EXPRESS CONTRACT TERMS AND THE IMPLIED CONTRACTUAL COVENANT OF DELAWARE LAW

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ABSTRACT

Delaware law conceives of the implied contractual covenant of good faith and fair dealing (the "Implied Covenant") in contradictory terms. It is both a gap filler subject to the express terms of a contract and an overriding obligation notwithstanding the express terms of a contract. It is not a judicial license to equitably rewrite bargained for agreements, yet courts may invoke the doctrine to limit express contractual rights when fairness dictates. How can these conflicting conceptions coexist?

The answer lies in an inescapable reality that is left all but unacknowledged by Delaware law: the express terms of every contract must be judicially construed. By eliding this reality, the law obscures the control that Delaware courts exercise over private agreements. Acknowledging the judicial role in contract construction not only harmonizes the Implied Covenant's conflicting conceptions, but because judicial construction inevitably implicates a court's idiosyncratic notions of equity and reasonableness, it also reveals a degree of indeterminate judicial discretion inherent in the enforcement of express contractual rights and obligations.

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I. INTRODUCTION

Delaware law conceives of the implied contractual covenant of good faith and fair dealing (the "Implied Covenant" or simply the "Covenant") in contradictory terms. It is both a gap filler subject to the express terms of a contract[1] and an overriding obligation notwithstanding the express terms of a contract.[2] It is not a judicial license to equitably rewrite bargained for agreements,[3] yet courts may invoke the Covenant to limit express contractual rights when fairness dictates.[4] How can these conflicting conceptions of the Implied Covenant coexist?

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[1] *See infra* Part II.B.1.

[2] *See infra* Part II.B.2.

[3] *See infra* notes 58-64 and accompanying text.

[4] *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444-45 (Del. 2005) (en banc) (ruling, in the context of an insurance policy, that the Implied Covenant is breached if the insurer "arbitrarily" exercises its express right to deny the insured coverage); Desert

To be sure, these doctrinal conflicts are neither new nor Delaware's alone.[5] Confusion regarding the interaction between express terms and the Implied Covenant abounds in all states.[6] But this question is one of particular concern in Delaware because of the significant role the state's law plays in the world of business.[7] Like the law of other states, the Implied Covenant is an unwaivable obligation implied into every contract under Delaware law.[8] Thus, the Covenant binds every

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Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199, 1208 (Del. 1993) (ruling, in the context of a limited partnership agreement, that the Implied Covenant is breached if the general partner exercises its express authority to exclude a limited partner from participation in future investments when the general partner does so with a "tortious state of mind" that reflects bad faith); Lola Cars Int'l Ltd. v. Krohn Racing, LLC, 2009 WL 4052681, at *8-*9 (Del. Ch. Nov. 12, 2009) (ruling, in the context of an LLC operating agreement, that the Implied Covenant is breached if an LLC member exercises its express right "inappropriately and in bad faith" by failing to consider its fellow member's requests); Amirsaleh v. Bd. of Trade of the City of N.Y., Inc. (*Amirsaleh I*), 2008 WL 4182998, at *8-*9 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 627-29 (2009) (ruling, in the context of a merger agreement, that the Implied Covenant is breached if the defendants' exercises their express right to extend the deadline for submitting documents relating to the pending merger "unfairly and in bad faith"); Wilmington Leasing, Inc. v. Parrish Leasing Co., 1996 WL 560190, at *3 (Del. Ch. Sept. 25, 1996), *reprinted in* 22 DEL. J. CORP. L. 875, 882 (1997) (ruling, in the context of a limited partnership agreement, that the Implied Covenant is breached if the defendant exercised its express right to remove the plaintiff as general partner "unreasonably and in bad faith").

[5] *See* Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227, 228 (2005) ("[A]lthough there is presently general agreement . . . that every contract includes an implied covenant of good faith in the performance of the contract, there is little agreement about how the common law duty of 'good faith' should be defined or what the duty of good faith requires.").

[6] *See* 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 7.17, at 341 (2d ed. 1998) ("It is . . . no simple matter to reconcile the mandatory character of the duty of good faith with the principle, often repeated by courts, that there is no such duty if it would conflict with an express provision of the contract."); Dobbins, *supra* note 5, at 229 ("Despite decades of attempts to clarify the good-faith duty . . . almost all acknowledge that the cases in which courts have applied the duty . . . are rife with inconsistencies and confusion, even within single jurisdictions."); Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1227 (1999) ("The precise interaction of the duty of good faith with express contract language . . . remains an important jurisprudential mystery.").

[7] *See* ERIN A. O'HARA & LARRY E. RIBSTEIN, THE LAW MARKET 82 & 237 n.35 (2009) (noting Delaware law ranks second (behind New York) as the choice of law among a large set of commercial contracts involving public companies; governing 28.5% of all such contracts); Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts*, 30 CARDOZO L. REV. 1475, 1489-90 & tbl.2 (2009) (finding Delaware law ranks second (behind New York) as the choice of law in a study of material contracts involving publicly-traded companies, governing nearly 15% of all such contracts).

[8] *See Dunlap*, 878 A.2d at 441-42 (observing that the Covenant is implied into all contracts governed by Delaware law); Paul M. Altman & Srinivas M. Raju, *Delaware Alternative Entities and the Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 BUS. LAW. 1469, 1480 (2005) (explaining that the Implied Covenant

single party to the countless significant business relationships governed by Delaware contract law—ranging from the most important transactions of the corporate world (mergers and acquisitions),[9] to the foundational contracts of the alternative entity world (limited partnership and LLC operating agreements),[10] and to every other conceivable type of business relationship.[11]

Yet, despite its universal applicability, Delaware courts concede that the basic contours of the Implied Covenant are largely undefined.[12]

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may not be waived).

[9]*See* Matthew D. Cain & Steven M. Davidoff, *Delaware's Competitive Reach*, 9 J. EMPIRICAL LEGAL STUD. 92, 94 (2012) (finding Delaware law ranks first among all states as the choice of law in a study of 1020 merger agreements announced between 2004 and 2008 and involving at least one public company, governing 66% of all such agreements); Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975, 1987 & tbl.2 (2006) (finding Delaware law ranks first among all states as the choice of law in a study of 412 merger agreements announced during a seven-month period ending July 31, 2002 and involving at least one public company, governing 32% of all such agreements).

[10]In the world of LLCs and limited partnerships in particular, the Implied Covenant plays an outsized role for two reasons. First, Delaware law views these non-corporate alternative entities as strictly "creatures of contract," meaning the Covenant is the only unwaivable obligation—the contractual "floor"—for LLCs and limited partnerships. *See* DEL. CODE ANN. tit. 6, § 17-1101(d) (2011) (governing limited partnerships); DEL. CODE ANN. tit. 6, § 18-1101(c) (2011) (governing LLCs); *see also* Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 225-26 (2011) (describing the contractual nature of LLCs under Delaware law). Second, as is the case for corporate charters, Delaware is the preeminent choice of law for large LLCs and limited partnerships. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91, 116 & tbl.2 (finding that among closely held LLCs with 50 or more employees that form outside of their home state, more than 61% are organized under and governed by Delaware law); Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 598 & n.236 (2012) (noting that all but one of the 85 publicly traded LLCs and limited partnerships in existence in 2011 are organized under and governed by Delaware law); Jens Dammann & Matthias Schündeln, *Where are Limited Liability Companies Formed? An Empirical Analysis* 3 (Univ. of Tex. Sch. of Law, Law and Econ. Research Paper No. 126, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633472 (finding that among closely held LLCs with 5000 or more employees that form outside of their home state, more than 95% are organized under and governed by Delaware law).

[11]*See* Eisenberg & Miller, *supra* note 7, at 1490-91 & tbls.2 & 3 (presenting data highlighting the use of Delaware law as the choice of law in a study of material contracts—ranging from asset and securities purchase agreements to trust agreements—involving publicly-traded companies).

[12]*See* E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 443 (Del. 1996) (en banc) ("Although the Covenant is a generally acknowledged principle, its precise contours are not fixed."); Amirsaleh v. Bd. of Trade of the City of N.Y., Inc. (*Amirsaleh II*), 2009 WL 3756700, at *4 (Del. Ch. Nov. 9, 2009) ("I recognize that the exact contours of the implied covenant . . . are not always easily discernible in the case law. This is partly driven by the 'fact-intensive' nature of the doctrine."); *Amirsaleh I*, 2008 WL 4182998, at *7 (Del. Ch. Sept.

Rather than attempting to articulate an all-encompassing definition of the Covenant to guide parties in future transactions, courts have applied the doctrine in a fact-intensive, case-by-case fashion,[13] spawning a growing body[14] of sometimes contradictory law.[15]

The only solace contracting parties have is Delaware law's frequent reassurance that the Implied Covenant is a "narrow,"[16] "limited and extraordinary legal remedy,"[17] a "most chary"[18] and "cautious [judicial] enterprise,"[19] applied "sparingly,"[20] "conservatively"[21] and only

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11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 626 (2009) ("While the existence and applicability of the implied covenant are well established, its substance and defining contours remain somewhat imprecise."); *see also* Altman & Raju, *supra* note 8, at 1478 (noting the "nebulous" and "fact-intensive" nature of the Implied Covenant).

[13] *Amirsaleh II*, 2009 WL 3756700, at *4 ("Courts routinely invoke the specific contours of the covenant that are relevant to the case at hand without attempting to articulate an all-encompassing definition that could be applied to any factual circumstance. I use the same approached today . . . ."); *see also* Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (noting that the application of the Implied Covenant " should be rare and fact-intensive, turning on issues of compelling fairness."); *cf.* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 440-41 (Del. 2005) (en banc) (noting that despite an existence spanning "at least three centuries of American legal thought . . . the term 'good faith' has no set meaning").

[14] In 2012 alone, the following cases found the Delaware Court of Chancery grappling with the Implied Covenant: Metropolitan Life Ins. Co. v. Tremont Grp. Holdings, Inc., 2012 WL 6632681, at *15-*16 (Del. Ch. Dec. 20, 2012) (involving a limited partnership agreement); *In re* Encore Energy Partners LP Unitholder Litig., 2012 WL 3792997, at *1, *12-*15 (Del. Ch. Aug. 31, 2012) (involving a master limited partnership agreement); Policemen's Annuity & Benefit Fund v. DV Reality Advisors, LLC, 2012 WL 3548206, at *13 (Del. Ch. Aug. 16, 2012) (involving an LP agreement); Blaustein v. Lord Baltimore Capital Corp., 2012 WL 2126111, at *5-*6 (Del. Ch. May 31, 2012) (involving a shareholder agreement); ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC (*ASB Allegiance I*), 2012 WL 1869416, at *1, *19 (Del. Ch. May 16, 2012) (involving an LLC operating agreement); Dawson v. Pittco Capital Partners, LP, 2012 WL 1564805, at *24-*26 (Del. Ch. Apr. 30, 2012) (involving an LLC operating agreement); JPMorgan Chase & Co. v. Am. Century Cos., 2012 WL 1524981, at *7-*8 (Del. Ch. Apr. 26, 2012) (involving a stock option agreement); *In re* K-Sea Transp. Partners LP Unitholders Litig., 2012 WL 1142351, at *9-*10 (Del. Ch. Apr. 4, 2012) (involving a master limited partnership agreement); *In re* Delphi Fin. Grp. S'holder Litig., 2012 WL 729232, at *17 (Del. Ch. Mar. 6, 2012) (involving a corporate charter); Matthew v. Laudamiel, 2012 WL 605589, at *18 (Del. Ch. Feb. 21, 2012) (involving an LLC operating agreement); Gerber v. Enter. Prods. Holdings, LLC, 2012 WL 34442, at *11-*13 (Del. Ch. Jan. 6, 2012) (involving a master limited partnership agreement).

[15] *See infra* Parts II.B-C.

[16] *See, e.g.*, *Pressman*, 679 A.2d at 438 ("Our holding here reinforces and reaffirms . . . the narrow and carefully crafted nature of the [Implied] Covenant.").

[17] *E.g.*, Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010) (en banc) ("[T]he covenant is a limited and extraordinary legal remedy.").

[18] *E.g.*, Allied Capital Corp. v. GC-Sun Holdings, LP, 910 A.2d 1020, 1035 (Del. Ch. 2006) ("[C]ourts should be most chary about implying a contractual protection when the contract could easily have been drafted to expressly provide for it.").

[19] *E.g.*, Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) ("[I]mplying obligations based on the covenant of good faith and fair dealing is a

in "rare" cases.[22] But a closer look at the case law does not seem to bear this out. Often, it seems, Delaware courts allow claimants alleging a breach of this purportedly "limited" doctrine, to survive into later stages of litigation,[23] increasing the cost of litigation and the value of settlements.

To make sense of the Covenant, this Article focuses on an inescapable reality that is all but unarticulated in Delaware law: the express terms of every contract must be judicially construed. Judicial construction is inevitable because all contracts contain gaps. It is through judicial construction that these gaps are revealed, and it is into these gaps that the Implied Covenant may be invoked. By eliding this reality, the law obscures the control that Delaware courts exercise over bargained-for agreements.[24] Acknowledging the judicial role in contract construction helps not only harmonize the Implied Covenant's conflicting conceptions,[25] but because judicial construction inevitably implicates a court's idiosyncratic notions of equity and reasonableness, it also reveals a degree of indeterminate judicial discretion inherent in the enforcement of express contractual rights and obligations.[26]

By articulating what Delaware law has left largely unarticulated, this Article aims to achieve three broad goals: (1) to explain why and how the Implied Covenant applies; (2) to impose order onto an increasingly sprawling and sometimes contradictory body of case law; and by doing so, (3) to guide courts, litigants, and the drafters of contracts to better understand and navigate the oftentimes imprecise contours of this frequently litigated doctrine.

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cautious exercise.").

[20]*E.g.*, Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009) ("Delaware courts rightly employ the implied covenant sparingly.").

[21]Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 888 (Del. Ch. 2009) ("[T]he implied covenant can only be used conservatively [and] . . . is only rarely invoked successfully.").

[22]*E.g.*, *Cincinnati SMSA*, 708 A.2d at 992 (noting that judicial use of the Implied Covenant to imply terms into a contract "should be rare and fact-intensive").

[23]Since the beginning of 2011 alone, Delaware courts have sustained claims based on the Implied Covenant in the following cases: Blaustein v. Lord Baltimore Capital Corp., 2012 WL 2126111, at *6 (Del. Ch. May 31, 2012) (involving a shareholder agreement); JPMorgan Chase & Co. v. Am. Century Cos., 2012 WL 1524981, at *8 (Del. Ch. Apr. 26, 2012) (involving a stock option agreement); Clean Harbors, Inc. v. Safety-Kleen, Inc., 2011 WL 6793718, at *9 (Del. Ch. Dec. 9, 2011) (involving a stock option agreement); QVT Fund LP v. Eurohypo Capital Funding LLC I, 2011 WL 2672092, at *13-*15 (Del. Ch. July 8, 2011) (involving an LLC operating agreement).

[24]*See infra* note 227 and accompanying text.

[25]*See infra* Part IV.A.

[26]*See infra* Part III.B.

The remainder of this Article proceeds in four parts. Part II describes the central tenet and conflicting conceptions of the Implied Covenant as it is applied under Delaware law. To make sense of these conflicts, Part III explains the unacknowledged role that judicial construction and equitable discretion play in the enforcement of express contract terms and the Implied Covenant. Using this explanation, Part IV harmonizes the conflicting conceptions of the Implied Covenant and explores its implications on various facets of the doctrine. Part V briefly concludes by reflecting on the unwaivability of the Implied Covenant as compared to corporate law's fiduciary obligations.

II. THE IMPLIED COVENANT

A central aim—if not *the* central aim—of contract law is to protect and fulfill the reasonable expectations of the parties in forming a contract.[27] Typically, parties articulate their intent in the express terms of an agreement, and courts fulfill the parties' expectations by enforcing those terms against them. But the law also recognizes that the expectations of contracting parties are not exclusively defined by the express terms of their agreement.[28] No matter how skilled, sophisticated, or resourceful, parties will be unable to anticipate and address every possible situation that may develop after their contract is formed.[29] Given this reality, there may be instances where one party takes actions that are not expressly prohibited, or even contemplated, by the contract, but nonetheless frustrate the broader intended purpose of the parties'

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[27] *See* Altman & Raju, *supra* note 8, at 1476 ("[O]ne of the central aims of contract law [is] to enforce the reasonable expectations of parties to a contract."); Dobbins, *supra* note 5, at 253 ("Party expectations are an integral part of contract law."); E. Allan Farnsworth, *Disputes Over Omission in Contracts*, 68 COLUM. L. REV. 860, 860 (1968) ("It is a commonplace that, absent some overriding public policy, courts are to enforce contracts in accordance with the 'expectations of the parties.'").

[28] *See* Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, 80 ST. JOHN'S L. REV. 559, 576 (2006) ("[C]ourts, whether implicitly or explicitly, and regardless of their jurisprudential philosophy . . . acknowledge the impracticality (due to transaction costs) and the impossibility (due to the limits of human imagination . . .) of producing an all-encompassing, express agreement."); Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131, 1147 (1995) ("The assumption that most parties in fact reduce their entire agreement to a single, perfectly accurate writing [is] unrealistic."); Van Alstine, *supra* note 6, at 1272 (explaining that modern contract law rejects the presumption "that the only relevant understandings and expectations [of contracting parties] are those that have found their way into the express terms of the parties' writing").

[29] *See infra* notes 170-73.

agreement. It is in these instances that the Implied Covenant applies.[30] Thus, like much of contract law, the Implied Covenant is fundamentally a doctrine invoked to protect and fulfill each party's reasonable expectations.[31]

A. *Basic Doctrine*

Over time, Delaware courts have formulated various definitions of the Implied Covenant. Under one common definition, the Covenant "requires a party in a contractual relationship to refrain from [conduct that] prevent[s] the other party to the contract from receiving the fruits of the bargain."[32] A second definition provides that "parties are liable for

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[30]As former Chancellor Allen recognized long ago in describing the Implied Covenant:

> If the purpose of contract law is to enforce the reasonable expectations of parties induced by promises, then at some point it becomes necessary for courts to look to the substance rather than to the form of the agreement, and to hold that substance controls over form. What courts are doing here, whether calling the process "implication" of promises, or interpreting the requirements of "good faith", as the current fashion may be, is but a recognition that the parties occasionally have understandings or expectations that were so fundamental that they did not need to negotiate about those expectations.

Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986) (quoting CORBIN ON CONTRACTS § 570, at 601 (Kaufman Supp. 1984)).

[31]*See* Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010) (en banc) (noting that the Implied Covenant is invoked to "imply contract terms when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected."); Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (Del. 2005) (en banc) ("The implied covenant . . . requires that [each party to a contract] act in a way that honors the [other's] reasonable expectations."); Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (noting that the Implied Covenant is invoked to "imply[] such terms in an agreement so as to honor the parties' reasonable expectations"); Airborne Health, Inc., v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009) ("[T]he [implied] covenant exists to fulfill the reasonable expectations of the parties . . . ."); *Amirsaleh II*, 2009 WL 3756700, at *5 (Del. Ch. Nov. 9, 2009) ("[T]he implied covenant is best understood as a judicial tool used to imply terms in a contract that protect the reasonable expectations of the parties . . . .") (internal quotation marks omitted); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981) ("Good faith . . . emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."); Altman & Raju, *supra* note 8, at 1476 ("The Implied Covenant arises to advance . . . the reasonable expectations of parties to a contract."); Van Alstine, *supra* note 6, at 1275-76 ("Among commentators and the courts alike there is now substantial agreement that the doctrine of good faith performance protects the 'reasonable' or 'justified' expectations of the contracting parties.").

[32]*Dunlap*, 878 A.2d at 442 (internal quotation marks omitted); *id*. at 447 (Ridgely, J., dissenting) (quoting, with approval, the *Dunlap* majority opinion); *Nemec*, 991 A.2d at 1128 &

breaching the [C]ovenant when their conduct frustrates the overarching purpose of the contract."[33] Still another definition describes the Covenant as a "judicial convention designed to protect the spirit of an agreement."[34] Despite varying diction, each definition articulates a common principle: that the Covenant implies terms into a contract to protect and fulfill each party's reasonable expectations.[35]

Beyond this core principle, however, Delaware law has never defined the precise contours of the doctrine.[36] In particular, Delaware courts have avoided providing an all-encompassing definition of the kinds or categories of conduct that may, without violating the express terms of a contract, still breach the Implied Covenant.[37] At various times, Delaware courts have articulated the Covenant to prohibit (a) "arbitrary or unreasonable conduct;"[38] (b) "oppressive or underhanded tactics;"[39] (c) "fraud, deceit or misrepresentation;"[40] and (d) opportunism, by "taking advantage of [one's] control [in the] implementation of the agreement[]."[41] But these articulations are less legal tests by which to measure one's actions and more conclusory descriptions of conduct found to upset another's reasonable expectations.[42] In the absence of any

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n.25 (quoting *Dunlap*, 878 A.2d at 442).

[33]*Dunlap*, 878 A.2d at 442 (internal quotation marks omitted); *see also Amirsaleh I*, 2008 WL 4182998, at *9 & n.48 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 628 & n.48 (2009) (quoting *Dunlap*, 878 A.2d at 442); Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 636 & n.26 (Del. Ch. 2011) (quoting *Dunlap*, 878 A.2d at 442).

[34]Chamison v. HealthTrust, Inc.—The Hosp. Co., 735 A.2d 912, 920 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000) (unpublished table decision); *Amirsaleh I*, 2008 WL 4182998, at *7 & n.41, *reprinted in* 34 DEL. J. CORP. L. at 628 & n.41 (quoting *Chamison*, 735 A.2d at 920); Bakerman v. Sidney Frank Imp. Co., 2006 WL 3927242, at *19 & n.114 (Del. Ch. Oct. 16, 2006), *reprinted in* 32 DEL. J. CORP. L. 551, 581 & n.114 (2007) (quoting *Chamison*, 735 A.2d at 920).

[35]*See supra* note 31 and accompanying text.

[36]*See supra* note 12 and accompanying text.

[37]*See supra* note 13 and accompanying text.

[38]*Dunlap*, 878 A.2d at 442 (internal quotation marks omitted).

[39]*Chamison*, 735 A.2d at 920.

[40]Merrill v. Crothall-American, Inc., 606 A.2d 96, 101 (Del. 1992) (internal quotation marks omitted) (noting, in the employment context, that a breach of the Implied Covenant requires "an aspect of fraud, deceit or misrepresentation"); Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992-93 (Del. 1998) (quoting *Merrill*, 606 A.2d at 101, and applying it in the context of a limited partnership agreement).

[41]*Dunlap*, 878 A.2d at 442.

[42]*See* Altman & Raju, *supra* note 8, at 1478 ("[A]lthough . . . cases issue relatively broad proclamations as to what constitutes good faith and faith dealing, none of these cases attempt to define [those broad proclamations]."); *cf. Amirsaleh I*, 2008 WL 4182998, at *8 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 627 (2009) ("Each turn of phrase—'oppressive or underhanded tactics' and 'arbitrary or unreasonable conduct'—is an attempt to capture what it means to act in contravention of the implied covenant or unfairly and in bad faith.").

well-defined standards, much about the scope and nature of the Covenant seems uncertain.[43]

B. *Doctrinal Conflicts*

Given this uncertainty, it is unsurprising that Delaware courts have over time adopted contradictory conceptions of the Implied Covenant. On one hand, Delaware courts describe the Covenant as a mere "gap filler," a doctrine that cannot be used to equitably rewrite the express terms of a bargained-for agreement.[44] But at the same time, Delaware courts describe the Covenant in language that suggests the doctrine is something broader: an unwaivable, overriding obligation implied into every contract and judicially invoked when fairness dictates.[45]

1. A Mere Gap Filler

From the Covenant's core tenet—to protect and fulfill the parties' reasonable expectations[46]—Delaware courts have consistently drawn a seemingly uncontroversial conclusion: that the Covenant *cannot* be invoked to imply terms that would "contradict,"[47] "override,"[48] or "circumvent"[49] the express terms of an agreement. The express terms are, after all, the best and clearest indication of the parties' expectations. So, to judicially imply terms to contradict an agreement's express terms would frustrate, not protect, those expectations.[50]

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[43]For one vivid illustration of the uncertainty surrounding the Implied Covenant, consider Chancellor Chandler's survey of Delaware case law suggesting that there is a legal difference between "bad faith" and "not in good faith," meaning that one could, in theory, act in "neutral faith." *See Amirsaleh II*, 2009 WL 3756700, at *4-*5 (Del. Ch. Nov. 9, 2009).

[44]*See infra* Part II.B.1.

[45]*See infra* Part II.B.2.

[46]*See supra* note 31 and accompanying text.

[47]*See* Nemec v. Shrader, 991 A.2d 1120, 1127 (Del. 2010) (en banc) ("The implied covenant will not infer language that contradicts a clear exercise of an express contractual right.").

[48]*See* Kuroda v. SPJS Holdings, L.L.C., 971 A.2d 872, 888 (Del. Ch. 2009) ("The implied covenant cannot be invoked to override the express terms of the contract.").

[49]*See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005) (en banc) ("Existing contract terms control . . . such that implied good faith cannot be used to circumvent the parties' bargain . . . ."); Homan v. Turoczy, 2005 WL 5756927, at *18 (Del. Ch. Aug. 12, 2005) ("[T]he implied covenant cannot be asserted to circumvent the express terms of the parties' bargain . . . .").

[50]*See* Altman & Raju, *supra* note 8, at 1479-80.

Thus, Delaware courts commonly characterize the Implied Covenant as a contractual "gap filler,"[51] invoked to imply terms only when it is necessary to address matters not otherwise addressed by the express terms of an agreement.[52] Where a contract is "truly silent"[53] with respect to a given matter, the Covenant "fills" the "gap" with an implied obligation of good faith and fair dealing. As such, the Covenant reflects a sensible legal presumption: that in the absence of express terms reflecting a contrary bargained-for expectation, the parties to a contract reasonably expect honesty and fairness.[54]

Conceived in this way, the Implied Covenant is invoked not because of equitable considerations, but because the parties' contract is incomplete, and the Covenant is necessary to advance or protect their reasonable expectations.[55] But "where the subject at issue is expressly covered by the contract . . . , the implied duty [of] good faith does not come into play."[56] There is no gap to fill. As a result, one "cannot base a

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[51]*See Nemec*, 991 A.2d at 1132 & n.42 (Jacobs, J., dissenting) ("The implied covenant is a 'gap filler.'"); Gerber v. Enter. Prods. Holdings, LLC, 2012 WL 34442, at *13 n.58 (Del. Ch. Jan. 6, 2012) ("[A]lthough the covenant of good faith and fair dealing may sound like some grandiose principle, it is a gap-filler . . . . [A]s the Supreme Court has explained [in *Nemec*], if a contract has no gaps, then the implied covenant is not applicable to that contract.").

[52]*See Nemec*, 991 A.2d at 1125; *Dunlap*, 878 A.2d at 441.

[53]*See In re* IAC/Interactive Corp., 948 A.2d 471, 506 & n.164 (Del. Ch. 2008) (quoting Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1032-33 (Del. Ch. 2006)); *Allied Capital*, 910 A.2d at 1032-33 ("[I]mplied covenant analysis will only be applied when the contract is truly silent with respect to the matter at hand . . . ."); *accord* AQSR India Private, Ltd. v. Bureau Veritas Holdings, Inc., 2009 WL 1707910, at *11 (Del. Ch. June 16, 2009) ("[T]he implied covenant . . . is recognized only where a contract is silent as to the issue in dispute.").

[54]*See Amirsaleh I*, 2008 WL 4182998, at *1 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 615 (2009) ("[T]he law presumes that parties never accept the risk that their counterparties will [act] in bad faith. Consequently, in every contract there exists an implied covenant of good faith and fair dealing."); Van Alstine, *supra* note 6, at 1289-92 (describing the Implied Covenant as a rebuttable legal presumption).

[55]*See* Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 1997 WL 525873, at *5 (Del. Ch. Aug. 13, 1997), *reprinted in* 23 DEL. J. CORP. L. 760, 773 (1998) ("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.") (internal quotation marks omitted), *aff'd*, 708 A.2d 989 (Del. 1998).

[56]Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc., 622 A.2d 14, 23 (Del. Ch. 1992), *aff'd*, 609 A.2d 668 (Del. 1992) (unpublished table decision); Airborne Health, Inc., v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009) (quoting *Dave Greytak*, 622 A.2d at 23); Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *10 (Del. Ch. May 7, 2008) ("[B]ecause the implied covenant is, by definition, *implied,* and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers

claim for breach of the implied covenant on conduct authorized by the [express terms of an] agreement."[57]

Consistent with this conception of the Implied Covenant as a gap filler, Delaware courts also assert that the Covenant is not a license to judicially "rewrite" an agreement,[58] equitably rebalancing the parties' economic interests.[59] Implying terms *ex post* that the parties never intended would frustrate, rather than fulfill, the parties' bargained-for expectations.[60] Recognizing this risk, Delaware law provides the Implied Covenant should not be used to imply terms to address matters that could have been anticipated but "that the parties simply failed to consider."[61] Doing so would grant plaintiffs "contractual protections that they failed to secure for themselves at the bargaining table."[62] It would have the court "substitute its notions of fairness for the terms of the agreement reached by the parties."[63] Thus, Delaware courts assert, "[p]arties have a right to enter into good and bad contracts, the law enforces both."[64]

2. An Unwaivable, Overriding Obligation

Alongside its conception as a gap filler, Delaware courts have also described the doctrine in broader terms, suggesting the Covenant is something more than a mere gap filler; it is an unwaivable, overriding

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the subject at issue.").

[57]*Nemec*, 991 A.2d at 1125-26 (internal quotation marks omitted); *see also Fisk Ventures, LLC*, 2008 WL 1961156, at *11 ("The mere exercise of one's contractual rights, without more, cannot constitute . . . a breach [of the implied covenant].") (internal quotation marks omitted).

[58]*See Nemec*, 991 A.2d at 1126 ("[W]e must . . . not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal."); *see also ASB Allegiance I*, 2012 WL 1869416, at *19 (Del. Ch. May 16, 2012) ("The [implied covenant] should not be used to 'rewrite the contract' that a party now regards as a 'bad deal.'") (quoting *Nemec*, 991 A.2d at 1126); Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 637 (Del. Ch. 2011) ("[T]he implied covenant is not a license to rewrite contractual language just because the plaintiff failed to negotiate for [better] protections . . . .").

[59]*See Nemec*, 991 A.2d at 1128.

[60]*Id.*

[61]*Id.* at 1126.

[62]Aspen Advisors LLC v. United Artists Theatre Co., 843 A.2d 697, 707 (Del. Ch. 2004), *aff'd*, 861 A.2d 1251 (Del. 2004) (en banc).

[63]Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at *28 (Del. Ch. Apr. 29, 2005), *reprinted in* 30 DEL. J. CORP. L. 993, 1043 (2005); *accord* Klig v. Deloitte LLP, 36 A.3d 785, 797 (Del. Ch. 2011) ("[The Implied Covenant] does not empower the Court to impose on the parties its own view of what would be fair or reasonable."); *Nemec*, 991 A.2d at 1128 ("Crafting . . . a post contracting equitable amendment that shifts economic benefits [from one contracting party to the other] would vitiate the limited reach of the [Implied Covenant].").

[64]*Nemec*, 991 A.2d at 1126.

obligation, *beyond* those expressed in the parties' agreement. For example, the Covenant "requires more than just literal compliance" with the express terms of a contract.[65] It requires parties "to preserve the *spirit* of the bargain"[66]—to adhere to the "*substance*" of their agreement rather than the "letter."[67] In short, it requires each party to honor the other's reasonable expectations.[68] Consequently, the Covenant may be invoked even if a party's actions "do[] not violate the express terms of the agreement."[69] Because even in the absence of any gaps in the contract, each party is bound to an unwaivable, overriding obligation to refrain from conduct that would frustrate the other party's reasonable expectations.[70]

Importantly, this broader conception of the Implied Covenant seems to fundamentally conflict with the doctrine's conception as a mere contractual gap filler. As a gap filler, the Implied Covenant may not be invoked to "contradict" or "override" the express terms of an agreement.[71] But under the doctrine's broader conception, even the express terms of an agreement are subject to and limited by an unwaivable, overriding obligation.[72] Thus, the broader conception of the Implied Covenant would prohibit one party from exercising its express rights under a

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[65]*Dunlap*, 878 A.2d at 444; *see also Nemec*, 991 A.2d at 1132 (Jacobs, J., dissenting) (quoting *Dunlap*, 878 A.2d at 444).

[66]*Dunlap*, 878 A.2d at 444 (internal quotation marks omitted); *accord* Chamison v. HealthTrust, Inc.—The Hosp. Co., 735 A.2d 912, 920 (Del. Ch. 1999) ("Th[e] implied covenant is a judicial convention designed to protect the spirit of an agreement . . . ."); *see also Amirsaleh I*, 2008 WL 4182998, at *9 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 629 (2009) (quoting *Chamison*, 735 A.2d at 920); *Frontier Oil*, 2005 WL 1039027, at *28, *reprinted in* 30 DEL. J. CORP. L. at 1043 (quoting *Chamison*, 735 A.2d at 920).

[67]*Dunlap*, 878 A.2d at 444; *In re* IAC/Interactive Corp., 948 A.2d 471, 506 (Del. Ch. 2008).

[68]*See Nemec*, 991 A.2d at 1131-32 (Jacobs, J., dissenting); *Dunlap*, 878 A.2d at 444.

[69]*Amirsaleh II*, 2009 WL 3756700, at *5 (Del. Ch. Nov. 9, 2009) ("[The Implied Covenant] is triggered when the defendant's conduct does not violate the express terms of the agreement but nevertheless deprives the plaintiff of the fruits of the bargain."); *accord Amirsaleh I*, 2008 WL 4182998, at *9, *reprinted in* 34 DEL. J. CORP. L. at 629 ("[T]he implied covenant . . . protects the spirit of the agreement and may, therefore, be offended even when a party has not violat[ed] an express term of the agreement.") (internal quotation marks omitted); PAMI-LEMB I Inc. v. EMB-NHC, L.L.C., 857 A.2d 998, 1016 (Del. Ch. 2004) ("A party may breach the implied covenant of good faith and fair dealing without violating an express term of the contract.").

[70]*See Nemec*, 991 A.2d at 1131 (Jacobs, J., dissenting); *Dunlap*, 878 A.2d at 444-45.

[71]*See supra* notes 47-49 and accompanying text.

[72]*See Nemec*, 991 A.2d at 1132 (Jacobs, J., dissenting) ("The exercise of any contractual right is limited by an implied duty to act reasonably and in good faith.").

contract where doing so would frustrate the other party's reasonable expectations.[73]

Consistent with this conception of the Implied Covenant as an unwaivable, overriding obligation, Delaware courts have long described the Covenant as a doctrine rooted in and guided by the courts' equitable discretion.[74] It is a judicial convention that arises from "fundamental notions of fairness"[75] and, therefore, the application of the Covenant is "governed solely by issues of compelling fairness."[76] Thus, the Covenant may be invoked to "preserve the *spirit* of the bargain rather than the letter, the adherence to *substance* rather than form."[77] Put differently, when fairness dictates, the Implied Covenant may be invoked, *despite* the express terms of a contract, to protect a party's reasonable expectations.

C. *Doctrinal Conflicts in Practice:* Dunlap *and* Nemec

Rather than resolving, or even acknowledging, these doctrinal conflicts, Delaware courts have applied the Implied Covenant in an ad hoc fashion, invoking one conception of the Covenant to decide a given dispute, without explaining why a conflicting conception of the doctrine does not compel a different conclusion.[78] This ad hoc approach has, in turn, yielded contradictory, indeterminate case law.

To see this, one need look no further than the Delaware Supreme Court's two most recent attempts to grapple with the Covenant: *Dunlap v. State Farm*[79] and *Nemec v. Shrader*.[80] Factually, *Dunlap* and *Nemec*,

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[73]*See Nemec*, 991 A.2d at 1131 (Jacobs, J., dissenting) ("[A] contracting party, even where expressly empowered to act, can breach the implied covenant if it exercises that contractual power arbitrarily or unreasonably.") (citing *Dunlap*, 878 A.2d at 442).

