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THE DIVERGING MEANING OF GOOD FAITH

BY MARK J. LOEWENSTEIN*  

ABSTRACT

This article explores the meaning of "good faith" in the context of corporations and unincorporated entities. The courts, particularly in Delaware, have developed two different approaches. In the corporate arena, the courts are fashioning a notion of good faith that seems to require an examination of director motivations. In the unincorporated arena, good faith has a meaning grounded in contract law. These are two different concepts and reflect the fundamental differences between corporations and unincorporated entities, with the former based on fiduciary duties and the latter on contract. There are, however, indications that this "divergence" is starting to disappear, and this article discusses that trend as well.

I. INTRODUCTION

Defining the fiduciary duties of those who control corporations and unincorporated business entities has tested the flexibility and resourcefulness of the Delaware courts.1 This challenge is traceable to the legislative response to the landmark decision of Smith v. Van Gorkom,2 where the Delaware Supreme Court held corporate directors liable in a derivative action for failing to fully inform themselves—that is, for acting in a grossly

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1The Delaware Court of Chancery hinted at this frustration in In re Walt Disney Co. Derivative Litigation (Disney III), the second of its two decisions in this derivative litigation, when it stated that "the law must be strong enough to intervene against [an] abuse of trust." In re Walt Disney Derivative Litig. (Disney III), 825 A.2d 275, 291 (Del. Ch. 2003). Commentators have observed that the standards-based approach to fiduciary duties of the state courts, developed case by case, allows the courts to adapt to changing norms. See Nadelle Grossman, Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform, 12 FORDHAM J. CORP. & FIN. L. 393, 399 (2007); Marcel Kahan & Edward Rock, Symbiotic Federalism and the Structure of Corporate Law, 58 VAND. L. REV. 1573, 1598 (2005). The former Chief Justice of the Delaware Supreme Court, Norman Veasey, foreshadowed the development of good faith as a policing tool in an October 2002 speech. See E. Norman Veasey, The Social Responsibilities of Lawyers: Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century, 12 WASH. U. J.L. & POLY 1, 9 (2003) ("[G]ood faith is likely to emerge as a central issue of the directors' standard of conduct.").

2488 A.2d 858 (Del. 1985).
negligent fashion—before agreeing to sell the company to an unaffiliated party. In response to that decision, the Delaware legislature amended its corporate code, adding section 102(b)(7), which allows corporations to limit the liability of directors for money damages arising from a breach of the duty of care. To be effective, the limitation must be in the corporation's certificate of incorporation. More than thirty other states have followed suit. Thus, state legislatures have allowed for, essentially, contractual modifications of a corporate director's fiduciary duty of care. A director's duties of loyalty and good faith, however, were unaffected by this legislation and, with one exception, remain intact.

On the unincorporated side, state legislatures, particularly the Delaware legislature, have been more aggressive in permitting modification of traditional fiduciary duties. Limited liability companies and partnerships have long been recognized as contractual relationships. Although corporate directors are constrained by fiduciary duties, participants in unincorporated entities have had much greater flexibility in structuring their relationship. When the Delaware Supreme Court suggested, in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, that the parties to a limited partnership agreement could not eliminate fiduciary duties of the general partner, the Delaware legislature promptly amended the partnership statute to make clear that they could and, for good measure, included parallel provisions in the Limited Liability Company Act.

The combination of these statutory changes has resulted in some hard cases; that is, cases in which the articles of incorporation relieved corporate directors of damages for breach of the duty of care, yet the directors' conduct appears at least grossly negligent, and cases in which a partnership

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3 *Id. at 893.
5 *Id.*
6 See, e.g., CAL. CORP. CODE § 204(a)(10) (West 1990); Colo. Rev. Stat. § 7-40-104(2)(a) (2006); 805 ILL. COMP. STAT. ANN. 5/2.10(b)(3) (West 2004); N.Y. BUS. CORP. LAW § 402(b) (McKinney 2003).
7 See infra notes 179-88 (dealing with the amendment by the Delaware legislature to DEL. CODE ANN. tit. 8, § 122 (2001), which allows a corporation to renounce any opportunities presented to its officers, directors, or stockholders).
8 See DEL. CODE ANN. tit. 6, §§ 15-103(f), 18-1101(c) (2005).
9 See id. § 15-103(d) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract . . . .").
10 817 A.2d 160 (Del. 2002).
11 *Id. at 167-68.
12 DEL. CODE ANN. tit. 6, § 18-1101(c) (2005).
13 See McCall v. Scott, 239 F.3d 808, 818-19 (6th Cir. 2001) (analyzing plaintiffs' breach of
agreement or limited liability company (LLC) operating agreement eliminates a partner's or manager's duty of loyalty, yet the conduct of the partner or manager is highly questionable by traditional standards. What is a court to do? This article explores how the courts (particularly Delaware, where a disproportionate number of cases have been decided) have responded to this question. In short, the duty of good faith, which cannot be contracted away in any entity, has evolved into a central doctrine, or tool, to police conduct that seems to need policing. Good faith provides a basis to avoid a section 102(b)(7) exculpatory provision, or a comparable provision in the operative documents of an unincorporated entity.

To this point, I have considered the directors of corporations together with the partners, or managers, as the case may be, of unincorporated entities. In the absence of an exculpatory provision in the articles of incorporation on due care, or a provision in a partnership or operating agreement addressing the duties of care or loyalty, the "fiduciaries" in these entities would all owe duties of loyalty, care, and good faith to their respective entities. Moreover, case law suggests that the duties of loyalty and care for corporate directors, general partners, and managers of LLCs are substantially similar, if not identical. Can the same be said of the duty of good faith? The thesis of this article is, somewhat counterintuitively, that good faith does not, and increasingly will not, mean the same thing for the duty of care claim under the good faith exception to a section 102(b)(7) exculpatory provision in the corporation's certificate.

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15See Veasey, supra note 1, at 9.
17Compare Benihana of Tokyo, Inc. v. Benihana, Inc., 891 A.2d 150, 191 (Del. Ch. 2005) (stating that directors' duty of loyalty "mandates that the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally"), and Glazer v. Zapata Corp., 658 A.2d 176, 183 (Del. Ch. 1993) (defining directors' standard of care in reference to an ordinary, reasonably prudent person), with Klotz v. Klotz, 117 S.E.2d 650, 656 (Va. 1961) (stating that partners' common law duty of loyalty requires each partner to guard his co-partners' interests "equally with his own" with undeviating devotion), and Kuznik v. Bees Ferry Assoc's., 538 S.E.2d 15, 27 (S.C. Ct. App. 2000) (stating that a partner who acts "with the care an ordinarily prudent person in a like position would exercise under similar circumstances" does not breach the duty of care).
corporate fiduciaries as it does for partners in partnerships or managers in LLCs. This divergence arises for two reasons: first, the relevant statutes differ; and second, the nature of the corporation, which is marked by mandatory rules, differs from unincorporated entities, which are characterized by contract. Indeed, the contractual nature of unincorporated entities allows investors to structure an entity so as to align the interests of managers and investors in ways unavailable to corporate managers. In addition, the managers of an unincorporated entity often hold significant stakes in the entity, which also incentivizes them to act in the entity's best interests. The combination of these factors reduces the importance of default fiduciary duties and judicial monitoring. This article proceeds with a discussion of what good faith means in the corporate context, then to a contrasting discussion of how the term is developing in unincorporated entities, and ends with a short conclusion and observation.

II. THE CONCEPT OF GOOD FAITH FOR CORPORATE DIRECTORS

Corporate directors fit the classic definition of fiduciaries: the shareholders place their "trust and confidence" in the directors, and directors serve with that understanding. Fiduciary obligations flow logically and naturally from such a relationship. After delineating the various duties that directors have, the comments to the Model Business Corporation Act (MBCA) observe that courts often use "the broad concept of fiduciary duty... as a frame of reference when evaluating a director's conduct."

