squid Soap was a \textit{sophisticated party represented by able counsel}. . . .
Squid Soap could have insisted on a provision binding Airborne.

\textsuperscript{200} Id.
\textsuperscript{201} Id.
\textsuperscript{202} Id. at 146–47.
\textsuperscript{203} Id. at 147.
Rather than holding out for these types of contractual protections, Squid Soap accepted earn-out provisions that [were] expressly phrased in conditional terms.\(^{204}\)

The court characterized the agreement as a reasonable contract that just happened to sour due to Airborne’s business difficulties.\(^{205}\) In the court’s view, this was a risk that was willingly assumed by Squid Soap.\(^{206}\) Therefore, the court did not view the facts presented as an appropriate context in which to consider the Implied Covenant.\(^{207}\) The alternative, contractarian argument would be that the court actually considered the Implied Covenant, but found that it had not been breached because the conduct in question did not violate the spirit of the agreement. However, when a court acts to define the spirit of the agreement by reference to one or more characteristics of the parties, an *Airborne*-type result is virtually inevitable because, in theory, sophisticated parties should be capable of drafting contracts that are substantially “complete.”

On one hand, the court made some plausible arguments—namely, that it would have been easy enough to draft an agreement that specifically obligated Airborne to expend resources, and that it was not for the court to intervene after-the-fact to save Squid Soap from a rational contract that was later affected by unforeseen business downturns. On the other hand, the court’s language begs the question: When the Implied Covenant is relevant in a certain situation, isn’t it usually the case that the parties could have included the disputed matter in their contract on explicit terms? Further, didn’t Squid Soap have a reasonable expectation that Airborne would actually expend resources in furtherance of the contract? It cannot be reasonably contended that Squid Soap entered into the agreement for the eventual return of its assets. Rather, it entered into the agreement to earn money, the bulk of which was to come from the earn-out when Airborne met the targets stipulated in the agreement.

The court’s emphasis on the sophistication of Squid Soap cuts both ways. Certainly, Squid Soap may have intended to agree to whatever was explicitly included in the contract—no more, and no less. However, perhaps it was precisely *because* Squid Soap was a sophisticated party that it assumed that the language of the agreement would be sufficient to induce Airborne to expend resources. If the latter is true, then the agreement

\(^{204}\) *Id.* (emphasis added).

\(^{205}\) *Id.* at 147–48.

\(^{206}\) *Id.* at 147.

\(^{207}\) *Id.*
would arguably come within the Implied Covenant’s “narrow band” under the theory that Airborne’s “duty” to expend resources and to make a good faith effort to market was consistent with the “purposes reflected in the express language of the contract.”

The influence of the “sophisticated parties” factor on the court’s analysis severely limits the general effectiveness of the Implied Covenant in cases where a court deems that one or more parties “should have known” to draft a more thorough, dispute-preventing agreement. The logic seems to unfold in the following way: (1) The Implied Covenant operates “where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but does not speak directly enough to provide an explicit answer.” (2) The Implied Covenant applies only when it is “clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach . . . had they thought to negotiate with respect to that matter.” (3) Sophisticated parties are more likely to negotiate matters thoroughly than non-sophisticated parties. (4) Courts should be hesitant about implying contractual protections, especially “when the contract easily could have been drafted to expressly provide for [these protections].” (5) If the parties are sophisticated, then they are more likely to be aware of the obligations that should be included in the agreement to protect their contractual expectations. (6) If certain obligations are not included in the agreement, then it is more likely than not that the parties, being sophisticated, did not intend for these obligations to attach at the time the agreement was signed.

Although the court did not view the Airborne–Squid Soap agreement as “irrational” or “unreasonable,” the outcome of the case itself suggests that the contract was risky at best and unwise at worst, especially for a party represented by reputable counsel. And, as Delaware cases have shown, Delaware courts will not intervene to mitigate the consequences of entering into unwise contracts.

Allied Capital Corp. v. GC–Sun Holdings, L.P. provides another

208 Id. at 146 (quoting Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P., 963 A.2d 746, 770 (Del. Ch.), aff’d, 976 A.2d 170 (Del. 2009)) (internal quotation marks omitted).

209 Id.

210 Id. (emphasis added) (quoting Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986)) (internal quotation marks omitted).

211 Id. (quoting Allied Capital Corp. v. GC–Sun Holdings, L.P., 910 A.2d 1020, 1035 (Del. Ch. 2006)) (internal quotation marks omitted).

212 See Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010).

213 Allied Capital, 910 A.2d 1020.
example of the “sophisticated party” factor in action. In that case, Allied sued GC (among other defendants), a limited partnership and one of Allied’s debtors, to collect on a promissory note. Allied claimed that, although the limited partnership itself was insolvent, it could have repaid Allied had GC’s general partner refrained from subordinating Allied’s claim on the promissory note to a new equity investment made by an affiliate of the general partner. In what the Delaware Chancery Court termed “a jurisprudentially-intergalactic campaign to recover on the note,” Allied brought no fewer than eight causes of action, including a claim for breach of the Implied Covenant, against a myriad of directly and remotely connected defendants.

The defendants successfully moved to dismiss. Faulting Allied for failing to secure certain substantive rights during the negotiation process, the court brushed off Allied’s Implied Covenant claim as “another in a long line of [unsuccessful Covenant] cases” in which plaintiffs attempt to make up for the consequences of certain contract drafting deficiencies. Allied alleged that it had been robbed of the fruits of the contract (repayment on the promissory note) because it had a reasonable expectation that no investments by the defendants would take priority over the note. Allied’s case was not helped by the fact that the promissory note explicitly forbade certain types of investments, but did not restrict the type of investment giving rise to Allied’s claim.

However, Allied may have had a cognizable argument based on its reasonable expectations. Allied argued that because the agreement prohibited unsubordinated debt investments, the agreement implied that unsubordinated equity investments (the type of investment made by the defendants) were also prohibited because otherwise, Allied would not have had any meaningful protection against “intentional evasions” of the debt-investment restriction. In other words, Allied relied on the implication that, because “equity by its very nature has a lower priority than debt,” the debt-investment restriction was the practical equivalent of an equity-investment restriction.

214 Id. at 1023.
215 Id.
216 Id. at 1023–24.
217 Id. at 1045.
218 Id. at 1024.
219 Id. at 1032.
220 Id. at 1024.
221 Id. at 1032.
222 Id. at 1031.
While it is unclear whether this argument would have withstood court scrutiny had the parties been unseasoned, it is clear that the fact that the sophistication of Allied and GP played a role in the court’s rejection of Allied’s Implied Covenant claim. Premising its analysis on the fact that the Implied Covenant is “intrinsically counterfactual and [prone to] hindsight-bias,” the court was unwilling to give Allied the benefit of the doubt because it had ample opportunity to negotiate for explicit contractual protections. One clear sign of the court’s lack of sympathy was its citation to *Shenandoah Life Insurance Co. v. Valero Energy Corp.*, 1988 WL 63491, at *8 (Del. Ch. June 21, 1988)—another case involving sophisticated business entities—for the proposition that where “a specific, negotiated provision [like the debt-investment restriction] directly treats the subject of the alleged wrong and has been found to have not been violated, it is quite unlikely that a court will find by implication [that] a contractual obligation of a different kind [like an obligation to refrain from equity investments] . . . has been breached.”

However, the “sophisticated party” analysis can be troublesome in the alternative-entity context. A court may assume that because the parties chose an alternative-entity structure for their enterprise, the parties are necessarily sophisticated. This assumption was illustrated by the Delaware Chancery Court’s language in *Abry Partners V, L.P. v. F & W Acquisition LLC*: “In the alternative entity context[,] . . . it is more likely that sophisticated parties have carefully negotiated the governing agreement . . . .” Courts may improperly assume sophistication among parties in alternative entities because these entities are riskier structures compared to the more “traditional” corporate and partnership forms which are supported by larger bodies of judicial precedent. However, empirical evidence does not support this assumption of sophistication—the vast majority of LLCs are created without much negotiation by parties that are not necessarily skilled contract drafters.

Would the outcome in *Airborne* have changed if the parties had not been sophisticated and represented by counsel from two top-notch law

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223 *Id.* at 1033 n.25.

224 *See Clancy v. King*, 954 A.2d 1092, 1100 n.14 (Md. 2008) (“Limited partnership agreements are more likely to be the result of extensive arm’s-length negotiations and thus involve business venturers in a better position to bargain for various terms . . . .”); *see id.* (“The fact that the present case deals with a limited partnership rather than a corporation provides even greater reason to defer [solely] to the provisions of the various contracts.”).


