JUDICIAL SCRUTINY OF FIDUCIARY DUTIES IN DELAWARE LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

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ABSTRACT

Delaware courts have tremendous experience in applying fiduciary duty principles when issues involving corporate governance arise. When the business entity involved is a limited partnership or a limited liability company, however, should the courts draw analogies from common law corporate fiduciary duty principles? In this article, Chief Justice Steele argues that parties forming limited partnerships and limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law and that courts should look to the parties' agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance. Chief Justice Steele also suggests that the application of a contractual analysis would comport with the statutory mandate expressed in the 2004 amendment to Delaware's Limited Partnership Act and would best serve the intent of the parties.

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In this, his most recent article, Delaware's Chief Justice Myron Steele once again reflects his unique prescience for the development of Delaware business law. The author first revealed his clairvoyance in In re Cencom Cable Income Partners, L.P. Litigation. During the 1990s, the Delaware Court of Chancery generally was applying corporate principles to Delaware limited partnerships—without explanation. In Cencom Cable, then-Vice Chancellor Steele reversed that trend by rebuffing plaintiff's argument for the application of "corporate common law or § 144 of the Delaware General Corporation Law." Rather, he stated that the \"[p]arties selected a limited partnership to carry on their business affairs...[and] the relationship between limited partners and the general partner in a limited partnership is more like that of a corporation to its preferred shareholders—\'primarily contractual in nature.\" This single decision began
what was to become the signature course of "freedom of contract" decisions led by Chief Justice Steele within the court of chancery.

This article, although dated 2005, was presented in significant part in 2003 at the First Annual Symposium on the Law of Delaware Business Entities, at the Widener University School of Law in Wilmington, Delaware. At that symposium, the author stated that freedom of contract permits the elimination—not merely the limitation—of fiduciary duties and that Delaware courts should apply this fundamental concept of contract law as provided in Delaware alternative entity statutes. In 2004, the Delaware General Assembly amended the Delaware alternative entity laws to include the term "eliminate" in the statutory provisions regarding fiduciary duties in limited partnerships and limited liability companies. These revisions were anticipated a year earlier by Chief Justice Steele. The author also anticipated the demise of the now well-known "independent fiduciary duty of good faith," recently articulated by an en banc decision of the Delaware Supreme Court.

I. INTRODUCTION

This article addresses the Delaware judiciary's role in determining the application of traditional fiduciary duty principles from corporate law to limited partnerships and limited liability companies. Much has been written recently about statutory and judicial approaches to fiduciary duties in unincorporated business organizations. This article cannot begin to cover all of the statutory nuances and differing judicial approaches that have resulted. The article, therefore, is necessarily limited to analyzing the

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5 Id. at 1012-13.
7 A growing phenomenon, unincorporated business organizations include limited partnerships, limited liability partnerships, and limited liability companies, among others. This article focuses on limited partnerships and limited liability companies.
State of Delaware's specific statutory provisions for limited partnerships and limited liability companies and examining its unique judicial culture. Delaware's blend of statutes and common law experience has no comparable combination elsewhere. The suggestions in this article, therefore, are not applicable to other jurisdictions. I suggest that although current judicial analysis seems to imply that fiduciary duties engrained in the corporate law readily transfer to limited partnerships and limited liability companies as efficiently and effectively as they do to corporate governance issues, that conclusion is flawed.

I conclude that parties to contractual entities such as limited liability partnerships and limited liability companies should be free—given a full, clear disclosure paradigm—to adopt or reject any fiduciary duty obligation by contract. Courts should recognize the parties' freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties, or the judicial scrutiny associated with them, where the parties have not contracted for those governance mechanisms in the documents forming their business entity.

II. SOME NECESSARY PREDICATES FOR A FRAME OF REFERENCE

Certain fundamental assumptions compel comment before any analysis can begin. First, this discussion concerns the rational and efficient mechanism for resolving tensions in the governance framework of limited


By way of comparison, the Delaware judiciary has long been charged with resolving governance tensions in the corporate arena. See, e.g., Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (holding that "inequitable action does not become permissible simply because it is legally possible"); see also William T. Allen et al., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 26 DEL. J. CORP. L. 859, 895 (2001) (acknowledging "the valued and creative accomplishments of the Delaware courts during an unprecedented era of rapid doctrinal change").
partnerships and limited liability companies. It is widely recognized that fiduciary duty principles currently operate within statutory parameters generally thought to be "enabling," and thus are flexible in a way that enhances wealth building. Second, there are at least two agreed-upon, well-defined fiduciary duties and an arguable, if incompletely defined, third. The first two are, of course, loyalty and care; the third is the highly enigmatic "good faith."

Third, limited partnerships and limited liability companies, like corporations, are creatures of statute, and do not exist at common law. The policy direction from the legislature—for the purpose of this article, the Delaware General Assembly—carries the day over even the most clearly defined doctrinal common law principles. Interestingly, no relevant Delaware statute names, numbers, or defines any fiduciary duty or refers to the famous "triad."

Fourth, to date, the Delaware courts do not agree on the extent to which even adequately informed parties can agree to "eliminate" all or some of the fiduciary duties in the documents they create to form their unincorporated business entities. This is equally true to the extent that those parties, by contract, choose to arrange a manager/investor governance relationship. This article addresses the implications of courts superimposing their view ex post on how that relationship should be structured and scrutinized.

Finally, a critique of the Delaware courts' disposition of limited partnership and limited liability company governance disputes, through the lens of common law fiduciary duty rather than contractual analysis, will demonstrate that the latter is more efficient, more consistent with the parties' business judgment about how to resolve manager/investor

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11See, e.g., Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) ("The directors of Delaware corporations have a triad of primary fiduciary duties: due care, loyalty, and good faith.").


13But see DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (permitting certificates of incorporation to limit or eliminate director liability except for breaches of "duty of loyalty" or for "acts or omissions not in good faith").
governance tension, and fulfills any rational view of appropriate public policy.

Instruments creating limited partnerships and limited liability companies can easily be structured to carve out safe harbors for self-dealing by managers where the parties, fully informed about the scope of those safe harbors, agree in writing. Barring any evidence to the contrary, courts should restrain themselves from reaching any conclusions other than those that the parties, who are perceived to have understood the terms of the written agreement and bargained for and negotiated the relationship created by the contract in exchange for consideration. Courts should assume, absent clear and convincing evidence to the contrary, that implicit in that process were considerations of fee arrangements and investment entry costs.

It is important to note that this article is limited to an examination of Delaware law, and that Delaware has not codified the model standards of conduct of directors or officers. Over forty states have adopted statutory standards, however. Delaware does, however, have an extensive body of common law addressing fiduciary duties imposed on managers, i.e., directors and officers, in the corporate structure. In the words of a prolific and thoughtful Delaware vice chancellor, this may be because:

the continued importance of the common law of corporations is not the result of happenstance, but reflects a policy choice made by the Delaware General Assembly. That choice deliberately deploys Delaware’s judiciary to guarantee the integrity of our corporate law through the articulation of common law principles of equitable behavior for corporate fiduciaries.