Somewhat ironically, corporate codes typically do not expressly provide that directors owe "fiduciary duties." The Delaware code simply provides that "[t]he business and affairs of every corporation... shall be managed by or under the direction of a board of directors..." The Delaware courts, however, have made it amply clear that Delaware directors operate subject to the fiduciary duties of loyalty, care, and good faith. The

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20 MODEL BUS. CORP. ACT § 8.30(a) cmt. 1 (2008).
21 DEL. CODE ANN. tit. 8, § 141(a) (2001).
MBCA is more forthcoming; it provides that when discharging his or her duties, a director shall act "in good faith," "in a manner the director reasonably believes to be in the best interests of the corporation," and "with the care that a person in a like position would reasonably believe appropriate under similar circumstances." But the MBCA does not characterize these as fiduciary duties; rather the heading of the applicable section is "Standards of Conduct for Directors." That these standards actually describe fiduciary duties is not without significance. Because the breach of a fiduciary duty is tortious conduct, in the absence of some exculpation by statute or enforceable contract, the defaulting director, and possibly anyone who aided and abetted the breach, may be liable for damages, including possible punitive damages. Thus, courts applying the MBCA have made clear that a breach by a director of this standard of conduct is also a breach of that director's fiduciary duties to the corporation.

Like all fiduciary relationships, however, the relationship of a director to a corporation is one of status, notwithstanding the inroad made by statutory provisions that allow corporations to exculpate directors for monetary damages for breach of the duty of care, and this is unlikely to change at any time in the near future. Indeed, the high-profile corporate scandals of just a few years ago, involving Enron, WorldCom, Tyco, Adelphia, and other large corporations, have encouraged courts to look more closely at director conduct. When a section 102(b)(7) exculpatory provision precludes liability for breach of care, and loyalty is not at issue, courts have


\[23^{23}\] MODEL BUS. CORP. ACT § 8.30(a)-(b) (2008).

\[24^{24}\] Id. § 8.30.


\[27^{27}\] See, e.g., Michaelson v. Michaelson, 939 P.2d 835, 841 (Colo. 1997); TJI Realty, Inc. v. Harris, 672 N.Y.S.2d 386, 388 (N.Y. App. Div. 1998). Interestingly, the Delaware corporate code does not expressly provide a cause of action to remedy a breach of the director's fiduciary duty. The same might be said of the MBCA, but in section 8.31 the MBCA sets forth the circumstances under which a director "shall not be liable to the corporation or its shareholders for any decision to take or not to take action, or any failure to take any action" and later in the same section, the MBCA specifies what a party must prove "to hold the director liable." MODEL BUS. CORP. ACT § 8.31(a)-(b) (2008). By contrast, in section 8.33 of the MBCA, the drafters provide an express cause of action on behalf of the corporation (presumably enforceable in a derivative action) for unlawful distributions. Id. § 8.33.

\[28^{28}\] It is noteworthy that these provisions only relate to the duty of care and monetary damages. A director still might be removed for breach of the duty of care, or be subject to injunctive relief. In short, corporate directors are everywhere subject to the fiduciary duty of care and, of course, to a duty of loyalty as well. But see infra notes 134-39, regarding section 122 of the Delaware corporate code.
increasingly looked to good faith to provide a basis for liability. Moreover, because good faith cannot be contracted away, even in Delaware, litigation implicating this concept is likely to grow.

III. PRE-DISNEY DELAWARE PRECEDENTS

In the corporate arena, the Delaware courts have struggled to define the duty of good faith. While the Delaware courts have provided some clarity to the concept of good faith in the Disney litigation and in Stone v. Ritter (discussed below), those decisions were not written on a blank slate and, because the facts of earlier cases differ from Disney and Stone, there is no reason to question their precedential value. An early formulation of good faith, for instance, Perrine v. Pennroad Corp., stated that directors' conduct that is "reckless and indifferent as to the rights of the stockholders" may breach the duty of good faith. In Perrine, the court held that a settlement of a shareholder's derivative suit for cancellation of a voting trust agreement and for an accounting was not so grossly inadequate as to indicate bad faith of the corporate directors in approving the settlement. On the basis of this case, one might characterize the obligation of good faith as an objective, substantive test in which the board's decision is measured against some post-hoc standard of reasonableness or fairness. Put differently, a board acts in good faith if its decision is not obviously inimical to the interests of the corporation.

31Brehm v. Eisner (Disney II), 746 A.2d 244, 261-64 (Del. 2000); In re Walt Disney Co. Derivative Litig. (Disney IV), 907 A.2d 693, 753-56 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006); Disney III, 825 A.2d at 286.
3347 A.2d 479 (Del. 1946).
34Id. at 489 (citing Karasik v. Pac. E. Corp., 180 A. 604 (Del. Ch. 1935)).
35Id. In re J.P. Stevens & Co. Shareholders Litigation, is another example of a substantive review as a mean to judge the absence of good faith. In re J.P. Stevens & Co. S'holders Litig., 542 A.2d 770, 780-81 (Del. Ch. 1988). The court inquired whether the "decision [was] so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." Id.
Somewhat in contrast to Perrine is the 2000 Delaware Court of Chancery decision in Nagy v. Bistricer, where a minority shareholder alleged that the directors violated their duties of loyalty, care, and good faith because they abdicated to the acquiring corporation, whose interests were adverse to the shareholders' interests, the right to set the amount of consideration the shareholders would receive in the merger. While the Delaware Court of Chancery referred to the "so-called 'duty of good faith,'" it also noted that if an independent concept of good faith is useful at all, its utility rests "in its constant reminder . . . [that] a director who consciously disregards his duties to the corporation and its stockholders" may be held personally liable. Although the court did not analyze the claims under the duty of good faith, it did grant summary judgment in favor of the minority shareholder's claim that the directors' abdication of their duty to determine a fair merger price breached their general fiduciary duties. Nagy may thus be characterized as one in which good faith has a subjective element, at least to the extent that the court noted the importance of the directors' mental state.

The most important pre-Disney case on good faith was likely In re Caremark International Inc. Derivative Litigation, a case that influenced the Delaware Supreme Court's decision in Stone. Caremark involved a claim that the directors breached their duty of care in failing to adopt an adequate system to monitor corporate compliance with the Federal Anti-Referral Payments Law. In the course of considering the strength of the plaintiff's claim—and, therefore, the fairness of the settlement agreement—Chancellor Allen observed that an "utter failure to attempt to assure a reasonable information and reporting system [exists]" would establish a breach of the duty of good faith. In a sense, such an "utter failure" describes grossly negligent behavior and, therefore, a breach of the duty of

37 770 A.2d 43 (Del. Ch. 2000).
38 id. at 48-49.
39 id. at 48-49 n.2.
40 id. at 61-64.
42 698 A.2d 959 (Del. Ch. 1996).
44 See Caremark, 698 A.2d at 960-61; 42 U.S.C.A § 1320a-7b (West 2008).
45 Caremark, 698 A.2d at 971.
due care. Moreover, assuming the directors did not have a conflict of interest—that is, the directors did not benefit personally by the failure to assure that an appropriate reporting system existed—it would appear that the "utter failure" cannot amount to a breach of the duty of loyalty. Nevertheless, as discussed below, such neglect by the board is now clearly a breach of the duty of loyalty, at least in Delaware. One consequence of this characterization is that the conduct is not excusable by charter provision. Another consequence is that the concept of good faith, and therefore proof of bad faith, inevitably requires an inquiry into a director's mental state.