[74]*See* E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 440-41 (Del. 1996) (en banc) (citing Blish v. Thompson Automatic Arms Corp., 64 A.2d 581 (Del. 1948)) (discussing the Implied Covenant's long history).

[75]Williams Natural Gas Co. v. Amoco Prod. Co., 1991 WL 58387, at *11 (Del. Ch. Apr. 16, 1991) (internal quotation marks omitted); Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at *28 (Del. Ch. Apr. 29, 2005), *reprinted in* 30 DEL. J. CORP. L. 993, 1043 (2005) (quoting *Williams Natural Gas*, 1991 WL 58387, at *11); *accord* FARNSWORTH, *supra* note 6, § 7.17, at 340-41 ("The implied duty [of good faith] is based on fundamental notions of fairness.").

[76]*Dunlap*, 878 A.2d at 444 (internal quotation marks omitted); *accord* Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (noting that the application of the Implied Covenant "should be rare and fact-intensive, turning on issues of compelling fairness.").

[77]*Dunlap*, 878 A.2d at 444 (internal quotation marks omitted).

[78]*See supra* note 13 and accompanying text.

[79]878 A.2d 434 (Del. 2005) (en banc).

[80]991 A.2d 1120 (Del. 2010) (en banc).

decided less than five years apart, are strikingly similar.[81] In both cases, the defendant took an action in accordance with its express rights under the unambiguous terms of a contract with the plaintiff. And in both cases, the plaintiff complained that the defendant's actions frustrated the plaintiff's reasonable expectations because, although expressly contemplated by the contract, the defendant's actions served no other purpose than to financially disadvantage the plaintiff.[82] Despite these basic factual similarities, the court reached opposite conclusions in its application of the Implied Covenant.

In *Dunlap*, the court endorsed the broader overriding-obligation conception of the Implied Covenant, holding that one may breach the Covenant even when one exercises its "clear and unambiguous" rights under an express agreement.[83] To reach this conclusion, the court reasoned that the Implied Covenant "requires more than just literal compliance with . . . provisions [of the express agreement] . . . . [It] requires that [each party] act in a way that honors the [other]'s reasonable expectations."[84] In holding so, the court seemed almost certainly influenced by equitable considerations. The court faced a particularly sympathetic plaintiff, an individual who had "suffered catastrophic injuries" at the hands of another's negligence, leaving her "partially paralyzed" and with "hundreds of thousands of dollars in medical expenses;"[85] along with a less sympathetic defendant, the insurance giant State Farm, which had, in the court's view, "take[n] advantage of [its] unequal position[]"[86] under the unnegotiated terms of a contract of adhesion.[87] Observing that the Implied Covenant is "governed solely by

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[81] *See id.* at 1134 (Jacobs, J., dissenting) (comparing the factual similarities of *Nemec* and *Dunlap*).

[82] In *Dunlap*, the plaintiff claimed that, despite the express terms of the insurance policy at issue in the case, the defendant's insistence on the exhaustion requirement of the policy was arbitrary and unreasonable because it advanced no legitimate interest of the defendant, yet resulted in the plaintiff risking and ultimately losing monetary recovery in a separate lawsuit. *Dunlap*, 878 A.2d at 444-45. In *Nemec*, the plaintiffs claimed that, despite the express terms of the stock option plan at issue in the case, the defendant's decision to exercise its call option on the plaintiffs' shares in the defendant just weeks before a lucrative merger was arbitrary and unreasonable because it advanced no legitimate interest of the defendant, yet denied the plaintiffs the right to participate in the merger consideration. *Nemec*, 991 A.2d at 1123-25.

[83] *Dunlap*, 878 A.2d at 439, 443-45.

[84] *Id.* at 444.

[85] *Id.* at 437-38.

[86] *Id.* 878 A.2d at 444.

[87] *See* Hallowell v. State Farm Mut. Auto. Ins. Co., 443 A.2d 925, 926 (Del. 1982) ("[A]n insurance policy is an adhesion contract and is not generally the result of arms-length

issues of compelling fairness,"[88] the court found occasion to invoke the Covenant, notwithstanding the unambiguous terms of the contract, an underinsured motorist policy, which under the circumstances provided State Farm an express right to deny the plaintiff coverage.[89]

In contrast to *Dunlap*, the court in *Nemec* deferred to the Covenant's more neutered gap filler conception, holding that the doctrine "will not infer language that contradicts . . . an express contractual right."[90] To justify its holding, the court reasoned that "[a] party does not act in bad faith by relying on contract provisions for which that party bargained."[91] Unlike *Dunlap*'s equitable considerations, the court in *Nemec* seemed unmoved by the plaintiffs—two wealthy retirees, former executives and shareholders of the defendant, the prestigious consulting firm Booz Allen—who sought to participate in the proceeds of a lucrative merger.[92] On this occasion, the court declined to invoke the Implied Covenant to prohibit Booz Allen from exercising its express contractual right[93] to repurchase the plaintiffs' stock for the sole purpose of excluding them from the merger consideration.[94] The Implied Covenant is "not an equitable remedy," the court concluded, that would imply terms *ex post* to prohibit "conduct authorized by the agreement."[95]

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negotiation . . . .").

[88]*Dunlap*, 878 A.2d at 442 (internal quotation marks omitted).

[89]In *Dunlap*, the insurance policy at issue provided, in relevant part, that the defendant shall not be obligated to make any payments under the policy unless the limits of "*all* bodily injury liability bonds or policies [available to the plaintiff] have been *used up* by payments of judgments or settlements." *Id.* at 446. Because the plaintiff had not yet exhausted her potential coverage under an unrelated third-party's policy, the defendant refused to make any payments under its policy. *Id.* at 438.

[90]Nemec v. Shrader, 991 A.2d 1120, 1127 (Del. 2010) (en banc).

[91]*Id.* at 1128.

[92]*See id.* ("[T]he plaintiffs would have us believe—without justification—that long term stockholders of a prestigious mergers and acquisition consulting firm would have no expectation that a future acquirer would be interested in purchasing all or part of the Company.").

[93]In *Nemec*, the stock option plan at issue provided the defendant Booz Allen with "the right, exercisable at any time . . . to purchase all or any portion of the Class A Non-Voting Common Stock" held by any former employees of the defendant. Nemec v. Shrader, 2009 WL 1204346, at *5 (Del. Ch. Apr. 30, 2009), *reprinted in* 35 DEL J. CORP. L. 367, 373 (2010). Weeks before consummating a lucrative merger transaction, Booz Allen exercised this right, denying the plaintiffs, former employees of Booz Allen, a pro rata share of the merger consideration. *Id.* at *3, *reprinted in* 35 DEL J. CORP. L. at 370-71.

[94]*See Nemec*, 991 A.2d at 1133-35 (Jacobs, J., dissenting) (articulating the plaintiffs' argument). In short, the plaintiffs argued that by excluding them from the merger consideration, Booz Allen obtained no benefit for itself; rather Booz Allen's repurchase of the plaintiffs' shares benefitted only Booz Allen's other shareholders, who received a larger pro rata share of the merger consideration.

[95]*Nemec*, 991 A.2d at 1126, 1128.

Curiously, in both *Dunlap* and *Nemec*, the court described the Implied Covenant with language that could have easily justified the opposite result. In *Dunlap*, the court observed that "one generally cannot base a claim for breach of the implied covenant on conduct authorized by the terms of the agreement,"[96] even while it applied the doctrine to prohibit the defendant State Farm from exercising its express right to deny the plaintiff coverage under the given circumstances.[97] Meanwhile, in *Nemec*, the court acknowledged that a party may breach the Implied Covenant when it "act[s] arbitrarily or unreasonably, thereby frustrating the fruits of the bargain,"[98] even while it declined to invoke the doctrine to prohibit the defendant Booz Allen from exercising its express repurchase right under circumstances similar to those that the *Dunlap* court found to fit this very description.[99]

Thus, taken together, *Dunlap* and *Nemec* highlight the indeterminacy of the Implied Covenant. Despite similar facts, the court reached opposite outcomes, drawing on contradictory facets of the same legal doctrine, with equitable considerations seeming to dictate the disparate results. But each case, standing alone, could be used to demonstrate the indeterminacy of the doctrine. Both *Dunlap* and *Nemec* are extraordinary for their dissenting opinions, which are a relative rarity for the Delaware Supreme Court.[100] These dissents reveal that even among the Delaware justices there is a fundamental disagreement as to when and how the Implied Covenant applies—not just to *similar* facts, but to the *same* facts.

Both *Dunlap* and *Nemec* were heard by the same five justices. In *Dunlap*, Chief Justice Steele along with Justices Berger, Holland, and Jacobs joined the majority opinion, applying the doctrine's broader

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[96]Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 441 (Del. 2005) (en banc).

[97]*See supra* note 82 and accompanying text.

[98]*Nemec*, 991 A.2d at 1126 (citing *Dunlap*, 878 A.2d at 442).

[99]*Id.* at 1128. In his dissent in *Nemec*, Justice Jacobs summarized the similarities between the two cases:

> Here, [the defendant]—like the [defendant] in *Dunlap*—had an express contractual right. Here, as in *Dunlap*, the [defendant] would have incurred no prejudice by forbearing to exercise that right . . . . In these circumstances, [the defendant's] exercise of that right . . . , which resulted in material prejudice to the plaintiffs, invokes—and pleads a cognizable claim for breach of—the implied covenant.

Id. at 1134 (Jacobs, J., dissenting); *see also Dunlap*, 878 A.2d at 444-45 (holding that the defendant's actions were arbitrary and unreasonable because they did not advance any legitimate interest of the defendant).

[100]*See* David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 129, 132 (1997).

conception.[101] In dissent, Justice Ridgley, while accepting the majority's doctrinal formulation of the Implied Covenant,[102] argued that the Covenant was inapplicable because "the subject at issue was expressly covered by the contract;" therefore, the defendant, State Farm, could not have frustrated the plaintiff's reasonable expectations.[103]

In *Nemec*, Justice Ridgley was in the majority, this time joined by Justice Holland and Chief Justice Steele, in applying the Covenant's more conservative gap filler conception.[104] In a thoughtful and biting dissent, Justice Jacob, joined by Justice Berger, consistent with their earlier position in *Dunlap* rearticulated the doctrine's broader conception,[105] asserting that "a contracting party, even where expressly empowered to act, can breach the implied covenant . . . ."[106]

III. EXPRESS TERMS AND JUDICIAL CONSTRUCTION

Together, *Dunlap* and *Nemec* highlight the fundamental contradictions of the Implied Covenant. It is both a gap filler, subject to the express terms of a contract, and an unwaivable, overriding obligation, notwithstanding the express terms of a contract. The Covenant is not a judicial license to equitably rewrite bargained for agreements, yet courts may invoke the doctrine to limit express contractual rights when fairness dictates. How can these conflicting conceptions of the Implied Covenant coexist?

The answer lies in an inescapable reality that is all but unacknowledged in Delaware case law: the express terms of every contract must be judicially construed. Strictly speaking, the process of construction is distinct from the process of interpretation.[107]

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[101] *Dunlap*, 878 A.2d at 437.

[102] *Id.* at 447 (Ridgely, J., dissenting) ("The implied 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.'") (quoting the majority in *Dunlap*).

[103] *Id.* at 446-47 (Ridgely, J., dissenting).

[104] *Nemec*, 991 A.2d at 1122.

[105] *Id.* at 1132 (Jacobs, J., dissenting) ("The grant of an unqualified contractual right is not, nor can it be, a green light that authorizes the right holder to exercise its power in an arbitrary or unreasonable way. The exercise of any contractual right is limited by the implied duty to act reasonably and in good faith.").

[106] *Id.* at 1131 (Jacobs, J., dissenting) (citing *Dunlap*, 878 A.2d at 442).

[107] *See* FARNSWORTH, *supra* note 6, § 7.7, at 255-56; 5 MARGARET N. KNIFFIN, CORBIN ON CONTRACTS: INTERPRETATION OF CONTRACTS § 24.3, at 7-8 (Joseph M. Perillo ed., rev. ed. 1998) [hereinafter CORBIN ON CONTRACTS].

Interpretation is the process by which a court resolves ambiguity in the express terms of a contract.[108] Ambiguity exists when the express terms of a contract are reasonably susceptible to different interpretations.[109] By contrast, construction is the process by which a court determines the scope and legal effect of those terms.[110] When a court construes the express terms of a contract, it must determine if and how those terms apply to the parties' dispute.[111]

All contract terms—even unambiguous terms—must be judicially construed.[112] Yet, when Delaware law simply proclaims that the Implied Covenant will not apply if "the subject at issue is expressly covered by the contract,"[113] or if doing so would "contradict" or "override" the parties' express agreement,[114] the law obscures this reality. Thus, Delaware courts may assert that the Implied Covenant "will only be applied when the contract is truly silent" as to a given matter without explaining when the express terms of a contract are "truly silent."[115] Whether a contract "expressly covers" or is "truly silent" as to a given matter is often an unacknowledged function of judicial construction. It is through judicial construction that contractual gaps are revealed, and it is into these gaps that the Implied Covenant may be invoked.

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[108] *See* FARNSWORTH, *supra* note 6, § 7.7, at 255; CORBIN ON CONTRACTS, *supra* note 107, § 24.3, at 8 ("Through 'interpretation' of a contract, a court determines what meanings the parties, when contracting, gave to the language used.").

[109] Twin City Fire Ins. Co. v. Del. Racing Ass'n, 840 A.2d 624, 628 (Del. 2003) ("Contract language is ambiguous if it is reasonably [. . .] susceptible of [two or more] interpretations or may have two or more different meanings.") (internal quotation marks omitted); *see also* FARNSWORTH, *supra* note 6, § 7.12a, at 305.

[110] *See* FARNSWORTH, *supra* note 6, § 7.7, at 255-56; CORBIN ON CONTRACTS, *supra* note 107, § 24.3, at 8 ("Through 'construction' of a contract, a court determines the legal operation of the contract—its effect upon the rights and duties of the parties.").

[111] *See* Ann E. Conaway, *The Multi-Facets of Good Faith in Delaware: A Mistake in the Duty of Good Faith and Fair Dealing; A Different Partnership Duty of Care; Agency Good Faith and Damages; Good Faith and Trust Law*, 10 DEL. L. REV. 89, 106 (2008) ("The process of construction is different and begins only after interpretation comes to an end. Construction is the process whereby a court extends legal effect to a contract for a situation in which the parties have not provided a relevant term to interpret.") (internal quotation marks omitted) (quoting JAMES F. HOGG, CARTER G. BISHOP & DANIEL D. BARNHIZER, CONTRACTS: CASES AND THEORY OF CONTRACTUAL OBLIGATION 386 (2007)).

[112] *See* CORBIN ON CONTRACTS, *supra* note 107, § 24.3, at 8 ("[T]he construction of a contract begins with the interpretation of its language but does not end with it . . . ."); Conaway, *supra* note 111, at 106-07.

[113] *See supra* note 56 and accompanying text.

[114] *See supra* notes 47-50 and accompanying text.

[115] *See supra* note 53.

A. *Construing Gaps*

No contract can address every aspect of every possible situation.[116] After all, the limits of human imagination make it impossible for the parties to foresee every potential situation that could arise after the contract's formation.[117] And even if it were possible, contracting is costly. It would be impractical to raise, negotiate, and address every conceivable situation in the express terms of even the most prolix agreement.[118]

Instead, all contracts will have gaps—matters as to which the contract does not expressly articulate the parties' expectations.[119] To deal with these gaps, the court must construe meaning into the contract—it must infer the parties' unexpressed expectations.[120] Of course, sometimes

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[116]*See* Lonergan v. EPE Holdings LLC, 5 A.3d 1008, 1018 (Del. Ch. 2010) (observing that contract parties will necessarily "fail to address [all] future state[s] of the world . . . because contracting is costly and human knowledge imperfect"); *Amirsaleh I*, 2008 WL 4182998, at *1 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 615 (2009) ("No contract, regardless of how tightly or precisely drafted it may be, can wholly account for every possible contingency."); Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991) (Allen, C.), *reprinted in* 17 DEL. J. CORP. L. 1099, 1139 (1992) ("In only a moderately complex or extend[ed] contractual relationship, the cost of attempting to catalog and negotiate with respect to all possible future states of the world would be prohibitive, if it were cognitively possible."); Altman & Raju, *supra* note 8, at 1476 ("Delaware courts have long recognized the difficulty inherent in contract formation relating to the parties' ability to negotiate and describe within their contract all of the possible provisions that could be included.").

[117]*See* Farnsworth, *supra* note 27, at 868-69 & n.60 (explaining that contracting parties have "limited attention" and, therefore, form expectations as to only a limited number of "significant situations"); Van Alstine, *supra* note 6, at 1282 & n.251; *see also* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 214 (1995) (explaining "bounded rationality" in the context of contract formation).

[118]*See* Farnsworth, *supra* note 27, at 869-73 (describing the reasons why, even as to foreseeable matters, contracting parties may fail to articulate their expectations); Van Alstine, *supra* note 6, at 1282.

[119]George M. Cohen, *Implied Terms and Interpretation in Contract Law*, *in* 3 ENCYCLOPEDIA OF LAW AND ECONOMICS pt. IV, § 4400, at 78, 79-80 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) ("[A] complete contract has referred to one that provides a complete description of a set of possible contingencies and explicit contract terms dictating a performance response for each of these contingencies . . . . [N]o real-world contracts are fully complete in this sense . . . ."); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1819 (1991) ("As a practical matter . . . most contracts are quite incomplete.").

[120]*See* Morrell E. Mullins, Sr., *Coming to Terms with Strict and Liberal Construction*, 64 ALB. L. REV. 9, 28 (2000) (noting the "unavoidable" reality of inference and implication in the context of statutory construction). Strictly speaking, "implication" is meaning that a writer has left unexpressed in her writing, while "inference is a conclusion that a [reader] concludes from whatever has been . . . written." *Id.* at 28 n.97. Defined as such, implication and

the express terms of a contract leave little to infer and, therefore, little work for judicial construction.[121] But often the contract will be less certain.