Delaware’s primary court for applying these principles is its court of equity—the Delaware Court of Chancery. That court reviews the exercise of the vast array of powers the Delaware General Corporation Law grants

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III. FIDUCIARY OBLIGATIONS IN CORPORATE, LIMITED PARTNERSHIP,
AND LIMITED LIABILITY COMPANY INTERNAL GOVERNANCE

Although the above-described scheme operates reasonably
effectively and efficiently in resolving daily tensions in corporate
governance, it is reasonable to ask: should it be the model for resolving
governance issues in limited partnerships and limited liability companies
as representative unincorporated business entities created by statute and
unrecognized at common law?

Traditionally, courts and draftsmen have reasoned from fiduciary
relationships recognized in one context to impose fiduciary duties in what
they believe to be analogous contexts. This certainly can be said to be the
approach of the Delaware courts, even where not expressly articulated.

In Cantor Fitzgerald, L.P. v. Cantor (C.F.L.P.),19 for example, a
limited partnership agreement contractually purported to create a fiduciary
duty of loyalty owed by the limited partners to the limited partnership
itself.20 The vice chancellor confronted a provision that used a term of art
(duty of loyalty) that was undefined in the agreement itself.21 The parties
to the agreement—the limited partnership, the managing partner, and the
allegedly disloyal limited partners—hotly disputed both the meaning of the
term, and the limited partnership's authority to impose the duty on passively
investing limited partners.22

Evidence of the drafting history, the nature of the relationships
between the parties, and the almost unique nature of Cantor Fitzgerald's

17See DEL. CODE ANN. tit. 8, § 141(a) (2001) (providing that the "business and affairs of
every corporation . . . shall be managed by or under the direction of a board of directors"); see also In re MONY Group, Inc. S'holder Litig., 853 A.2d 661, 673-74 (Del. Ch. 2004) ("This court,
relying on the General Assembly's determination [in Section 141(a)] . . . in most circumstances
defers to decisions made by boards of directors in how to run the corporation's affairs.").
20Id. at *5.
21Id.
22Id. at *4.
business was introduced at trial to help the court analyze the provision.\textsuperscript{23} The vice chancellor ultimately concluded that the parties had lawfully adopted language in the agreement imposing the obligation of the duty of loyalty on the limited partners.\textsuperscript{24} The term "duty of loyalty," although undefined in the agreement, was clearly distinct from other provisions that limited competition, and would have been construed as it would be under common law principles derived from Delaware's corporate law.\textsuperscript{25} "Duty of loyalty" was determined to be a term of art, specifically intended by the drafters to address the comparable common law duty.\textsuperscript{26} The amended agreement engrafted that common law duty into the relationship between the limited partners and the limited partnership,\textsuperscript{27} even though limited partnerships did not exist at common law and the Delaware Revised Uniform Limited Partnership Act\textsuperscript{28} did not impose a duty of loyalty on limited partners.

That an analogy would be drawn from corporate law to explain an undefined term of art in a limited partnership agreement was unremarkable. In developing fiduciary duties in business contracts, courts traditionally have analyzed a new concept (in \textit{C.F.L.P.}, the unusual imposition of a duty of loyalty on limited partners) as it applies in a more familiar context. Thus, in developing the fiduciary duties of corporate actors, courts borrowed fiduciary duty concepts from agency, trust, and partnership law.\textsuperscript{29}

For purposes of this article, it must be accepted that fiduciary duties will be developed in each new business context by drawing analogies from duties recognized in already existing contexts. The alternative is to develop fiduciary duties in these new statutory entities as an entirely new body of law, recognizing all business fiduciaries as a single group with a distinct body of principles and rules. The latter is an unlikely and unwise course for Delaware, given its rich common law of corporations readily adaptable, when appropriate, to limited partnerships and limited liability companies. But given their rapid growth and continued variety, there is also a danger in continuing to analogize principles of fiduciary duty as used in the corporate governance context to the internal governance of limited

\textsuperscript{23}Cantor, 2001 Del. Ch. LEXIS, at *16-17.
\textsuperscript{24}Id. at *14-15.
\textsuperscript{25}Id. at *16-17.
\textsuperscript{26}Id. at *17.
\textsuperscript{27}Cantor, 2001 Del. Ch. LEXIS, at *17.
partnerships and limited liability companies.\textsuperscript{30} Wrong analogies can be drawn for many possible reasons: a lack of appropriate focus, a desire to effect a particular purpose or result, or a desire to delegate or distribute power so that the fiduciary can act more effectively while preventing the fiduciary from effecting its own conflicting needs.

IV. THE LEFT HAND MAY NOT KNOW WHAT THE RIGHT HAND IS DOING: FIDUCIARY DEFAULTS

When deciding to draw analogies from corporation law, Delaware courts need to be mindful of the distinction between status relationships and contractual relationships. At present, it can be argued that the Delaware Supreme Court focuses on status relationships, while the Delaware Court of Chancery, and perhaps the General Assembly, focus on contractual relationships.\textsuperscript{31}

This premise is best illustrated by contrasting the Delaware Supreme Court's view that the common law fiduciary duties of loyalty and good faith cannot be eliminated by the agreement of the parties, with the view of the court of chancery that, given an expressed waiver in the agreement establishing the limited partnership or limited liability company, they can. The court of chancery and the supreme court, however, do appear to agree on at least one proposition: default rules for judicial intervention apply where the parties to the agreement have not set out, in writing, their own preferred rules.\textsuperscript{32}

Absent evidence to the contrary, it must be assumed that passive investors who authorize, in the unincorporated business entities' enabling documents, the elimination or restriction of one or more fiduciary duties are fully informed of the risks and benefits. Because the passive investor is

\textsuperscript{30}As of March 2005, there were more domestic limited liability companies registered in Delaware (288,809) than domestic corporations (274,905). That lead shows a trend toward increasing every month. Delaware Dept. of State, Div. of Corp. (Mar. 25, 2005) (internal statistics on file with author).


\textsuperscript{32}In at least one opinion, the court of chancery has been bold enough to state that when the terms of the agreement are inconsistent with traditional common law fiduciary duties, the inconsistency alone establishes the parties' intent to restrict, eliminate, or at least modify the default to the common law fiduciary duties. See, e.g., R.S.M. Inc. v. Alliance Capital Mgmt. Holdings L.P., 790 A.2d 478, 497-98 (Del. Ch. 2001). Another decision implies that to supplant the default provisions of law, the agreement must expressly state the parties' intent, i.e., no elimination by implication. Miller v. Am. Real Estate Partners, L.P., No. 16,788, 2001 Del. Ch. LEXIS 116, at *29 (Del. Ch. Sept. 6, 2001).
ordinarily in no position to supervise the fiduciary, it must be assumed that
the passive investor has bargained for a power-sharing relationship that
serves his or her best interests. It must further be assumed that the passive
investor knows that once the limited partnership or limited liability
company becomes active, again absent court intervention, there is little the
passive investor can do to determine the ongoing risk of abuse of
authorized power or the potential loss the passive investor might suffer.
One would assume the contract negotiations, or a review of the documents
generated before the LLP or LLC agreement has been signed, would enable
a reviewing court to conclude who the contracting partners agreed would
bear the costs of monitoring the fiduciary's compliance with whatever
duties or risks the documents impose. 33