IV. Disney and Stone: Good Faith Clarified in the Corporate Context

The paucity of cases in Delaware and elsewhere is somewhat surprising because the business judgment rule, which protects directors' business judgments from judicial scrutiny, is inapplicable if the directors did not act in good faith. Thus, one might have expected a robust jurisprudence to develop over the meaning of good faith. It did not. Section 102(b)(7) and its progeny in other states, however, provided a strong push to the development of that jurisprudence because under section 102(b)(7), directors cannot be relieved of liability if they failed to act in good faith. Plaintiffs who could not base a case on breach of the duty of care, because of a section 102(b)(7) exculpatory provision, and who could not plead a breach of the duty of loyalty, because the directors acted without a conflict of interest, were left to argue that the directors' decision was nonetheless

\[46\text{See, e.g., McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001) (applying Delaware law);}\\ \text{Stephen M. Bainbridge et al., The Convergence of Good Faith and Oversight, 55 UCLA L. REV.}\\ \text{559, 595-96 (2008). \textit{See also Ribstein, supra note 18, at 16 (characterizing Caremark as a state law version of section 404 of the Sarbanes-Oxley Act, 15 U.S.C. § 7242 (2008), which requires disclosure of deficiencies in internal controls).}}\\ \[47\text{See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).}\\ \text{See also Stone, 911 A.2d at 367 ("[S]ection 102(b)(7) . . . can exculpate directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith or a breach of the duty of loyalty."}).\\ \[48\text{See, e.g., Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007). Vice Chancellor Strine, writing about a claim that directors failed to adequately oversee the corporation's compliance with law (a Caremark claim), observed that plaintiffs must allege facts "suggesting that the board knew that internal controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed." \textit{Id.} at 940 (emphasis added).}\\ \[49\text{See, e.g., Cede, 634 A.2d at 361 (explaining that the presumption of the business judgment rule and good faith is rebutted by evidence of directors breach of a fiduciary duty).}\\
actionable because they did not act in good faith. That is precisely the sort of case that describes the *Disney* litigation, which provided the Delaware Supreme Court with an opportunity to explicate the meaning of the term.

The *Disney* litigation, a shareholders' derivative action, generated five reported decisions over a period of eight years (1998 to 2006), including two opinions by the Delaware Supreme Court. The action arose out of the hiring and firing of Michael Ovitz, who served as Disney's president from October 1, 1995 to December 11, 1996, completing only fourteen months of a five-year employment agreement. Ovitz's termination was designated by the board as a non-cause termination, entitling him to certain benefits under his agreement, which amounted to approximately $140 million. The plaintiffs complained that the board approvals of the initial employment agreement and the subsequent non-cause termination were in breach of the directors' fiduciary duties. Although the plaintiffs were able to get a trial on the merits, they ultimately failed to sustain their burden of proof.

The plaintiffs' initial amended complaint alleged that the directors breached their duties of loyalty, good faith, and due care. That complaint was dismissed by the Delaware Court of Chancery for inadequate allegations, and that dismissal was sustained in the first trip to the Delaware Supreme Court. In the first supreme court opinion, however, the plaintiffs were given a glimmer of hope; the court allowed the plaintiffs to file an amended complaint. In their amended complaint, drawing on hints contained in the supreme court's first opinion, the plaintiffs successfully alleged that the Disney board of directors breached its duty of good faith. On that basis, Chancellor Chandler, in his second formal opinion in the litigation, sustained the complaint. This opinion, in many ways, was the most important of the five because the chancellor set out a concept of good

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51 *In re* Walt Disney Co. Derivative Litig. (*Disney V*), 906 A.2d 27 (Del. 2006); Brehm v. Eisner (*Disney II*), 746 A.2d 244 (Del. 2000).
54 *Id.* at 277-79.
56 *Disney I*, 731 A.2d at 353.
57 *Disney II*, 746 A.2d at 267.
58 *Id.*
59 *Disney III*, 825 A.2d at 289-90.
60 *Id.*
faith that guided his subsequent opinion (following the trial) and the supreme court's opinion upholding the chancellor's verdict in favor of the defendants. Chancellor Chandler wrote that the plaintiffs' allegation that the directors had "consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision" amounted to an allegation that the directors acted in bad faith.61

In concluding that the plaintiffs failed to sustain their burden of proof, Chancellor Chandler reiterated that good faith incorporates a notion of intentional conduct: "[T]he concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith."62 This notion was central to the supreme court's 2006 decision, which ended the litigation.63 The court, citing the Chancellor's opinion with approval, chose to frame the meaning of good faith with reference to what constitutes bad faith: conduct motivated by "subjective bad intent" and conduct that amounts to "a conscious disregard for one's responsibilities" would constitute bad faith.64 The court stated that these categories of bad faith were not "exclusive," but they do provide a framework to think about what good faith and bad faith mean in Delaware.65

Drawing on this pronouncement, one can observe that good faith turns on a director's motivation or mental state.66 The notion of a "subjective

61Id. at 289 (emphasis omitted).
63In re Walt Disney Co. Derivative Litig. (Disney V), 906 A.2d 27, 62-68 (Del. 2006).
64Id. at 66.
65Id. at 67.
66Chancellor Chandler’s opinion, after trial, identified the sources of acting in bad faith: "greed, hatred, lust, envy, revenge, ... shame or pride." Disney IV, 907 A.2d at 754 (quoting Guttman v. Huang, 823 A.2d 492, 506 (Del. Ch. 2003)). This, of course, is a list of motives or mental states underlying an action. Interestingly, the chancellor added that "sloth" might be added to the list "if it constitutes a systematic or sustained shirking of duty." Id. Sloth is generally not thought of as a motivation; indeed, it is the absence of motivation. Including sloth, however, highlights the problem with the good faith doctrine because sloth, or a systematic shirking of duty, really describes a lack of care. So, the chancellor effectively defined an extreme lack of care as bad faith behavior. For a case discussing the duty of good faith of a general partner in a limited partnership, see Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199 (Del. 1993). In that case, Desert Equities, a limited partner, sued the general partner alleging that it acted in bad faith in exercising its authority under the partnership agreement to exclude Desert from participating in investments of the partnership. Id. at 1202. Desert alleged that the general partner did this in retaliation for Desert's act of filing a suit against affiliates of the general partner in a different limited partnership. Id. The court, in allowing the case to go to the finder of fact, stated
intent" or a "conscious disregard" forces one to examine the director's motivation, in contrast to the fiduciary duty of care, which looks to the process undertaken by directors to inform themselves, or the fiduciary duty of loyalty, which looks to the relationship of the director to the transaction under scrutiny. These demarcations are not, however, bright and independent of one another. For instance, a director may disapprove a transaction, say the acquisition of an asset, because he prefers that another entity in which he has an interest make the acquisition. This motivation would fall neatly under a "subjective bad intent," but could also be understood as a breach of loyalty. Similarly, a director may choose not to inform herself, breaching the duty of care, because she has determined to approve a transaction to further an interest she has in another venture. For instance, a director may vote to approve the building of a corn-based ethanol plant because that director also raises corn. Under these circumstances, the director would have violated the duties of care, loyalty, and good faith.

Perhaps sensing the difficulties of differentiating the duty to act in good faith from the duties of care and loyalty, the Delaware Supreme Court announced in Stone v. Ritter that good faith was not an independent fiduciary duty and that the failure to act in good faith "is not conduct that results, ipso facto, in the direct imposition of fiduciary liability." Rather, the Stone court characterized the duty to act in good faith as a "subsidiary element[,] i.e., a condition, 'of the fundamental duty of loyalty,'" despite previously having referred to good faith as one of the "triad" duties of care, loyalty, and good faith.

By positioning good faith as part of the duty of loyalty, the court entered into a doctrinal thicket that has muddied, rather than clarified, the law. Indeed, having determined to explicate the meaning of good faith in that "a claim of bad faith hinges on a party's tortious state of mind." It quoted as follows from Black's Law Dictionary in support of its conclusion that bad faith is a state of mind:

[The] term "bad faith" is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will.

Id. (quoting BLACK'S LAW DICTIONARY 337 (5th ed. 1983)).


See Disney I, 731 A.2d at 367.


Id. at 370 (quoting Gutman, 823 A.2d at 506 n.34).