226 *See Sale*, *supra* note 128, at 457 (calling Delaware the “mother of all corporate law” jurisdictions).

firms? Clancy v. King involved a partnership dispute between divorcing spouses.\textsuperscript{228} Although Clancy is a Maryland Supreme Court case, it provides some useful insight regarding how a Delaware court might approach an Implied Covenant case in which the litigants are individuals rather than business entities.\textsuperscript{229} Clancy, a successful author, and his wife, King, each held a 1% general partnership interest and a 49% limited partnership interest in their book-franchise limited partnership.\textsuperscript{230} While the parties were still married, King obtained the right to manage the limited partnership through a court order.\textsuperscript{231} The partnership then entered into a joint venture and the joint venture acquired the rights to convert Clancy’s books into a television show and a series of paperback books.\textsuperscript{232}

The joint venture agreement stated that key decisions regarding the “development, use and exploitation” of the television show proposal would be made by Clancy and a third party, but that if they failed to agree, Clancy’s decision would control.\textsuperscript{233} When Clancy and King divorced, a marital property agreement was incorporated into the divorce decree.\textsuperscript{234} This agreement stated that Clancy would be the managing partner of the limited partnership, and that he would have the right to enter into contracts to exploit the literary assets of the joint venture.\textsuperscript{235}

After Clancy and King’s divorce was finalized, Clancy revoked his permission to the joint venture to use his name in marketing future books.\textsuperscript{236} As a result, the limited partnership’s share of the joint venture’s profits plummeted from 75% to 25%, thereby proportionately affecting King’s interest in the limited partnership.\textsuperscript{237} King sued Clancy, alleging breach of fiduciary duty.\textsuperscript{238} While the trial and intermediate appellate courts ruled in King’s favor, the Maryland Court of Appeals reversed.\textsuperscript{239}

\begin{itemize}
\item Clancy, 954 A.2d at 1095.
\item Maryland’s approach is similar to Delaware’s contractual approach to the Covenant when fiduciary duties have been modified. See id. at 1100–01. Further, the Clancy court cited multiple Delaware cases throughout its analysis. See generally id. at 1092–1115.
\item Id. at 1095.
\item Id. at 1099.
\item Id. at 1095 & n.3.
\item Id. at 1096 & n.6.
\item Id. at 1096 & n.5.
\item Id.
\item Id. at 1097.
\item Id. at 1097 n.8.
\item Id. at 1097.
\item Id. at 1111.
\end{itemize}
Like the Delaware courts, the court of appeals heavily focused its attention on the role of the limited partnership agreement and the joint venture agreement in governing the relationship between the parties, and largely disregarded the role of fiduciary duties. In the court’s view, fiduciary duties had been modified by the portions of the limited partnership agreement allowing the partners to compete with the partnership, and by the portions of the joint venture agreement giving Clancy final decisionmaking authority—provisions “that otherwise would be flagrant violations of common law and statutory fiduciary duties.”

However, the next step in the court’s analysis was to view Clancy’s conduct through the lens of the Implied Covenant. The court emphasized that Clancy had an obligation to exercise his discretion in good faith, and cited multiple cases standing for the proposition that the Implied Covenant assumes even greater importance in the context of discretionary decisionmaking. The issue was whether Clancy’s decision to withdraw permission to use his name was made in bad faith. The court stated that “[a] general or managing partner acts in bad faith where the primary motivation of his or her conduct is to injure either the firm/venture or his or her business partners.” While conceding that, as an artist, Clancy had the right to “seek to retain creative control over a project that bore his . . . name,” the court ultimately found that Clancy owed a duty of good faith, apart from fiduciary duties.

Although Clancy appears to lend more significance to the Implied Covenant than Delaware cases, this case does not necessarily provide a complete template for Delaware. For example, Clancy differs from Airborne because in Clancy, King did not have a real opportunity to prevent the arbitrary exercise of Clancy’s discretion. Clancy’s discretion could not have been subject to an “efforts” obligation—either Clancy would continue to grant permission to use his name or he would not. In contrast, Squid Soap could have obligated Airborne to either expend a certain amount of its resources in marketing Squid Soap’s products, or make a good-faith effort to market and advertise before returning the purchased assets to Squid Soap. And, whereas the parties in Allied could

240 Id. at 1102 n.18.
241 Id. at 1106.
242 Id. at 1107.
243 Id. at 1108.
244 Id. at 1106.
245 Id. at 1110. The case was remanded to determine whether Clancy had acted in good faith. Id.
246 But see Karen Eggleston et al., The Design and Interpretation of Contracts: Why Complexity Matters, 95
have drafted an express provision prohibiting equity investments, parties like those in *Clancy* are not likely to include an express provision prohibiting the arbitrary exercise of discretion, given that discretely defining “arbitrary” conduct in a contract would be impractical and would leave parties free to engage in potentially arbitrary conduct that was not explicitly listed.

*Clancy* also differs from *Airborne* and *Allied* because Squid Soap, Airborne, Allied and GC were sophisticated business entities that had ample opportunity to negotiate for contractual protections at arm’s length, whereas Clancy and King were individuals whose contractual relationship was intertwined with their disintegrating personal relationship, thereby giving Clancy a motive to harm King financially. In this respect, motivational considerations provide an independent basis for Implied Covenant analyses.


The motive underlying the actions giving rise to the complaining party’s claim plays a role in the outcome of Implied Covenant disputes. As a general matter, if the plaintiff can demonstrate (or even just suggest) that the defendant’s actions were spiteful or malicious, the plaintiff is more likely to prevail on his Implied Covenant claim. In contrast, if the defendant simply took an action that fell within the bounds of the agreement, or if the plaintiff’s injury was merely a consequence of the plaintiff’s entry into a “bad” contract, the plaintiff is less likely to prevail on his Implied Covenant claim.

For example, the general implication in *Clancy* was that the timing of Clancy’s withdrawal—after divorce proceedings—was indicative of Clancy’s potential bad faith and desire to harm King by reducing her profit share:

If a significant motive for Clancy exercising his contractual right to withdraw his name from the Op–Center series was to

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247 See, e.g., *Clancy*, 954 A.2d at 1108 (citing Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199 (Del. 1993)).

248 For example, in *Fisk Ventures, LLC* v. *Segal*, No. 3017–CC, 2008 WL 1961156, at *10–11 (Del. Ch. May 7, 2008), aff’d, 984 A.2d 124 (Del. 2009), the plaintiff essentially alleged that the mere exercise of a contractual right violated the Implied Covenant. This claim was swiftly rejected by the court. *Id.* at *11; see also *infra* Part IV.C (discussing *Fisk* in greater detail).
decrease the profitability of the series, thereby denying his JRLP partner and ex-wife revenue, because he desired to spite or punish King for or as a consequence of their divorce, it reasonably could be maintained that he acted in bad faith towards both the Op–Center Joint Venture and JRLP. One certainly breaches the promise of good faith owed in contract and as fiduciary in a partnership by working actively to decrease directly the profits of the business venture.249

The deteriorating marital relationship between the parties in Clancy clearly had an influence on the lens through which the court evaluated Clancy’s conduct because Clancy had a personal motive to harm the plaintiff.250 In this vein, the plaintiff is more likely to prevail under an Implied Covenant theory if he can support the conclusion that the contract must be interpreted more liberally to adequately protect the plaintiff—such as when the defendant has engaged in some egregious conduct that is far outside the bounds of the agreement. However, this is an extremely high bar for the plaintiff to meet.251

Delaware courts view a defendant’s conduct as arbitrary, unreasonable, or egregious, and therefore in violation of the Implied Covenant, when “the other contracting party is thereby disadvantaged and no legitimate interest of the party exercising the right is furthered by doing so.”252 In other words, if a plaintiff can only show that he was injured by the defendant’s conduct, this will not necessarily persuade a Delaware court to imply contractual protections. This is a major disadvantage of the Implied Covenant when it stands unaccompanied by fiduciary duties. Unlike in the fiduciary duty context, the Implied Covenant allows a fairly full range of self-interested behavior.253 Therefore, the “no legitimate interest” prong is necessary to differentiate permissible and impermissible conduct under the Covenant. If the defendant’s conduct disadvantages the plaintiff but helps the defendant in

249 Clancy, 954 A.2d at 1109.
250 See Sale, supra note 128, at 488 (positing that good faith inquiries necessarily raise issues regarding the parties’ motives).
251 See Gold, supra note 108, at 127–28 (“[B]arring egregious cases, such as unconscionability, fraud, or misappropriation of assets, contract doctrine mandates few restrictions on the discretion of nonfiduciaries.”).
253 See Ribstein, supra note 123, at 909 (“In contrast to fiduciary duties, the implied covenant enables contracting parties to act selfishly as long as this conduct is at least broadly consistent with the parties’ ex ante expectations based on the contract.”).
the process, then the defendant’s actions are presumably reasonable. It is only when the defendant disadvantages the plaintiff and does not legitimately benefit the defendant in the process that the court will consider getting involved under a narrow conception of the Implied Covenant. For example, in Clancy, the defendant’s refusal to allow his name to continue to be used not only reduced the plaintiff’s share of distributions, but it also impaired the general success of the business while failing to render any apparent benefit to the defendant.

3. Complexity of the Agreement or Governance Scheme.

Another important factor that can be gleaned from Implied Covenant decisions is the nature of the agreement or the structure that is sought to be established by the agreement. If either of these elements is particularly complex, the complaining party is less likely to prevail under an Implied Covenant theory. According to the Delaware Chancery Court, “Delaware courts rightly employ the implied covenant sparingly when parties have crafted detailed, complex agreements, lest parties be stuck by judicial error with duties they never voluntarily accepted.”

For example, Lonergan v. EPE Holdings LLC addressed an Implied Covenant claim in a class action brought by a unitholder in a master limited partnership (“MLP”). The plaintiff challenged a proposed merger between Enterprise GP Holdings (“Holdings”) and Enterprise Products Partners L.P. (“Partners”) because Holdings was the sole owner of Partners’ general partner. For this reason, the plaintiff alleged conflicts of interest and certain disclosure violations. Holdings and Partners were both MLPs, creating a two-tiered structure in which (1) Partners’ distributions would trigger Holdings’

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254 For example, see Nemec, 991 A.2d at 1127–28, where the court opted to avoid “moral questions” based on the appearance of the defendant’s actions, and stated that the “directors made a rational business judgment to exercise the Company’s contractual right for the $60 million benefit.” Notably, this language is similar to that found in cases applying the business judgment rule—a standard of review that is used in breach of fiduciary duty cases. See supra notes 59–62 and accompanying text. However, the Nemec court had already foreclosed the application of fiduciary duties because the plaintiff’s claims arose from the contractual right to redeem. See Nemec, 991 A.2d at 1129. This is another example of Delaware’s reversion to fiduciary duty principles in contractual inquiries. See also supra text accompanying notes 89–99.


256 Lonergan v. EPE Holdings, 5 A.3d 1008, 1011 (Del. Ch. 2010).

257 Id.

258 Id.
incentive distribution rights ("IDRs") and generate a certain percentage of Partners’ distributions as cash for Holdings, and (2) Holdings would then distribute this cash to its unitholders. Because the IDRs were directly linked to the performance of Partners, Holdings had an incentive to manage Partners in a way that would increase the cash available for distribution to Holdings’ unitholders and attract investors.