A. The Statutory Framework

The Delaware General Assembly recognizes the value of bargaining
for limitations on traditional fiduciary duty principles. On July 1, 2000, the
General Assembly amended section 122(17) of the Delaware General
Corporation Law, permitting a corporation to renounce "any interest or
expectancy of the corporation in, or in being offered an opportunity to
participate in, specified business opportunities or specified categories of business opportunities that are presented to the corporation or
1 or more of its officers, directors or stockholders." 34 Corporate opportu-
nity "takings" were, until this amendment, a fundamental focus in the
development of the constraints imposed by the common law on fiduciaries
under the heading of the duty of loyalty. 35

In August 2004, the General Assembly amended the Delaware
Revised Uniform Limited Partnership Act to express its intent to establish
legislative policy in derogation of the common law's fiduciary duty
principles and to give maximum effect to the principle of freedom of
contract. 36 A partner who acts in "good faith" reliance on the provisions
of the agreement escapes liability at law or in equity. Whatever duties or
liabilities that would potentially flow from a breach of those duties "may

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(providing early discussion of the theoretical underpinnings of the relationship of fiduciary duties
in an alternative business world).


diverse and often competing obligations faced by directors and officers, . . . the corporate
opportunity doctrine arose as a means of defining the parameters of fiduciary duty in instances
of potential conflict.").

be expanded or restricted or eliminated by provision in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing."

The August 2004 amendment to section 17-1101(d) is arguably the General Assembly's response to the Delaware Supreme Court's restrictive interpretation of the earlier version of that statute. In *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, the Delaware Supreme Court held that, while a limited partnership agreement could provide for contractually created fiduciary duties substantially mirroring corporate law fiduciary duties, a limited partnership agreement could not "eliminate" the fiduciary duties or liabilities of a general partner. Before the August 2004 amendment specifically authorized the "elimination" of a partner's duties, the court of chancery had interpreted the earlier language of section 17-1101—"the partner's . . . duties may be expanded or restricted"—to include the ability to eliminate one or more of the traditional fiduciary duties analogized from the corporate law.

Apparently concerned by the court of chancery's overreliance on the policy to "give maximum effect to the principle of freedom of contract" announced clearly in the statute, the supreme court pointedly criticized the court of chancery for its expansive interpretation of the statute. Both courts no doubt believed that they were giving effect to the General Assembly's intent, though in so doing they reached different results. The court of chancery found the term "restrict[ion]" of the application of corporate law fiduciary principles to be consistent with eliminating one or more of those duties when such an intent appeared in the limited partnership agreement. The supreme court rejected that broad construction.

It is fair to say that the Delaware Supreme Court, following our
earlier reference to the "triad" of fiduciary duties at common law,47 failed to recognize a clear legislative intent to enable parties to negotiate contractual relationships based upon free exchange of consideration for a set of rights and risks unfettered by common law fiduciary duty principles.48 The supreme court apparently found it difficult to abandon the view that judicial oversight of disputes within the governance structure of limited liability unincorporated entities must invariably be from the perspective of a set of freestanding non-waivable equitable principles, drawn from the common law of corporate governance.49

B. Precursors to Legislative Action

In Gotham, the Delaware Supreme Court seemed to adopt the view that although in a corporate law setting, modification of the fiduciary duty of care can be authorized by statute in the form of exculpation and indemnification, in a contractual entity setting the parties to the contractual relationship should not be free to abrogate, even voluntarily and after full disclosure, fiduciary duties moralistically based such as loyalty and "good faith."50 No doubt the vast body of case law drawn from corporate jurisprudence, as well as the limiting nature of the exculpation statute,51 heavily influenced the court's view.52 The fiduciary principles of loyalty and "good faith" simply could not, in the court's mind, be trumped by principles of "freedom of contract."53 The implicit premise appeared to be that although a passive investor would still have recourse to the court of chancery when seeking to apply, interpret, or enforce the limited partnership agreement, elimination of any fiduciary duty by contract would limit the ability of courts to fashion an equitable remedy for harm caused

47Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001). See also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty—good faith, loyalty[,] or due care.") (emphasis omitted).

48Gotham, 817 A.2d at 167-68.

49Id. at 175-76.

50Id. at 176 (stating that the proper "scope of recovery for a breach of the duty of loyalty is not to be determined narrowly [because the] strict imposition of penalties under Delaware law are designed to discourage disloyalty") (quoting Cantor Fitzgerald L.P. v. Cantor, No. 16,297, 2001 Del. Ch. LEXIS 70, at *10 (Del. Ch. May 11, 2001)).


52Gotham, 817 A.2d at 176.

53Id.
by a fiduciary's lawful act, inequitably taken.54

Commentators knowledgeable about Delaware law were, however, already of the view, even before the August 2004 amendment, that a reviewing court should first look to the agreement of the parties. They suggested that courts should employ analogies drawn from the vast body of fiduciary duty common law only when necessary to address the scope of a party's duties and liabilities for its breach of those duties.

Thus, in determining the scope of the fiduciary duties owed by a general partner of a limited partnership, a partnership agreement must be consulted since any definition of fiduciary duty whether or not arrived at by analogy to corporate law may have been modified in the partnership agreement. Ultimately, under Delaware law, a partnership agreement will generally control the answer to the question of whether any duty has been breached and, if so, what liability, if any, may exist on the part of the breaching partner.55

The Delaware Supreme Court's singular focus on status relationships, treating the parties to all limited partnership or limited liability company agreements as having a dependency relationship (e.g., a trustee to beneficiary or agent to principal), rather than a contractual relationship, appears to have drawn Gotham's rationale. One must conclude that the Delaware Supreme Court's analysis resulted in the General Assembly's August 2004 amendment which reaffirmed the policy that parties may contract away common law fiduciary duties with contractual language that addresses expansion, restriction, or elimination of a partner's duties—"(including fiduciary duties)."56 The General Assembly clearly established, in response to Gotham, that contractual relationships and not status relationships control the duties and liabilities of parties to a contractual entity agreement.57

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54Id. (stating that "the [court of chancery's] powers are complete to fashion any form of equitable and monetary relief as may be appropriate") (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983)).

55MARTIN I. LUBAROFF & PAUL M. ALTMAN, DELAWARE LIMITED PARTNERSHIPS § 11.2.2 (2002); see also J. Dennis Hynes, Freedom of Contract, Fiduciary Duties, and Partnerships: The Bargain Principle and the Law of Agency, 54 WASH. & LEE L. REV. 439, 441 (1997) (explaining that, "absent special circumstances, contracts addressing fiduciary duties should enjoy the same treatment as contracts addressing other matters").


V. REACTING TO THE DELAWARE REVISED UNIFORM LIMITED PARTNERSHIP ACT'S AUGUST 2004 AMENDMENT

If the import of the language of the August 2004 amendment, by its reference to "restricted or eliminated by provisions in the partnership agreement," was not clear enough, the quintessential contract reference, "provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing," should make the legislature's intent abundantly clear. This language, carefully borrowed from contract law, as distinguished from corporate law, to set the parameters of action deemed to be in "good faith," must be read as an affirmation that the three-legged stool—the "triad" or "troika" of corporate fiduciary duty—is not the lens through which the action of parties to a limited partnership or limited liability company agreement will be viewed.