Delaware law, the court might just have easily gone in the opposite direction, characterizing the duty to act in good faith as the only fiduciary duty, with the duties of loyalty and care as subsets. If good faith means that a fiduciary must act in the best interests of the beneficiary, then care and loyalty are automatically covered. Can one act in the best interests of another when one is serving one's own interests (loyalty), or acting in a consciously negligent fashion (care)? The Delaware courts have not embraced this approach, probably for at least two reasons. First, the law has long evolved as recognizing independent fiduciary duties of care and loyalty. It would be too radical a departure from precedent to reformulate these duties as a single duty of good faith. Second, such a reformulation would run counter to the statutory construct of section 102(b)(7), which assumes a template of fiduciary duties of care and loyalty. But underpinning the language in Disney, Stone, and Caremark is this unified fiduciary duty and, more importantly for present purposes, this unified notion informs fiduciaries how they should conceptualize, for themselves, what their obligations include.

The doctrinal complexity arising from this formulation is apparent from its application in Stone itself. Stone involved a Caremark claim: a derivative action seeking compensation from the board of directors for damages that the company suffered because, allegedly, the board failed to adequately oversee the corporation's compliance with applicable positive law.\textsuperscript{72} In Caremark, the applicable law in question prohibited kickbacks from Medicare providers to physicians and others.\textsuperscript{73} In Stone, the applicable laws related to anti-money-laundering statutes and regulations.\textsuperscript{74} In both cases, the federal agencies accused the corporations of violating federal law, resulting in substantial civil penalties, $10 million in Stone and $250 million in Caremark.\textsuperscript{75}

The procedural posture in Caremark was a bit unusual; the Delaware Court of Chancery was asked to approve a settlement of a derivative action.\textsuperscript{76} To decide whether the settlement was fair, the chancellor had to determine the strength of the underlying claim. Chancellor Allen concluded that a claim based on a failure to properly oversee the corporation's compliance with law would only lie if there was "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a

\textsuperscript{72} Caremark, 698 A.2d at 960.
\textsuperscript{73} Id. at 961-62.
\textsuperscript{74} Stone, 911 A.2d at 365.
\textsuperscript{75} Id.; Caremark, 698 A.2d at 960-61.
\textsuperscript{76} Caremark, 698 A.2d at 960.
reasonable information and reporting system [exists]." Caremark seemed to be implicating the directors' duty of care, and was so characterized by some courts and scholars.78

The Stone court thought otherwise. While it embraced the Caremark opinion, the court characterized Caremark as a duty of loyalty case, reasoning that liability for lack of oversight requires a showing that "the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith."79 That seems somewhat circuitous and, in any event, excessively complex. Why not conclude, as Chancellor Allen seemed to conclude, that a systematic failure to exercise oversight breaches the duty of care? The answer may relate back to Van Gorkom and section 102(b)(7). If lack of oversight is a care claim, then the section 102(b)(7) exculpation clause may operate to preclude relief for the corporation (or a derivative plaintiff), while the same result would not ensue if the claim is one of loyalty. Moreover, the court may have been concerned with situations in which the board affirmatively decides, after careful deliberation, to forego any information and reporting system because the costs associated with one would exceed the reasonably perceived benefits. As an abstract proposition, and assuming due care was exercised, such a decision would be protected by the business judgment rule and by a section 102(b)(7) exculpatory provision. Stone changes that by simply characterizing lack of oversight as a duty of loyalty claim.

The Stone court did not explain why it chose not to treat the duty of good faith as an independent fiduciary duty. In rejecting this notion, however, the court hedged a bit: "[T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."80 Why did the court continue after the phrase "independent fiduciary duty"? Two explanations come to mind. First, the court may have been saying that the duty of good faith is a duty, just not a fiduciary one like loyalty and care. In so characterizing the duty of good faith, the court may have thought that it was simplifying fiduciary law.
Second, and not unrelated to the first point, the way the court described good faith is indistinguishable from the duty of loyalty in many instances; good faith truly is a manifestation of loyalty.

A final consideration in understanding good faith in the corporate context is the question of proof. Good faith, after all, is a subjective standard of conduct, depending at least in part on a director's motivations or mental state. The Delaware courts, however, have recognized the inevitability of relying on inferences in proving that a director acted in bad faith. For instance, Chancellor Allen observed that measuring a business decision against some objective standard of reasonableness will indicate whether that decision is so egregious that it is not entitled to the protections of the business judgment rule.\(^8\) That, in turn, provides a basis for inferring, or concluding, that the board acted in bad faith.\(^2\) The Delaware Supreme Court made the same observation in its first opinion in the Disney litigation, suggesting that "[i]rrationality . . . may tend to show that the decision is not made in good faith."\(^3\)

V. THE DUTY OF GOOD FAITH FOR PARTNERS, MEMBERS, AND MANAGERS OPERATING UNINCORPORATED ENTITIES

The formulations of good faith for corporate directors cannot explain the contractual duty of good faith to which members, partners, and managers of unincorporated entities are subject, at least not when the operating or partnership agreement disclaims fiduciary duties. Almost by definition, the parties to such an agreement have agreed that those operating the business may act with their own interests in mind and the partnership statutes (both in Delaware and the uniform acts) expressly recognize this: "A partner does


\(^{82}\)Id.

\(^{83}\)Brehm v. Eisner (Disney II), 746 A.2d 244, 264 (Del. 2000). See also White v. Panic, 783 A.2d 543, 554 n.36 (Del. 2001) ("The standards for corporate waste and bad faith by the board are similar. To prevail on a waste claim or a bad faith claim, the plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests."); Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, No. 20,228-NC, 2004 WL 1949290, at *17 n.92 (Del. Ch. Aug. 24, 2004), reprinted in 30 DEL. J. CORP. L. 535, 564 n.92 (2005) ("[T]he court will generally be required to look to the Board's actions as circumstantial evidence of [a] state of mind."); Andrew S. Gold, A Decision Theory Approach to the Business Judgment Rule: Reflections on Disney, Good Faith, and Judicial Uncertainty, 66 MD. L. REV. 398, 426-32 (2007) (discussing the issue).
not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.\textsuperscript{84}

Thus, the duties of a partner in a partnership or a manager of a limited liability company are not fiduciary duties. While the fiduciary nature of, say, a partnership was once beyond peradventure,\textsuperscript{85} Delaware and many other states have clearly moved in a different direction. For instance, although the Delaware Revised Uniform Partnership Act (DRUPA), like the standard Revised Uniform Partnership Act (RUPA), states that a partner owes to the partnership the fiduciary duties of loyalty and care,\textsuperscript{86} the Delaware statute also provides that "relations among the partners and between the partners and the partnership are governed by the partnership agreement"\textsuperscript{87} and that "[a] partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner."\textsuperscript{88} Other partnership statutes pointedly avoid characterizing the duties of loyalty and care as "fiduciary duties."\textsuperscript{89} Therefore, in Delaware and other jurisdictions that allow modification or elimination of the duties of care and loyalty, whether such duties are statutorily characterized as fiduciary duties or not, the relationship of the parties is best viewed as contractual rather than status based.\textsuperscript{90} The statute serves the role of providing default terms, not defining the underlying relationship of the parties.\textsuperscript{91} In the Delaware code, that result is stated expressly, as noted above.

For the hard cases involving unincorporated entities, then, the Delaware courts have moved outside of the familiar jurisprudence of fiduciary duties. A source of the jurisprudence may well be the Delaware

\textsuperscript{84}\textsc{Revised Unif. P'ship Act} § 404(e) (2007). The Delaware act is similar, substituting the word "solely" for "merely." \textsc{Del. Code Ann. tit. 6, § 15-404(d)} (2005).
\textsuperscript{85}\textsc{See Meinhard v. Salmon}, 164 N.E. 545, 546 (N.Y. 1928).
\textsuperscript{87}Id. § 15-103(a).
\textsuperscript{88}Id. § 15-103(f).
\textsuperscript{89}\textsc{See}, e.g., \textsc{Colo. Rev. Stat. § 7-64-404} (2008); \textsc{Tex. Bus. Orgs. Code Ann. § 152.204(d)} (Vernon 2007).
\textsuperscript{90}\textsc{See the comments of Delaware Chief Justice Myron T. Steele in a recent law review article: "[C]ourts should look to the parties' agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance." Myron T. Steele, Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 \textsc{Del. J. Corp. L.} 1, 1 (2007).}
Supreme Court's venerable decision in Schnell v. Chris-Craft Industries, Inc. 92 Schnell, a corporate law case, was expressly decided on what the court referred to as equitable grounds. 93 But the case can be viewed as an ancestor of the modern concept of good faith for unincorporated entity law.

