



ALTERNATIVE INVESTMENT LAW



REPORT

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HEDGE FUNDS

Hedge Funds and Corporate Governance by Contract: The Boundaries of Fund Manager Conduct Under Delaware Alternative Entity Law

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Hedge funds are an increasingly prevalent and growing force in today's financial marketplace,¹ and many if not the vast majority of U.S. domestic funds are formed under Delaware alternative entity law, i.e., as limited partnerships ("LPs") or limited liability companies ("LLCs").² Given the fact that the hedge fund industry operates free from many of the

¹ By some estimates, the global hedge fund industry now manages approximately \$2.5 trillion of assets. See, e.g., *Global Hedge Fund Survey 2007, Navigating New Complexities*, by Ernst & Young in cooperation with Ipsos Mori (estimating hedge fund global industry assets at \$2.48 trillion).

² *Sonet v. Timber Co., LP*, 722 A.2d 319, 322-24 (Del.Ct.Ch. 1998) (recognizing that Delaware limited partnerships have become the entity of choice for certain closely-held business ventures, and are especially prevalent in enterprises where a general partner is actively engaged in investing the limited partners' passive investments, most likely explained by a combination of beneficial tax treatment and the statutory authority to contract around or enhance fiduciary duties).

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registration requirements imposed by federal securities laws,³ the law governing the interrelationships between the Fund's general partners or managing members (the "Fund Manager")⁴ and its investors is principally a function of the parties' LP or LLC agreement. These agreements, in turn, are governed by Delaware statute and a growing body of case law interpreting and defining the boundaries of permissible conduct by general partners and managing members to their respective limited partners or members. Although many of the reported cases to date have arisen outside of the hedge fund context, LP and LLC statutes and case law interpreting them are applicable to all general partners and managing members. It should be anticipated that this growing body of law will be applied to Fund Managers specifically in the investment management context.

In short, Delaware alternative entity law as it pertains to the obligations owed by a general partner or managing member, such as a Fund Manager, to its limited partners or members is evolving, and has been and will continue to be the subject of litigation in the investment

³ See *infra* note 19.

⁴ Although the term "fund manager" is a term of art that generally refers to a hedge fund's investment advisor, for ease of reference and consistency with the single-entity LP and LLC model discussed below, the term "Fund Manager" as used herein includes the general partner or managing member responsible for management of the fund.

management context during periods of market turbulence. It is imperative, therefore, that Fund Managers and investors alike understand their rights and responsibilities toward one another under Delaware alternative entity law and contract accordingly to protect their respective interests *before* having to test these principles in court.

Delaware Alternative Entity Law Alters the Economics and Risk-Reward Metrics for Investors in LPs and LLCs. Investors in Delaware LPs and LLCs should also understand that while the policy of freedom of contract underlying Delaware alternative entity law makes possible operating efficiencies for hedge funds that may result in higher returns to investors, it does so in exchange of standard protections afforded to investors under the common law of fiduciary duty in order to free Fund Managers to act nimbly and expeditiously. Thus, the substantive and procedural norms otherwise applicable to Fund Managers as fiduciaries to their limited partners or members are limited and replaced with individually-negotiated contractual standards of conduct.

This tradeoff presents fundamental investment issues that should be considered by investors before deciding whether and how to invest in hedge funds organized as a LP or LLC. By contracting away Fund Managers' fiduciary duties and imbuing them with broad discretion in order to promote economic efficiency and freedom of contract, Delaware alternative entity law alters the risk-reward metrics and pricing of these investments in two key ways. First, transactional costs are increased because generalized standards governing Fund Manager conduct are replaced by individualized standards which must be constructed, negotiated and agreed to within each fund.

Second, to the extent investors are bargaining away standard fiduciary protections, such as provided by the duties of loyalty and care (as explained herein), they have traded away, "legal protections routinely afforded to corporations' shareholders [that] flow from an established and predictable jurisprudence."⁵ As recognized by Delaware courts, against this potentially limitless range of standards governing Fund Manager conduct it becomes, "unclear how the market goes about pricing the value of protection afforded to limited partners in any particular flavor of limited partnership."⁶

While Delaware courts are keenly aware of this tradeoff, the "desirability, from an efficient-pricing perspective . . . is not a matter for adjudication" by Delaware courts⁷, nor will they, "be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly

⁵ See, e.g., *Sonet*, 722 A.2d at 323, n.11 (noting that Delaware corporations are not as affected by such uncertainty and market pricing issues as they often have very similar corporate charters and routine legal protections afforded to shareholders that flow from an established and predictable body of law (i.e., fiduciary duty law)).