For example, if a limited partnership agreement provides expressly and unequivocally that all three fiduciary duty principles found in the common law of corporations are to be eliminated, then a partner's act in furtherance of his duties as a manager would be scrutinized first to determine whether the agreement authorized or empowered the partner to so act, and second, whether the action did or did not breach the implied contractual covenant of good faith and fair dealing. There would be no focus on any party's fiduciary relationship to another nor any invocation of the common law principles embodied in the duties of loyalty, care, or "good faith."

The August 2004 amendment leaves little, if any, room for argument over whether the contract relationship has triumphed over the status relationship in Delaware limited partnership and limited liability company internal governance scrutiny. What the amendment potentially does is takes away from the courts a well-developed framework of doctrine from the corporate law arena and requires the courts to delve into an area of ex post scrutiny where Delaware has little developed law. Few Delaware cases address the concept of the implied contractual covenant of good faith and fair dealing outside of the subject matter of employment contracts.

What, then, would be the approach taken by Delaware courts when confronting the issue of a limited partnership agreement, created after August 2004, that (1) purports to eliminate the application of all common

fiduciary world view of the common law and the UPA for an essentially contractarian world view”).

58DEL. CODE ANN. tit. 6, § 17-1101(d) (2005) (emphasis added).

law fiduciary duties to a party in a limited partnership or a limited liability company; (2) purports to restrict or eliminate one or modify another of those duties; or (3) is silent about the application of common law fiduciary duties to the acts of a party?  

In examining these three possible inquiries, it is helpful to look at cases dealing with this subject before the August 2004 amendment and discuss how they might now be decided in light of the more recent and clearer expression of legislative intent.

A. The Inferential Impact of the Cases

First, to date there are no Delaware cases addressing the contractual relationship or status relationship of a general partner, member, or manager where the agreement purported expressly to eliminate all fiduciary duties of the party occupying fiduciary status—the acting managing partner, member, or manager. Nevertheless, it is helpful to predict how a Delaware court might react to a claim that a general partner, member, or manager has violated the statutorily mandated implied contractual covenant of good faith and fair dealing, and what liability scheme might be imposed for harm caused by any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing. In anticipating the (admittedly hypothetical) court's approach, one must examine Delaware case law that addresses the implied contractual covenant of good faith and fair dealing.

Second, one must further contrast the concept of good faith as derived from a contractual relationship as opposed to the status relationship viewed through the prism of the fiduciary duty of "good faith." Perhaps only in Delaware would one have to undertake such an inquiry. However,

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To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or manager or to another person that is a party to or is otherwise bound by a limited liability agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

Id. (emphasis added). The language cited above is essentially identical to the language found in Del. Code Ann. tit. 6, § 17-1101(d) (2005).

61 See id. § 17-1101(d) (stating that "the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenants of good faith and fair dealing").
given Delaware's tendency to default to and on occasion misapply fiduciary duty principles, and given also the established body of case law that suggests the existence of a freestanding, independent fiduciary duty of good faith as a standard of conduct, the contrast should be instructive.

As we examine the covenant of good faith in the context of the contractual relationship between partners and limited partners and manager and members, three factors should be considered. First, there is no current Delaware case law addressing the implied contractual covenant of good faith and fair dealing in this context. Second, the case law that does address the covenant of good faith and fair dealing does so in employment, commercial, and insurance contract scenarios, not in the context of allocating power or liability within a governance structure of a business entity. And third, the lure of the case law from the corporate governance context may tend to cause the courts to misfocus, particularly in a vacuum, especially where the conduct of the defendant may appear so inequitable that the court will look to the fiduciary relationship between the parties and not their contractual arrangement. Delaware courts repeatedly claim to expand the application of the implied covenant cautiously, but seem much less reluctant to identify and then apply "unremitting" and "inviolable" fiduciary duties when the results of an otherwise lawful act by a fiduciary appears inequitable.62

B. The Implied Contractual Covenant of Good Faith and Fair Dealing: Background in Delaware Jurisprudence

Although bad faith is invariably described in the case law and secondary literature as the absence of good faith,63 the covenant itself is a freestanding regulator of conduct. The Delaware Supreme Court has

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62See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 938 (Del. 2003) ("The fiduciary duties of a director are unremitting and must be effectively discharged in the specific context of the actions that are required with regard to the corporation or its stockholders as circumstances change.") (emphasis added); McMullin v. Beran, 765 A.2d 910, 920 (Del. 2000) ("[A]lthough the [defendant] Board could not effectively seek an alternative to the proposed Lyondell sale by auction or agreement, and had no fiduciary responsibility to engage in either futile exercise, its ultimate statutory duties under [the DGCL] and attendant fiduciary obligations remained inviolable.") (emphasis added).

63See Merrill v. Crothall-Am., Inc., 606 A.2d 96, 101 (Del. 1992) (characterizing party's "bad faith" as breach of the covenant); RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981) ("The phrase 'good faith' is used in a variety of contexts, and its meaning varies somewhat with the context . . . ; it excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness[,] or reasonableness."); Robert S. Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 VA. L. REV. 195, 201 (1968) (stating that "good faith . . . serves to exclude a wide range of heterogeneous forms of bad faith").
recognized, reluctantly, "the occasional necessity" of implying contract terms to ensure that the parties' "reasonable expectations" are honored.64 This quasi reformation remedy, however, "should be [a] rare and fact-intensive" exercise, governed solely by "issues of compelling fairness."65 Only when it is clear from the writing that the contracting parties "would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter" may a party invoke the covenant's protections.66

Stated in general terms, the covenant requires "a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits" of the bargain.67 Thus, parties are liable when their conduct frustrates the "overarching purpose" of the contract "by taking advantage of their position to control" implementation of the agreement's terms.68 Traditional contract principles still control, however, as parties may bargain away covenant protections.69 Furthermore, only parties to the contract can breach the covenant.70

In E.I. Du Pont de Nemours & Co. v. Pressman,71 the Delaware Supreme Court categorized actionable claims based on the covenant in the employer-employee context, noting that to be actionable, an employer's conduct "must constitute an aspect of 'fraud, deceit, or misrepresentation.'"72 The court, however, narrowed this broad characterization in

64 See, e.g., Cincinnati SMSA Ltd. P'ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) ("Delaware Supreme Court jurisprudence is developing along the general approach that implying obligations based on the covenant . . . is a cautious enterprise."); Pressman, 679 A.2d at 443.
71 679 A.2d 436 (Del. 1996).
72 Id. at 440 (citing Merrill v. Crothall-Am., Inc., 606 A.2d 96, 96 (Del. 1992)).
successive applications.73 Despite this doctrinal limitation, the covenant is most often implicated in the employment context.74

But the covenant extends to other contexts as well. Insureds, filing suit against their insurers, must prove a claim of payment was delayed or denied "without reasonable justification."75 Insurers have no duty under the covenant, however, to inform insureds of the existence of a shortened limitations-statute provision contained in a policy.76 The standards for implying the covenant in a partnership agreement, as another example, are "no less cautious or exacting" than those applied to employment contracts.77 In a separate context, the "mere exercise" of a contractual right to terminate a tender offer, "without more," cannot lead to liability for breach of the covenant.78 In addition, the court of chancery has had occasion to examine the covenant in a variety of business contexts.79

Kelly v. McKesson HBOC, Inc.80 summarizes the jurisprudential floor for breach-of-covenant claims.