1. Gaps in Discretionary Powers

Consider, for example, the question presented to then-Vice Chancellor (now Chancellor) Strine in *Bay Center Apartments*, a case in which an LLC operating agreement gave the defendant manager the broad power to "*manage* and conduct the operations and affairs of [the LLC] and make all decisions regarding [the LLC] and its business and assets."[122] Without more, this seemingly simple provision leaves an obvious gap in the contract: what limitations, if any, apply to this managerial power? For example, may the defendant cause the LLC to pursue a course that would ultimately deprive the plaintiff, a non-managing member, of the value of its investment?[123]

To be sure, the terms of the contract may be construed to "expressly cover" this gap. After all, the terms do not specifically prohibit the defendant to pursue this particular course of action. And without such language, the terms of the contract may be construed broadly to mean the defendant has the unrestricted power to do so. Importantly, however, this additional meaning is not express in the contract; in that sense the contract is "truly silent." If the parties intended this additional meaning, it must be inferred into the contract. It must be inferred through judicial construction.

In *Bay Center Apartments*, the court declined to infer this additional meaning. Rather, it invoked the Implied Covenant.[124] But the court never explained the contractual gap into which it was applying the doctrine.[125] Instead, the court cited well established precedent applying the Implied Covenant in contracts to limit a party's discretion.[126]

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inference are "inseparably linked" facets of the linguistic meaning of express contract terms. *See id*.; *cf*. Farnsworth, *supra* note 27, at 876 (distinguishing implication from inference in the context of contractual gap filling).

[121] *See infra* note 133 and accompanying text. Note that even when parties fill a gap with express terms, those terms may present issues of judicial interpretation. *See infra* note 154 and accompanying text.

[122] Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451, at *6 (Del. Ch. Apr. 20, 2009).

[123] *See id.* at *7-*8.

[124] *See id.*

[125] *See id.* at *7-*8.

[126] *See Bay Ctr. Apartments*, 2009 WL 1124451, at *7 & n.29.

In the typical "discretion case," the contract explicitly or implicitly gives one party the power to control a significant aspect of the contractual relationship, but otherwise provides few details on how that discretionary power is to be exercised.[127] As the Vice Chancellor noted in *Bay Center Apartments*, in such cases Delaware courts often invoke the Implied Covenant to limit discretionary power.[128] But the Covenant is not invoked simply because one party enjoys discretion under the contract.[129] Nor is it invoked simply because one party's discretionary power creates vulnerability in the other party that justifies equitable limitations.[130] Indeed, the recurring focus on discretion in such cases is misguided. What permits the Implied Covenant to be invoked in such cases is that, in the absence of express terms delineating the scope of a discretionary power, there is a gap in the contract as to the parties' expectations.[131] To fill this gap, the parties' expectations must instead be

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[127]Consider, for example, the typical earn-out dispute, in which a buyer of business assets agrees, as partial consideration for those assets, to make one or more contingent post-closing payments to the seller based on the buyer's revenue or profits generated from the assets. When the so-called earn-out payments leave the seller disappointed, the seller will claim the buyer exercised its discretion over the use of the assets post-closing to benefit itself at the expense of the seller. *See* Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 634 (Del. Ch. 2011); Airborne Health, Inc., v. Squid Soap, LP, 984 A.2d 126, 132-35 (Del. Ch. 2009). Importantly in such cases, the parties' contract does not expressly specify what, if any, post-closing obligations the buyer owes the seller with respect to the buyer's use of the assets. *See Winshall*, 55 A.3d at 632; *Airborne Health*, 984 A.2d 126, 133 ("A . . . noteworthy aspect of the [Asset Purchase Agreement] is the absence of any specific commitments by [the buyer] regarding the level of efforts or resources that it would devote.").

[128]*See Bay Ctr. Apartments*, 2009 WL 1124451, at *7 & n.29. In earn-out disputes, *see supra* note 127, the courts acknowledge the Implied Covenant applies to cabin the buyer's discretion. *See Winshall*, 55 A.3d at 638; *Airborne Health*, 984 A.2d at 146-47.

[129]Lest there is any doubt on this point, consider that even when a contract grants broad discretionary power, a court will *not* invoke the Implied Covenant if the parties expressly agree on the scope of that power. In such cases, there is no gap to fill. *See infra* note 135. Where the Implied Covenant is applied to limit a discretionary power it is not because of the discretionary power *per se;* rather it because there is a gap—a lack of an express agreement—as to the scope of that power.

[130]Even if one party's discretionary power creates extreme vulnerability for another party, a court will not invoke the Implied Covenant when the parties expressly address the scope of that power, because there is no gap to fill. *See* Gerber v. Enterprise Prods. Holdings, LLC, 2012 WL 34442, *12-*13 (Del. Ch. Jan. 6, 2012) (declining to invoke the Covenant, in the context of a master limited partnership agreement, where the defendant general partner allegedly engaged in a grossly unfair self-dealing transaction, because the express terms of the agreement created a conclusive presumption of good faith with respect to the general partner's actions). Where the Implied Covenant is applied to protect a vulnerable party, the gap in which the Implied Covenant operates arises not from the vulnerability created by a discretionary power *per se;* rather it arises from the lack of an express agreement as to the scope of that power.

[131]*See infra* Part IV.B.2.

inferred by the court; the gap must be filled through judicial construction. The court may construe the discretionary power broadly, inferring that the parties intended the power to be unfettered. Or, more commonly, the court may infer otherwise and invoke the Implied Covenant to construe limitations on the scope of discretion.[132]

Notably, however, when the express terms of a contract grant one party's discretion, the gap in the contract is often readily apparent. Hence, it is common for parties to agree on terms expressly defining the scope of a discretionary power. The parties may agree that the discretion-exercising party enjoys unfettered, sole, and absolute discretion[133] or, alternatively, limit the discretionary power with a reasonableness, good faith, or other like qualifier.[134] Any such term would fill the gap in the contract by articulating the parties' bargained-for expectation.[135] Without such language, however, there is a gap in the

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[132] *See infra* Part III.A.2.

[133] *See* Gelfman v. Weeden Investors, LP, 792 A.2d 977, 985 (Del. Ch. 2001) (involving a limited partnership agreement that expressly defined the scope of the general partner's discretionary powers to resolve conflicts of interests in its "sole discretion").

[134] *See* Matthew v. Laudamiel, 2012 WL 605589, at *17-*20 (Del. Ch. Feb. 21, 2012) (involving an LLC operating agreement that under various circumstances expressly defined the scope of the LLC manager's discretionary power with requirements that he "act with diligence," "not unreasonably delay," expending "best efforts" and other like standards); Great-West Inv. LP v. Thomas H. Lee Partners, LP, 2011 WL 284992, at *14 (Del Ch. Jan. 4, 2011) (involving a limited partnership agreement that expressly defined the scope of the general partner's discretionary power with a contractual standard of "good faith"); *In re* Atlas Energy, LLC, 2010 WL 4273122, at *12 (Del. Ch. Oct. 28, 2010), *reprinted in* 36 DEL. J. CORP. L. 823, 841-42 (2011) (involving a master limited partnership agreement that expressly defined the scope of the officers and directors discretionary powers with a contractual standard of subjective "good faith").

[135] When a contract expressly defines the scope of a discretionary power, *see supra* notes 129-30, the express term will govern, and the Implied Covenant will be inapplicable. *See Matthew*, 2012 WL 605589, at *17-*20; *Great-West Investors LP*, 2011 WL 284992, at *14; *In re Atlas Energy*, 2010 WL 4273122, at *12-*13, *reprinted in* 36 DEL. J. CORP. L. at 842-43; *see also* Policemen's Annuity & Benefit Fund v. DV Reality Advisors, LLC, 2012 WL 3548206, at *12 (Del. Ch. Aug. 16, 2012) ("When a contract provision states how a grant of discretion is to be exercised, there is no place for the implied covenant in that provision."); ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member LLC (*ASB Allegiance II*), 50 A.3d 434, 441 (Del. Ch. 2012) ("The contract may identify factors that the [discretion exercising party] can consider, and it may provide a contractual standard for evaluating the decision. Express contractual provisions always supersede the implied covenant . . . .").

This principle often plays out in the context of merger and acquisition agreements, where a party's "discretionary power" to close (or not close) on the transaction is normally subject to terms that expressly define the scope of that power and, thus, preclude the Implied Covenant. *See* Narrowstep, Inc. v. Onstream Media Corp., 2010 WL 5422405, at *11 (Del. Ch. Dec. 22, 2010) (holding, in the context of a merger agreement, that because defendant's failure to close is subject to an express "reasonable best efforts" standard, the Implied

contract—a gap which requires judicial construction. And into this gap, the court may construe limitations by applying the Implied Covenant.

2. Gaps in Express Rights

From the discussion above, one can begin to see how the Implied Covenant, even as a gap filler, may limit a party's express rights under a bargained-for agreement. It is because parties often neglect to expressly define the scope of their contractual rights. Instead, the scope of their rights must be defined by judicial construction.

Consider the issue presented to former Chancellor Chandler in *Amirsaleh*,[136] a remarkable case[137] in which the defendants exercised an express contractual right to extend the plaintiff's deadline for submitting certain documents relating to a pending merger.[138] In particular, the merger agreement gave the defendants the right to extend the plaintiff's deadline to "such other time and date as [the defendants] may mutually

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Covenant is inapplicable); NACCO Indus., Inc. v. Applica, Inc., 997 A.2d. 1, 20 (Del. Ch. 2009) (holding, in the context of a merger agreement, that because the express "no shop" and "prompt notice" clauses "establish the scope" of the parties' rights and obligations, the Implied Covenant is inapplicable); AQSR India Private, Ltd. v. Bureau Veritas Holdings, Inc., 2009 WL 1707910, at *11 (Del. Ch. June 16, 2009) (holding, in the context of a purchase agreement, that because defendant's decision not to close is subject to an express "material adverse effect" standard, the Implied Covenant is inapplicable).

[136] *Amirsaleh I*, 2008 WL 4182998 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615 (2009).

[137] *Amirsaleh* is notable for two reasons. First, the litigation, which culminated in a trial and a decision on the merits, produced three thoughtfully written opinions analyzing the Implied Covenant. *See Amirsaleh I*, 2008 WL 4182998, *reprinted in* 34 DEL. J. CORP. L. 615 (2009); *Amirsaleh II*, 2009 WL 3756700 (Del. Ch. Nov. 9, 2009); Amirsaleh v. Bd. of Trade of the City of N.Y., Inc. (*Amirsaleh III*), 2010 WL 177681 (Del. Ch. Jan. 19, 2010), *reprinted in* 36 DEL. J. CORP. L. 291 (2011). Second, the Delaware Supreme Court had two opportunities to reverse or correct the doctrinal analysis in those opinions, but in both instances, it declined to do so. The first opportunity came in *Nemec*, where the Delaware Supreme Court considered *Amirsaleh* and, rather than criticize, clarify or overturn Chancellor Chandler's reasoning or holding as it related to the Implied Covenant, merely noted that *Amirsaleh* was "factually distinguishable." Nemec v. Shrader, 991 A.2d 1120, 1127 n.23 (Del. 2010) (en banc). After *Nemec* was decided, the Delaware Supreme Court reviewed *Amirsaleh* directly on appeal, giving the court a second opportunity to clarify or overturn Chancellor Chandler's reasoning or holding as it related to the Implied Covenant. Amirsaleh v. Bd. of Trade of the City of N.Y., Inc., 27 A.3d 522 (Del. 2011) (en banc). Instead, the supreme court avoided the question altogether, reversing Chancellor Chandler's thoughtful opinions on unrelated grounds. *See id.* at 529 (resolving the dispute on the basis of the doctrine of waiver). Given the unanimity norm among the justices of the Delaware Supreme Court, *see* Skeel, *supra* note 100, at 132, the court's ultimate resolution of *Amirsaleh* may have been motivated, in part, by a desire to avoid another fractured opinion involving the Implied Covenant.

[138] *Amirsaleh I*, 2008 WL 4182998, at *7, *reprinted in* 34 DEL. J. CORP. L. at 625-26.

agree."[139] To be sure, this otherwise unambiguous language has only one reasonable interpretation: that the defendants may extend the plaintiff's deadline by their mutual agreement. In that sense, the matter is "expressly covered" by the contract. But even this unambiguous language requires judicial construction because, as to scope of the defendants' otherwise unqualified express right, the language of the contract is "truly silent." For example, may the defendants exercise their right for no other purpose than to disadvantage the plaintiff? It may be that the parties intended the defendants to have the unrestricted right to do so—to extend the plaintiff's deadline under any circumstances and for any reason. But without express language confirming that bargained-for expectation, this additional meaning must be inferred into the contract through judicial construction.

In *Amirsaleh*, the court again declined to infer this additional meaning. Rather, it invoked the Implied Covenant.[140] But like the court in *Bay Center Apartments*,[141] and indeed characteristic of Implied Covenant case law, the court never explained the contractual gap into which it was applying the doctrine. Instead, like then-Vice Chancellor Strine in *Bay Center Apartments*,[142] Chancellor Chandler likened *Amirsaleh* to the same Delaware precedent applying the Implied Covenant in contracts to limit a party's discretion.[143] And in a sense, this is right; the exercise of any contractual right, when there is no obligation to do so, is itself an act of discretion.[144] But the discretion to exercise an

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[139]In particular, the merger agreement provided that the plaintiff must submit an "Election Form" specifying his preferred form of merger consideration "on or before 5:00 p.m. on the fifth day before the NYBOT Members Meeting (*or such other time and date as [the defendants] may mutually agree*)." *Id*., *reprinted in* 34 DEL. J. CORP. L. at 625 (emphasis added).

[140]*See Amirsaleh I*, 2008 WL 4182998, at *9, *reprinted in* 34 DEL. J. CORP. L. at 629 (holding, in the context of a motion for summary judgment, that the defendants' exercise of their express right may breach the Implied Covenant if defendants acted in bad faith). After discovery and a trial, in which the defendants were forced to explain the motives behind their actions, the Court of Chancery ultimately ruled that the defendants' exercise of their express contract right did not breach the Implied Covenant. *Amirsaleh III*, 2010 WL 177681, at *1, *reprinted in* 36 DEL. J. CORP. L. at 291.

[141]*See* Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009).

[142]*See id.* at *6-*8.

[143]*See Amirsaleh I*, 2008 WL 4182998, at *9 & nn.48-49, *reprinted in* 34 DEL. J. CORP. L. at 628-29.

[144]*See* Nemec v. Shrader, 991 A.2d 1120, 1132 n.44 (Jacobs, J., dissenting) (arguing that the exercise of an express contract right, where there is no obligation to do so, is itself an act of discretion); Van Alstine, *supra* note 6, at 1284-86 ("Every contractual right admits, of course, of some form of discretion for its beneficiary.").

expressly specified right seems palpably different than the unbound discretion to control significant aspects of a contractual relationship.[145] All of which goes to show again that the focus on discretion is misguided.[146]

What permitted the application of the Implied Covenant in *Amirsaleh*—and what is left unarticulated by the court in *Amirsaleh*—was not the defendants' discretion to exercise a specific contractual right, but rather that the express language articulating that right left a gap in the contract as to the parties' expectations. The contract expressly granted the defendants the unambiguous right to extend the plaintiff's deadline, but the contract did not expressly define the scope of that right.[147] Like other cases involving discretion, the parties to the contract could have filled this gap. The parties could have expressly agreed that the defendants' right may be exercised under any circumstances and for any reason[148] or, alternatively, limited that right with a reasonableness, good faith or like qualifier.[149] But without such language defining the scope of the defendants' right, there was again a gap in the contract as to the parties' expectation.[150] To fill this gap, the

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[145]Ironically, Chancellor Chandler makes this very point in *Nemec* when he attempts to distinguish *Amirsaleh* by reasoning that there is a difference between the discretion to exercise a "specifically grant[ed]" right (as was evidently the case in *Nemec*) and the discretion to exercise a more broadly granted right (as was evidently the case in *Amirsaleh*). *See* Nemec v. Shrader, 2009 WL 1204346, at *5 n.10 (Del. Ch. Apr. 30, 2009), *reprinted in* 35 DEL. J. CORP. L. 367, 373 n.10 (2010), *aff'd*, 991 A.2d at 1127 n.23 (Del. 2010) (en banc) (affirming that *Amirsaleh* was "factually distinguishable").

[146]*See infra* Part IV.B.2.

[147]*See Amirsaleh I*, 2008 WL 4182998, at *2, *reprinted in* 34 DEL. J. CORP. L. at 616-17.

[148]*See, e.g.*, N.K.S. Distributors, Inc. v. Tigani, 2010 WL 2178520, at *2 n.10 (Del. Ch. May 28, 2010) (holding, in the context of a loan agreement, that the Implied Covenant is inapplicable because the agreement expressly defined the lender's right to pursue its available remedies, even in the event of a minor default, "'singly, successively, or together' against [the borrower or any individual guarantor] 'at [the lender's] sole discretion'").

[149]*See, e.g.*, Policemen's Annuity & Benefit Fund v. DV Reality Advisors, LLC, 2012 WL 3548206, at *12-*13 (Del. Ch. Aug. 16, 2012) (holding, in the context of a limited partnership agreement, that the Implied Covenant is inapplicable because the agreement defined the scope of the limited partner's right to remove the general partner with a contractual standard of "good faith").