⁶ *Id.* at 323 (reflecting on the difficulties posed to the market in pricing the varying range of risk applicable to these entities once fiduciary duties are eliminated or modified).

⁷ *Id.* (instructing that such issues should not concern Delaware courts when enforcing LP agreements).

exempted itself from traditional fiduciary duties."⁸ Investors should understand, therefore, that Delaware courts will not write into their LP and LLC agreements new terms borrowed from the law of fiduciary duty on an *ex post facto* basis. As explained by one Delaware court:

Once authorized by law, the decision to adopt and operate under a particular limited liability structure is the sort of fundamental business decision that courts routinely protect. As a general matter, courts should be, and are, reluctant to import jurisprudence from one area of the law—which is loaded with notions of efficiency and fairness that are well developed for that particular context—into a separate area of the law—where many procedural and substantive aspects present in other legal regimes are only optional defaults When a particular limited partnership has plainly opted out of the statutory default scheme, judicial review, in my opinion, must look to the limited partnership's distinct doctrinal foundation in contract theory. There is no reason, at least in the case before me, to depart from that source to further some highly generalized interest of equity.⁹

An examination of these tradeoffs at the time of contracting is described below under the framework of a single-entity, Fund Manager-investor relationship (either LP or LLC) in order to provide a simple illustration of hedge fund governance by contract.¹⁰ Special consideration is given to the implied covenant of good faith and fair dealing—the one contractual obligation that parties to a Delaware LP and LLC may not waive, and which ultimately defines the standard of conduct to which they are subject once their fiduciary duties have been eliminated by agreement.

Hedge Funds and Delaware Alternative Entity Law. Delaware LP and LLC law is the jurisdiction of choice for hedge funds because it is particularly liberal in allowing private parties to contractually arrange the terms of their relationship as they deem fit.¹¹ Specifically, it enables parties to allocate risk, deploy capital, and operate with maximum efficiency in a manner that might otherwise be impaired by common law and typical corporate fiduciary standards of conduct. In short, Delaware law recognizes that for sophisticated parties¹², a "one-size-fits-all" approach, as reflected by the common law of fiduciary duty, is too paternalistic and inefficient a mechanism to impose in order to protect parties from their own freely-made investment decisions.¹³

⁸ *Miller v. Am. Real Estate Partners, LP*, No. Civ. A. 16788, 2001 WL 1045643, at *8 (Del.Ct.Ch. Sep. 6, 2001).

⁹ *Sonet*, 722 A.2d at 323-34.

¹⁰ The application and complexity of these principles in the multi-entity (e.g., master-feeder) and international context, which is increasingly being utilized by hedge funds, present additional issues of their own is outside the scope of this article.

¹¹ *Gotham Partners, LP v. Hallwood Realty Partners, LP*, 817 A.2d 160, 170 (Del. 2002) (Delaware LP Act embodies policy of freedom of contract); *Elf Atochem North America, Inc. v. Jafari*, 727 A.2d 286, 290 (Del. 1999) (the policy of freedom of contract underlies both the LLC Act and the LP Act).

¹² *Abry Partners V, LP v. F&W Acquisition LLC*, 891 A.2d 1032 (Del.Ct.Ch. 2006) (noting that in the alternative entity context where *sophisticated parties* have carefully negotiated their governing documents, Delaware has authorized broad exculpation and the elimination of fiduciary duties).

¹³ *Miller*, 2001 WL 1045643, at *8 (DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and Delaware courts will not be tempted by the

Parties are presumed to understand the implications of the different forms of business organization available to them and to have deliberately chosen the form that best suits their needs.¹⁴

Stated differently, Delaware's policy of freedom of contract is in large part built upon a controlled application of the doctrine of *caveat emptor*, or buyer beware.¹⁵ Commercial self-legislation is the rule. In the hedge fund context, this is consistent with the fact that interests in the vast majority of hedge funds are sold on an unregistered basis to accredited investors and/or qualified purchasers pursuant to exemptions under the federal securities laws. Accredited investors and qualified purchasers are presumed to be sophisticated parties capable of understanding the risks involved in their investments and relationships with the Fund Manager so that the protections afforded in registered offerings and the common law of fiduciary duties may be avoided.