[A] party to a contract has made an implied covenant to act reasonably to fulfill the intent of the parties to the agreement.

73See Lord v. Souder, 748 A.2d 393, 400 (Del. 2000) ("Delaware law has evolved, however, through recognition of a limited implied covenant of good faith and fair dealing as an exception to the harshness of the employment at-will doctrine."); see also Bailey v. City of Wilmington, 766 A.2d 477, 480 (Del. 2001) (holding procedural defects in termination proceeding cannot supply fraudulent element required for breach of covenant in at-will employment context); cf. Merrill, 606 A.2d at 101 (directing that conduct must be "intentionally deceptive in some way material to the contract").


This implied covenant was created to promote the spirit of the agreement and to protect against one side using underhanded tactics to deny the other side the fruits of the parties' bargain. In such a claim, the Court must extrapolate the spirit of the agreement 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. . . . To state a claim for breach of an implied covenant of good faith and fair dealing, the Plaintiffs must identify a specific implied contractual obligation.  

C. How Do the Cases Express a Policy Bias?

The Delaware Supreme Court's holding in Gotham illustrates, quite effectively, the lure of analogizing to the corporate law (i.e., the status relationship analysis) as opposed to employing a contractual relationship analysis that supports a freedom of contract policy and redress for overstepping the bounds of lawful activity only where a partner or manager has breached an implied contractual covenant of good faith and fair dealing.

I submit this reluctance to recognize a clearly articulated legislative policy stems from two sources: (1) the relative certainty of, and long experience with, the application of fiduciary duty concepts in the common law of corporate governance in many different contexts; and, (2) the desire to proceed cautiously in expanding the application of an implied contractual covenant of good faith and fair dealing in any context outside employment.

In Gotham, Hallwood Realty Partners, L.P., a Delaware limited partnership, proposed to the partnership's board that it approve a reverse split, a unit option plan, and an odd lot tender offer. The offer was made subject to Hallwood Group, Inc.'s (HGI) willingness to finance the transactions by buying any fractional units generated by a reverse split and any units purchased by the partnership in an odd lot tender offer. HGI was the parent of Hallwood Realty Partners, L.P.'s general partner, Hallwood Realty Corporation. Gotham, a limited partner-unitholder, filed a books and records action and later a derivative action. Gotham alleged

81 Id. at *31-32 (footnotes omitted and emphasis added).
83 Id. at 164.
that the transactions were unfair to the unitholders, and claimed that Hallwood Realty Corporation breached both a set of traditional fiduciary duties as well as contractually based fiduciary duties.\textsuperscript{85} 

On a motion for summary judgment, the court of chancery dismissed the traditional breach-of-fiduciary-duty claims on the basis that the partnership agreement supplemented traditional fiduciary duties and provided for contractual fiduciary duties by which the conduct of the defendants, including the general partner, would be measured.\textsuperscript{86} In doing so, the vice chancellor recognized that he should analyze the claims based on the contractual relationship between the parties, not their status relationship.\textsuperscript{87} The vice chancellor further stated, consistent with the then-language of the Delaware Revised Uniform Limited Partnership Act (Limited Partnership Act), that the Act "expressly authorizes the elimination, modification[,] or enhancement of . . . fiduciary duties in the written agreement governing the limited partnership."\textsuperscript{88} 

At the time of the court's summary judgment opinion, the Limited Partnership Act provided that its policy was to "give maximum effect to the principle of freedom of contract,"\textsuperscript{89} and that the partner's duties "may be expanded or restricted by provisions in a partnership agreement."\textsuperscript{90} The vice chancellor interpreted those provisions together and concluded the power to restrict fiduciary duties, interpreted broadly consistent with freedom of contract, would include the ability to eliminate one or more of the "triad" of traditional common law fiduciary duties.\textsuperscript{91} Although the precise word "eliminate" did not appear in the statute at the time of his opinion, the vice chancellor's dictum seems entirely consistent with both the policy of the statute and a contractual relationship analysis.\textsuperscript{92} 

On appeal, while apparently understanding that the vice chancellor's language constituted dictum, the Delaware Supreme Court nonetheless took pains to emphasize that the vice chancellor's statements "create[d] a separate problem."\textsuperscript{93} The court stated:

\textsuperscript{85}Gotham, 817 A.2d at 166.
\textsuperscript{87}Id.
\textsuperscript{88}Id. at *34, reprinted in 27 Del. J. Corp. L. at 263.
\textsuperscript{89}Del. Code Ann. tit. 6, § 17-1101(c) (2000).
\textsuperscript{90}Id. § 17-1101(d) (amended in 2004) (emphasis added).
\textsuperscript{91}Gotham, 2000 Del. Ch. LEXIS 146, at *34, reprinted in 27 Del. J. Corp. L. at 263.
\textsuperscript{92}Id.
[I]n the interest of avoiding the perpetuation of a questionable statutory interpretation that could be relied upon adversely by courts, commentators[,] and practitioners in the future, we are constrained to draw attention to the statutory language and the underlying general principle in our jurisprudence that scrupulous adherence to fiduciary duties is normally expected.94

What could the supreme court have meant, other than to express its intent to continue to draw on common law corporate principles of fiduciary duty to address governance issues, even where it had to be clear that such an approach was at odds with statutory policy favoring freedom of contract and freedom from the constringence of the common law?

The court avoided the statutory language that recognized the right of the contracting partner to abrogate the common law by contract and "restrict" fiduciary duties not welcome by the parties to the agreement. One could argue that the supreme court merely interpreted the word restrict narrowly, properly noting that to "restrict" did not mean to "eliminate" fiduciary duties completely. To accept this view, however, one must overlook the clearly announced legislative intent that the statute be construed broadly, and to abrogate the common law, and that freedom of contract would guide its purpose. The supreme court's restrictive interpretation, at least in hindsight, neither advanced the policy of the statute nor recognized the status relationship of the parties in the trust, agency, and corporate governance arenas rather than explicit contractual language, dictated the imposition of traditional fiduciary duties. The supreme court consciously rejected the view that status relationships should not trump explicit contractual language inconsistent with traditional fiduciary duties dependent upon status relationships. This view should be reserved for a case where contracting parties can be found to have defaulted into a status relationship by entering into a partnership agreement that is silent on fiduciary duties, or have used language expressing the duties and liabilities of parties consistent with traditional fiduciary relationships in the corporate governance context.