[150]Nemec v. Shrader, 991 A.2d 1120, 1132 & n.44 (Del. 2010) (en banc) (Jacobs, J., dissenting) (observing that "unless the contract expressly allows the exercise [of a contractual right] for any (or even no) reason," the scope of a contractual right may be limited by the Implied Covenant.); *see also* Wilmington Leasing, Inc. v. Parrish Leasing Co., 1996 WL 560190, at *2 (Del. Ch. Sept. 25, 1996), *reprinted in* 22 DEL. J. CORP. L. 875, 880 (1997) (holding, in the context of a limited partnership agreement, that although an express term empowering the limited partner to remove the general partner "generally addressed" the

court could construe the contract right broadly, inferring that the parties expected the right to be unrestricted, exercisable under any circumstances and for any reason. Or it could, as it did in *Amirsaleh*, infer otherwise and construe limitations using the Implied Covenant.[151]

B. *Filling Gaps through Judicial Construction*

The preceding discussion makes clear that when parties do not define the scope of an express right or discretionary power, they leave a gap in their contract as to their expectations. Their expectations must instead be inferred; the gap must be filled through judicial construction. This is true regardless of whether a court invokes or declines to invoke the Implied Covenant. In either case, the court is forced to go beyond merely interpreting the express terms of the contract to inferring the parties' unexpressed expectations. But, as explained below, because it is impossible to know the parties' unexpressed expectations, to fill the gap in their contract, a court must inevitably rely on its idiosyncratic notions of equity and reasonableness.

1. The Realities of Contracting and the Limits of Negative Inference

Why did the contracting parties in *Bay Center Apartments*[152] fail to include an express term defining the scope of the defendant's managerial power? And why did the contracting parties in *Amirsaleh*[153] neglect to expressly define the scope of the defendants' right to extend the plaintiff's deadline? In each case, the parties could have easily filled the gap in their contract by articulating their shared expectations. Although there still may have been problems of ambiguity that would require judicial interpretation,[154] doing so would have obviated the need for gap filling by judicial construction. But when parties fail to articulate the scope of a contractual right or power, the resulting gap in the contract makes it

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matter,"[t]he specific question presented here—the scope of the discretion allowed to the limited partners in effecting the general partner's removal—is not. The disputed provision does not, for example, explicitly state that the limited partners' determination will be 'in their sole discretion.'").

[151] *See Amirsaleh I*, 2008 WL 4182998, at *9 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 628-29 (2009).

[152] *See supra* Part III.A.1.

[153] *See supra* Part III.A.2.

[154] *See, e.g.*, Policemen's Annuity & Benefit Fund v. DV Reality Advisors, LLC, 2012 WL 3548206, at *12-*13 (Del. Ch. Aug. 16, 2012) (interpreting a contract term defining the scope of the plaintiff's discretion by an express "good faith" standard).

impossible to know the parties' expectations.[155] It is impossible because a court cannot know the *reason* for the gap—why the parties failed to articulate a relevant term in their express agreement.

The most obvious reason a term would not appear in the parties' express agreement is that the parties simply rejected that term *ex ante* when they articulated their contractual rights and obligations. Perhaps, for example, the parties in *Bay Center Apartments* considered including a term in the LLC agreement prohibiting the defendant from exercising its managerial power to take the particular actions the plaintiff later disputed. But having considered the term, and perhaps some give-and-take dickering, the parties agreed the term should not be made part of their agreement.[156] They thus rejected the term by purposefully omitting the term. If that were the case, then implying the term *ex post* using the Implied Covenant would "rewrite" the contract.[157] It would have the court "substitute its notions of fairness for the terms of the agreement."[158] In short, it would frustrate, rather than fulfill, the parties' bargained-for expectations.

Delaware courts routinely apply this logic of negative inference whenever a litigant seeks to imply a term *ex post* to limit another's contractual rights or powers. The reason that term was not included *ex ante* is because the parties rejected that term when they formulated their express agreement. The term was thus "expressly excluded" from the contract;[159] the contract was left "intentionally silent."[160] Delaware courts

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[155] *See* FARNSWORTH, *supra* note 6, § 7.16, at 335.

[156] Under a Delaware law, a court could never know these facts because, unless an express term of the contract is ambiguous, Delaware law prohibits the court from considering extrinsic evidence. *See* BLGH Holdings LLC v. enXco LFG Holding, LLC, 41 A.3d 410, 414 (Del. 2012) (Where . . . the plain language of a contract is unambiguous *i.e.,* fairly or reasonably susceptible to only one interpretation, we construe the contract in accordance with that plain meaning and will not resort to extrinsic evidence to determine the parties' intentions."); GMG Capital Inv., LLC v. Athenian Venture Partners I, LP, 36 A.3d 776, 783 (Del. 2012) (en banc) ("[I]n contract disputes where the language at issue is clear and unambiguous . . . [,] the parol evidence rule bars the admission of evidence from outside the contract's four corners to vary or contradict that unambiguous language."). If allowed to consider extrinsic evidence, Delaware courts would arguably have no need for the Implied Covenant. They could instead protect and fulfill the parties' unarticulated expectations through a liberalized process of contract interpretation. *See* Dobbins, *supra* note 5, at 275-76; Dubroff, *supra* note 28, at 583-84.

[157] *See supra* note 58 and accompanying text.

[158] *See* Aspen Advisors LLC v. United Artists Theatre Co., 843 A.2d 697, 707 (Del. Ch. 2004) (asserting that the Implied Covenant will not imply terms that "grant . . . plaintiffs contractual protections that they failed to secure for themselves at the bargaining table"), *aff'd*, 861 A.2d 1251 (Del. 2004) (en banc); *supra* note 63 and accompanying text.

[159] *See* Related Westpac LLC v. JER Snowmass LLC, 2010 WL 2929708, at *6 (Del.

will cite various factors to support this inference: the foreseeable need for the term;[161] the ease with which the term could have been inserted into the express agreement;[162] the negative implication created when a similar term is found elsewhere in the agreement;[163] the perceived sophistication of the contracting parties;[164] the fact that the parties were advised by able legal counsel;[165] the fact that the contract was heavily negotiated;[166] as

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Ch. July 23, 2010) (holding that the Implied Covenant will not "imply a condition . . . that was expressly excluded by the terms of the contract").

[160] *See* Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc., 622 A.2d 14, 23 (Del. Ch. 1992) ("[W]here the contract is intentionally silent as to [the] subject [at issue], the [Implied Covenant] does not come into play."), *aff'd*, 609 A.2d 668 (Del. 1992) (unpublished table decision).

[161] *See* Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010) (en banc) ("The implied covenant only applies to developments that could not be anticipated, not developments that [could be anticipated but that] the parties simply failed to consider . . . .").

[162] *See* Kuroda v. SPJS Holdings, L.L.C., 2010 WL 925853, at *10 (Del. Ch. Mar. 16, 2010), *reprinted in* 36 DEL. J. CORP. L. 399, 413 (2011) (observing that "the implied covenant . . . should not be used as a tool to insert language into an agreement . . . [that the] defendants obviously knew how to employ."); Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146-47 (Del. Ch. 2009) (observing that a litigant's argument for implying terms using the Implied Covenant is "undercut by the ease with which" the parties could have inserted the terms themselves, especially when such terms "are familiar to any transactional lawyer"); Corporate Prop. Assocs. 14, Inc. v. CHR Holding Corp., 2008 WL 963048, at *5 (Del. Ch. Apr. 10, 2008) (dismissing Implied Claim, in the context of stock warrants, where "sophisticated parties such as those involved in this transaction know that cash dividends are a dilution technique, . . . and that there are methods for protecting themselves contractually").

[163] *See Related Westpac LLC*, 2010 WL 2929708, at *6 (reasoning, by negative inference, that a reasonableness qualifier was "expressly excluded" from an LLC operating agreement); Allied Capital Corp. v. GC-Sun Holdings, LP, 910 A.2d 1020, 1033 (Del. Ch. 2006) (reasoning, by negative inference, that because a promissory note "explicitly restricted a particular type" of transaction, the note "implies[] by omission" that other types of transactions were permitted); Aspen Advisors LLC v. United Artists Theatre Co., 843 A.2d 697, 707 (Del. Ch. 2004) (reasoning, by negative inference, that because a stock warrant granted the warrantholders the express right to participate in certain types of transactions, the warrants "also (by omission) defined" the limitations of the warrantholders' rights as to other types of transactions), *aff'd*, 861 A.2d 1251 (Del. 2004) (en banc).

[164] *See Nemec*, 991 A.2d at 1128 (declining to invoke the Implied Covenant to imply terms where the plaintiffs were "long term stockholders of a prestigious mergers and acquisition consulting firm"); Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 641 (Del. Ch. 2011) (declining to invoke the Implied Covenant to imply terms where the parties were "sophisticated commercial actor[s]"); NACCO Indus., Inc. v. Applica, Inc., 997 A.2d. 1, 20 (Del. Ch. 2009) (declining to invoke the Implied Covenant to imply terms where the express agreement was "crafted by sophisticated parties"); *Allied Capital Corp.*, 910 A.2d at 1035 (declining to invoke the Implied Covenant to imply terms where the parties were "sophisticated players who had experience in negotiating the particulars of a debtor-creditor relationship").

[165] *See Kuroda*, 2010 WL 925853, at *11, *reprinted in* 36 DEL. J. CORP. L. at 415 (declining to invoke the Implied Covenant to imply terms where the claimants were "sophisticated investors . . . [and] their transactional counsel were, too"); *Airborne Health*, 984 A.2d at 147 (declining to invoke the Implied Covenant to imply terms where the plaintiff was

well as the length,[167] complexity[168] and even the line-spacing of the written agreement.[169]

But the logic of negative inference has an obvious limitation: it cannot rule out alternative explanations for why a relevant term was omitted from an express agreement. It may be that, through haste or limited imagination, the parties simply failed to foresee the need for the term and, therefore, never considered to include it.[170] Or it may be that the parties considered the term, but given practical considerations, judged it too remote, unlikely, or otherwise unimportant to warrant raising during negotiations.[171] They instead sensibly focused their attention on the terms they deemed more likely to be significant.[172] Or perhaps the parties, hoping to avoid an unmanageably prolix agreement, thought the term too obvious to articulate—it "goes without saying," they figured—given the other express terms of their agreement.[173]

"a sophisticated party represented by able counsel"); *Allied Capital Corp.*, 910 A.2d at 1035 (declining to invoke the Implied Covenant to imply terms where the plaintiff-lender used a large law firm to negotiate the terms of its promissory note).

[166] *See, e.g.*, *NACCO Indus.*, 997 A.2d at 20 (declining to invoke the Implied Covenant to imply terms into an agreement that was "bargained for . . . by sophisticated parties").

[167] *See, e.g.*, *Winshall*, 55 A.3d at 639 (declining to invoke the Implied Covenant to imply terms into a 79 page agreement).

[168] *See Kuroda*, 2010 WL 925853, at *1, *reprinted in* 36 DEL. J. CORP. L. at 399 (declining to invoke the Implied Covenant to imply terms into a "complex web of overlapping contracts"); *NACCO Indus.*, 997 A.2d at 20 (declining to invoke the Implied Covenant to imply terms into a "detailed contract"); Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009) ("Delaware courts rightly employ the implied covenant sparingly when parties have crafted detailed, complex agreements.").

[169] *See Winshall*, 55 A.3d at 639 (declining to invoke the Implied Covenant to imply terms "into the interstices of [a] 79-page, *single-spaced* Merger Agreement") (emphasis in original); *Allied Capital Corp.*, 910 A.2d at 1035 (declining to imply terms into a "detailed 15-page single-spaced promissory note").

[170] *See* FARNSWORTH, *supra* note 6, § 7.15, at 329; Farnsworth, *supra* note 27, at 871; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. b (1981) ("The parties to an agreement may entirely fail to foresee the situation which later arises and gives rise to a dispute; they then have no expectations with respect to that situation, and a search for their meaning with respect to it is fruitless.").

[171] *See* FARNSWORTH, *supra* note 6, § 7.15, at 328.

[172] *See id.* § 7.15, at 328-29; Farnsworth, *supra* note 27, at 872-73; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. b (1981) ("[Contracting parties] may have expectations but fail to manifest them . . . because the situation seems to be unimportant or unlikely, or because discussion of it might be unpleasant or might produce delay or impasse."); RESTATEMENT (SECOND) OF CONTRACTS § 261 cmt. c ("Factors such as the practical difficulty of reaching agreement on the myriad of conceivable terms of a complex agreement may excuse a failure to deal with improbable contingencies.").

[173] Farnsworth, *supra* note 27, at 872 ("[There are] instances where a party is so confident that his expectation follows from what has been said that it does not seem worthwhile to reduce it to contract language. Given man's penchant for elliptical expression, much may be left to 'go without saying.'"). *See* FARNSWORTH, *supra* note 6, § 7.15, at 328-29.

Given these alternative explanations, it is impossible to know why a particular term was not included in the parties' express agreement.[174] Moreover, because there will be at least two parties involved, each party may have had its own reasons.[175] Thus, a court can never credibly determine that an omitted term was implicitly rejected by the parties' mutual agreement. When a court invokes this logic, it relies on a necessarily speculative inference.[176] Because a contract will never explain why an omitted term was omitted, a court can never know if the parties mutually rejected the term or, instead, simply failed to contemplate the term or come to a shared agreement. It is because a contract will never rule out these alternative explanations that Delaware courts will still invoke the Implied Covenant to imply terms that were foreseeably necessary[177] but nonetheless omitted by sophisticated parties[178] in complex and detailed agreements.[179]

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[174]*See* Farnsworth, *supra* note 27, at 873.

[175]*See id.*

[176]Farnsworth argues that because judicial inference based on foreseeability assumes "the ill-conceived premise that a party can be expected to deal in appropriate [contractual] language with all situations he can foresee[,]" that logic "has no merit as a general rule and should be discarded." *id*. at 885, 887; *see also id*. at 876 n.90 (cautioning against judicial construction relying on negative inference).

[177]*See, e.g.*, JPMorgan Chase & Co. v. Am. Century Cos., 2012 WL 1524981, at *8 (Del. Ch. Apr. 26, 2012). The Delaware Court of Chancery in *JPMorgan Chase* reasoned, in the context of a stock option agreement, that:

> Although [the defendant] is correct that "the parties could reasonably anticipate at the time of contracting that [defendant] would exercise its option at a time while the arbitration was pending," . . . they could not have anticipated that [the defendant] would fail to provide [the third-party appraiser] with the information . . . needed to value the Shares accurately.

Id. As this reasoning shows, relying on the foreseeable need of a term to infer that that term was implicitly rejected by its omission from the express agreement is particularly dubious because, as a legal construct, foreseeability is easily subject to manipulation. *See infra* Part IV.B.4.

[178]*See JPMorgan Chase*, 2012 WL 1524981, at *7-*8 (sustaining an Implied Covenant claim to imply terms into an agreement involving international banking giant JPMorgan Chase); BAE Sys., Inc. v. Lockheed Martin Corp., 2009 WL 264088, at *6, *8 (Del. Ch. Feb. 3, 2009), *reprinted in* 35 DEL. J. CORP. L. 326, 336, 338 (2010) (sustaining an Implied Covenant claim to imply terms into a side agreement that is part of a larger, "complex contract negotiated by sophisticated parties").

[179]*See, e.g.*, Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009) (Strine, V.C.) (sustaining an Implied Covenant claim despite the "parties hav[ing] crafted detailed, complex agreements").

2. Hypothetical Bargains and Equitable Considerations

Because it is impossible to know the parties' unarticulated expectations, a court must ultimately rely on inference to fill the gaps in their express agreement. Recognizing this reality, Delaware courts tellingly turn to a "familiar thought experiment"[180]—the hypothetical bargain—to construe contracts and guide the application of the Implied Covenant. Under the widely adopted standard[181] formulated by former Chancellor Allen in *Katz v. Oak Industries*, Delaware law fills a gap found in an express agreement with what the parties "would have agreed to . . . had they thought to negotiate [the] matter."[182]

But this "intrinsically counterfactual and hindsight-bias prone test"[183] asks the court to infer the parties' fictionalized expectations as to a matter on which the only source of the parties' actual expectations—the express terms of their agreement—is silent or, at best, indeterminate.[184] Thus, while *Katz* purports to ground the hypothetical bargain in the parties' actual agreement,[185] the inquiry is more realistically grounded in the court's idiosyncratic notions of equity and reasonableness.[186] As such,

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[180]D. Gordon Smith, *Independent Legal Significance, Good Faith, and the Interpretation of Venture Capital Contracts*, 40 WILLAMETTE L. REV. 825, 847 (2004).

[181]*See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442 (Del. 2005) (en banc) (citing Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986)); Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (citing *Katz*, 508 A.2d at 880); E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 443 (Del. 1996) (en banc) (citing *Katz*, 508 A.2d at 880).

[182]*Katz*, 508 A.2d at 880. The Delaware Court of Chancery has also rearticulated the *Katz* standard in recent cases. *See ASB Allegiance II*, 50 A.3d 434, 440 (Del. Ch. 2012) ("The implied covenant seeks to enforce the parties' contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them."); *Amirsaleh II*, 2009 WL 3756700, at *5 (Del. Ch. Nov. 9, 2009) ("The parties' reasonable expectations are determined by inquiring whether the parties would have bargained for a contractual term proscribing the conduct that allegedly violated the implied covenant had they foreseen the circumstances under which the conduct arose.").

[183]Allied Capital Corp. v. GC-Sun Holdings, LP, 910 A.2d 1020, 1032-33 (Del. Ch. 2006) (Strine, V.C.); *accord* Schwartzberg v. CRITEF Assocs. LP, 685 A.2d 365, 376 (Del. Ch. 1996) (Allen, C.) (acknowledging that "this test requires resort to a counterfactual world [of] what if.").

[184]*See* Cohen, *supra* note 119, at 82 ("[T]o admit incompleteness is to admit that the intention of the parties is uncertain . . . ."); Conaway, *supra* note 111, at 107 ("Because the terms are missing, intent is necessarily silent . . . .").

[185]*See Katz*, 508 A.2d at 880 (noting that the hypothetical bargain must derive "from what was expressly agreed upon").

[186]*See* Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for Unincorporated Firms*, 41 WAKE FOREST L. REV. 123, 166-67 (2006) ("The appropriate content of hypothetical bargains is controversial . . . , even when judges broadly

Katz resolves the question of contract construction, but only by resorting to gap filling by judicial discretion.