Schnell involved an effort by a corporate board to thwart a proxy contest by dissident shareholders. 94 The tactic chosen by the directors was the advancement of the date of the annual meeting by five weeks, thereby shortening the time that the dissidents would have to solicit other shareholders. The Delaware Court of Chancery refused to enjoin the meeting, reasoning that the board of directors changed the bylaws in a manner consistent with the Delaware corporate code. 95 The Delaware Supreme Court, however, reversed, announcing that "inequitable action does not become permissible simply because it is legally possible." 96 Interestingly, the court did not cite fiduciary duties, much less the concept of good faith in rendering its opinion. But good faith fits rather nicely, at least to the extent that good faith looks to the actor's motivations. In Schnell, the directors were motivated not by the best interests of the corporation, but rather by maintaining themselves in office. 97 And while many cases have condemned such motivations as violating a director's fiduciary duty, 98 until recently courts rarely characterized such motivations as a violation of good faith. That is, indeed, what is at issue. Acting for the best interests of Chris-Craft would require the directors to put aside all personal interests. Their conduct suggested that personal interests did inform their decisions.

There is another respect in which good faith could be used to understand the outcome in Schnell, one that depends on contractual analysis and fits neatly with the concept of unincorporated entities as contractual entities. The power and authority upon which the directors depended was derived from the bylaws. The bylaws form part of the contract or

93Schnell II, 285 A.2d at 439.
94Id. at 438.
96Schnell II, 285 A.2d at 439.
97Id.
understanding between the shareholders and the directors. In exercising their discretionary authority under the bylaws to change the date of the annual meeting, the directors were subject to the \textit{contractual} duty of good faith. They could not use that discretionary authority in a way that disappointed the reasonable expectations of the shareholders, but that is precisely what they did, and intentionally so. Thus, the directors violated the contractual duty of good faith and their action was rightly set aside by the court.

Several recent cases support this notion of good faith. Perhaps the most engaging of these cases is \textit{VGS, Inc. v. Castiel}, which involved a freeze-out merger engineered by two of the three managers of Virtual Geosatellite LLC. Geosatellite had, essentially, two investors. One, Castiel, owned 75\% of the equity, and the other, Sahagen, owned 25\%. Each of the investors held their membership interests in Geosatellite indirectly, through limited liability companies that they owned and controlled. Under the operating agreement, Castiel was entitled to appoint two managers and Sahagen one. Each of the investors named themselves as managers and Castiel also named Quinn. Less than two years after the venture came together, Sahagen convinced Quinn to join forces with him. The two agreed to merge Geosatellite into VGS, Inc., reducing Castiel's equity from 75\% to 37.5\%. They achieved this by executing a written consent, as permitted by Delaware law, without notice to Castiel.

While the procedures followed by Sahagen and Quinn were perfectly consistent with the letter of Delaware law, just as the conduct of the directors was in \textit{Schnell}, then-Vice Chancellor Steele would not permit the action to stand. Expressly relying on equitable maxims, the court found a fiduciary duty between managers of LLCs, writing:

\textit{See DEL. CODE ANN. tit 8, § 109 (2001).}
\textit{Id. at *2, reprinted in 27 DEL. J. CORP. L. at 457.}
\textit{Id. at *1, reprinted in 27 DEL. J. CORP. L. at 456.}
\textit{Id.}
\textit{VGS, Inc., 2000 WL 1277372, at *1, reprinted in 27 DEL. J. CORP. L. at 456.}
\textit{Id.}
\textit{Id. at *2, reprinted in 27 DEL. J. CORP. L. at 456.}
\textit{Id., reprinted in 27 DEL. J. CORP. L. at 457.}
The General Assembly never intended, I am quite confident, to enable two managers to deprive, clandestinely and surreptitiously, a third manager representing the majority interest in the LLC of an opportunity to protect that interest by taking an action that the third manager's member would surely have opposed if he had knowledge of it. My reading of Section 18-404(d) [which permits action by managers without prior notice] is grounded in a classic maxim of equity—"Equity looks to the intent rather than to the form."\textsuperscript{109}

Our system of law would be a sad one indeed if there was not some basis to set aside an action grounded in such duplicity. But getting there is another matter entirely. It may be that Quinn was an agent of Castiel and acted disloyally, but that might simply give rise to a claim by Castiel against Quinn, leaving the merger intact. Moreover, it is unclear that a manager of an LLC is an agent of the person responsible for his or her appointment. It may be that managers, like corporate directors, have a fiduciary duty to act in the best interests of the entity, and it might have been in the best interests of the entity to approve this transaction. That inquiry did not arise in the opinion.

Alternatively, it may be that Sahagen and Quinn breached duties to their co-manager, Castiel. Indeed, the court so found, holding that Sahagen and Quinn "owed a duty of loyalty to the LLC, its investors and Castiel, their fellow manager."\textsuperscript{110} That a manager owes duties to a co-manager, however, is not immediately self-evident. A manager's duty is to act in the best interests of the entity, not the interests of a co-manager.\textsuperscript{111}

Yet another way to think about this case is in terms of good faith, which the court did not address. Could Quinn and Sahagen have been acting in good faith, given their contractual understandings with Castiel, if they so conspired? To ask the question is, of course, to answer it. Castiel's reasonable expectations were that he would participate in managerial decisions, notwithstanding the statutory provision that allowed his co-managers to act without him.\textsuperscript{112} So, it was not a gloss on the statute that protects Castiel, but

\textsuperscript{109}Id. at *4, reprinted in 27 DEL. J. CORP. L. at 459 (citations omitted).
\textsuperscript{110}Id., reprinted in 27 DEL. J. CORP. L. at 460.
\textsuperscript{111}See DEL. CODE ANN. tit. 6, § 18-1101(c) (2005).
\textsuperscript{112}VGS, Inc., 2000 WL 1277372, at *4, reprinted in 27 DEL. J. CORP. L. at 460.
an application of the good faith standard, which protects a contracting party from the opportunistic behavior of the other party to the contract.\textsuperscript{113}

While the bylaws represented the relevant contract in \textit{Schnell}, in \textit{VGS, Inc.}, the relevant contract was the Delaware statute. The Delaware Limited Liability Company Act consists, essentially, of default provisions.\textsuperscript{114} Section 18-404(d), under which Sahagen and Quinn achieved their nefarious plot, permitted them to consent to a merger without notifying Castiel.\textsuperscript{115} Under the circumstances of this case, however, good faith required them to notify Castiel, and the decision could easily have rested on that ground.

Another recent case demonstrating the equitable tendency of the Delaware Court of Chancery, and the overlap of equity and good faith, is \textit{Haley v. Talcott}\.\textsuperscript{116} This case involved an attempt by Haley, a fifty percent owner of an LLC, to obtain judicial dissolution of the LLC on the grounds that it was not reasonably practicable to carry on the business of the LLC.\textsuperscript{117} Haley's co-owner, Talcott, objected on the basis that the company was continuing to operate, and the LLC operating agreement included an exit provision that precluded judicial dissolution.\textsuperscript{118} The court sided with Haley because if Haley's interest was acquired pursuant to the exit provision, he would still be liable for a mortgage on LLC property that he had personally guaranteed.\textsuperscript{119} The court thus concluded that it was not "equitable to force Haley to use the exit mechanism in this circumstance."\textsuperscript{120} The exit provision was unconditional and, aside from equitable considerations, the court cited no reason why the provision should not apply under the circumstances.