Even more interestingly, at least to this author, is that the Delaware Supreme Court in Gotham held that the partnership agreement "supplanted fiduciary duty and became the sole source of protection for the public unitholders of the Partnership," just as the vice chancellor had ruled.95 Nevertheless, expressing its continued reluctance to depart from corporate

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94Id. (emphasis added).
governance fiduciary duty law, the court imposed a fairness-standard overlay "akin to the common law one applicable to self-dealing transactions by fiduciaries."96 The court reached that result despite the clear language of then section 17-1101: "The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter."97

_Gotham_ thus teaches that first, Delaware courts remain reluctant to leave the secure ground of fiduciary duty common law so well fleshed out in corporate governance decisions even in the face of a statute instructing them to do so. Second, _Gotham_ teaches that even when the courts hold that common law duties are "supplanted" by the language of a valid partnership agreement as authorized by statute, absent a clearly articulated standard, the courts will default to the tried (and occasionally, true) method of judicial scrutiny utilized in equity as if the parties were in a status, rather than a contractual, relationship.

Why did the Delaware Supreme Court suggest "fairness scrutiny" in _Gotham_? One can only speculate that because the legal action resembled a self-dealing transaction by a fiduciary (a correct observation of the status of the parties), the court believed that that status relationship implicated the heightened scrutiny that a fiduciary's conduct would demand in a corporate governance setting. The supreme court—almost reluctantly, it would seem—conceded that the contract controlled the duties and liabilities of the parties. Yet, when it came to examining any breach or its consequences, the court defaulted to common law principles of corporate governance to determine the methodology of judicial review, rather than basic contract principles. Gap filling, if needed, would be performed under principles analogized to breach of fiduciary duty at common law, rather than by examining whether there had been a breach of an implied contractual covenant of good faith and fair dealing. In its nostalgia for the familiar, and inability to escape the lure of the common law, the Delaware Supreme Court simply created more work for the General Assembly—a General Assembly that did not hesitate in August 2004 to alter the court's interpretation.

_Gotham_ teaches that the General Assembly remains poised to correct the courts when they get it wrong. The August 2004 amendment makes it clear that "practitioners," if not "commentators" and "courts," knew what the General Assembly originally intended even though the supreme court in _Gotham_ suggested that court of chancery opinions to that point in time might mislead them.

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96 _Id._
VI. BEYOND THE AUGUST 2004 AMENDMENT

The August 2004 amendment should put the Delaware Supreme Court on notice that, except where the parties to an LLP or LLC agreement do not address fiduciary duties, parties to limited partnership and limited liability company agreements will normally seek to craft their own status relationship by contract. In these cases, the courts must recognize that the contracting parties have not superimposed upon their relationship a set of duties and liabilities drawn from common law fiduciary duty with its complex overlay of levels of scrutiny.98

The General Assembly recognized the greater desirability, if not flexibility, of allowing parties to define their respective duties and liabilities by contract. These duties are subject to a modest potential modification of gap filling—namely an implied contractual covenant of good faith and fair dealing—in cases where the contract is not explicit.

A. Later Case Law Has Compounded the Problem

In its initial forays into resolving limited partner governance tensions, the court of chancery also has sometimes found the attraction of analogizing to the common law corporate governance principles irresistible—even where disputes might, and perhaps should, have been resolved by resorting to contract language.

In Davenport Group MGLP. v. Strategic Investment Partners Inc.,99 Davenport, as the general partner of Madison Group L.P., sought to invalidate a vote of Madison's limited partners removing Davenport as general partner.100 The defendants were limited partners who consented in writing to removing Davenport as general partner of Madison.101 The court of chancery found that the limited partners had properly removed Davenport as general partner because Davenport allowed the management company, hired by, and dominated by Davenport, "to use transaction fees to pay salaries and bonuses to employees of the Management Company" without any authority in either the limited partnership agreement or the

98 This overlay of scrutiny increasingly comes under criticism for its Needless complexity, doctrinal inconsistency, and procedural niceties. See STILL, supra note 15, at 93-178 (providing practitioner's view of the difficulties of winding one's way through the maze of procedurally-driven scrutiny); Allen et al., supra note 9.


100 Id. at 717.

101 Id.
service agreement between the management company and Madison.\textsuperscript{102}

Davenport's obligations or duties under the limited partnership agreement were not couched in the traditional language of common law principles applicable to a fiduciary. The vice chancellor found that "Davenport, as the General Partner, must carry out this responsibility [to manage] Madison dutifully and in accordance with the Limited Partnership Agreement."\textsuperscript{103} The court held that Davenport's duty to manage Madison, consistent with the terms of the limited partnership agreement, required it to prevent the controlled entity from making the unauthorized payments.\textsuperscript{104} Since Davenport failed to carry out that duty, the court determined that the limited partners had properly removed Davenport whether because of a breach of contract or because of a breach of the duty of loyalty owed by a fiduciary as recited in the limited partnership agreement.\textsuperscript{105}

The result is, no doubt, unsurprising. What, on reflection, is surprising is the court's palpable compulsion to address the issue, arguably unnecessarily, as a breach of the fiduciary duty of loyalty where the contract language clearly addressed the substance of the main contentions of the parties and would have sufficed to resolve the question in dispute.\textsuperscript{106} The issues were simple. Did the general partner fail in its contractual duty to enforce the terms of the limited partnership and service agreement by allowing its controlled service management company to pay improperly its employees' salaries and bonuses from transaction fees? The vice chancellor determined Davenport had breached its contractual obligation to manage the limited partnership dutifully. The court, therefore, sanctioned Davenport's removal as general partner.\textsuperscript{107} Why was there a need to address common law fiduciary duty principles at all? Because the parties argued that those principles applied? Because the plaintiffs brought the action in a court of equity? Because the safer course would be to fall back into known, familiar doctrinal territory? Even if all of the above were true, I submit that with hindsight this case should have been decided on the contract breach alone. There was no jurisdictional obstacle: the court of chancery has jurisdiction over actions to interpret, apply, or enforce provisions of a limited partnership agreement.\textsuperscript{108}

\begin{flushright}
\textsuperscript{102}See id. at 719, 722-24.
\textsuperscript{103}Davenport, 685 A.2d at 721.
\textsuperscript{104}Id. at 719.
\textsuperscript{105}Id. at 722-24.
\textsuperscript{106}See id. at 720-21.
\textsuperscript{107}Davenport, 685 A.2d at 721.
\textsuperscript{108}See DEL. CODE ANN. tit. 6, § 17-1101(d) (2005) ("To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership . . . .") (emphasis added); see also id. § 18-1101(c) (echoing "at law or in equity" language for
The case, and the vice chancellor's dual rationale for resolving it, further demonstrate a reluctance to come to grips with the reality that the contractual relationship between parties to limited partnership and limited liability company agreements should be the analytical focus for resolving governance disputes—not the status relationship of the parties. When the parties specify duties and liabilities in their agreement, the courts should resist the temptation to superimpose upon those contractual duties common law fiduciary duty principles analogized from the law of corporate governance.