The complexity of the facts underlying the plaintiff’s claim was not lost on the Delaware Chancery Court. According to the court, the two-tiered Holdings–Partners structure “create[d] a web of conflicts” that Holdings had to unwind in order to legitimize the proposed transaction before it was approved. Holdings’ general partner’s member interests were solely owned by an LLC whose member interests were owned by three voting trustees. These trustees, through control of a closely-held corporation that owned the majority of Holdings’ outstanding units, controlled the entire two-tier Holdings–Partners structure.

The trustees also occupied positions on Holdings’ general partner’s eight-person board of directors. Another member of the board had served in various executive capacities at the closely-held corporation owned by the trustees. Only the remaining half of the board was facially disinterested. Before the proposed merger was considered, an audit committee was created and one of the three trustees was replaced with a disinterested board member. The merger would have eliminated the second tier by cancelling Holdings’ interests in Partners. With the counsel of a reputable legal team and the financial advice of Morgan Stanley, and with the power to approve or reject the transaction resting solely with the independent audit committee, the proposed merger was approved.

The plaintiff brought an Implied Covenant claim based on the conflicting interests of the merging parties, alleging that the proposed

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259 Id. at 1012.
260 Id.
261 Id. at 1013.
262 Id.
263 Id.
264 Id.
265 Id.
266 Id. at 1013–14.
267 Id. at 1014.
268 Here, notice the overlap between the “complex agreement or governance scheme” and “sophisticated parties” factors.
269 Lonergan, 5 A.3d at 1015.
merger should not have been approved until a majority of Holdings’ minority unitholders had also approved the transaction. The court rejected the plaintiff’s claim, and this rejection may have had some connection to the complexity of the agreement.

To illustrate, the logic underlying the “complexity factor” is somewhat similar to the logic underlying the “sophistication of the parties” factor: (1) The Implied Covenant operates “where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but does not speak directly enough to provide an explicit answer.” (2) The Implied Covenant applies only when it is “clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach . . . had they thought to negotiate with respect to that matter.” (3) Parties to a “simple” LLC agreement, may not engage in extremely detailed contract drafting because they may either expect the probability of a dispute to be low, or they may fail to anticipate the myriad of ways that a dispute could arise. However, parties who are either drafting a particularly complex agreement, or drafting an agreement creating a particularly complex governance structure, are more likely to have thought through and negotiated for the contractual provisions that, in their respective views, would best protect their interests in light of the intricate nature of their prospective relationship. (4) Courts should be hesitant about implying contractual protections, especially “when the contract easily could have been drafted to expressly provide for [these protections].” (5) If certain obligations are not included in the agreement, then it is more likely than not that the parties did not intend for these obligations to attach at the time the agreement was signed.

In sum, a plaintiff is not likely to be successful on an Implied Covenant claim because the Covenant covers very little territory under Delaware’s contractarian approach, especially when the parties are sophisticated, when the defendant does not exhibit a personal motive for harming the plaintiff, or when the agreement at issue is complex. The
following section discusses why a plaintiff’s chances of success are even slimmer when the parties have contractually eliminated fiduciary duties.277

C. The Failure of the Nested-Sphere Model in Delaware in the Context of Fiduciary Waivers

When parties have eliminated fiduciary duties or have opted to make an Implied Covenant claim instead of a breach of fiduciary duty claim, the Delaware Chancery Court has indicated that especially extreme hesitancy to find that a party has breached the Implied Covenant is warranted, without exception for situations that would appear to deny the complaining party the benefits of the contract.278 This hesitancy has skewed the natural operation of the nested-sphere model by shrinking the scope of the Implied Covenant.279 Therefore, parties should take care not to rely solely on the Implied Covenant to fill in when fiduciary duties have been eliminated, especially when their particular situation involves the factors contributing to Delaware’s restrictive approach to the Covenant.280

Lonergan clearly lends credence to this warning because it does more than clarify the role of contractual complexity in Delaware’s narrow reading of the Implied Covenant. This case is also critical because it involves an Implied Covenant claim following an express fiduciary opt-out. In the Delaware Chancery Court’s first paragraph analyzing the plaintiff’s Implied Covenant claim, the court noted that “the complaint contain[ed] the types of allegations commonly advanced by stockholder plaintiffs when challenging a merger involving a corporation” and that, presumably, “[i]n such a pleading, the plaintiff [will] assert[] claims for breaches of fiduciary duty.”281

Here, the court suggested the following: If the plaintiff cannot allege the breach of a fiduciary duty, then the plaintiff will not prevail under another theory if the plaintiff’s claim mirrors that of other plaintiffs who have sued successfully under fiduciary theories. With this suggestion in mind, the plaintiff’s claim was greatly disadvantaged by the fact that Holdings’ limited partnership agreement completely eliminated fiduciary duties—in the court’s view, the plaintiff had not sufficiently alleged bad

277 See infra app. D.
279 See infra app. D.
280 See supra Part IV.B (analyzing these factors in detail).
281 Lonergan v. EPE Holdings, 5 A.3d 1008, 1016 (Del. Ch. 2010).
faith within the framework of the limited partnership agreement.  

Separating the court’s reasoning from the merits of the court’s ultimate decision, observe the language of the court which strongly indicates that a fiduciary opt-out should cause the scope of the Implied Covenant to narrow even further:

When parties exercise the authority provided by the LP Act to eliminate fiduciary duties, they take away the most powerful of a court’s remedial and gap-filling powers. As a result, parties must draft an LP agreement as completely as possible, and they bear the risk of incompleteness. If the parties have agreed how to proceed under a future state of the world, then their bargain naturally controls. But when parties fail to address a future state of the world—and they necessarily will because contracting is costly and human knowledge imperfect—then the elimination of fiduciary duties implies an agreement that losses should remain where they fall. After all, if the parties wanted courts to be in the business of shifting losses after the fact, then they would not have eliminated the most powerful tool for doing so.

This language is extremely significant because it eliminates the possibility of loss reallocation under the Implied Covenant when fiduciary duties are waived for two reasons. First, the court imposed an additional burden on parties to draft a complete agreement to avoid bearing the risk of incompleteness. However, the court then predicted the failure of this endeavor, stating that parties will “necessarily” be unable to address all future contingencies. Second, the court rejected the notion that parties can separate fiduciary duties from the Implied Covenant and obtain protection from the latter after eliminating the former.

Under Lonergan, once the parties significantly alter or eliminate fiduciary duties, this action operates as a signal that the Implied Covenant no longer holds remedial significance for the parties. This signal then appears to play a role in how courts will interpret contracts at issue.

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282 Id. at 1016–17, 1021–22.
283 Id. at 1018.
Unfortunately, however, this signaling effect can cause courts to improperly fuse fiduciary duty and the Implied Covenant, resulting in an “all-or-nothing” approach where one obligation cannot be modified without proportionally affecting the other.286

Although the Implied Covenant is a matter of statutory law in Delaware, Lonergan essentially allows the parties to control the effectiveness of the Covenant by the manner in which they address fiduciary duties. Thus, the problem with the nested-sphere model reveals itself. While, in theory, the parties should be able to remove the outer layer of fiduciary duty without compromising the inner core of the Implied Covenant,287 in reality, Lonergan suggests that the remedial importance or “accessibility” of the Implied Covenant can be altered by courts based on the parties’ alteration of fiduciary duties in the contract.288 Instead of “peeling away” fiduciary duties and leaving the Implied Covenant untouched, Lonergan exerts inward pressure on the Covenant’s inner sphere, thereby reducing the Covenant’s already narrow scope even further until the conduct complained of no longer falls within the Covenant’s territory.289

Lonergan suggests that if the parties severely reduce the scope of fiduciary duties, then the Implied Covenant would theoretically apply only to egregious conduct that violates the essence of the agreement.290 However, if the parties eliminate fiduciary duties altogether, then the Implied Covenant will retain little to no residual significance in a court’s view because the parties will have failed to retain the strongest tools available to courts to save one party from the commercial misconduct of another.291 In other words, the Delaware courts will not help those who do not help themselves—if the parties choose to eliminate the courts’

286 E.g., Douzinas v. Am. Bureau of Shipping, 888 A.2d 1146, 1149–50 (Del. Ch. 2006) (“[I]n the alternative entity context, it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would be, under default law, a fiduciary relationship.”). This proposition suggests that the governing instrument can have an impact on fiduciary duty inquiries, and vice versa.

287 See infra app. C.

288 See Gold, supra note 108, at 153 (arguing that a precisely tailored fiduciary waiver allows courts to better determine whether the conduct at issue falls within the Implied Covenant’s boundary).

289 See infra app. D.

290 See Steele, supra note 88, at 30; cf. Sale, supra note 128, at 485 (noting that only “egregious or conspicuous” conduct may be subject to liability under a fiduciary conception of good faith). As mentioned previously, however, such claims could likely be framed as fiduciary duty claims. See supra notes 136–39 and accompanying text.

291 Ribstein, supra note 123, at 900 (classifying the duty of good faith and fair dealing as a “lesser” duty).

Interestingly, while the standard for fiduciary waiver is fairly strict (presumably to ensure that the parties are aware
most effective method of regulating the parties’ relationship, then the courts will lose sympathy for the plaintiff who attempts to use the Implied Covenant as a means of imposing liability for conduct that could otherwise have been addressed under a fiduciary analysis. Given Delaware courts’ comfort with the well-established fiduciary duty framework, and given their historical “tendency to default to . . . fiduciary duty principles,”292 this phenomenon may be all the more acute.293

The history of Delaware’s good faith jurisprudence sheds some light on this tendency. The Delaware Supreme Court first identified the duty of good faith as an independent fiduciary duty in Cede & Co. v. Technicolor Inc.294 Strangely, the court did not discuss why the good faith duty was worthy of elevation to the status of a fiduciary duty when previous cases merely referenced good faith as the absence of bad faith (where bad faith was limited to tortious or borderline-tortious conduct).295 Regardless, because Delaware has a history of classifying good faith as either a fiduciary duty or a subset of the fiduciary duty of loyalty,296 it is not surprising that Delaware courts would take the view that an agreement eliminating fiduciary duties is practically equivalent to a hypothetical agreement that eliminates good faith requirements.