It is fair to ask, with respect to the decision, whether a healthy deference to contractual freedom might not have yielded a different result. In a two-person LLC, if the parties provided, as these parties did, an opportunity for either to exit and have his interest repurchased at fair market value, it is arguably inequitable to the nonexiting partner to require a dissolution and liquidation of the entity. Each party presumably assumed the risk that a falling out would result in a buy-out of his interest. Further, if a guarantee was executed after formation of the entity, each party assumed an

\textsuperscript{113}See \textit{Anthony's Pier Four, Inc. v. HBC Assocs.}, 583 N.E.2d 806, 821 (Mass. 1991); \textit{Warner v. Konover}, 553 A.2d 1138, 1141 (Conn. 1989).
\textsuperscript{114}See \textit{DEL. CODE ANN. tit. 6, § 18-101 to -1109} (2005).
\textsuperscript{115}\textit{VGS, Inc.}, 2000 WL 1277372, at *4, \textit{reprinted in} \textit{27 DEL. J. CORP. L.} at 459.
\textsuperscript{116}864 A.2d 86, 96-98 (Del. Ch. 2004).
\textsuperscript{117}Id. at 87.
\textsuperscript{118}Id. at 87-88.
\textsuperscript{119}See id. at 88-89.
\textsuperscript{120}\textit{Haley}, 864 A.2d at 98.
additional risk that the guarantee obligation would continue even after a buy-out. From a contractual perspective, one might argue that the court rewrote the parties' operating agreement, so that it provided that if either party wanted to withdraw from the company while a guarantee was outstanding, the withdrawing party could force a liquidation of the company.

There is, however, another way to look at the case. The real problem may have been that Talcott failed to take any steps to restructure the guarantee and relieve Haley from liability. Indeed, the court included a footnote in its opinion disclosing that, when asked, counsel for Talcott demurred on the problem of the continuing liability and just stated that each party would remain liable on the guarantee. Thus, this case, too, implicates contractual notions of good faith. Yes, Talcott had a right under the agreement to insist on the repurchase of Haley's membership interest if Haley wished to withdraw, but acting in good faith Talcott would, at least, have sought to relieve Haley from the mortgage obligation. Talcott's refusal to do so made dissolution of the company more appealing to the court.

This interpretation of *Haley v. Talcott* fits nicely with the analysis in *VGS, Inc.* In both cases, the courts implicitly recognized that resolving disputes by reference to the unadorned words in an agreement or statutory provision was not sufficient. Rather, notions of contractual good faith cannot be ignored; parties who have rights under an agreement are limited in the way that they may exercise those rights so as not to unreasonably disappoint the expectations of the other party. This is precisely the concept that animated Vice Chancellor Strine's lengthy and persuasive opinion in *Gelfinan v. Weeden Investors, L.P.*

*Gelfinan* involved a squeeze out of outside investors by the management of Weeden Investors at a price substantially below fair market value. The limited partnership agreement in *Gelfinan* gave a great deal of discretion to the general partner in managing the partnership and ordering its affairs. In conflict situations, however, including the transactions involved in this case, the general partner was required to consider, among other things, "the relative interests of each party to such conflict." Based on a careful review of the record, the court concluded that the general
partner did not rationally consider the interests of the complaining limited partners and, therefore, breached the partnership agreement. An important factor in reaching this decision was what the court considered to be the reasonable expectations of the plaintiffs, who could not have anticipated being forced out of the partnership at less than fair market value, while the insiders fared far better. The court colorfully concluded: "For a General Partner to knowingly deprive an equity partner of her partnership interest for less than what it is worth without a pre-existing contractual right to do so is, by an American's definition, bad faith action. That is precisely what occurred here." In other words, the contract interpretation was informed by underlying notions of good faith. The contractual freedom that the general partner thought it had provided for itself—and the contract was extraordinarily protective of the general partner—was not, and could not be, an impenetrable shield.

A more reinforced shield was pierced in Solar Cells, Inc. v. True North Partners, LLC. This case, like VGS, Inc., involved a near freeze-out merger with a resulting complaint by the diluted party. Solar Cells and True North each owned a fifty percent interest in an LLC called First Solar. For various reasons, however, True North was entitled to appoint three of the five managers of the LLC and clearly controlled First Solar. The venture required additional capital, which True North provided in the form of convertible loans. The parties sought additional investors and engaged the services of an investment banker. Eventually, True North unilaterally decided to convert its loans to equity and to merge First Solar into a new LLC that it wholly owned. As a result of the merger, Solar Cells' equity interest would be reduced to five percent. It sought and obtained an injunction from the Delaware Court of Chancery.

The "reinforced shield" in this case consisted of an operating agreement that sought to relieve True North from liability for claims that it

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127 Gelfinan, 859 A.2d at 121.
128 Id. at 124.
130 Id. at *1.
131 Id. at *1-2.
132 Id. at *1.
134 Id.
135 Id.
136 Id.
engaged in a conflict of interest transaction. Section 4.18(a) of the operating agreement provided:

Solar Cells and [First Solar] acknowledge that the True North Managers have fiduciary obligations to both [First Solar] and to True North, which fiduciary obligations may, because of the ability of the True North Managers to control [First Solar] and its business, create a conflict of interest or a potential conflict of interest for the [T]rue North Managers. Both [First Solar] and Solar Cells hereby waive any such conflict of interest or potential conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

The court dismissed this provision because the plaintiff was only seeking to enjoin the merger, not obtain a recovery from True North. The court then went on to explain that it was likely that plaintiff would prevail on the merits because True North did not appear to have acted in good faith. This finding was based on the fact that the True North managers consented to the merger the day after having met with the Solar Cells managers, a meeting at which the True North managers failed to disclose their intent to merge into their affiliate. Since the True North managers did not act in good faith, the court concluded, they would have the burden of demonstrating the entire fairness of the merger: fair dealing and fair price. Based on the record, the court held that it was unlikely that True North could satisfy that burden of proof.

This case turns on contractual notions of good faith. Yes, the True North managers had the power and authority to approve a merger with an affiliate, but they had to exercise that power in good faith. The way that they

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138 Id. at *4 (emphasis added).
139 Id.
140 Id. at *4-5.
142 Id. at *4-5 (citing Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)).
143 Id. at *5.
went about their business convinced the court that they did not act in good
faith.

This case raises some intriguing questions. The court seemed to
ignore the waiver by Solar Cells of True North's conflict of interest. Did that
waiver not preclude relief? Was there a contractual solution that would
protect True North? Suppose that the above-quoted exculpatory provision
had been a bit more comprehensive and precluded equitable relief. Or,
suppose that the operating agreement had expressly provided that when the
True North managers act, they need not give notice to the Solar Cells
managers. It is fair to speculate that contractually there was nothing that
True North could have provided that would give it the freedom to act as it
sought to act in this case. The court cited Schnell in its analysis,144
signaling that Delaware will not abandon equitable principles, regardless of the
underlying operating agreement.145

Finally, consider the recent case of Blackmore Partners, L.P. v. Link
Energy LLC,146 in which the court sustained a complaint in a class action
despite the absence of specific allegations that would suggest that the
business judgment rule did not protect the actions of the defendants.147 The
LLC agreed to sell substantially all of its assets for an amount of money that
would pay off its creditors but leave nothing for the members, or "common
unit holders," of the LLC.148 There was no allegation that the defendants
labored under a conflict of interest or failed to exercise adequate care in
rendering the decision.149 Nevertheless, Vice Chancellor Lamb denied the