Thus, the policy of freedom of contract embedded in Delaware alternative entity law is reflected in hedge fund LP and LLC agreements that utilize broad-based, contractual disclaimers of the Fund Manager's common law fiduciary duties, especially of care and loyalty, in favor of contractually-negotiated (and limited) standards of conduct.¹⁶ While Delaware law permits Fund Managers to define the scope of their duties and contractual obligations to investors, by contrast Fund Managers typically reserve to themselves broad discretion (often stated as "sole discretion" in fund documents) in the exercise of their powers.

The only limit recognized by Delaware law upon the exercise of discretion that cannot be waived, however, is the implied covenant of good faith and fair dealing. This is a venerable doctrine of contract law that prohibits one party to a contract from acting in bad faith to deprive the other party of the benefit of its bargain.¹⁷ Thus, the implied covenant of good faith is the backstop check and balance to which a Fund Manager's control and discretion are subject even after his or her fiduciary duties have been waived by the parties.¹⁸ The contours of the good faith doctrine in the alternative entity context, however, are fluid and still being written by the Delaware courts.

In light of the frequent reference in fund documents to the rights of Fund Managers to commit many acts

pitious pleas of limited partners seeking to escape the consequences of their own decisions to become investors in such partnerships).

¹⁴ *In re Cencom Cable Income Partners, LP Litig.*, Civ. Action No. 14634, 1996 Del.Ch. LEXIS 17, at *10 (Del.Ct.Ch. Feb. 15, 1996)

¹⁵ *Miller*, 2001 WL 1045643, at *8 (instructing that in large measure, the Delaware RULPA reflects the doctrine of *caveat emptor*).

¹⁶ See, e.g., *Anglo American Security Fund, L.P. v. S.R. Global Int'l Fund, L.P.*, Case No. Civ.A 2066-N, 2006 WL 1494360 (Del.Ct.Ch. May 24, 2006) (hedge fund operator did not violate partnership agreement, the terms of which exculpated it from negligence and instead required gross negligence, by inadvertently booking and misdisclosing to limited partners the withdrawal of its incentive fee from its capital account).

¹⁷ See *infra* notes 42-46.

¹⁸ See, e.g., *Gelfman v. Weedon Investors, L.P.*, 792 A.2d 977, 987 (Del.Ct.Ch. 2001) (finding that parties created a contractual bad faith standard to serve as a check on the general partner once they had eliminated the general partner's fiduciary duties of loyalty and care).

with broad and "sole" discretion, the boundaries of what is and is not permissible under the good faith doctrine will continue to be tested by hedge fund participants and, unless exercised with restraint, be the subject of future legal challenges. Indeed, the implied covenant of good faith and fair dealing may be the final arbiter of these conflicts given the limited application of federal investment advisor and Delaware common law fiduciary standards to many hedge funds.¹⁹

To make an informed decision when considering whether and how to invest in a hedge fund organized under Delaware alternative entity law, therefore, it is necessary to understand the distinctions between common law fiduciary duties and those applicable to general partners and managing members under Delaware LP and LLC law.

Fiduciary Duties of General Partners and Managing Members Under Delaware Common Law.

General partners of Delaware LPs and managing members of Delaware LLCs owe fiduciary duties to their respective partners or members, including the traditional fiduciary duties of loyalty, care, good faith and fairness.²⁰ These duties are akin to those owed by directors or officers of a corporation. In short, general partners and managing members:

- may not place their own interests in front of those of their beneficiaries;

- must act in an informed manner, in good faith, and in the honest belief that their actions are in the best interest of their entities; and

- may not play favorites among their beneficiaries.

They must also act in accordance with a fiduciary duty of good faith (not to be confused with the implied contractual covenant of good faith and fair dealing).²¹ While the contours of this duty, like its contractual good faith counterpart, are undergoing significant develop-

¹⁹ Susan Beck, "Daring and Controversial Legal Structures Help Fortress and Blackstone Avoid Tax and SEC Scrutiny," *The American Lawyer*, November 5, 2007 (outlining controversy regarding how Blackstone had set up its corporate structure to avoid *inter alia* regulation by the SEC as an investment company and thus the range of protections afforded investors under the Investment Company Act, shareholder rights and protections mandated by NYSE rules that are not applicable to partnerships, and arguably investor protections generally applicable under Delaware law). See also *Goldstein v. SEC*, 451 F.3d 873 (D.C.Cir. 2006) (overturning SEC rule requiring most hedge fund advisors to register with the SEC under the Investment Advisors' Act).