B. Prospective Approaches to LLP or LLC Entity Agreements

The courts' approach should be, first, to examine the agreement to determine if the act complained of is legally authorized by statute or by the terms of the agreement itself. If so, a court should then proceed to inquire whether the implementation of the lawful act requires equity to intervene and craft a remedy? At this point, the court should look to the agreement to determine the extent to which it establishes the duties and liabilities of the parties, i.e., their bargained for, negotiated, contractual relationship. Is the agreement silent about traditional fiduciary duties, but creates a fiduciary relationship consistent with those duties thus allowing the court to imply them by default? Does the agreement expand, restrict, or eliminate one or more of the traditional fiduciary duties? Is the contract language creating those duties and liabilities so inconsistent with common law fiduciary duty principles that it can be concluded that the parties consciously modified them in a discernible way? If so, which duties and in what respect were they modified? Finally, without regard to traditional overlays of scrutiny under the common law of corporate governance, has a party breached its implied covenant of good faith and fair dealing?

Delaware's Limited Liability Company Act does not specify the duties owed by a member or manager. It does, however, like the Limited Partnership Act, provide for a default position "to the extent, at law or in equity" limited liability companies have "duties (including fiduciary duties)." These duties, in turn, "may be expanded or restricted or eliminated" in the agreement, provided that the "agreement may not

limited liability companies).

111Id. § 18-1101(c).
eliminate the implied contractual covenant of good faith and fair dealing."\textsuperscript{112}

The same issues and considerations that arise in limited partnerships arise in governance disputes in limited liability companies. There is an assumed default to traditional corporate governance fiduciary duties where the agreement is silent, or at least not inconsistent with the common law fiduciary duties. Lack of clarity in the agreements on this point may confuse the court and cause it to focus improperly when addressing the conduct complained of in a derivative action or in an action to interpret, apply, or enforce the terms of the limited liability company agreement. Predictably, but not necessarily correctly, Delaware courts will gravitate toward a focus on the parties' status relationship and not their contractual relationship in the search for a legal and equitable resolution of a dispute unless the agreement explicitly compels the court to look to its terms and not to the common law fiduciary gloss.

C. Temptation Remains Because Fiduciary Analogies Are Attractive

\textit{VGS Inc. v. Castiel}\textsuperscript{113} affords a good example. There, an entity controlled by a single individual formed a one-member limited liability company.\textsuperscript{114} In an attempt to infuse additional capital into a cash poor enterprise, two additional entities, one of which was controlled by the owner of the original member, became members of the formerly "one member" limited liability company.\textsuperscript{115} The members amended the limited liability company agreement to create a three-member board of managers with broad authority to govern the company.\textsuperscript{116} The agreement gave the individual who owned the original member and controlled one of the two new members authority to name and remove two of the three members of the board of managers.\textsuperscript{117} He also became the CEO.\textsuperscript{118}

The third member's owner, also a member of the board of managers, became disenchanted with the CEO/owner's leadership. He convinced the CEO owner's appointed (third) member of the board of managers to join

\textsuperscript{112}Id.
\textsuperscript{114}Id. at *1, reprinted in 27 DEL. J. CORP. L. at 455.
\textsuperscript{115}Id. at *3-5, reprinted in 27 DEL. J. CORP. L. at 455-56.
\textsuperscript{116}Id. at *2, reprinted in 27 DEL. J. CORP. L. at 455.
\textsuperscript{117}VGS, 2000 Del. Ch. LEXIS 122, at *2, reprinted in 27 DEL. J. CORP. L. at 455.
\textsuperscript{118}Id.
him in a clandestine strategic coup, which included merging the LLC into a Delaware corporation. They did not give the CEO/owner and fellow member of the board of managers notice of their plan or of the meeting they held to effectuate the plan. The merger closed and the CEO/owner found himself relegated to a minority position in the surviving Delaware corporation.\footnote{See id. at \#2-3, reprinted in 27 DEL. J. CORP. L. at 456-57.}

A majority of the board of managers consummated the transaction by written consent, an action they had both statutory and contractual authority to take.\footnote{Id. at \#5-6, reprinted in 27 DEL. J. CORP. L. at 456-57.} As both managers voting for the transaction well knew, had the third manager gotten notice of their action he would have exercised his authority under the statute and agreement to remove his appointee, appointed another, and thus prevented the merger.\footnote{VGS, 2000 Del. Ch. LEXIS 122, at \#5-6, reprinted in 27 DEL. J. CORP. L. at 456.} The limited liability company agreement did not expressly state whether the board of managers must act unanimously or by majority vote.\footnote{Id.} The agreement did state, however, that the "Board of Managers shall \textit{initially} be composed of three . . . Managers."\footnote{Id. at \#7, reprinted in 27 DEL. J. CORP. L. at 458 (emphasis added).}

The vice chancellor, noting that section 18-404(d),\footnote{Del. Code Ann. tit. 6, § 18-404(d) (2000) (providing default class and voting rules in absence of standards established in limited liability company agreement).} the applicable statute, had yet to be interpreted by the Delaware courts, concluded that the purpose of permitting action by written consent without notice was to enable managers to take quick, efficient action in situations where a minority of the managers could not block or adversely affect the course set by the majority, even if the minority were notified of the proposed action and objected to it.\footnote{VGS, 2000 Del. Ch. LEXIS 122, at \#10-11, reprinted in 27 DEL. J. CORP. L. at 459.} Here, the original member and majority owner, by operation of law and without notice, became the "minority" manager.\footnote{Id. at \#4, reprinted in 27 DEL. J. CORP. L. at 456-57.} He, ironically, had appointed the third manager now voting against his appointing authority's interests, knowing the original member who had appointed him had the power to replace him. Had the original member received fair notice of the board's proposed action, the original member would have prevented it by removing and replacing his appointee.\footnote{Id. at \#10, reprinted in 27 DEL. J. CORP. L. at 457.} The vice chancellor concluded that the General Assembly never intended two managers, under these circumstances, to be able to deprive a manager, representing the majority interest in the limited liability company, of the

\textit{...}
opportunity to protect that interest. Because the "majority" here was "will of the wisp" and would have imploded if notice had been given of its proposed action, the vice chancellor, relying upon equitable principles, concluded that the two managers had a duty of loyalty to the majority owner which they should have discharged in good faith. They breached that duty by clandestinely acting to prevent the majority member from exercising his right under the limited liability company agreement to remove his appointed member and replace him with another who would have protected the majority member's interests. The vice chancellor granted equitable relief by rescinding the merger.

VGS illustrates the continuing theme of this article—that Delaware courts have continued to focus on the status relationships of the parties, rather than upon their contractual relationship when resolving governance disputes. The "gap filler" found most comfortable where LLP or LLC agreements do not expressly resolve the dispute will, rightly or wrongly, continue to be traditional common law fiduciary duty principles accompanied by, when breached, common law equitable relief, rather than by contractual terms, statutory ambiguities, or breaches of implied contractual covenants of good faith and fair dealing. In VGS, the vice chancellor's passing reference to a failure to discharge a duty of loyalty, in good faith, evidences yet another and perhaps the most vexing of problems accompanying the tendency to resolve governance disputes within unincorporated entities based on common law fiduciary duty principles and remedies. The common law duties of loyalty, with its arguable subsets of disclosure and candor, and of care, with its gross negligence standard of conduct, although reasonably clear and often litigated, are not appropriate in most governance disputes involving LLPs and LLCs. This litigation has over decades produced a substantial body of case law that provides some reasonable degree of predictability, consistency, and clarity. But what about "good faith" as a freestanding, independent duty? What bearing or place does or should this alleged common law fiduciary duty have given the announced statutory preference for review under the rubric of the implied contractual covenant of good faith and fair dealing?