So, what exactly is the purpose of the Implied Covenant when parties eliminate fiduciary duties? If parties retain traditional fiduciary duties in an LLC agreement, for example, then reliance on the Implied Covenant is unnecessary—a court can simply use a fiduciary duty analysis to allocate losses. Revisiting the nested-sphere model, because fiduciary duties impose liability for a broader range of conduct than the Implied Covenant, conduct violating the Implied Covenant would also violate traditional fiduciary duties. This is a factor that makes fiduciary duties attractive to Delaware courts—fiduciary duties are relatively easy to apply because they cover broad territory, and because the fiduciary rubric is of what they are waiving), once this standard is met, Delaware courts are not hesitant to eliminate the significance of the Implied Covenant. See, e.g., Auriga Capital Corp. v. Gatz Properties, 40 A.3d 839, 853 (Del. Ch. 2012).

292 Steele, supra note 88, at 17.
293 See supra notes 86–98 and accompanying text.
294 Cede & Co. v. Technicolor Inc., 634 A.2d 345 (Del. 1993); Steele, supra note 88, at 29.
295 Steele, supra note 88, at 29.
296 E.g., Cede, 634 A.2d at 361; In re Gaylord Container Corp. S’holders Litig., 753 A.2d 462, 475 n.41 (Del. Ch. 2000). Delaware courts have not taken into account the fact that one can act loyally and in bad faith simultaneously. Sale, supra note 128, at 484. There is not necessarily an overlap between the duty of loyalty and the duty of good faith. For example, a disinterested fiduciary can approve a transaction that no other person would have approved in good faith, or can act with “deliberate indifference” without the presence of a conflict of interest. Id. In both situations, the fiduciary’s good faith is implicated although his loyalty is not. Id.
well-cemented in Delaware jurisprudence. Fiduciary characterizations assist courts not necessarily because they assume the total lack of self-interest of the parties, but because they allow the court to assess whether the parties “subordinate[d] their immediate self-interest to their long-term collective interest.” Without such an assessment, a court can determine that an LLC is no longer a “vehicle[ ] for the collective pursuit of long-term, individual, self-interest” (requiring at least some consideration for the interests of the other parties). Rather, the LLC would become a vehicle for the individual pursuit of long-term, individual, self-interest akin to an extended series of discrete, arms-length transactions (requiring little to no consideration for the interests of the other parties). Therefore, it seems that the Implied Covenant is practically inaccessible in Delaware, whether or not the parties choose to eliminate traditional fiduciary duties.

This inaccessibility can trigger significant consequences because while LLCs arise from contracts, they are also highly relational entities characterized by complex, fluid, long-term relationships. Therefore, LLC operating agreements devoid of fiduciary duties potentially pose difficulties in situations where the Implied Covenant is no longer sufficient to meet the changing expectations of the parties. While, in theory, the nested-sphere model is applicable in Delaware via DLLCA, the way in which the Delaware courts subscribe to this model creates the potential for results that could not be predicted by the model in its unaltered form.

Notably, the Lonergan court observed that, unlike discrete transactions, relational contracts can be renegotiated if the parties are

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297 See generally Manesh, supra note 6 (discussing the benefits of entity formation in Delaware).
298 Vestal, supra note 7, at 550 (discussing fiduciary duties in the partnership context).
299 Id. (emphasis added); see also Callison & Vestal, supra note 149, at 304 (“[P]articipants only join [a] firm if they expect their long-term self-interest . . . to be maximized.”).
300 See Kleinberger, supra note 154, at 22 (noting that in jurisdictions that take the contractual approach to the Implied Covenant, “contractual permission to compete with the LLC as a business mean[s] (implicitly) that the members [are] at arm’s length”); see also Clancy v. King, 954 A.2d 1092, 1100 n.13 (Md. 2008) (“A limited partnership is essentially . . . a series of contracts.”); Vestal, supra note 7, at 524 (discussing the partnership context, and contending that under the contractarian view, “the partnership relation is simply a shorthand for a bundle of mutable contractual rights and obligations”).
301 See Gold, supra note 108, at 153 (“[T]here is uncertainty as to precisely when an implied good faith term will preclude conduct otherwise covered by fiduciary duties.”).
302 See Miller, supra note 12, at 740–41; Miller, supra note 30, at 607.
303 DLLCA is designed to give independent effect to retained fiduciary duties and the Implied Covenant. See Del. Code Ann. tit. 6, §§ 17-1101(d), 18-1101(c) (2005).
304 Compare infra app. C, with infra app. D.
unsatisfied with where economic losses will fall under their existing agreement. This is certainly true. However, given that the majority of long-term contracts are incomplete contracts, these contracts will likely remain incomplete, even after renegotiation. Because the Implied Covenant is a gap-filling tool, and because LLCs mainly consist of gaps when viewed contractually, the Implied Covenant is critical. It is doubtful that a single renegotiation will resolve the fundamental problem, which is Delaware’s consistently hesitant approach to the Implied Covenant, and its increased reluctance to trigger the Covenant when fiduciary duties are waived. The only truly effective renegotiation would be one involving the reinstatement of fiduciary duties to govern the parties’ relationship. Anything less would merely increase both parties’ transactions costs without proportionally increasing the protection of either party.

D. Fisk Ventures, LLC v. Segal: The LLC-Specific Implied Covenant Case That Is the Exception, Not the Rule

There is limited Delaware case law directly addressing the fiduciary

305 Lonergan v. EPE Holdings, 5 A.3d 1008, 1018 & n.4 (Del. Ch. 2010).
307 See Easterbrook & Fischel, supra note 14, at 426–27 (“When the task is complex, when efforts will span a substantial time, ... a detailed contract would be silly.”); cf. Charles R. O’Kelley, Jr., Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis, 87 NW. U. L. Rev. 216, 216 (1992) (making this argument in the context of closely-held corporations); Weinher, supra note 50, at 82 (“[I]ndividuals rarely ‘bargain’ as equals for partnership agreements that completely define their relationship. The law should assume that the completely defined partnership relationship is the exception rather than the norm.”).
308 Mkt. St. Assocs. Ltd. P’ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (stating that the doctrine of good faith is designed to minimize performance costs and advance the mutual goals of the parties).
309 Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (warning that the application of the Implied Covenant should be a “cautious enterprise”).
310 See Easterbrook & Fischel, supra note 14, at 427 (“The duty of loyalty replaces detailed contractual terms.”); see also Morey W. McDaniel, Bondholders and Corporate Governance, 41 Bus. Law. 413, 447 (1986) (arguing that “[f]iduciary duties are a substitute for costly contracts.”); Miller, supra note 30, at 606 (arguing that prohibiting the elimination of fiduciary duties would be best to protect contractual freedom while guarding against opportunistic conduct). Especially in light of Delaware’s restrictive approach to the Implied Covenant, a contract retaining fiduciary duties would be a more efficient choice than a contract that would be subject to a constant and costly cycle of dispute and renegotiation. See Eggleston et al., supra note 246, at 120 (contending that simple contracts are beneficial in reducing enforcement costs and the risk of improper judicial interpretation).
311 See Means, supra note 306, at 1189 (noting that transactions costs limit parties’ ability to rectify contractual gaps).
duty—Implied Covenant relationship in the LLC context. Fisk Ventures, LLC v. Segal is Delaware’s current template for addressing the Implied Covenant in light of a fiduciary opt-out in the LLC context. In that case, Fisk Ventures LLC was a member of Genetrix LLC, a company with an extended history of fundraising difficulties. The Genetrix LLC agreement eliminated fiduciary duties and required the approval of 75% of the Genetrix board of directors to implement certain financing proposals. Segal, the president of Genetrix, presented certain financing proposals to the Genetrix board, but failed to obtain the requisite 75% vote of approval.

When Fisk Ventures attempted to dissolve Genetrix, Segal responded by alleging, among other things, that Fisk breached its fiduciary duty as well as the Implied Covenant by undermining Segal’s proposal for Genetrix. The Delaware Chancery Court swiftly rejected Segal’s claims in light of the LLC agreement, under which Genetrix’s board members could freely vote in favor or against Segal’s (or any individual’s) financing proposals. According to the court, the mere exercise of contractual rights could never constitute a bad faith violation of the Implied Covenant. Rather, the court maintained that Segal failed to state a claim by making the conclusory allegation that the board had acted in bad faith by failing to approve Segal’s plan. The Delaware Supreme Court later affirmed the chancery court’s ruling.

If there was any lingering confusion regarding the limited scope of the Implied Covenant under Delaware law, the chancery court eliminated it:

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312 Robert R. Keatinge et al., Limited Liability Entities—2005 Developments in Limited Liability Companies and Limited Liability Partnerships, ALI–ABA VIDEO L. REV. (March, 17, 2005) (“It cannot be stated with confidence how the Delaware courts will interpret the limitation imposed by [DLLCA] section 18-1101(e) that waivers of fiduciary duties may not extend to bad faith violations of the covenant of good faith and fair dealing.”); Manesh, supra note 6, at 244 (noting that the tension between fiduciary duties and the Implied Covenant have planted the “latent seeds of indeterminacy” in Delaware LLC law); Scott Gordon Wheeler, Comment, LLC Fiduciaries: Where Has All the Good Faith Gone?, 59 U. KAN. L. REV. 1063, 1074 (2011).