²⁰ *Gotham Partners*, 817 A.2d at 170; *Twin Bridges Ltd. P'ship v. Draper*, Case No. Civ. A. 2351-VCP, 2007 WL 2744609, at *20 (Del.Ct.Ch. Sep. 14, 2007) (a general partner in a limited partnership has a duty to exercise the utmost good faith, fairness and loyalty comparable to that of corporate directors); *Metro Communication Corp. BVI v. Advanced Mobilcomm Technologies, Inc.*, 854 A.2d 121 (Del.Ct.Ch. 2004) (minority member of LLC stated claim for breach of fiduciary duty against majority member and managers for failure to disclose alleged bribery scheme); *Boxer v. Husky Oil Co.*, 429 A.2d 995, 997 (Del.Ct.Ch. 1981) (general partners owe to limited partners fiduciary duties of utmost good faith, fairness and loyalty, no less than that of a corporate director to a shareholder).

²¹ Myron T. Steele, *Article: Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del.J.Corp.L., 1, at *14 (2007) (noting that the concept of good faith borrowed from contract law as opposed to the triad duties of loyalty, care and good faith of fiduciary duty law, is the lens through which the Delaware legislature decided to view LP and LLC agreements).

ment under Delaware law, the fiduciary duty of good faith generally precludes fiduciaries from acting: with an intent to do harm; in conscious disregard of their known duties; with a purpose other than that of advancing the best interests of the entity; or with an intent to violate the law.²²

In addition, Delaware law also recognizes a fiduciary duty of disclosure,²³ which requires a fiduciary to disclose all material facts when asking its beneficiaries to act, and prohibits the knowing dissemination of false information when a disclosure is not connected to a specific request to act.²⁴

The source of these duties ultimately flows from the nature of the relationship between the parties—in short, society charges those with day-to-day control of business entities or their investments with duties, or substantive norms of commercially acceptable conduct, in order to prevent them from abusing their power at the expense of the entity and its equity stakeholders—the true beneficiaries of the entity’s assets, property and value.²⁵ Thus, when a fiduciary is on both sides of a transaction with its entity or derives a personal benefit not shared with the other stakeholders, he or she carries the burden of demonstrating the utmost good faith and the inherent fairness of the bargain.²⁶ The fiduciary is charged with demonstrating both: **fair dealing**, addressing such questions as the timing of the transaction, and how it was initiated, structured, negotiated, disclosed, and approved; and, **fair price**, reflecting the economic and financial aspects of the transaction.²⁷

This is particularly true where a fiduciary exercises discretion in the management of and in its interactions with the entity or its stakeholders. Under the law of fiduciary duty, when a fiduciary exercises its control, its decisions must be made according to a fair process. This turns primarily on the extent to which the interests of the limited partners or members were given due consideration in the decision-making process.²⁸ A fiduciary may not exercise its discretion in a manner that is inconsistent with the purposes of the LP or LLC, such as by knowingly depriving a limited partner or member of its interest for less than it is worth absent a pre-existing contractual right to do so²⁹, or by favoring the interests

of one partner or member over another.³⁰ While the grant of sole discretion may alter these principles by eliminating the fair process component of the fiduciary’s conduct, it does not obviate the requirement that the fiduciary’s conduct and exercise of discretion be substantively fair.³¹

Needless to say, the law of fiduciary duty provides powerful substantive and procedural safeguards which sit at the heart of Delaware business law.

Delaware Alternative Entity Law and the Freedom of Contract. Delaware, however, recognizes that the forced application of generalized, common law standards of conduct may not apply effectively or efficiently for sophisticated and innovative parties whose ventures may have different operating needs and whose risk tolerances may be quite different than those of the typical investor. As such, Delaware LP and LLC law affords parties the opportunity to self-legislate the terms of their relationship and make radical departures from the substantive and procedural norms of the common law of fiduciary duty.

Section 17-1101(d) of the Delaware Revised Uniform Limited Partnership Act (“DRULPA”) allows partners to define the parameters of their duties to one another. In pertinent part, it provides that:

To the extent that . . . a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by the partnership agreement, the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions of the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.³²

Section 18-1101(c) of the Delaware Limited Liability Company Act provides the same with respect to members and managers of LLCs.³³

While courts may look to the common law of fiduciary duty for guidance, a Fund Manager’s obligations largely depend upon the terms of the partnership agreement³⁴ or LLC agreement.³⁵ Assuming the parties have made their intentions plain to adopt a contractually-negotiated standard of conduct, their common law fiduciary duties will be pre-empted by the contractual standard they choose.³⁶ This is usually accomplished by the parties placing various explicit clauses in their LP or LLC agreement amending the Fund Manager’s fidu-

breached its fiduciary duty by forcibly redeeming outside investors at less than fair market value).