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144Id. at *4 n.9.
145Not all would agree with the observation that Delaware courts would fail to honor an
agreement in such circumstances. See Larry E. Ribstein, The Uncorporation and Corporate
Indeterminacy, 2009 U. ILL. L. REV. 131 (arguing that the Delaware cases involving unincorporated
entities demonstrate a strong fidelity to the parties' agreement). Professor Ribstein cites, among
other cases, Miller v. American Real Estate Partners, L.P., where, indeed, Vice Chancellor Strine
states that the agreement must be honored, even over the "piteous pleas of limited partners who are
seeking to escape the consequences of their own decisions . . . ." Id. at 148-50 (quoting Miller v.
Am. Real Estate Partners, L.P., No. 16,788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001)). But
in Miller the limited partners prevailed, as Vice Chancellor Strine ultimately held that the drafters of
the partnership agreement did not explicitly preclude the application of default fiduciary duties.
Miller, 2001 WL 1045643, at *9. Narrow construction of an agreement provided relief for plaintiffs
in two other Delaware cases: Cont'l Ins. Co. v. Rutledge & Co., No. 15,539, 2000 WL 268297, at
*3 (Del. Ch. Feb. 15, 2000), and In re Marriott Hotel Prop. II Ltd. P'ship., No. 14,961, 2000 WL
146864 A.2d 80 (Del. Ch. 2004).
147Id. at 81.
148Id.
149Id. at 84.
motion to dismiss for failure to state a claim, reasoning that "the allegation that the Defendant Directors approved a sale of substantially all of Link's assets and a resultant distribution of proceeds that went exclusively to the company's creditors raises a reasonable inference of disloyalty or intentional misconduct."\(^{150}\)

While the vice chancellor's decision is defensible—plaintiffs should be given the opportunity to make a case—the necessary factual allegations are nonetheless lacking. At least, the opinion fails to point to any specific allegations to support the inference of disloyalty or intentional misconduct. Rather, the plaintiffs are complaining about the substance of the decision, which normally is not something that the directors have to defend.\(^{151}\) But the vice chancellor's decision can be justified on the basis that there is an inference of bad faith, which would, of course, remove the protection of the business judgment rule and the exculpation clause in the operating agreement. Arguably, the complaint suggested that the directors acted "in conscious disregard" of their responsibilities, which, in this case, was to maximize the return to unit holders.\(^{152}\) This is not disloyalty in the normal sense of a conflict of interest, but is disloyalty in the sense that other cases used the term in reference to good faith.

Those skeptical of my observation that the Delaware courts will avoid inequitable contracts, might cite two cases as taking a contrary view: Brickell Partners v. Wise\(^{153}\) and Sonet v. Timber Co., L.P.\(^{154}\) These cases seem to support freedom of contract over a claim based on vague equitable notions. A closer look at these cases, however, demonstrates that the

\(^{150}\)Blackmore Partners, L.P., 864 A.2d at 86.

\(^{151}\)Id. at 85.

\(^{152}\)See id. at 84; see also Forsythe v. ESC Fund Mgmt. Co., No. 1091-VCL, 2007 WL 2982247 (Del. Ch. Oct. 9, 2007), reprinted in 33 DEL. J. CORP. L. 239 (2008) (providing an example in which the court's rather narrow construction of a limited partnership agreement enabled the plaintiff to withstand a motion to dismiss). Professor Ribstein characterizes this case as an exception to the approach of the Delaware courts to agreements involving unincorporated entities, where in his view the courts defer to the agreement of the parties and recognize that the agreement may provide alternatives to the need for judicial monitoring. See Ribstein, supra note 145, at 158-61. But this case, too, is better explained as an application of the concept of contractual good faith than an exception to contractual freedom. The plaintiff complained that the general partner had breached his duty of oversight and the court agreed that such a duty existed. Forsythe, 2007 WL 2982247, at *1, reprinted in 33 DEL. J. CORP. L. at 239-40. In the absence of oversight by the general partner, the limited partners were dependent on conflicted parties to manage their investments. Id. Arguably, at least, given those conflicts, the limited partners could have reasonably expected oversight by the general partner.

\(^{153}\)794 A.2d 1 (Del. Ch. 2001).

\(^{154}\)722 A.2d 319 (Del. Ch. 1998).
equities involved made it easy for the courts to enforce the contracts against what were, in reality, weak claims based on fiduciary duty.

In Brickell, for instance, the limited partners of El Paso Energy Partners, L.P. brought a derivative action complaining of an acquisition by the partnership of Crystal Gas Storage, Inc., which was an affiliate of El Paso's general partner, DeepTech International.\textsuperscript{155} El Paso Energy Corporation owned both DeepTech and Crystal Gas.\textsuperscript{156} This affiliation meant that DeepTech had a conflict of interest in structuring and approving the acquisition on behalf of the partnership. The partnership agreement provided that in conflict situations, the general partner could refer the matter to a special committee of its board for approval, which happened in this case.\textsuperscript{157} The limited partner complained that the special committee was conflicted because the committee consisted of two directors of DeepTech.\textsuperscript{158} Such directors, the plaintiffs argued, would have loyalties to the general partner and to the partnership and, thus, in this instance, were in conflict.\textsuperscript{159} That being the case, the burden should be on the defendants to demonstrate the fairness of the transaction.\textsuperscript{160}

Vice Chancellor Strine rejected this argument and dismissed the complaint, noting that the general partner acted consistently with the agreement.\textsuperscript{161} On its face, Brickell is a troubling case because the partnership agreement arguably did not contain sufficient safeguards to assure fair treatment to the partnership and limited partners in conflict transactions. The plaintiff argued that the fairness of the transaction would be enhanced if the decision makers for the general partner were unaffiliated with the general partner and that the agreement should be so construed.\textsuperscript{162} The court, however, found that the agreement did not require that the members of the special committee be unaffiliated.\textsuperscript{163} Rather, the agreement implied that the special committee would consist of directors.\textsuperscript{164}

But the court did not end the opinion by simply stating that the general partner acted consistently with the agreement. First, the court noted that the

\begin{footnotes}
\item[155]Brickell, 794 A.2d at 2.
\item[156]Id.
\item[157]Id. at 2-3.
\item[158]Id. at 2.
\item[159]Brickell, 794 A.2d at 2.
\item[160]Id. at 4-5.
\item[161]Id. at 4.
\item[162]Brickell, 794 A.2d at 2.
\item[163]Id.
\end{footnotes}
plaintiff failed to allege that the members of the special committee had any conflict other than the structural conflict that arises from being directors of the corporate general partner. Second, the court noted that the members of the special committee were not members of the management of the general partner, were not shareholders of the general partner or the general partner's parent, and that there were no allegations that the process of the special committee was tainted, by fraud or otherwise. Finally, the court noted early in the opinion that there was little support in the complaint for the allegation that the terms of the merger were substantively unfair to the limited partnership. Taken together, the court's observations leave the door open for a different outcome in a subsequent case where the plaintiff can allege that, even though the process followed was consistent with the agreement, the transaction is nonetheless challengeable on the basis of a substantial conflict by the decision makers or a specific allegation of unfairness. Under those circumstances, the evolving concept of good faith would provide the basis for judicial scrutiny.

Similar observation can be made about the Sonet case. Under the partnership agreement, the general partnership had sole discretion to decide upon, and recommend to the limited partners, the terms of the conversion or merger. The limited partners alleged, among other things, that notwithstanding this broad grant of power, the general partner owed the limited partners the default fiduciary duties set forth in the DRULPA. Chancellor Chandler framed the issue as, "what controls the governance process in the context of limited partnerships—the partnership agreement or common law fiduciary duty doctrines?" The court resolved this issue with a forceful statement "that the unambiguous terms of the partnership agreement have the effect of limiting the Court's review of the transaction presently in dispute." Somewhat later in the opinion, Chancellor Chandler restated his holding with a statement that seemed to embrace freedom of contract with little opportunity for future attack on the principle: "Thus, I think it is a
correct statement of law that principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain."\textsuperscript{172}

Notwithstanding these categorical statements, a few aspects of this case are worth noting. First, while the partnership agreement granted the general partner "sole discretion" to recommend the terms of the conversion, the deal required the approval of sixty-six and two-thirds percent of the limited partners.\textsuperscript{173} Second, the case was brought before the limited partners had voted; indeed, "the proxy statement ha[...]d not yet been distributed."\textsuperscript{174} Thus, the court may have determined (although it did not so state) that the plaintiffs' claims were not yet ripe for adjudication. If the limited partners failed to approve the deal, the complaint becomes moot. On the other hand, if the proxy statement did provide full disclosure and if the limited partners then approved the transaction, the equities would seem to lie with the general partner. All the court decided in this case was that the limited partners could protect themselves: "their remedy is the ballot box, not the courthouse."\textsuperscript{175} In short, this was an easy case for freedom of contract; plaintiff had little, if anything, to complain about.