This is necessarily so, however, given the practical realities of contracting and the limits of human imagination. These realities mean that when parties enter into a contract, they will only express a narrow range of their expectations—those consciously contemplated, mutually shared by the parties, and deemed worthy of articulation.[187] Beyond this narrow range lie the gaps of their agreement: the myriad expectations—conscious and unconscious; shared and unshared[188]—reasonably held by the parties but that escaped expression.[189]

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agree on a . . . methodology . . . . There are a range of different approaches . . . [,] [and] which option is chosen may depend upon the court's goals as far as individual autonomy, reciprocity within the agreement, economic efficiency, and other instrumental effects . . . ."); *see also* FARNSWORTH, *supra* note 6, § 7.16, at 335 ("[I]t is often naive to assume that a court can determine how the parties would have dealt with [a matter] had they foreseen it."); Conaway, *supra* note 111, at 94, 107 ("The 'hypothetical bargain' approach is nothing more than judicial reformation of a contract based upon some other concern regarding the case . . . . '[It] only provides insight[] as to what is otherwise 'reasonable' under the circumstances.'") (quoting HOGG, *supra* note 111, at 387); Farnsworth, *supra* note 27, at 879-881 (criticizing the hypothetical bargain approach to gap filling as "contrived"); Farnsworth, *supra* note 27, at 877 (observing that a court may fill gaps by invoking "basic principles of fairness [and] justice" absent a "reliable indication actual expectation[s]"); *cf.* RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. d (1981) ("[W]here there is in fact no agreement, the court should supply a term which comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process."). As Professor Gold observes in advocating a textualist approach to gap filling, the hypothetical bargain inquiry is particularly contrived in the context of limited partnership and LLC operating agreements, where there are often multiple parties with different purposes, expectations, and ranges of sophistication and risk aversion. *See* Gold, *supra* note 186, at 168-69.

[187]*See* Farnsworth, *supra* note 27, at 874-75 (explaining that the express terms of a contract articulate the parties' expectations with respect to only a limited range of foreseeable situations); Van Alstine, *supra* note 6, at 1280-81.

[188]The *Dunlap* court explicitly recognized the Implied Covenant may be invoked to protect one party's unilaterally held expectations. Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (Del. 2005) (en banc) ("The implied covenant . . . requires that the insurer act in a way that honors *the insured's* reasonable expectations.") (emphasis added). Some might be troubled by the suggestion that the Implied Covenant would protect a party's unilaterally held expectations. *See, e.g.*, Dobbins, *supra* note 5, at 253-57. In the absence of an express term reflecting the parties' shared understanding, however, each party might reasonably hold different, conflicting expectations. When, in such cases, a court is presented with two conflicting expectations, then the task of the court is to weigh the reasonableness of each in light of the context and the express terms of the parties' agreement. This unexceptional task is no different than when a court must resolve contractual ambiguity by choosing among contradictory interpretations. *See* Farnsworth, *supra* note 27, at 876.

[189]*See* RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. b (1981) ("[Contracting parties] may have expectations but fail to manifest them . . . because the expectation rests on an assumption which is unconscious or only partly conscious, or because the situation seems to be unimportant or unlikely, or because discussion of it might be unpleasant or might produce delay or impasse."); *see also* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete*

The law addresses this reality with the Implied Covenant. It is the law's recognition that when parties enter into a contract, they cannot say everything. Of course, what they do say—the rights and obligations articulated by their express agreement—the courts will enforce in order to protect and fulfill the parties' bargained-for expectations. Beyond what they say, the Implied Covenant fills the gaps with the presumption that each party to the contract reasonably expects the other will act with good faith and reason. This expectation, although not express in the contract, is inferred by judicial construction. But because what is "good faith" and "reasonable" are legally indeterminate "fact-intensive" questions,[190] the scope and contours of this inferred expectation is necessarily a matter of the court's equitable judgment.[191]

3. Discretionary Powers and Reasonable Expectations

The interaction between express contract terms, equity, and judicial construction reveals itself most concretely in cases where the Implied Covenant is invoked to construe limits on a party's discretionary power. Recall the express terms of the LLC agreement in *Bay Center Apartments*. The LLC agreement explicitly granted the defendant the power to manage the LLC.[192] But without express language defining the scope of that discretionary power, there was a gap in the contract as to the parties' expectations.[193] Did the parties expect that the defendant would have the power to take the specific actions that ultimately deprived the plaintiff of the value of its LLC investment? Because of the gap in their agreement, the answer to that question depends on judicial construction.

Contracts: An Economic Theory of Default Rules, 99 YALE L.J. 87, 92 n.29 (1989) (referring to the same as "subtle" gaps); Farnsworth, *supra* note 27, at 875 & n.85 (referring to such gaps as "omitted cases" or, in Latin, "*casus omissus*"); Van Alstine, *supra* note 6, at 1284 (referring to the unarticulated expectations of contracting parties as "hidden" gaps).

[190] *See supra* notes 12-13 and accompanying text.

[191] *See* Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 639 (Del. Ch. 2011) (declining to imply additional terms under the Implied Covenant because the implied terms would be inconsistent with the court's notions of commercial reasonableness); Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146-47 (Del. Ch. 2009) (declining to imply additional terms under the Implied Covenant because express terms construed literally are not "irrational, or even unreasonable").

[192] *See supra* Part III.A.1.

[193] *See* Van Alstine, *supra* note 6, at 1286 ("To say that the content of the contract is subject to one party's discretion . . . tells us little about the parties' actual expectations concerning the exercise of that discretion.").

A discretionary power may, of course, be construed broadly to "expressly cover" the gap—to allow the exercise of that power under any circumstances and for any reason (that do not otherwise violate the express agreement). But because the scope of the discretion must be defined by judicial construction, equitable considerations—the intuition that one party will not readily put itself at the mercy of another—may be factored into the court's determination. Thus, in the absence of express language confirming unfettered, sole, and absolute discretion, Delaware courts readily infer that the parties reasonably expect the discretion afforded under a contract will be exercised in good faith and within reason.[194] Hence, courts will deploy the Implied Covenant to construe this limitation into a contract in order to protect the parties' unexpressed expectation.

But a court will imply such a term only where there is a gap in the parties' express agreement. Where the parties instead adopt express terms articulating the scope of the discretion granted by their agreement, the court no longer needs to draw on its equitable intuitions to infer the parties' expectations. Rather, the court's equitable intuitions will succumb to the parties' express agreement.[195] Thus, when the express terms of a contract unambiguously grant one party unfettered, sole, and absolute discretion, the court will readily construe the express terms to permit the discretion-exercising party to act under any circumstances and for any reason, free of judicial intervention.[196] It is because, the Implied Covenant notwithstanding, such language in the contract permits only that reasonable expectation.

4. Express Rights and Reasonable Expectations

While the interaction between express terms, equity and judicial construction is readily apparent in cases invoking the Implied Covenant

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[194] *See* Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146-47 (Del. Ch. 2009) ("When a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith."); Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 638 n.31 (Del. Ch. 2011) (citing *Airborne Health*); Altman & Raju, *supra* note 8, at 1481.

[195] *See supra* notes 133-35 and accompanying text.

[196] For example, in a pair of recent cases involving publicly traded master limited partnerships, the Delaware Court of Chancery has made clear that the express terms of an agreement may define the scope of a party's discretionary power in such a way that conclusively displaces the Implied Covenant, altogether precluding judicial scrutiny. *See In re* K-Sea Transp. Partners, LP Unitholders Litig., 2012 WL 1142351, at *9-*10 (Del. Ch. Apr. 4, 2012); Gerber v. Enter. Prods. Holdings, LLC, 2012 WL 34442, at *12-*13 (Del. Ch. Jan. 6, 2012).

to limit a party's discretion, the interaction is more subtle in cases where the doctrine is invoked to limit one's express rights under a bargained-for agreement. The interaction is more subtle only because the gap is less apparent.

Recall the merger agreement in *Amirsaleh*.[197] The parties anticipated that the defendants may want to extend the plaintiff's deadline and, therefore, specifically provided the defendants with the unambiguous right to do so, to "such other time and date as [the defendants] may mutually agree."[198] Yet, by neglecting to articulate the scope of this right, the parties also neglected to articulate the scope of their expectation.[199] Thus, the matter again depends on judicial construction. Did the parties expect that the defendants' right may be exercised with no other purpose than to disadvantage the plaintiff?

To be sure, when parties to a contract articulate an otherwise unambiguous unqualified right, the parties plainly express a shared expectation; namely that the rightholder will be entitled to exercise that right as it deems fit in its self-interest. But the realities of contracting also suggest limits to this bargained-for expectation. For one, the parties drafted the contract subject to temporal constraints and the limits of human imagination. Thus, when they articulated that right, they were able to envision it exercised in only so many situations.[200] And even then, the parties likely did not intend that right to be exercisable in every situation that they envisioned.[201] Some situations perhaps seemed too remote, improbable, or otherwise unimportant to raise in their negotiations—to suggest the right should be made subject to a particular exception or limitation.[202] And for other situations, the parties'

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[197] *See supra* Part III.A.2.

[198] *See supra* note 139.

[199] *See supra* note 150 and accompanying text.

[200] *See* RESTATEMENT (SECOND) OF CONTRACTS § 203 cmt. e (1981) ("People commonly use general language without a clear consciousness of its full scope and without awareness that an exception should be made."); Van Alstine, *supra* note 6, at 1282-83; *cf.* Eisenberg, *supra* note 117, at 239 (making the same observation in the context of express conditions in contracts).

[201] *See* Nemec v. Shrader, 991 A.2d 1120, 1131 n.42 (Del. 2010) (en banc) (Jacobs, J., dissenting) ("Gaps may occur in a contract even if the parties, judicially endowed with perfect rear-view mirror clairvoyance, could be found (after the fact) to have been able to anticipate the 'gap' issues."); Van Alstine, *supra* note 6, at 1283.

[202] For an example of an arguably foreseeable but unlikely situation, consider JPMorgan Chase & Co. v. Am. Century Cos., Inc., 2012 WL 1524981, at *7-*8 (Del. Ch. Apr. 26, 2012) (sustaining an Implied Covenant claim, in the context of a stock option agreement, where the defendant withheld material information relating to the value of the underlying stock).

expectations likely seemed too obvious to warrant expression.[203] After all, contracting is costly; the parties cannot say everything they may ever think in their express agreement.[204]

So, even while an otherwise unqualified express right could be construed broadly, by inferring that the parties expected the right to be exercisable under any circumstances and for any reason, the realities of contracting favor a less generous construction.[205] This is why the Implied Covenant is invoked to limit a party's bargained-for rights under an express agreement. Because without express language confirming that a contractual right may be exercised under any circumstance and for any reason, a court will infer that this was not the parties' bargained for expectation.[206] Instead, to fill the gap in their express agreement, a court will infer that the parties reasonably expected that the right would be exercised only in good faith and within reason.[207]

Thus, Delaware courts *will not* use the Implied Covenant to imply terms to prohibit mere selfishness.[208] Although it is not typically expressed in a contract, Delaware courts infer that each party reasonably

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[203]Allied Capital Corp. v. GC-Sun Holdings, LP, 910 A.2d 1020, 1032-33 (Del. Ch. 2006) (Strine, V.C.) (observing that the Implied Covenant applies to protect "the expectations of the parties [that] were so fundamental that it is clear that they did not feel a need to negotiate about them"); Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 853 nn.54-56 (Del. Ch. 2012) (Strine, C.) (citing and quoting *Allied Capital Corp*. after *Nemec*); *accord* Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 1997 WL 525873, at *5 (Del. Ch. Aug. 13, 1997), *reprinted in* 23 DEL. J. CORP. L. 760, 773-74 (1998) (Chandler, V.C.) (recognizing that contracting parties may have understandings or expectations that they may fail to express "because they are too obvious to need expression"), *aff'd*, 708 A.2d 989 (Del. 1998); Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986) (Allen, C.) (recognizing that "[contracting] parties occasionally have understandings or expectations that were so fundamental that they did not need to negotiate about those expectations."). *But see* Overdrive, Inc. v. Baker & Taylor, Inc., 2011 WL 2448209, at *8 & n.49 (Del. Ch. June 17, 2011) (Chandler, C.) (questioning the validity of this assertion under Delaware law in light of *Nemec*).

[204]*See supra* notes 116-18 and accompanying text.

[205]*See supra* notes 187-91 and accompanying text.

[206]*See* Van Alstine, *supra* note 6, at 1284.

[207]*See* Nemec v. Shrader, 991 A.2d 1120, 1132 n.44 (Del. 2010) (en banc) (Jacobs, J., dissenting) (observing that "unless the contract expressly allows the exercise [of a contractual right] for any (or even no) reason," the scope of a contractual right may be limited by the Implied Covenant).

[208]*See, e.g.*, *Nemec*, 991 A.2d at 1128 ("A party does not act in bad faith by relying on contract provisions for which that party bargained where doing so simply limits advantages to another party."). Even in contracts involving fiduciary relationships, such as LLCs and limited partnerships, where the duty of loyalty creates a presumption of selflessness, it is common for parties to eliminate this duty, thus rebutting the fiduciary presumption. *See* Manesh, *Contractual Freedom*, *supra* note 10, at 583-84.

expects the other will act in its self-interest.[209] But Delaware courts *will* imply terms to prohibit arbitrary, unreasonable, oppressive, underhanded, fraudulent, deceitful, or opportunistic actions.[210] Because in the absence of express language reflecting a contrary agreement, the courts infer that any such actions, even when exercising an otherwise unqualified express right, go beyond the parties' bargained-for expectations—beyond judicially construed notions of fairness and good faith and, therefore, breach the Implied Covenant.[211] But because "fairness" and "good faith" are indeterminate concepts,[212] the elusive line between mere selfishness and a breach of the Implied Covenant is defined in each case by the court's equitable judgment, guided by "fundamental notions of fairness" through the contract's construction.[213]

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[209]*See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1140 (1992) (Allen, C.) ("Generally speaking, contracting parties are, to a large extent, entitled to act selfishly to promote their own interests under the contract.").

[210]*See supra* notes 38-41 and accompanying text.

[211]*See* JPMorgan Chase & Co. v. Am. Century Cos., 2012 WL 1524981, at *7-*8 (Del. Ch. Apr. 26, 2012) (sustaining an Implied Covenant claim, in the context of a stock option agreement, where the option holder concealed material information relating to the value of the underlying stock prior to exercising its call right); Clean Harbors, Inc. v. Safety-Kleen, Inc., 2011 WL 6793718, at *9 (Del. Ch. Dec. 9, 2011) (sustaining an Implied Covenant claim, in the context of a call option agreement, where the option holder misrepresented its intentions immediately prior exercising its call option to the plaintiff's detriment); Lola Cars Int'l Ltd. v. Krohn Racing, LLC, 2009 WL 4052681, at *8-*9 (Del. Ch. Nov. 12, 2009) (Noble, V.C.) (sustaining an Implied Covenant claim, in the context of an LLC agreement, where one member exercised its express right "inappropriately and in bad faith by failing to consider" a fellow member's requests); *see also supra* note 4.

[212]*See supra* notes 190-91 and accompanying text.

[213]*See supra* note 75 and accompanying text. Hence, a contract party's actions taken to advance its selfish interests may be under one set of facts perfectly acceptable but under different facts opportunistic or unreasonable and, therefore, in bad faith. *Compare* Fisk Ventures, LLC v. Segal, 2008 WL 1961156, at *10-*11 (Del. Ch. May 7, 2008) (dismissing an Implied Covenant claim, in the context of an LLC agreement, where LLC managers refuse to take an action detrimental to their personal interests), *with* Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC, 2009 WL 1124451, at *7-*8 (Del. Ch. Apr. 20, 2009) (sustaining an Implied Covenant claim, in the context of an LLC agreement, where the LLC manager refuses to take action detrimental to its own interests). *See also Credit Lyonnais Bank*, 1991 WL 277613, at *23, *reprinted in* 17 DEL. J. CORP. L. at 1140 (Allen, C.) ("[W]hile contracting parties are not fiduciaries for each other, there are outer limits to the self-seeking actions they may take under a contract. Where one party's actions are such as to deprive the other of a material aspect of the bargain for which he contracted, the first party will be found to have violated that elemental obligation of all contracting parties to deal with each other in good faith and to deal fairly with each other with respect to the subject matter of the contract.").

C. Dunlap *and* Nemec *Revisited*

Understanding the relationship between express terms, the Implied Covenant and judicial construction helps elucidate the indeterminacy of *Dunlap* and *Nemec*.[214] In short, the disagreements within these cases stem not from contradictory doctrinal conceptions of the Implied Covenant, but from the indeterminate equitable judgment involved in judicial construction. The conflicting results and dissenting opinions reflect the justices' disagreement as to what is fair and good faith, given a gap in the parties' express agreement.

In *Dunlap*, the court majority conceded that the defendant State Farm's express right to deny the plaintiff coverage under the insurance policy was "clear and unambiguous."[215] But what the *Dunlap* majority did not mention is that the scope of this right must be defined by judicial construction. In particular, the policy did not provide that State Farm may exercise this right under any circumstances or for any reason, even where doing so would arguably provide State Farm with no legal or economic benefit.[216] Without such language, there was a gap in the contract as to the parties' expectations. Given this gap and compelling equitable considerations,[217] the *Dunlap* majority held that State Farm's decision to deny the plaintiff coverage went beyond the judicially construed scope of its express contractual right and, therefore, frustrated the plaintiff's reasonable expectations.[218] The court was thus willing to invoke the Implied Covenant notwithstanding State Farm's unambiguous express right to deny the plaintiff coverage.[219]

Yet when faced with the same gap,[220] the *Nemec* majority reached a contradictory conclusion given similar facts but less compelling

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[214] *See supra* Part II.C.

[215] Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 439 (Del. 2005) (en banc) ("The trial court . . . properly concluded that the exhaustion provision . . . is clear and unambiguous.").

[216] *See Dunlap*, 878 A.2d at 444; *supra* note 89.

[217] *See supra* text accompanying notes 85-86.

[218] *See Dunlap*, 878 A.2d at 444-45 (describing the circumstances in which "it would be reasonable to expect the [defendant] to invoke the exhaustion provision" to deny coverage and holding that the exercise of the exhaustion provision in the other circumstances, like those alleged in the plaintiff's complaint, would be arbitrary and unreasonable).