314 Id.

315 Id. at *2, *11.

316 Id. at *5–6.

317 Id. at *6.

318 Id. at *2, *10–11.

319 Id. at *11.

320 Id.

Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact it is clear that a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter. Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was actually bargained and negotiated for in the contract. Moreover, because the implied covenant is, by definition, implied, and because it protects the spirit of the agreement rather than the form, it cannot be involved where the contract itself expressly covers the subject at issue.322

The court’s language begs the question of whether the Implied Covenant has been reduced to a mere formality. It would certainly appear so, given the court’s language.

However, it is clearly poor strategy for a litigant to claim that conduct breached either fiduciary duties or the Implied Covenant when that conduct was well within the scope of conduct allowable under the LLC agreement, especially when the agreement eliminated fiduciary duties.323 In the context of the nested-sphere model, there is nothing exceptional about the Fisk decision. Rather, the outcome in Fisk was unremarkable given the weakness of Segal’s counterclaim—Segal was improperly attempting to use a bad faith allegation to avoid the LLC agreement and to obtain unilateral control over the direction of Genetrix’s financing.324

Therefore, Fisk is entirely outside the bounds of the nested-sphere model, and is an exception to this Article’s observations regarding the two effects of Delaware Covenant law on the nested-sphere model—the
Covenant’s initially narrow scope and its reduced scope after a fiduciary waiver. First, *Fisk* is outside the bounds of this Article’s previous discussion of the factors influencing Delaware’s narrow view of the Implied Covenant. Although the parties in *Fisk* could accurately be portrayed as sophisticated, this factor did not appear to have any effect on the court’s decision. In fact, the claim was bound to fail regardless of the Implied Covenant’s initial scope. Revisiting the nested-sphere model and disregarding the parties’ fiduciary waiver, the mere exercise of explicitly-granted contractual rights fails to give rise to an action for breach of the Implied Covenant.325

Second, *Fisk* appears to be the exception to the “Lonergan rule” because the *Fisk* decision did not condition loss allocation under the Covenant on the parties’ treatment of fiduciary duties. In other words, the conduct at issue fell within a range of permissible conduct, necessarily precluding a breach of fiduciary duty claim.326 No alteration of the model was necessary to achieve this result, even though the parties eliminated fiduciary duties. In contrast, the *Lonergan* court did not say that the plaintiff’s claim would have failed under a fiduciary duty analysis. Therefore, while the *Lonergan* court’s interpretation of the effect of a fiduciary waiver on the Implied Covenant can be categorized as a major alteration of the nested-sphere model, the *Fisk* court’s interpretation of the same waiver cannot be similarly categorized.

However, parties relying solely on the Implied Covenant should not overfocus on the specific facts of *Fisk*—taken together, the rule in *Lonergan* combined with the chancery court’s language in *Fisk* are indicative of Delaware’s likely future approach to the Implied Covenant in the LLC context.

V. DELAWARE IS SET TO TAKE THE WRONG APPROACH TO THE IMPLIED COVENANT IN THE LLC CONTEXT

Undoubtedly, it *should* be more difficult to prevail under the Implied Covenant than fiduciary duties. Otherwise, every contractual relationship would be a fiduciary relationship, and vice versa. However, the Covenant must be given some meaning independent of fiduciary duties. Otherwise, the elimination of fiduciary duties risks leaving parties completely unprotected from the opportunistic behavior of their fellow parties.327

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325 See infra app. A.
326 See *Fisk*, 2008 WL 1961156, at *11.
327 In this respect, an approach to the contractual Covenant that considers a certain degree of fairness is
An agreement that relies solely on the Implied Covenant provides little by way of analogy to partnership and corporate law—two arenas in which Delaware courts have enjoyed considerable comfort. This is precisely where the problem arises with Delaware’s approach arises. As mentioned previously, Delaware’s corporate law paradigm has historically conflated the duty of good faith and the fiduciary duty of loyalty. However, at least in the corporate context, the duty of loyalty cannot be eliminated, meaning that, even in a jurisprudential regime that conflates the two obligations, the duty of good faith can never be eliminated. Therefore, there is no practical need to distinguish between fiduciary duties and the duty of good faith under Delaware corporate law. In contrast, Delaware’s alternative-entity paradigm allows fiduciary duties to be completely eliminated, while by statute, the Implied Covenant cannot be eliminated. Therefore, there is a need to distinguish the Covenant from fiduciary duties in this context.

As the following sections discuss, while Delaware courts addressing Covenant claims purport to consider the contemplations of the parties during the negotiation and drafting processes, their failure to consider the Covenant independently of fiduciary duties leads these courts to neglect parties’ reasonable, post-agreement expectations in deciding whether to trigger the Covenant. This approach is especially problematic after the parties have opted out of fiduciary duties. Further, this approach does not properly accommodate average LLCs, which are typically formed without extensive negotiation.

A. The Consequences of Favoring Party Contemplations over Party Expectations in an Implied Covenant Inquiry

Delaware requires the parties to contemplate—but fail to express—a resolution to the matter in dispute before the Implied Covenant can apply. To the extent that it is impossible for parties to “negotiate and preferable. See, e.g., Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (Del. 2005) (“[A]lthough the obligation of good faith does not require the insurer to relieve the insured of all possible harm that may come from his choice of policy limits, it does obligate the insurer not to take advantage of the unequal positions in order to become a secondary source of injury to the insured.” (internal quotation marks omitted)).

328 See Cede & Co. v. Technicolor Inc., 634 A.2d 345, 361 (Del. 1993); supra text accompanying notes 294–96.
330 See tit. 6, § 18–1101(c).
describe within their contract all of the possible provisions that could be included,"\textsuperscript{332} this requirement is justifiable. However, while all long-term contracts are incomplete to some extent,\textsuperscript{333} Delaware court treatment of the Implied Covenant creates a perverse incentive to draft contracts that are “uncomfortably” incomplete: To successfully make an Implied Covenant claim, the parties must have entered an agreement that is silent on a matter that they clearly contemplated and could have expressed,\textsuperscript{334} but they must not have entered an agreement that will be deemed “intentionally silent,” in which case the Covenant will not apply at all.\textsuperscript{335}

However, if the parties clearly contemplated a matter, it would seem that the matter contemplated would be the most likely to be actually included in the contract, and that Implied Covenant protection would therefore be unnecessary. So why are Delaware courts seemingly willing to reward parties with the protection of the Implied Covenant for drafting “half-baked” contracts that fail to mention basic matters that are within the parties’ contemplation? Arguably, the matters that should be the subject of the Implied Covenant are those that are just outside of the parties’ contemplations, but are within the realm of the parties’ reasonable expectations.

Instead, in applying Implied Covenant analyses, Delaware courts have neglected the reasonable expectations of the parties in favor of the parties’ unexpressed contemplations.\textsuperscript{336} The Delaware Chancery Court illustrated this phenomenon in \textit{Danby v. Osteopathic Hospital Ass’n of Delaware},\textsuperscript{337} a case that was later affirmed by the Delaware Supreme Court:

\begin{quote}
The law will imply an agreement by the parties to contract and to do and perform those things which according to reason
\end{quote}


\textsuperscript{333} Cf. O’Kelley, Jr., supra note 306 (closely-held corporation context); Weidner, supra note 50, at 82 (partnership context).


\textsuperscript{335} See Dave Greytak Enters. v. Mazda Motors, 622 A.2d 14, 23 (Del. Ch. 1992).

\textsuperscript{336} See generally Means, supra note 305 (arguing that contractarian theory does not protect party expectations as well as the application of equitable contract principles).

\textsuperscript{337} Danby v. Osteopathic Hosp. Ass’n of Del., 101 A.2d 308 (Del. Ch. 1953), aff’d, 104 A.2d 903 (Del. 1954).
and justice they should do in order to carry out the purpose for which the contract is made. However, such promise can be implied only where it can be rightfully assumed that it would have been made if attention had been directed to it. A promise will not be read into a contract unless it arises by necessary implication from the provisions thereof. Terms are to be implied in a contract not because they are reasonable but because they are necessarily involved in the contractual relationship so that the parties must have intended them and have only failed to express them because they are too obvious to need expression.338

This language suggests that when parties contemplate terms, they can get the protection of the Implied Covenant when they stop short of including explicit evidence of their contemplation in their agreement, so long as the matter contemplated is sufficiently obvious.339 However, by stating that “[t]erms are [not] to be implied in a contract . . . because they are reasonable,” the court suggested that the Implied Covenant will not protect expectations that were not contemplated, that were non-obvious, or that arose after the agreement was complete, even if it would be reasonable to do so.340 This reasoning is necessarily incomplete because it fails to consider certain unique instances in which the Implied Covenant should be triggered—such as when parties form expectations without contemplating the precise instances in which those expectations will be undermined.

Cincinnati SMSA v. Cincinnati Bell Cellular Systems Co.341 illustrates the consequences of this approach. In Cincinnati, the parties formed a limited partnership for the purpose of providing one type of cellular service.342

338 Id. at 313–14 (emphasis added) (citations omitted).
339 There is a separate argument here that if an issue or term is sufficiently obvious, there is no need to contemplate it in the first place.
340 Lonergan cited Dunlap (an insurance torts case discussed supra Part III.B.1) for the proposition that “[i]mplying contract terms is an occasional necessity . . . to ensure [that] parties’ reasonable expectations are fulfilled.” Lonergan v. EPE Holdings, 5 A.3d 1008, 1018 (Del. Ch. 2010) (second alteration in original) (quoting Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005)) (internal quotation marks omitted). As discussed supra Part III.B, using language from tort cases while taking a contractual stance in an Implied Covenant inquiry is problematic. Because a contractual approach does not consider fairness, it can be concluded that Delaware courts would view the consideration of the parties’ reasonable expectations—a standard imported from the tort context—as unnecessary and irrelevant in a contract case. In other words, Lonergan’s citation to Dunlap implies that the “occasional necessity” to trigger the Covenant to protect reasonable expectations only arises in the tort context.
342 Id. at 991.
The limited partnership agreement contained a noncompete clause prohibiting the parties from providing any competing services within the FCC’s existing two-license framework. The plaintiff sued for breach of the Implied Covenant based on the defendant’s provision of a new type of cellular service that was not included in the noncompete clause (because the new type of service did not exist at the time of the limited partnership agreement), but which resulted in competition with the plaintiff.