Of equal importance, for present purposes, is that the court did not close the door to the consideration of equitable notions in future cases.\textsuperscript{176} The court stated that, while alternative business entities are not subject to the notions of fairness inherent in corporate law, a Delaware court will look to "statutory default rules" and what the court referred to as "traditional notions of fiduciary duties" when "principles of equity are implicated."\textsuperscript{177}

\section*{VI. A MOVE TOWARD CONVERGENCE}

In 2000, and in response to \textit{Siegman v. Tri-Star Pictures, Inc.},\textsuperscript{178} the Delaware legislature added a subsection to the powers section of the

\begin{footnotesize}
\begin{enumerate}
\item<sup>172</sup>\textit{Sonet}, 722 A.2d at 322.
\item<sup>173</sup>\textit{Id.} at 324 & n.13.
\item<sup>174</sup>\textit{Id.} at 327.
\item<sup>175</sup>\textit{Id.} at 326. See also \textit{R.S.M. Inc. v. Alliance Capital Management Holdings L.P.}, which, like \textit{Sonet}, involved a challenge by outside investors to a reorganization of a partnership. \textit{R.S.M. Inc. v. Alliance Capital Mgmt. Holdings L.P.}, 790 A.2d 478, 481 (Del. Ch. 2001). In \textit{R.S.M.}, however, the court concluded that the complaint alleged inadequate disclosure in the proxy statement. \textit{Id.} at 502.
\item<sup>176</sup>\textit{Sonet}, 722 A.2d at 323-24.
\item<sup>177</sup>\textit{Id.} at 324.
\end{enumerate}
\end{footnotesize}
Delaware corporate code. Section 122(17) of the Delaware corporate code now provides that a Delaware corporation has the power to:

[r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.

To the extent that the renunciation is by resolution of the board of directors, the provision is not a significant departure from pre-existing law: the board always had the power to forgo a business opportunity and allow a director to seize that opportunity. Such a decision, however, was, and presumably continues to be, subject to judicial review. If the board was conflicted, or failed to act with care, in appropriate circumstances it may face liability for its decision. The statute goes beyond that, however, permitting the certificate of incorporation to specify classes or categories of business opportunities that the corporation, in advance, renounces. Thus, the certificate of incorporation of a cellular telephone company might provide that the corporation renounces any interest or expectancy in business opportunities to develop cellular systems outside of a particular region. Investors in the

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180 Id.
183 See Broz, 673 A.2d at 154-57. In Broz, Cellular Information Systems, Inc. (CIS) alleged that Broz, a former director of CIS, breached his fiduciary duties to CIS when he accepted a corporate opportunity to acquire a cellular service license for a certain region without formally presenting the opportunity to CIS's board of directors. Id. at 150-51. Under the accepted corporate opportunity doctrine, a corporate director may still be able to take a business opportunity for himself if the corporation is financially unable to exploit the opportunity, "the corporation holds no interest or expectancy in the opportunity," or the opportunity is presented to the director in his individual capacity. Id. at 155. But without an express provision, if the director does not present the "corporate opportunity" to the corporation first, his actions may be subject to a judicial review of
company presumably understand this when making their investment, and they should have no grounds to object when a director pursues a business opportunity that, but for this provision, he would have been obligated to present to the corporation. Such a provision would clearly be unobjectionable in an unincorporated entity, and now corporate investors are treated similarly.

One, however, should not overlook the significance of this provision. While the certificate of incorporation has always been a contract of sorts, the ability of the promoters of a corporation to alter fiduciary duties in the certificate has been limited. Section 102(b)(7) of the Delaware corporate code was the first significant departure from this tradition. Section 122(17) now permits modification of the duty of loyalty. With the duties of care and loyalty now subject to modification in the certificate, the bright line between corporations and unincorporated entities, where the former was characterized by mandatory fiduciary duties and the latter by freedom of contract, has been blurred. That, in turn, suggests that the role that good faith plays in unincorporated entities, a contract principle, may find its way in corporate law as well.

whether the objective facts support a reasonable inference that the director did or did not usurp a corporate opportunity. See id. Here, under appellate review, the Delaware Supreme Court held that Broz did not usurp a corporate opportunity because the corporation was financially unable to exploit the opportunity, it was not clear that CIS had an interest in the license, and the opportunity was offered to the director in his individual capacity. Id. at 155-57.


186 id. § 122(17).

187 See Mark J. Loewenstein, A New Direction for State Corporate Codes, 68 U. COLO. L. REV. 453, 453-73 (1997) (reasoning that as states' corporate statutes become more enabling, thus containing fewer mandatory provisions, the statutes governing corporations and unincorporated associations will become indiscernible from one another, but also arguing that the statutes should remain distinct because both the traditional corporation and the contract-based limited liability business entity have their own distinct advantages).

188 Another "convergence" example may be found in In re Regional Diagnostics, LLC, where the court refused to dismiss, on motion, a complaint against the managers of a limited liability company for breach of fiduciary duty. In re Reg'l Diagnostics, LLC, 372 B.R. 3, 31 (Bankr. N.D. Ohio 2007). The crux of the complaint was that the managers failed to exercise adequate oversight, a Caremark claim. See id. at 9. The bankruptcy court, applying Stone and Caremark, refused to dismiss the complaint, thus recognizing that the managers of a limited liability company had a fiduciary duty of oversight identical to that of corporate directors. See id. at 28-31. Interestingly, however, the opinion focused on whether, or the extent to which, the operating agreement absolved the managers of their fiduciary duties. Id. Thus, the case can fairly be characterized as a contract case.
VII. CONCLUSION

In corporate law, good faith is becoming solidified as a concept turning largely on director motivations or the mental state of directors: did the directors act in conscious disregard of their responsibilities? Directors charged with acting in the best interests of their corporation breach their duty of good faith (and loyalty) when they consciously disregard that duty. Motive is an important element here because we can best understand if it was a conscious disregard if we understand what motivated their conduct. The Delaware courts have been cognizant of the need to protect directors from liability for their negligent, or even grossly negligent, conduct. The way to do that is to recognize that the same conduct may be explained by inattention (negligence) or conscious disregard of responsibilities (bad faith).

In the law of unincorporated entities, however, motivations play a lesser role because the actors may not be under a duty to act in the best interests of others. Rather, the duties of partners and managers are contractual in nature. Recognizing this, the courts have had to fashion a concept of good faith, which statutorily cannot be contracted away, that addresses objectionable, usually opportunistic, behavior. Pursuing this endeavor, the courts are developing a coherent jurisprudence grounded on long-standing equitable principles but true to principles of contract law.

Are the two concepts of good faith consistent with one another? While on their face they are divergent, in fact there are important commonalities. A manager of an LLC who has contractual freedom to agree to a certain proposal (as in VGS, Inc.) may nonetheless be found to act in bad faith if the manager disappoints the reasonable expectations of a member. It is conceivable, however, that a court may recharacterize this behavior as violating good faith because it is an action in reckless disregard of the interests of the complaining member. While the law has apparently developed parallel, but distinct, standards for the concept of good faith—"conscious disregard" derived from fiduciary law in the corporate world and "reasonable expectations" derived from contract principles in the unincorporated world—this divergence may be more apparent than real. I have tried to show that these concepts are malleable and derived from an overarching principle of equity articulated in Schnell. The amendment to the Delaware corporate code permitting modification of the duty of loyalty suggests that corporations will become more contractual in nature, at least in regard to fiduciary duties, encouraging courts, in difficult cases, to draw on the notion of good faith developed in the parallel universe of unincorporated entity law. At the same time, the evolving principle of good faith being developed in corporate law may prove alluring to judges deciding difficult
cases in unincorporated entity law, where the contract seems to clearly permit the conduct in question.