[219] *See id.*

[220] Arguably, the language of the agreement in *Nemec,* which provided that the express right at issue was exercisable "at any time," left less uncertainty as to parties' intent regarding the scope of that right. *See* Nemec v. Shrader, 991 A.2d 1120, 1123 (Del. 2010) (en banc). But as the *Nemec* dissent observed, "unless the contract expressly allows the exercise [of the right] for any (or even no) reason," the express terms leave the scope of the right uncertain.

equitable considerations.[221] By construing the scope of the defendant Booz Allen's contractual repurchase right broadly, the majority held that the defendant's actions could not frustrate the plaintiffs' reasonable expectations.[222] The *Nemec* majority therefore declined to invoke the Implied Covenant notwithstanding the unacknowledged gap in the parties' express agreement.[223] But because in each case the terms of the contract contained a gap as to the scope of the express right in question, equitable intuitions led dissenting justices in both *Dunlap*[224] and *Nemec*[225] to draw a different, yet equally reasonable construction.

IV. APPLICATIONS AND IMPLICATIONS

Despite its pervasiveness, Delaware law never clearly articulates the role that judicial construction plays in the application of the Implied Covenant.[226] Yet, by eliding this reality, the law obscures the discretion and, therefore, control that Delaware courts often exercise in the enforcement of bargained-for agreements.[227] The process of judicial construction explains both why and how the Implied Covenant may be used to limit a party's express rights under a contract. And judicial candor acknowledging this process would do much to advance the clarity and coherence of the doctrine.

See Nemec, 991 A.2d at 1132 n.44 (Jacobs, J., dissenting).

[221] *See supra* note 92 and accompanying text.

[222] *Nemec*, 991 A.2d at 1126 ("[P]laintiffs lacked a reasonable expectation of participating in the benefits of the [merger] transaction.") (internal quotation marks omitted).

[223] Although the *Nemec* majority opinion never acknowledged the relevant gap in the parties' express agreement, the *Nemec* dissent did when it observed that "unless the contract expressly allows the exercise [of a contractual right] for any (or even no) reason," the right may be limited by the Implied Covenant. *Id.* at 1132 n.44 (Jacobs, J., dissenting).

[224] *See Dunlap*, 878 A.2d 446-47 (Ridgely, J., dissenting) (arguing that "because the subject at issue was expressly covered" by the parties' agreement "there could be no reasonable expectation" that the defendant would waive its express rights even in circumstances like those alleged in the plaintiff's complaint).

[225] *See Nemec*, 991 A.2d at 1132 (Jacobs, J., dissenting).

[226] In this sense, Delaware law is in good company with the common law of almost all other states, which rarely articulate a distinction between the interpretation and construction of express contract terms. *See* CORBIN ON CONTRACTS, *supra* note 107, § 24.3 ("Rarely do courts articulate this distinction.").

[227] *See* FARNSWORTH, *supra* note 6, § 7.7, at 256 (observing that courts regularly elide the difference between construction and interpretation "in order to obscure the extent of their control over private agreement"); *cf.* Mullins, *supra* note 120, 86-87 (arguing, in the context of statutory construction, that judicial construction of statutes that may be used as a tool "to mask substantive policy choices or other hidden motivations").

A. *Harmonizing Conflicting Conceptions of the Covenant*

An understanding of judicial construction, and the equitable discretion involved in judicial construction, helps harmonize the seemingly conflicting conceptions of the Implied Covenant. Fundamentally, the Covenant is a gap filler, an implied obligation that is subject to and limited by the express terms of an agreement.[228] But this conception of the doctrine, while accurate, is also incomplete. It is true that the Covenant will never "contradict," "override" or "circumvent" the express terms of a contract.[229] And it is true that the Covenant is not a doctrine that allows courts to equitably "rewrite" contracts,[230] "substitut[ing] . . . notions of fairness for the terms of the agreement."[231]

Yet, stopping there ignores the inescapable reality of judicial construction. Contracts must be construed because no contract can address every aspect of every possible situation.[232] Given the inevitable gaps in contracts, it is judicial construction that must determine the scope of the parties' bargained-for rights and obligations. It is judicial construction that often determines whether a contract "expressly covers" a matter or is "truly silent." Surely, "[p]arties have a right to enter into [both] good and bad contracts,"[233] but whether a contract is good or bad can be a matter of judicial construction.

Admitting the reality of judicial construction means that equity—"fundamental notions of fairness"[234]—plays a central role in the application of the Implied Covenant. Yes, courts are not free to equitably "rewrite" contracts. But the express terms of a contract articulate only a narrow range of the parties' expectations.[235] Thus, parties are obligated to "more than just literal compliance" with the express terms of a contract.[236] Thus, courts look beyond the express contract to construe the "spirit," "substance," and "overarching purpose" of the agreement—the expected "fruits of the bargain."[237] Expectations

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[228] *See supra* Part II.B.1.

[229] *See supra* notes 47-49 and accompanying text.

[230] *See supra* note 58 and accompanying text.

[231] Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at *28 (Del. Ch. Apr. 29, 2005), *reprinted in* 30 DEL. J. CORP. L. 993, 1043 (2005).

[232] *See supra* notes 187-89 and accompanying text.

[233] Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. Ch. 2010) (en banc).

[234] *See supra* note 75 and accompanying text.

[235] *See supra* notes 187-89 and accompanying text.

[236] *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (Del. 2005) (en banc); *Nemec*, 991 A.2d at 1132 (Jacobs, J., dissenting) (quoting *Dunlap*, 878 A.2d at 444).

[237] *See supra* notes 32-34, 66-67 and accompanying text.

arising from "experience, relationship and, context" may all be reasonable but left unarticulated in the parties' express agreement.[238] It is these unexpressed expectations that find their expression through the Implied Covenant.[239] Because no contract can address every aspect of every possible situation, what is unsaid in the contract must be left to the parties' good faith and reason.[240] *This is* the reasonable expectation that courts protect and fulfill with the Implied Covenant. But because this expectation must be inferred, left to be defined by judicial construction, the Covenant is necessarily applied ad hoc "governed solely by issues of compelling fairness."[241]

Importantly, however, because the Implied Covenant is a "creature of contract,"[242] fairness is ultimately bounded by the parties' express agreement.[243] The Covenant is subject to the freedom of contract and, therefore, the parties' bargained for expectations.[244] And so, it is true that the Implied Covenant may not be invoked to "substitute . . . notions of fairness for the terms of the agreement."[245] But there will always be gaps

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[238]*See* Van Alstine, *supra* note 6, at 1277-78, 1281-82; *see also* JPMorgan Chase & Co. v. Am. Century Cos., 2012 WL 1524981, at *7-*8 (Del. Ch. Apr. 26, 2012) (invoking the Implied Covenant, in the context of a stock option agreement, to protect unarticulated reasonable expectations based on a valuation system used by the defendant before execution of the agreement).

[239]As Professor Van Alstine has observed in explaining the purpose and function of the Implied Covenant:

> [T]he face of [an] express agreement alone cannot determine the full force of the protected expectations. The core function of the duty of good faith, rather, is to permit the parties to have legally cognizable expectations (if "reasonable" under the circumstances) that do not necessarily find expression in the parties' formal agreement.

Van Alstine, *supra* note 6, at 1281.

[240]*See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 Del. J. Corp. L. 1099, 1139 (1992) (Allen, C.) ("[T]he cost of attempting to catalog and negotiate with respect to all possible future states of the world would be prohibitive, if it were cognitively possible. [Consequently], some things must be left to the good faith of the parties.").

[241]*Dunlap*, 878 A.2d at 444 (internal quotation marks omitted); *accord* Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del. 1998) (noting that the application of the Implied Covenant "should be rare and fact-intensive, turning on issues of compelling fairness.").

[242]Wood v. Baum, 953 A.2d 136, 143 (Del. 2008). In that sense, the Implied Covenant is fundamentally unlike corporate law's unwaivable fiduciary obligations. *Id*.; *see also* Manesh, *Contractual Freedom*, *supra* note 10, at 560-62 (describing the mandatory nature of fiduciary obligations under corporate law).

[243]*See, e.g.*, Nemec v. Shrader, 991 A.2d 1120, 1127 (Del. 2010) (en banc).

[244]*ASB Allegiance II*, 50 A.3d 434, 439-41 (Del. Ch. 2012) (Laster, V.C.).

[245]Frontier Oil Corp. v. Holly Corp., 2005 WL 1039027, at *28 (Del. Ch. Apr. 29, 2005), *reprinted in* 30 DEL. J. CORP. L. 993, 1043 (2005).

in contracts. "[E]ven the most carefully drafted agreement will harbor residual nooks and crannies for the implied covenant to fill."[246]

B. *Advancing Doctrinal Clarity*

Beyond harmonizing otherwise conflicting conceptions of the Implied Covenant, recognizing the role of judicial construction presents opportunities for advancing the clarity and coherence of the doctrine. The discussion that follows highlights four.

1. Acknowledging Construction and the Limits of Equitable Discretion

By leaving the role of judicial construction unacknowledged, Delaware law obscures the process by which its courts determine the legal effect of bargained-for agreements.[247] To acknowledge the necessity of judicial construction would be to admit the degree of discretion and control that courts often retain in the enforcement of contracts.[248] It would admit that judicial construction and, therefore, the application of the Implied Covenant, unavoidably involves indeterminate equitable judgment.[249] But to admit this reality would be to also admit the limited source of this judicial power: the gaps left when the parties to a contract articulate their expectations.[250] It would alert the parties to future transactions of the actual source of the indeterminacy that can result from the Implied Covenant. It would, perhaps, guide parties to circumscribe this indeterminacy by drafting more complete agreements.

Thus, acknowledging the reality of judicial construction would be salutary for both courts and the parties who draft and perform contracts under the yoke of the Covenant. For courts, it would promote greater transparency and rigor in adjudication.[251] Rather than suggesting that the outcome of a dispute is the inexorable consequence of the parties' bargained-for agreement, a court instead would acknowledge the gaps of

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[246] *ASB Allegiance II*, 50 A.3d at 441.

[247] *See supra* Part III.A.

[248] *See supra* note 227 and accompanying text.

[249] *See supra* notes 190-91 and accompanying text..

[250] *See supra* Part III.B.4.

[251] *See* CORBIN ON CONTRACTS, *supra* note 107, § 24.3 ("The principal reason for preserving the distinction between interpretation and construction is the clarity of thought that may result."); Farnsworth, *supra* note 27, at 879 ("It would be a significant contribution to clarity of thought . . . if courts would . . . expose the process of [gap-filling by judicial] inference . . . .").

the contract and focus its attention on the necessary task of construction. So, it would no longer suffice to assert that the Implied Covenant cannot apply because the contract "expressly covers" the matter[252] or is otherwise "intentionally silent;"[253] or because implying terms would "contradict," "override," or "circumvent" the express agreement.[254] Nor would it suffice to summarily apply the Implied Covenant to limit a party's discretionary power.[255] Instead, a court would recognize the gaps of a contract and justify its preferred construction.[256]

For contracting parties, such judicial candor would provide greater clarity regarding the application of the Implied Covenant. [257] It would provide guidance as to how contractual rights may be drafted with greater certainty in their enforcement.[258] By expressly articulating the scope of their bargained-for expectations, the parties to future contracts may occupy the gaps otherwise filled by judicial construction. Only armed with such knowledge may parties realize the full freedom of contract that Delaware law so often trumpets.[259]

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[252]*See supra* note 56 and accompanying text.

[253]Dave Greytak Enters., Inc. v. Mazda Motors of Am., Inc., 622 A.2d 14, 23 (Del. Ch. 1992), *aff'd*, 609 A.2d 668 (Del. 1992) (unpublished table decision).

[254]*See supra* notes 47-49.

[255]*See* Bay Ctr. Apartments Owner, LLC, v. Emery Bay PKI, LLC, 2009 WL 1124451, at *7-*8 (Del. Ch. Apr. 20, 2009); *Amirsaleh I*, 2008 WL 4182998, at *8-*9 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 628-29 (2009).

[256]For examples of cases where the court explicitly identifies the gaps of a contract, see Policemen's Annuity & Benefit Fund v. DV Reality Advisors, LLC, 2012 WL 3548206, at *12 (Del. Ch. Aug. 16, 2012) (explaining that, although the Implied Covenant may apply to limit discretion, the Covenant is inapplicable to the contract at issue because the terms of the contract expressly define the scope of the discretion); Wilmington Leasing, Inc. v. Parrish Leasing Co., 1996 WL 560190, at *2 (Del. Ch. Sept. 25, 1996), *reprinted in* 22 DEL. J. CORP. L. 875, 880-81 (1997) (explaining that the because the "scope of the discretion allowed to the limited partners in effecting the general partner's removal" is not expressly addressed in the contract, the Implied Covenant may be applied to fill the gap).

[257]*See* CORBIN ON CONTRACTS, *supra* note 107, § 24.3 (observing that a "reader's analysis of judicial reasoning will be more accurate when [a judicial] opinion indicates" whether the court is interpreting or construing.).

[258]*See id.*

[259]*See* DEL. CODE ANN. tit. 6, §§ 17-1101(c), 18-1101(b) (2012) (providing with respect to limited partnership and LLC operating agreements, respectively, the statutory policy is "to give maximum effect to the freedom of contract"); Related Westpac LLC v. JER Snowmass LLC, 2010 WL 2929708, at *6 (Del. Ch. July 23, 2010) ("Delaware law respects the freedom of parties in commerce to strike bargains and honors and enforces those bargains as plainly written."); Personnel Decisions, Inc. v. Bus. Planning Sys., Inc., 2008 WL 1932404, at *6 (Del. Ch. May 5, 2008) ("Delaware is a freedom of contract state . . . .").

2. Shifting the Focus from Discretionary Power

Rather than focusing on the process of judicial construction, Delaware courts have often emphasized the role of the Implied Covenant to limit a party's discretion. It is now a common judicial refrain that "[w]hen a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith."[260] Predictably, perhaps, given the doctrine's many uncertain contradictions, the repeated judicial focus on discretion has captured many practitioners' attention.[261] As a consequence, litigants are sometimes locked into a farcical debate distinguishing contractual rights from acts of discretion—a debate on which the courts have reached indeterminate conclusions.[262]

To be sure, every contract right, in a sense, creates for the rightholder a discretionary power.[263] But the focus on discretion is misleading. It suggests that discretionary power, or the vulnerability created by mere discretion, justifies the application of the Implied Covenant.[264] The Implied Covenant does not apply to discretionary

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[260] Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146-47 (Del. Ch. 2009); *see also ASB Allegiance II*, 50 A.3d 424, 441 (Del. Ch. 2012) ("When exercising a discretionary right, [the Implied Covenant requires that] a party to the contract must exercise its discretion reasonably."); Winshall v. Viacom Int'l, Inc., 55 A.3d 629, 638 & n.31 (Del. Ch. 2011) (citing *Airborne Health*, 984 A.2d 126, 146-47); *Amirsaleh I*, 2008 WL 4182998, at *8 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 628 (2009) ("The implied covenant is particularly important in contracts that endow one party with discretion in performance; *i.e.,* in contracts that defer a decision at the time of contracting and empower one party to make that decision later. Simply put, the implied covenant requires that the 'discretion-exercising party' [act] in good faith."); *Bay Ctr. Apartments*, 2009 WL 1124451, at *7 ("Part of [an LLC managers] contractual obligation is to use the discretion granted to them in the [LLC]'s organizational documents in good faith.").

[261] *See* Altman & Raju, *supra* note 8, at 1480-85; Lewis H. Lazarus & Jason C. Jowers, *The Implied Covenant of Good Faith and Fair Dealing: Does it Protect Members of Delaware LLCs?*, BUS. L. TODAY (Nov. 2011), *available at* http://apps.americanbar.org/buslaw/blt/content/2011/11/article-3-jowers-lazarus.pdf.

[262] For example, in *Amirsaleh*, Chancellor Chandler held that the defendant's exercise of the express right at issue in that case involved an act of discretion, thus justifying the application of the Implied Covenant. *Amirsaleh I*, 2008 WL 4182998, at *8, *reprinted in* 34 DEL. J. CORP. L. at 628. But only a few months later in *Nemec*, the Chancellor came to the opposite conclusion with respect to the express right at issue in that case, reasoning that the exercise of a "specifically grant[ed]" right (as was the case under the contract in *Nemec*) is "factually different" than the exercise of a more broadly granted right (as was evidently the case in *Amirsaleh*). *See* Nemec v. Shrader, 2009 WL 1204346, at *5 & n.10 (Del. Ch. Apr. 30, 2009), *reprinted in* 35 DEL. J. CORP. L. 367, 373-74 & n.10 (2010), *aff'd*, 991 A.2d at 1127 n.23 (en banc) (agreeing that *Amirsaleh* was "factually distinguishable").

[263] *See supra* note 144 and accompanying text.

[264] *See supra* notes 129-30 and accompanying text.

power *per se*. Rather, whether it is the broad discretion to control significant aspects of a contractual relationship,[265] or the discretion to exercise an expressly specified right,[266] if the Implied Covenant applies, it is because there is a gap in the contract as to the parties' expectation—that is, no express term defining the scope of that discretion.[267]

Acknowledging that a gap in the contract, rather than mere discretion, is what gives rise to the Implied Covenant avoids a fruitless debate.[268] It refocuses litigation on what is ultimately important: the express terms of the contract, and the parties' reasonable expectations.[269]

3. Abandoning the Requirement of Subjective Bad Faith

Acknowledging the role of judicial construction clarifies another recurring source of doctrinal confusion: the sometimes mercurial relevance that a party's subjective motivations play in the courts' application of the Implied Covenant. Over time, various Delaware courts have held that a breach of the Covenant involves culpable intent, some form of subjective "bad faith" or scienter.[270] Thus, on several occasions

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[265] *See Winshall*, 55 A.3d at 637-38 (involving the discretion as to how best to exploit certain business assets subject to an earn-out agreement); *Airborne Health*, 984 A.2d at 146-47 (same); *Bay Ctr. Apartments*, 2009 WL 1124451, at *6 (involving the broad managerial discretion granted under the terms of an LLC operating agreement).