The Delaware Supreme Court affirmed the chancery court’s ruling that the competing partner did not breach the Implied Covenant on the grounds that the competitive conduct was not covered under the limited partnership agreement. However, when the limited partnership agreement at issue was drafted, the complaining party could not have anticipated that a new type of cellular service—one falling outside of the FCC’s licensing framework available at the time of the agreement—would serve as a means for the other party to compete with the partnership in spite of the agreement’s noncompete clause. Therefore, the new form of cellular service could not truly be classified as “too obvious to need expression.” This is the “contemplation” prong of the analysis that caused the Cincinnati court to decline to trigger the Implied Covenant to prevent the competing partner from continuing to offer the competitive cellular service.

But what about the role of reasonable expectations? In Implied Covenant cases, courts “must extrapolate the spirit of the agreement

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343 Id.

344 Id. In Cincinnati, it was not apparent whether or not the parties had retained, modified, or eliminated fiduciary duties in their agreement. On one hand, it could be argued that the noncompete clause merely reinforced the duty of loyalty. On the other hand, it could be argued that the inclusion of the clause indicated that the duty of loyalty had been modified to cover only the matters included in the clause. However, this point is not critical to the analysis in this section because not only must fiduciary waivers be express, see supra note 119 and accompanying text, but also the plaintiff did not bring a breach of fiduciary duty claim against the defendant for competing with the limited partnership. As shown in Appendix B, a fiduciary duty of loyalty claim could have substituted for the Implied Covenant claim in Cincinnati. See infra app. B. However, if a party chooses not to bring a fiduciary duty claim when such a claim is available to them, then this is the functional equivalent of a situation in which the parties eliminated fiduciary duties. See infra app. D. Therefore, in light of Lonergan, the outcome in Cincinnati presumably would have been the same, with or without a fiduciary waiver, due to Lonergan’s conflation of fiduciary duties with the Covenant.

345 Cincinnati, 708 A.2d at 994.

346 See id. at 991. Here, an approach to the Covenant that incorporates fairness considerations is preferable, because it uses the Covenant as a tool to imply contractual terms in light of “unanticipated developments.” See Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005) (“The covenant is ‘best understood as a way of implying terms in the agreement,’ whether employed to analyze unanticipated developments or to fill gaps in the contract’s provisions.”).
through the express terms and determine the terms that the parties would have bargained for to govern the dispute had they foreseen the circumstances under which their dispute arose.”347 However, the Cincinnati court failed to independently include the expectations of the complaining party in its analysis. Prevention of competition was the fundamental purpose of the Cincinnati noncompete clause. By restricting all existing methods of providing competing services at the formation of the partnership, the complaining party clearly had a reasonable expectation that the other party would not compete with the partnership. Therefore, it is reasonable to conclude that had the new form of competition existed during negotiations, the parties would have included it in the noncompete clause. It cannot be logically contended that the complaining party—by signing an agreement that prohibited cellular service under the two-license framework in existence at the time of the agreement—was granting permission to the other party to compete with the partnership in the future by using a new form of competition that had not been conceived when the agreement was signed. However, this is essentially the proposition that was suggested by the court’s decision.

It is often noted that the Implied Covenant cannot be used to override one or more express contractual provisions.348 Does this restriction justify the outcome in a case like Cincinnati? The answer depends on what it means to “override” a contractual provision. A contractualist would say that any attempt to impose liability under the Implied Covenant for conduct falling outside the bounds of the noncompete clause would constitute an improper override. This is the strict contractual approach that was taken by the Cincinnati court. On the other hand, there is an argument that implying a general covenant not to compete would not have overridden the noncompete clause, but rather would have been complementary to the contractual provision that was already in place. This is an argument supporting a broader reading of the Implied Covenant’s role.349 In this respect, Cincinnati is unique because, although the parties addressed the issue of competition in their agreement, the timing of their

349 See Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (2005) (“[T]he implied covenant of good faith is the obligation to preserve the spirit of the bargain rather than the letter, the adherence to substance rather than form. . . . It requires more than just literal compliance with [contracts] and statutes. The implied covenant of good faith and fair dealing requires that [one party] act in a way that honors the [the other party’s] reasonable expectations.” (citation omitted) (internal quotation marks omitted)).
agreement prevented them from foreseeing and addressing the type of competition that would give rise to their future dispute.

Not all courts are quite as strict as Delaware courts are when applying (or failing to apply) the Implied Covenant in the contractual setting. For example, a Texas court observed that a party breaches the Implied Covenant by performing a contract “in a manner that is unfaithful to the purpose of the contract and justified expectations of the other party are thus denied.”350 This approach not only examines the four corners of the contract, but also gives weight to the complaining party’s reasonable expectations of what protections the contract would likely provide should a dispute arise.351 This broader reading arguably accommodates the relational nature of the LLC better than Delaware’s purely contractual approach.352

In contrast, an extremely narrow interpretation of the Implied Covenant, leads to Cincinnati-type outcomes, and allows parties to circumvent the purpose of a contract by conducting themselves in a manner that falls just outside of the four corners of the agreement. In contrast, a broader interpretation better protects the purpose of the Implied Covenant by ensuring that the reasonable expectations of the complaining party are met.353 Essentially, the difference between these two approaches to the Implied Covenant is marked by what the court chooses to emphasize—the purpose and substance of the parties’ interactions giving rise to the parties’ expectations, or the form of the contract evidencing the parties’ contemplations.

Would party expectations be better protected by the Implied Covenant in situations allowing one or more parties to exercise discretion under a contractual term? The issue in this context is whether and when a court will limit the exercise of discretion when a contract itself does not.354 There are two ways of interpreting a discretion-granting clause: either it is complete and “gapless” (and therefore, precludes application of the Implied Covenant if the defendant’s conduct was not unreasonable), or it leaves one or more gaps by failing to set concrete parameters for the

351 This approach is similar to the approach taken by the Restatement. See Restatement (Second) of Contracts § 205 cmt. a (1981).
352 See discussion infra Part VI.
353 See Altman & Raju, supra note 332, at 1469, 1474 (“The Implied Covenant . . . serves as a method of protecting the reasonable expectations of the parties, and is best understood in that sense.”).
354 Id. at 1480–81.
discretion-exercising party (in which case the Implied Covenant would theoretically apply to a wider range of conduct). Delaware cases have occasionally utilized the Implied Covenant to deny defendants’ motions to dismiss with respect to discretionary decisions including stock valuation at “fair value,” and modification of preferred stockholders’ conversion rights.

Overall, however, a plaintiff’s luck in a discretion-type case is not much better than in any other context. In Nemec v. Shrader, the Delaware Supreme Court failed to utilize the Implied Covenant in the corporate context to impose liability on a defendant who redeemed the plaintiffs’ stock the day before the defendant planned to sell a portion of its business to a private equity firm for four times the stock’s book value. Although the defendants had a contractual right to redeem the plaintiffs’ stock at the defendant’s discretion, the supreme court did not take the timing of the redemption into consideration in evaluating whether the defendant’s discretion was exercised in good faith and whether the plaintiff was stripped of his reasonable expectations. Notably, the Nemec court highlighted that because the plaintiff’s claim arose from the defendant’s exercise of contractually-granted discretion, fiduciary duty claims had been fully foreclosed.

The Nemec holding mirrors holdings in the alternative-entity context. For example, in the limited partnership context, the court in Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund II, L.P. noted that the defendant–general partner’s contractual right to exercise discretion in deciding whether to include the plaintiff–limited partner in the partnership’s new investments was subject to a standard of reasonableness, but failed to impose liability based on the duty of good faith.

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360 Id. at 1129. Note that Nemec closely parallels cases in which fiduciary duties and the Implied Covenant would apply to the dispute, but in which the parties have chosen to eliminate fiduciary duties. See supra Part IV.D (discussing Fisk, a case in which the plaintiff brought an Implied Covenant claim when the parties had agreed to eliminate fiduciary duties).
faith.362 Rather, the court granted the defendant’s motion for judgment on the pleadings.363 The Supreme Court reversed (instructing that the parties be given a chance to conduct discovery), but maintained that while a standard of reasonableness applied to the defendant’s conduct, the plaintiff would need to prove that the defendant had a tortious state of mind if the parties reached trial.364 Notably, neither the chancery court nor the supreme court addressed the fact that the defendant could have acted unreasonably without acting tortiously, and that the defendant could have thereby defeated the plaintiff’s case while simultaneously violating the applicable standard of conduct.

B. Delaware’s Conception of the Implied Covenant Does Not Adequately Protect Parties in the “Average” LLC

Proponents of a strict contractarian view may have a viable argument that without accompanying fiduciary duties, “good faith as a lens through which judges scrutinize past acts does no more than encourage subjective conclusions in hindsight based upon events never anticipated much less assumed by the parties who initiated the conduct the court must scrutinize.”365 However, this is not a necessary conclusion. At best, this view limits the role of the Implied Covenant to those cases “where abject and inexcusable inaction in the face of a known duty to act has been established.”366 At worst, this view demotes the Implied Covenant to the status of a mere “labeling tool” or “rhetorical device.”367

According to the contractarian perspective, if a jurisdiction adopts a broader conception of the Implied Covenant, courts run the risk of blocking parties’ abilities to truly define the entire scope of their interactions through their contractual expressions.368 For example, a contractualist might support the decision of the Cincinnati court by arguing that it was possible that the parties intended to limit the range of prohibited competition to exactly what was provided for in the limited

363 See Desert Equities, 624 A.2d at 1208.
364 Id.
365 Steele, supra note 88, at 30.
366 Id.
367 Id.
368 Van Alstine, supra note 355, at 1292 (“There is persuasive force in the argument that informed parties should be able to agree at the formation stage on a contractual power whose exercise is not subject to subsequent review under external standards of ‘fair’ and ‘reasonable’ conduct.”).
partnership agreement’s noncompete clause. In addition to eliminating fiduciary duties, parties may actually want to reduce the risk that one party or another will later sue successfully under an Implied Covenant theory. This is likely the reasoning behind Delaware’s overwhelming aversion to imposing liability under the Implied Covenant when fiduciary duties are eliminated—“[t]he capacity to achieve contractual certainty and contractual control over the business relationship is . . . an important policy goal when the parties have chosen to form an LLC and to enter into an LLC operating agreement.”