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128 Id. at *11, reprinted in 27 Del. J. Corp. L. at 458.
130 Id. at *16-17, reprinted in 27 Del. J. Corp. L. at 461-62.
131 Id. at *13-14, reprinted in 27 Del. J. Corp. L. at 460.
VII. THE BENEFITS OF A CONTRACTUALLY BASED GOVERNANCE SCHEME

A. Increased Certainty

There are ample and significant reasons for Delaware courts to retreat from resolving governance disputes within unincorporated entities based upon a focus on status relationships that entails a common law scrutiny potentially at odds with statutory policy and the contracting parties' intent. That potential disconnect is reason enough for Delaware courts to refocus on contractual relationships and the potential for gap filling through the implied covenant of good faith and fair dealing.

But there is another reason to retreat cautiously but consciously away from analogizing to common law fiduciary duties—the uncertainty of the fiduciary duty of good faith as opposed to the relatively clear implied contractual covenant of good faith and fair dealing. Granted, Delaware case law is sparse on both—but at least the contractual covenant is defined and workable within known parameters. The alleged fiduciary duty of good faith is, I submit, neither defined clearly anywhere in the case law nor even imaginably workable as a predictable, clear, and consistent standard of conduct. Much has been written recently about the concept. Even those who urge its adoption and the introduction of false teeth into its structure cannot define it in any workable way. In the view of this author, the concept is more freewheeling than "freestanding," if freestanding is taken to mean that the concept has independent legal significance.

Delaware courts first recognized the duty of good faith as a freestanding fiduciary duty, with no discussion about why, in the Delaware Supreme Court's opinion in Cede & Co. v. Technicolor Inc. That opinion appeared to suggest that directors must act honestly and in a manner that is not knowingly unlawful or contrary to public policy. Earlier cases touched on the phrase "good faith" without elevating it to an independent fiduciary duty, referring to bad faith as tantamount to fraud or an absence of "rationality" or a decision "so far beyond the bounds of reasonable judgment" that it established a "bad faith" act or omission.

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133 See Sale, supra note 12, at 482.
134 Id.
135 634 A.2d 345, 361 (Del. 1993).
136 Id.
In 1996, Chancellor Allen, in deciding *In re Caremark International Inc. Derivative Litigation*,\(^{139}\) suggested that corporate directors may have a duty to establish monitoring and compliance programs "in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists."\(^{140}\) Since the recent corporate "scandals" of the early twenty-first century, more intense discussion of the elusive concept of good faith has entered the secondary literature and opinions of Delaware courts.\(^{141}\)

Whether the academic literature persuades Delaware courts to arm the good faith weapon against corporate wrongdoing by expanding its scope to a reason not yet foreseen, or whether more practical and workable parameters can be forged in order for good faith to provide a usable doctrine for predicting liability and thus encourage good internal governance practices, remains to be seen.

It may well be that using "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. Perhaps courts will conclude that "good faith" is an inutile labeling tool, an insubstantial magic carpet to ride to the right result and not a pronouncement of a standard of conduct that leads to predictable results that encourage good governance practices and discourage bad governance practices. Perhaps it will apply only to cases where abject and inexcusable inaction in the face of a known duty to act has been established. Perhaps it will, as one commentator suggests, continue to be used merely as a rhetorical device, albeit on occasion, a useful one.\(^{142}\)

**B. Legislative Intent Advanced**

Whatever the Delaware courts' ultimate resolution of this contemporary dilemma might be, some conclusions appear self-evident.

First, the General Assembly does not contemplate that judicial scrutiny of the actions of the parties to a limited partnership agreement or a limited liability company agreement will be through the mechanism of a

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\(^{139}\) 698 A.2d 959 (Del. Ch. 1996).

\(^{140}\) *Id.* at 970 (emphasis added).


\(^{142}\) See Griffith, *supra* note 12, at 34-53.
common law duty of good faith. The express statutory provision allowing parties to eliminate fiduciary duties that might otherwise apply by default is accompanied by a provision requiring scrutiny by the mechanism of a breach of the implied contractual covenant of good faith and fair dealing. This statutory policy makes sense because it focuses the court on the contractual relationship of parties to a negotiated agreement, and because it comes with an established frame of reference for resolving a dispute supported by case law that is clear, consistent, and flexible enough to address any dispute. It is a frame of reference or methodology inconsistent with "good faith," as that concept is currently interpreted in the common law of corporate governance.

Second, why should courts seek to incorporate uncertainty, inconsistency, and unpredictability into the world of negotiated agreements? As Delaware lawyers Paul Altman and Srinivas Raju point out in their annual review of developments relating to Delaware's alternative entities, practitioners know that:

[a]s a general perspective, these recent cases relating to alternative entities demonstrate that Delaware courts will continue to adhere firmly to the principle of freedom of contract. In addition, these cases emphasize the importance of using clear, express and unambiguous language in the agreements governing an alternative entity to ensure that the contractual bargain reached by parties is in fact enforced by a Delaware court.

At least some Delaware judges are getting this message. In R.S.M. Inc. v. Alliance Capital Management Holdings L.P., the court of chancery considered whether a limited partnership agreement had established that the parties intended to supplant traditional fiduciary duties:

[W]here the use of default fiduciary duties would intrude upon the contractual rights or expectations of the general partner or be insensible in view of the contractual mechanisms governing the transaction under consideration, the court will eschew fiduciary concepts and focus on a purely contractual analysis of the dispute. Put somewhat differently,

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144Id. at 221.  
145790 A.2d 478 (Del. Ch. 2001).
the irreconcilability of fiduciary duty principles with the operation of the partnership agreement can itself be evidence of the clear intention of the parties to preempt fiduciary principles. 146

This is the firmest statement to date that Delaware courts will follow the stated statutory policy of promoting freedom of contract and recognize that as attractive as it may be, the common law governing corporate fiduciary relationships must yield to statutory policy. This statement, it is worth noting, came before the August 2004 statutory amendments.

VIII. CONCLUSION

There is as much a premium on the Delaware courts focusing clearly on the contractual relationship of parties to unincorporated business entities as there is on the parties bargaining for and negotiating clear, precise terms that define that relationship. Delaware courts, despite the statutory policy expressly stated in sections 17-1101 and 18-1101, have not yet reconciled themselves to freedom of contract and the General Assembly's intent that its limited partnership enabling statute and its limited liability company enabling statute be interpreted broadly, despite being in derogation of the common law. It is understandable that, in circumstances where the parties have not clearly expressed the intention to expand, restrict, or eliminate traditional common law fiduciary duties, the Delaware courts will retreat to familiar territory by analogy. Where that territory provides more questions than answers, as in the fiduciary concept of good faith, the Delaware courts should look to the statutes and fill any gaps in the parties' express intent by following the statutory mandate to apply the implied contractual covenant of good faith and fair dealing, rather than the enigmatic "good faith" fiduciary duty at common law. In this way, the parties, the public, and the courts will be better served.

146 Id. at 497-98.