[266] *See* Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444-45 (Del. 2005) (en banc) (involving the discretion to insist on an unambiguous exhaustion provision); Lola Cars Int'l Ltd. v. Krohn Racing, LLC, 2009 WL 4052681, at *8-*9 (Del. Ch. Nov. 12, 2009) (involving the discretion to terminate and replace the LLC's chief operating officer per the express terms of an LLC operating agreement); *Amirsaleh I*, 2008 WL 4182998, at *7, *reprinted in* 34 DEL. J. CORP. L. at 625-26 (involving the discretion to exercise a specific contractual right to extend the plaintiff's deadline to submit certain documentation).

[267] It is true, as Professor Van Alstine observes, that "[t]he very existence of post-formation discretion[ary power]" often means that there is a gap in the parties' expectations. Van Alstine, *supra* note 6, at 1286. But the gap arises not from the discretionary power *per se;* rather it arises from the lack of an express agreement as to the scope of that power. *See supra* notes 129-30 and accompanying text. Thus, Professor Van Alstine also observes that the uncertainty created by a discretionary power may be resolved—the gap in the parties' agreement may be filled—when the parties expressly agree on the scope of that power. *See* Van Alstine, *supra* note 6, at 1294-96.

[268] *See supra* note 261-62 and accompanying text.

[269] *See supra* note 27 and accompanying text.

[270] *See* Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, LP, 624 A.2d 1199, 1208 (Del. 1993) (holding, in the context of a limited partnership agreement, that "a claim of bad faith hinges on a party's tortious state of mind"); Merrill v. Crothall-American, Inc., 606 A.2d 96, 101 (Del. 1992) (holding, in the employment context, that "[a]n employer acts in bad faith" when it acts in a manner that is "intentionally deceptive"); *Amirsaleh II*, 2009 WL 3756700, at *5 & n.24 (Del. Ch. Nov. 9, 2009) (interpreting the foregoing cases to hold

when wielding the Implied Covenant, courts have been willing to examine a party's motives in exercising its express contractual rights under an agreement.[271]

Motives do matter, but it is only because an obligation of good faith is inferred into contracts through judicial construction. That is, in the absence of language suggesting the parties bargained for a contrary expectation, equitable intuitions have led courts to infer that each party to a contract reasonably expects the other will refrain from acting with bad faith or scienter.[272] Thus, Delaware law holds that when one acts under a contract with culpable intent—to oppress, to deceive, or to exploit the other—its bad faith actions breach the Implied Covenant.[273]

But to the extent Delaware courts and practitioners fixate on culpable intent—suggesting that subjective bad faith is *required* to breach the Implied Covenant[274]—they conflate the purpose of the doctrine with its "good faith" moniker.[275] One may exercise its

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that a breach of the Implied Covenant "must demonstrate that the defendant's conduct was motivated by a culpable mental state").

[271] *See Desert Equities*, 624 A.2d at 1208-09 (denying a motion for judgment on the pleadings, in the context of a limited partnership agreement, because "a claim of bad faith hinges on a party's tortious state of mind [and, therefore,] bad faith is an issue of fact [that] cannot be resolved on the pleadings"); *Amirsaleh I*, 2008 WL 4182998, at *8-*9 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 627-29 (2009) (denying summary judgment against an Implied Covenant claim, in the context of a merger agreement, because there is an issue of material fact as to the defendants' motive in exercising an express contractual right); *Amirsaleh II*, 2009 WL 3756700, at *5-*6 (same). *Compare* Dawson v. Pittco Capital Partners, LP, 2012 WL 1564805, at *26 (Del. Ch. Apr. 30, 2012) (taking consideration of the defendants' salutary motives in ruling that the defendants' actions to amend an LLC operating agreement in accordance with the express provisions of the agreement did not breach the Implied Covenant), *with In re* Delphi Fin. S'holder Litig., 2012 WL 729232, at *17 (Del. Ch. Mar. 6, 2012) (taking consideration of the defendants' opportunistic motives in ruling that the defendants' actions to amend a corporation charter in accordance with the express provisions of the charter is "reasonably likely" to breach the Implied Covenant).

[272] *See ASB Allegiance II*, 50 A.3d 434, 442-45 (Del. Ch. 2012).

[273] *See supra* notes 39-41 and accompanying text.

[274] *See Amirsaleh II*, 2008 WL 4182998, at *5 ("'[B]ad faith' *must be shown* to establish an implied covenant breach . . . [and] to prove bad faith a plaintiff *must* demonstrate that the defendant's conduct was motivated by a culpable mental state. In other words, the defendant's conduct *must be* driven by an improper purpose.") (emphasis added); Altman & Raju, *supra* note 8, at 1477 (interpreting Delaware case law to "suggest that a violation of the Implied Covenant *requires* proof of a culpable mental state") (emphasis added); Lazarus & Jowers, *supra* note 261, at 1 (interpreting Delaware case law to mean that a valid claim for breach of the Implied Covenant "*must* allege the breaching party's actions were motivated by an improper purpose reflecting bad faith") (emphasis added).

[275] *See ASB Allegiance II*, 50 A.3d at 442, 444 (ruling that "[n]otwithstanding the covenant's potentially misleading moniker" and "references in Delaware case law" suggesting otherwise, "[p]roving a breach of contract claim does not depend on the breaching party's mental state").

contractual rights without culpable intent, but still frustrate another's reasonable expectation.[276] Indeed, the Delaware legislature implicitly confirmed this principle when it statutorily prohibited exculpating only "*bad faith* violation[s] of the implied . . . covenant,"[277] thus suggesting that one may also in *good faith* violate the Implied Covenant. Most notably under Delaware law, a party can breach the Implied Covenant without scienter when it exercises its contract rights arbitrarily or unreasonably.[278] It is because courts infer that one party's arbitrary and unreasonable actions, even if taken in subjective good faith, can frustrate the other party's reasonable expectations.

But, as with all judicially inferred expectations, the construed obligation of good faith may be displaced by the parties' express agreement. Thus, motives become irrelevant when parties fill the gap of their contract by articulating the scope of the express right in question.

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[276] *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *26 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 DEL. J. CORP. L. 1099, 1145 (1992) (Allen, C.) (noting it is unnecessary to "psychoanalyze" a party's conduct because even if a party believes his conduct to be justified, it may nonetheless breach the Implied Covenant); *accord* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981) ("[A contracting party may] violate the obligation of good faith . . . even though [he] believes his conduct to be justified [because] . . . fair dealing may require more than honesty.").

[277] DEL. CODE ANN. tit. 6, § 17-1101(f) (2012) (emphasis added) (governing LPs); *id.* § 18-1101(e) (2012) (emphasis added) (governing LLCs). The negative implication of this language is, of course, that unincorporated alternative entities may exculpate *good faith* breaches of the Implied Covenant.

[278] *See* Nemec v. Shrader, 991 A.2d 1120, 1134 (Del. 2010) (en banc) (Jacobs, J., dissenting) (noting that although the defendant in *Dunlap* had "no improper motive," the exercise of its express contractual rights under the circumstances of that case "was arbitrary and in breach of the implied covenant"); Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 446-47 (Del. 2005) (en banc) (Ridgely, J., dissenting) ("Reasonable conduct is at the core of whether there has been a breach of the implied covenant . . . ."). *Compare* Lola Cars Int'l Ltd. v. Krohn Racing, LLC, 2009 WL 4052681, at *8-*9 (Del. Ch. Nov. 12, 2009) (sustaining an Implied Covenant claim, in the context of an LLC operating agreement, where plaintiff alleged the defendant had exercised its express right "inappropriately and in bad faith by failing to consider" plaintiff's requests), *with* Lola Cars Int'l Ltd. v. Krohn Racing, LLC, 2010 WL 3314484, at *19 (Del. Ch. Aug. 2, 2010) (ruling in a post-trial judgment against an Implied Covenant claim because evidence adduced at trial showed the defendant had exercised its express right reasonably). *Compare* Wilmington Leasing, Inc. v. Parrish Leasing Co., LP 1996 WL 560190, at *2-*3 (Del. Ch. Sept. 25, 1996) (sustaining an Implied Covenant claim, in the context of a limited partnership agreement, where plaintiff alleged defendant exercised its express right to remove the plaintiff as general partner "unreasonably and in bad faith"), *reprinted in* 22 DEL. J. CORP. L. 875, 880-82 (1997), *with* Wilmington Leasing, Inc. v. Parrish Leasing Co., LP 1996 WL 752364, at *12-*14 (Del. Ch. Dec. 23, 1996) (ruling in a post-trial judgment against an Implied Covenant claim because evidence adduced at trial showed the defendant had exercised its express right reasonably), *reprinted in* 22 DEL. J. CORP. L. 1337, 1358-61 (1997).

In such cases, the court's equitable intuitions succumb to the parties' bargained-for expectations.[279] The Implied Covenant, after all, protects each party's reasonable expectations;[280] it does not require good faith intentions.

4. Recognizing the Limits of *Nemec* and its Logic

Despite the inevitable discretion involved in judicial construction, there are valid reasons why courts would be "most chary" to deploy the Implied Covenant.[281] The availability of *ex post* judicial intervention limits parties' incentive to bargain *ex ante* as to their expectations. Thus, by refraining from *ex post* judicial intervention, the law encourages parties to negotiate and draft more complete agreements.[282] Recognizing this, Delaware courts sensibly issue regular admonishments that the Implied Covenant is a "narrow"[283] and "sparingly"[284] applied doctrine.[285] By doing so, the courts unambiguously signal a preference for "*ex ante* bargaining over *ex post* judicial intervention."[286]

But perhaps preoccupied with the zeal of encouraging more complete agreements, the court in *Nemec* went beyond these mere rhetorical admonishments. The Delaware Supreme Court held that the Implied Covenant would not be applied to situations "that could be . . . anticipated, [but] that the parties simply failed to consider."[287] The problem with this holding is that it imposes on parties an unrealistic

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[279]*See* N.K.S. Distribs. Inc. v. Tigani, 2010 WL 2178520, at *7 (Del. Ch. May 28, 2010) (holding, in the context of a loan agreement, that a lender is entitled to "pursue the full extent of its rights over any apparently minor default" notwithstanding the Implied Covenant and allegations of personal ill will where the express terms provide the lender may pursue its rights and remedies "at [its] sole discretion"); AQSR India Private, Ltd. v. Bureau Veritas Holdings, Inc., 2009 WL 1707910, at *11 (Del. Ch. 2009) (holding, in the context of an asset and stock purchase agreement, that because defendant's decision to not close is subject to an express "material adverse effect" standard, it is irrelevant whether the defendant's actions were taken in bad faith); *supra* note 133-35 and accompanying text (discussing express contractual terms limiting the scope of discretionary power).

[280]*See supra* note 27 and accompanying text.

[281]*See, e.g.*, Allied Capital Corp. v. GC-Sun Holdings, LP, 910 A.2d 1020, 1035 (Del. Ch. 2006).

[282]*See* Smith, *supra* note 180, at 848.

[283]*See supra* note 16.

[284]*See supra* note 20.

[285]In the same vein, the *Katz* hypothetical bargain inquiry purports to only imply terms when it is "clear" that the parties would have agreed to them. *See* Katz v. Oak Indus., Inc., 508 A.2d 873, 880 (Del. Ch. 1986).

[286]Smith, *supra* note 180, at 850.

[287]Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010) (en banc).

burden of expression.[288] It would require parties, at the time of the contract's formation, to address *ex ante* all foreseeable situations.

As explained above, however, parties will inevitably leave gaps in contracts for reasons that go beyond the limits of their foresight and imagination.[289] The practical realities of contracting mean that parties cannot address every aspect of every foreseeable situation.[290] It may, of course, be good policy to demand more complete agreements, at least from sophisticated parties to contracts negotiated by able legal representation[291]—those who may be able to be bear a heightened burden of expression.[292] But an inflexible blanket rule, applicable in all contexts and to all agreements, demands a degree of contractual completeness that is both impractical and inefficient.[293] It would permit opportunism in the absence of bargained-for expectations.[294] As a policy matter, therefore, it has no merit.[295] As binding precedent, however, it cannot be so easily discarded.

Fortunately, this facet of *Nemec* is particularly susceptible to judicial manipulation. In practice, the question of foreseeability is

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[288]*See* Farnsworth, *supra* note 27, at 885.

[289]*See supra* notes 170-73 and accompanying text; *see also Nemec*, 991 A.2d at 1131 n.42 (Jacobs, J., dissenting) ("Gaps may occur in a contract even if the parties, judicially endowed with perfect rear-view mirror clairvoyance, could be found (after the fact) to have been able to anticipate the 'gap' issues.").

[290]*See supra* note 118 and accompanying text.

[291]*See supra* notes 164-66 and accompanying text.

[292]*See* Farnsworth, *supra* note 27, at 884-87 (describing judicial gap filling as the allocation of the burden of expression among contracting parties).

[293]For example, because a nondrafting party is unable to add terms to a contract of adhesion, the nondrafting party cannot bear the burden of expression (that is, to propose additional terms to address its expectations). It is, for this reason, unsurprising that courts will more readily invoke the Implied Covenant to protect and fulfill a nondrafting party's reasonable but unexpressed expectations. *See, e.g.*, Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444-45 (Del. 2005) (en banc) (invoking the Implied Covenant to protect the reasonable but unexpressed expectations of the nondrafting insured party to an insurance policy); *cf. Amirsaleh I*, 2008 WL 4182998, at *8-*9 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 628-29 (2009) (invoking the Implied Covenant to protect the reasonable but unexpressed expectations of a nondrafting third party beneficiary). In this sense, gap filling by the Implied Covenant is consistent with the interpretive principle of *contra proferentem,* interpreting ambiguous provisions against the drafting party. *See* SI Management LP v. Wininger, 707 A.2d 37, 43 & n.19 (Del. 1998) (applying the principle of *contra proferentem*).

[294]*Cf.* Smith, *supra* note 180, at 852 (arguing, in the context of venture capital contracts, the judicial reluctance to invoke the Implied Covenant "virtually ensures that preferred stockholders will be the subjects of opportunistic behavior").

[295]*See* Farnsworth, *supra* note 27, at 886-87.

applied only as broadly as a court's equitable intuitions.[296] Thus, a court may readily concede that the parties could have generally foreseen a particular situation, but still hold that the parties could not have foreseen the unique facts and circumstances that gave rise to the litigation.[297] As such, despite *Nemec*'s attempt to cabin the Implied Covenant, equitable discretion, and not the question of foreseeability, should continue to guide the doctrine's application.[298]

V. CONCLUSION

Echoing, inadvertently, its now famous description of corporate law's fiduciary obligations,[299] the Delaware Supreme Court once aptly observed that the Implied Covenant "requires more than just literal compliance" with the express terms of a contract.[300] After all, "[c]ontracting is costly and human knowledge imperfect."[301] Try as they may, the express terms of a contract cannot give full expression to the parties' expectations.

In this reality, the Implied Covenant operates as a gap filler—a legal presumption that when parties enter into a contract, they do not expect to be treated arbitrarily or unreasonably, to be deceived or exploited.[302] It is a presumption that, in the absence of an express

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[296] *Compare* Nemec v. Shrader, 991 A.2d 1120, 1126 (Del. 2010) (en banc) (characterizing the disputed matter generally as the possibility "that the Company, a Delaware corporation, would [] be for sale in whole or in part"), *with id*. at 1133 (Jacobs, J., dissenting) (characterizing the same more specifically as the "Carlyle transaction, as timed in relation to the redemptions [disputed] here").

[297] *See supra* note 177.

[298] Reflecting this reality, the Delaware Court of Chancery has, in subsequent opinions, rearticulated *Nemec* to allow the Implied Covenant to apply in gaps relating to any matter "that could not *reasonably* have been anticipated" at the time the contract was formed. *Compare* Brinckerhoff v. Enbridge Energy Co., 2011 WL 4599654, at *11 (Del. Ch. Sept. 30, 2011) (emphasis added) (internal quotation marks omitted), *reprinted in* 36 DEL. J. CORP. L. 823, 842 (2011)), Great-West Investors LP v. Thomas H. Lee Partners, LP, 2011 WL 284992, at *14 (Del. Ch. Jan. 14, 2011) (emphasis added), *and In re* Atlas Energy Res., LLC Unitholder Litig., 2010 WL 4273122, at *13 (Del. Ch. Oct. 28, 2010) (emphasis added), *with Nemec*, 991 A.2d at 1128 ("Delaware's implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events *that could have been anticipated* . . . .") (emphasis added).

[299] *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) ("Management contends that it has complied strictly with the provisions of the [statute]. The answer to that contention, of course, is that inequitable action does not become permissible simply because it is legally possible.").

[300] Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 444 (Del. 2005) (en banc).

[301] Lonergan v. EPE Holdings LLC, 5 A.3d 1008, 1018 (Del. Ch. 2010) (Laster, V.C.).

[302] *See* Van Alstine, *supra* note 6, at 1290-92.

agreement reflecting a contrary expectation, the parties to a contract reasonably expect to be dealt with honestly and with reason.[303] Such expectations, although not articulated in the parties' express agreement, are inferred and borne through judicial construction.

But unlike the fiduciary duties of corporate law—unwaivable and defined only *ex post* by judicial intervention[304]—the Covenant is ultimately a rebuttable presumption. It is a doctrine of contract, subject to and limited by the parties' *ex ante* expectations.[305] So, it is true that the Implied Covenant may not be invoked to contradict the express terms of a bargained-for agreement. But "[n]o contract, regardless of how tightly or precisely drafted it may be, can wholly account for every possible contingency."[306] Inevitably, "some things must be left to the good faith of the parties."[307]

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[303] *See Amirsaleh I*, 2008 WL 4182998, at *1 (Del. Ch. Sept. 11, 2008), *reprinted in* 34 DEL. J. CORP. L. 615, 615 (2009) ("[T]he law presumes that parties never accept the risk that their counterparties will exercise their contractual discretion in bad faith.").

[304] *ASB Allegiance II*, 50 A.3d at 440 (contrasting the Implied Covenant and fiduciary obligations).

[305] *See id.* at 439-41.

[306] *See Amirsaleh I*, 2008 WL 4182998, at *1, *reprinted in* 34 DEL. J. CORP. L. at 615 (Chandler, C.).

[307] Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991), *reprinted in* 17 Del. J. Corp. L. 1099, 1139 (1992) (Allen, C.).