However, this policy choice cuts both ways: Why should a court be permitted to determine that the parties did not want to both eliminate fiduciary duties and retain the full protection of the Implied Covenant? This is a question that the Delaware courts have yet to answer. Thus, Delaware’s approach, while arguably defensible in theory, is not ideal in practice. The fact that LLCs are contractual creatures creates a significant downside for parties that eliminate fiduciary duties under a narrow reading of the Implied Covenant because this approach fails to properly take the relational nature of LLCs into consideration by improperly equating an LLC agreement with a transaction in which the parties are disinterested in the future evolution of their relationship. However, as the frequency and significance of the interactions between parties increase, so do the parties’ reasonable expectations and reliance interests. Therefore, when a court intervenes but disregards the unique nature of an LLC by adhering solely to the parties’ contract and reading the Implied Covenant too narrowly, that court neglects the Implied Covenant’s

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369 See Means, supra note 306, at 1185 (stating that a “decision to waive certain protections is not an oversight; it is a specific choice”).

370 Miller, supra note 12, at 741.


372 See supra text accompanying notes 302–04.

373 Miller, supra note 12, at 741; cf. Phillips, supra note 101, at 1205–06 (“The duty of good faith and fair dealing has been invoked by courts in creditor–debtor disputes on grounds that the continuing and established course of relations between the parties may give rise to expectations of the parties beyond that in their express agreement.” (emphasis added)); Means, supra note 306 (discussing this point in the context of the unlimited life span of corporations).
potential for flexible application.\textsuperscript{374}

It can be assumed that the parties, by entering into an LLC agreement, are seeking mutual benefit by allocating risk and minimizing performance costs.\textsuperscript{378} However, in situations marked by unequal bargaining power, more powerful parties may be able to alter this balance of mutuality and promote a greater level of allowable self-interest by eliminating fiduciary duties to the detriment of the weaker party.\textsuperscript{376} Referring to the partnership setting, one commentator argued that “[w]hen coupled with a duty of good faith, eliminating mandatory fiduciary duties will allow efficient agreements with maximum certainty.”\textsuperscript{377} Notably, however, this statement was tempered by the commentator’s presumption that the parties would have equal bargaining power, identical powers and rights once the entity was formed, and sufficient reputational constraints to support greater freedom of contract.\textsuperscript{378} Without these factors, certainty is compromised. Further, the presumption of equal bargaining power is unrealistic given that the typical “bargaining process involves human foible and important information asymmetries, if not outright fraud.”\textsuperscript{379}

Regardless of the relative bargaining power of the parties, the pattern of Delaware’s Implied Covenant jurisprudence warns parties that an agreement that eliminates fiduciary duties constitutes a “bad” bargain because it will necessarily fail to protect against the broadest possible range of objectionable conduct.\textsuperscript{380} And if a dispute arises under a bad bargain in Delaware, then the court has a legitimate reason to refuse to enforce the Implied Covenant in favor of the complaining party—it is well recognized that the Implied Covenant is not designed to rescue parties from unfair, unwise, or unreasonable agreements, or to “rebalance[] economic

\textsuperscript{374} See Means, supra note 306, at 1190–91 (advocating for the use of “equitable contract principles” and noting that courts can use contract law to reduce transactions costs by preventing opportunistic behavior).

\textsuperscript{375} Mkt. St. Assocs. Ltd. P’ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991); see Hanno, supra note 128, at 105 (noting that, under the traditional view, LLC parties are not just contractual cooperators, but their relationship is “inherently fiduciary” (internal quotation marks omitted)).

\textsuperscript{376} Miller, supra note 12, at 732 (warning that “judicial monitoring and statutory constraints [are needed] to address the hazards of power imbalances” during LLC formation). But cf. Wartski v. Bedford, 926 F.2d 11, 20 (1st Cir. 1991) (stating that privately ordered corporate exculpatory provisions do not create a “license to steal” (internal quotation marks omitted)).


\textsuperscript{378} Id.

\textsuperscript{379} Weidner, supra note 50, at 82.

\textsuperscript{380} See infra app. D.
interests” after-the-fact.\footnote{Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010).} Therefore, under this line of reasoning, advocates of the contractarian approach to the Implied Covenant would construe these “strict” court decisions as the mere enforcement of bad contracts.\footnote{Means, supra note 336, at 1185 (“[C]ourts routinely enforce unwise contractual bargains . . . .”).}

Although parties can protect themselves from similar findings by raising their customized standard of good faith above the “floor,” in a context in which the parties have chosen to eliminate fiduciary duties, it is unlikely that they would make their standard of good faith more rigorous in the same agreement.\footnote{Hynes, supra note 377, at 48.} This situation creates a substantial degree of risk, especially for unsophisticated parties.\footnote{Id. at 113–14.}

Empirical evidence shows that the vast majority of LLCs are created with uncomplicated agreements or basic forms, and that a substantial percentage of LLCs are formed without a written agreement at all.\footnote{Hanno, supra note 12, at 739 (“[T]he contractarian approach to fiduciary duties presupposes perfect market conditions—that is, the existence of [parties] who are equally poised to bargain for optimal fiduciary duty protections.”).} Further, many drafters are unaware of changes in Delaware fiduciary duty law,\footnote{See id. at 114; see also Miller, supra note 12, at 739 (discussing studies showing that many lawyers are not fully informed with respect to relevant LLC law); Miller, supra note 12, 734, 737–38 & nn.41–59 (suggesting that the representation of legal counsel in the LLC context is less than optimal in a substantial number of LLC arrangements and that most LLC agreements are insufficiently tailored).} and small LLCs may initially rely on trust as a substitute for incurring the exponential transaction costs associated with drafting detailed agreements.\footnote{Means, supra note 305, at 1164.} Consequently, many drafters may not realize that by eliminating fiduciary duties, they are actually damaging their chances of prevailing under the Implied Covenant—moreover, they may not know that they never had a high probability of prevailing under the Implied Covenant in the first place.

Delaware courts’ treatment of parties who eliminate fiduciary duties is better suited to large, sophisticated LLCs that have adequate legal representation\footnote{Hanno, supra note 128, at 114.} and the desire to reduce negotiation costs by “effectively mak[ing] a public good of the private complexity, . . . alienation, and suspicion” of traditional fiduciary duties.\footnote{Vestal, supra note 7, at 572–73.} However, “[t]he contractarian approach misses the mark . . . if the goal is to meet the reasonable expectations of typical [entities] and society.”\footnote{Id. at 573 (emphasis added).} Small
businesses or unsophisticated parties may mistakenly rely on the Implied Covenant as a suitable “catch-all” protection. Moreover, given that there are varying levels of sophistication among LLC members, unequal bargaining power can leave less-sophisticated members with unprotected and ultimately unrealized expectations.391 For this reason, one commentator noted that Delaware’s “[u]nbridled ‘freedom of contract’ [policy] is little more than the law of the jungle.”392

VI. Admitting That the Current Role of the Implied Covenant Is No Role at All

Delaware’s statutory scheme is designed to impart independent significance to fiduciary duties and the Implied Covenant.393 The nested-sphere model is representative of this design.394 However, because the reasoning of the Delaware courts has improperly skewed the model, the “implied covenant of good faith and fair dealing” has become a deceivingly grandiose phrase that suggests so much in theory but accomplishes so little in practice.395 An extremely high evidentiary standard combined with an extremely limited willingness to invoke the Covenant has resulted in complete failure of alternative-entity Covenant claims in Delaware.396 Ultimately, therefore, the Implied Covenant is not sufficient to replace or emulate the protections that fiduciary duties provide.397

Part V argued that Delaware’s current approach to the Implied Covenant is less than ideal. However, assuming that Delaware continues with this approach, one is left to question why the Delaware courts cling to the Implied Covenant’s “unbecomingly ostentatious moniker.”398 One

391 See Hanno, supra note 128, at 114.
393 DEL. CODE ANN. tit. 6, §§ 17-1101(d), 18-1101(c) (2005); see Steele, supra note 88, at 14.
394 See infra app. A.
395 See Mkt. St. Assocs. Ltd. P’ship v. Frey, 941 F.2d 588, 595 (7th Cir. 1991) (arguing that the Implied Covenant does not actively serve to inject morality in the contracting process); Wheeler, supra note 312, at 1076 (arguing that the Implied Covenant does little to protect parties in Delaware).
396 See Miller, supra note 30, at 606–11 (providing reasons why the Implied Covenant does not sufficiently check opportunistic behavior in LLCs); Hanno, supra note 128 (arguing that the Implied Covenant is an “inadequate substitute” for fiduciary duties). But see Manesh, supra note 6, at 244 (“[T]he universality, unwavability, and contextual evolution [of the Implied Covenant]—suggest that it is well-suited to serve as a doctrinal substitute for the fiduciary duties of corporate law, to deal with the ongoing relational context of LLCs, and to ensure equitable results.” (footnotes omitted)).
397 Wheeler, supra note 312, at 1076.
398 Wheeler, supra note 312, at 1076.
reason could be that the Delaware courts dislike change. After all, it took a statutory amendment to nudge the courts away from the fiduciary-based analyses that had become second nature in the corporate and partnership contexts.399

However, because the Delaware alternative-entity statutes are designed to promote maximum contractual freedom, on some level, the Implied Covenant does not fit with the Delaware legislature’s extreme bent in favor of contractual freedom. Certainly, the outcomes of Delaware Covenant cases have resolved this lack of synchronicity in favor of the portion of the statutory provisions emphasizing contractual freedom. However, while the courts’ resolutions thus far have suggested a complete lack of regard for the relevancy of the Implied Covenant, the courts’ language deceivingly suggests that the Implied Covenant may apply in future, sufficiently “worthy” cases containing the perfect mixture of factors and circumstances that the courts have deemed critical to the success of Covenant claims. In the meantime, while Delaware courts continue to wait for the “ideal” Implied Covenant case, ambiguity and uncertainty will continue to taint the contract-negotiation process as many parties may be lulled into eliminating fiduciary duties, believing that the Implied Covenant will provide adequate protection should disputes arise.400

Because the Implied Covenant is unwaivable as a matter of statutory law, Delaware courts cannot explicitly render the Implied Covenant toothless, lest they find themselves repeating the mistakes that were made in Gotham. However, the Delaware statutes do not enumerate exactly what protections the Covenant provides, thereby opening a loophole for the courts.401 Therefore, the courts have retained the Implied Covenant paradigm, but have made it clear that the Covenant has no role in an analysis that strictly interprets the elimination of fiduciary duties as a signal that the parties intended to be unhindered by the limitations of external behavioral norms (including the norms that would be imposed by the courts themselves). Although the courts’ current approach to the Covenant facially honors the prohibition on the contractual elimination of


400 See Frey, 941 F.2d at 593 (“The particular confusion to which the vaguely moralistic overtones of ‘good faith’ give rise is the belief that every contract establishes a fiduciary relationship.”); Phillips, supra note 101, at 1188 (“When the lines between acceptable and unacceptable conduct are bright, . . . parties can effectuate valid bargains between themselves because they know in advance what behavior will be deemed acceptable. But the line is not so bright between actions that are in good faith and those that are not.”).

good faith and fair dealing, the courts’ restrictive tack has preemptively eliminated the effectiveness of the Covenant. As a result, parties to LLC agreements in which fiduciary duties have been waived have a perverse incentive to misbehave in the “right” way, knowing that the Implied Covenant does not pose a genuine threat to curtail their conduct.\footnote{See Miller, supra note 30, at 604 (noting the “trail of opportunistic behavior created by the past decade of LLC litigation”); see also Keatinge, supra note 312 (listing opportunistic behavior as one of the issues that is most likely to arise in an LLC).} This could not have been the intent of the Delaware legislature—if it was, then there would not have been a need to independently reference the Implied Covenant in the alternative-entity statutes.

In \textit{Gotham}, the Delaware Supreme Court zealously guarded fiduciary duties, supposedly for the benefit of the complaining party in spite of contrary statutory language. However, the Delaware courts are now engaging in reverse \textit{Gotham}-type analyses in which their holdings sometimes undercut the legislature’s intent to limit absolute contractual freedom, to the detriment of the complaining party. Thus, the pendulum has swung too far, and the courts’ attempts to extract the parties’ intent through the narrowest of lenses is no more faithful to parties’ true intent than if the courts were to reinstate fiduciary duties after parties had eliminated them.\footnote{Cf. Means, supra note 306, at 1189–90 (“Although the hypothetical contract approach purports to advance the parties’ own autonomy interests by helping them to avoid economically irrational outcomes, it actually gets no closer to the parties’ real bargain than does the blanket imposition of fiduciary duties drawn from partnership law.”) (footnote omitted); see Phillips, supra note 101, at 1188 (“Courts may frame the expectations of the parties with no or only slight deference to the parties’ express expectations in the relationship. The result is often counter to the purpose of effectuating the parties’ expectations in the relationship, leaving the bargaining process and the negotiated contract unnecessarily bereft of certainty. It is the intrusion of the societal interest, and the possibility of overriding contractual terms or even the entire contract, that creates the complexity and risk of uncertainty in contractual relationships when the standard of conduct is unclear.”) (footnotes omitted). Current good faith analyses in Delaware are prone to subjectivity because they are merely “stab[s] at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute.” Frey, 941 F.2d at 595.}

It is unclear whether a Delaware court will give meaningful practical effect to the Implied Covenant protections afforded by the Delaware statutes in the future.\footnote{Another revision of the Delaware statue may be necessary to achieve this goal. Cf. Catherine M. Rogers, \textit{Business Organizations—Staying Afloat with a Hole in the Wyoming LLC Act: Default Rules in a Contractual LLC World: Lieberman v. Wyoming.com LLC, 82 P.3d 274 (Wyo. 2004), 5 Wyo. L. Rev. 351, 383–84 & n.210 (2005) (predicting the need for specialized statutory provisions in Wyoming to prevent majority opportunism and abuse).} To do so would mean to broaden the scope of the Covenant by engaging in an inquiry that is completely separate from
fiduciary duties. As it stands, it would take the perfect storm to succeed on an Implied Covenant claim: unsophisticated parties, an uncomplicated agreement, ill will, unintentional silence on a contemplated matter, and sufficient detail to suggest, but not reveal, the precise nature of the parties’ contemplations. It would be remarkable, indeed, if such a unique combination of facts ever arose.

VII. Conclusion

The LLC is an attractive conglomeration of features, doctrines, and laws from the partnership and corporate models of business organization. However, Delaware’s clear policy of contractual flexibility and independence in the arena of alternative-entity creation and governance has transformed LLCs into entities that resist attempts to uniformly classify, characterize, or predict the outcomes of disputes. It is precisely because individualized contracts govern LLC disputes that a myriad of widely-varying results is possible within one body of law.

When it comes to the Implied Covenant, a three-dimensional tension arises. In one plane, Delaware law sanctions nearly absolute freedom of contract. In another plane, fiduciary defaults operate in full, absent contractual modification or elimination. In a third plane, the Implied Covenant persists as a dormant obligation that applies to all contracts. However, the Covenant only activates when it is triggered by the Delaware courts, which have, as a general matter, opted to avoid interfering with the natural effects of private ordering. In a hypothetical situation in which the plane of fiduciary duties has been removed, the courts’ contractual bent will likely lead them to interpret this removal as a manifestation of intent to manage losses where they fall. However, this narrow treatment has encouraged a curious misalignment between the theoretically ideal operation of the Implied Covenant, and the practical effectiveness of the Covenant as a means of re-allocating losses in a breach of contract action. Moreover, there are no indications that this approach

405 Perhaps the lack of a fiduciary relationship could also be added to this list. As discussed supra Part IV.C, when parties have a fiduciary relationship, Lonergan provides that they must retain fiduciary duties if they want the court to conduct a loss re-allocation. Therefore, it appears that parties will not have any chance of success on an Implied Covenant claim unless their relationship was not governed by fiduciary duties in the first place. See Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1024 (Del. Ch. 2006) (“Although other legal doctrines—such as equitable principles of fiduciary duty . . . —might condemn the equity investment if its terms were unfairly advantageous . . . , the plain terms of the [contract] preclude the notion that the [contract] itself forbade that investment.”).
helps courts come any closer to approximating the parties’ actual intentions than a broader interpretation of the Covenant.

Parties who rely on the Implied Covenant to pick up where fiduciary duties leave off are at a significant disadvantage because Delaware courts have “trapped” the Implied Covenant between fiduciary duties and express, contractually permitted conduct. First, an Implied Covenant claim is deemed redundant if a plaintiff can sue for breach of fiduciary duty under an agreement that retains these duties, which are wider ranging, more likely to be breached, and better synchronized with Delaware’s vast body of fiduciary-duty law. Second, not only is the Covenant’s scope narrow to begin with, but because Delaware courts have also conflated the Covenant with fiduciary duties, parties functionally destroy the Covenant’s usefulness when they eliminate fiduciary duties because Delaware courts will address the dispute as if the parties had essentially eliminated the Covenant as well.

Ultimately, Delaware parties must beware of the consequences of fiduciary waivers in this unique setting.\textsuperscript{406} The Implied Covenant and fiduciary duties are obligations that operate in tandem. Attempting to isolate the Covenant is a futile exercise—it can be done, but when relationships sour, parties should not expect the Delaware courts to find any sweetness in their deal.

\textsuperscript{406} Kleinberger, supra note 154, at 19 (“Freedom [of contract] has its risks, and . . . he who lives by the contractarian sword can get skewered by that sword . . . .” (internal quotation marks omitted)).
X = challenged conduct

APPENDIX A: THE “NESTED-SPHERE” MODEL WHEN HYPOTHETICAL PARTIES RETAIN FIDUCIARY DUTIES
$X = \text{challenged conduct}$

**Range of Permissible Conduct**

- **Fiduciary Duties Retained**
  - **Implied Covenant**
    - **$X_1$**
      - Claim will succeed and substitute for Claims $X_2$ and $X_3$
    - **$X_2$**
      - Claim will fail but can be substituted with Claim $X_1$
    - **$X_3$**
      - IC in Del.

**APPENDIX B: THE “NESTED-Sphere” MODEL WHEN DELAWARE PARTIES RETAIN FIDUCIARY DUTIES**
\[X = \text{challenged conduct}\]

**APPENDIX C: THE “NESTED-SPHERE” MODEL WHEN HYPOTHETICAL PARTIES ELIMINATE FIDUCIARY DUTIES**
\[ X = \text{challenged conduct} \]

**Court's approach is already narrow due to disregard for fairness inquiries and the consideration of certain factors**

**Range of Permissible Conduct Increases via**

**Contract**

**Range of Permissible Conduct Increases via**

**Court Interpretation**

**Implied Covenant**

**Fiduciary Duties Eliminated**

\[ X \]

**Claim will fail**

**IC in Del.**

**IC Assessment Upon Elimination of Fiduciary Duties**

**APPENDIX D: THE “NESTED-SPHERE” MODEL WHEN DELAWARE PARTIES ELIMINATE FIDUCIARY DUTIES**