²² *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 63-67 (Del. 2006).

²³ *Malone v. Brincat*, 722 A.2d 5 (Del. 1998); *Metro Communication*, 854 A.2d at 156-58.

²⁴ *Malone*, 722 A.2d at 6-13; *Metro Communications*, 854 A.2d at 156-58.

²⁵ See, e.g., *In re USA Cafes, LP Litig.*, 600 A.2d 43, 47-49 (Del.Ct.Ch. 1991) (explaining same and finding that directors of a corporate GP could be liable for breach of fiduciary duty to the limited partners of the LP for allegedly causing or allowing the GP to sell the LP’s assets for less than fair value to the GP’s corporate shareholders in exchange for personal compensation to the directors); *In re Boston Celtics Ltd. P’Ship Shareholders’ Litig.*, C.A. No. 16511, 1999 Del.Ch.LEXIS 166, at *10 (Del.Ct.Ch. Aug. 6, 1999) (instructing same and that the form of the enterprise does not diminish the duty of fair dealing by those in control of the entity’s investments).

²⁶ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 71-11 (Del. 1983).

²⁷ *Id.* See also *In re Boston Celtics Ltd. P’Ship Shareholders’ Litig.*, 1999 Del.Ch.LEXIS 166, at *13 (instructing same in the limited partnership context)

²⁸ *Miller*, 2001 WL 1045643, at *10.

²⁹ *Gelfman v. Weedon Investors, L.P.*, 859 A.2d 89, 124-25 (Del.Ct.Ch. 2004) (finding same where general partner

³⁰ *Fitzgerald v. Cantor*, No. Civ.A 16297, 1999 WL 182571, at *1 (Del.Ct.Ch. Mar. 23, 1999).

³¹ *Miller*, 2001 WL 1045643, at *10-11 (concluding same on tentative basis).

³² 6 Del.C. § 17-1101(d) (emphasis added).

³³ 6 Del.C. § 18-1101(c).

³⁴ *Gotham Partners*, 817 A.2d at 170.

³⁵ *Douzinis v. American Bureau of Shipping, Inc.*, 888 A.2d 1146, 1149-50 (Del.Ct.Ch. 2006) (recognizing that in the alternative entity context, it is frequently impossible to decide fiduciary duty claims without close examination and interpretation of the governing instrument of the entity giving rise to what would otherwise by default be a fiduciary relationship).

³⁶ *Sonet*, 722 A.2d at 322. Compare *Miller*, 2001 WL 1045643, at *10 (finding that fiduciary duty standards applied where parties had not explicitly provided that the terms of the partnership agreement displaced general partner’s fiduciary duties when acting in its sole discretion).

ciary duties.³⁷ A typical contractual clause eliminating or curtailing fiduciary duties might appear as follows:

Each limited partner and assignee hereby agrees that any standard of care or duty imposed under the Delaware RULPA or any other applicable law is hereby modified, waived or limited as required to permit the General Partner to act according to the standards provided for by this Agreement.

Delaware courts will give full force to such clauses assuming they are plain and unambiguous.³⁸ Apparently, so too will federal regulators.³⁹ Any question regarding a Fund Manager's obligations will thus be decided by the explicit terms of the contract,⁴⁰ subject to good faith-bad faith considerations.⁴¹

The Contours of Good Faith & Fair Dealing. The implied covenant of good faith and fair dealing, not to be confused with the fiduciary duty of good faith, requires that a party to a contract refrain from arbitrary or unreasonable conduct which would have the effect of preventing the other party from receiving the fruits of the contract.⁴²

In other words, the covenant protects the "spirit" of the contract by preventing one party from using oppressive or underhanded tactics to deny the other party the benefit of its bargain.⁴³ Faithfulness to the parties' agreed common purpose is required, and the parties' justified expectations at the time of contract formation will determine the reasonableness of any challenged conduct.⁴⁴ These principles apply even where a contract allows a party to exercise discretion.⁴⁵ Thus, in theory, a party may breach the implied covenant of good faith and fair dealing even if it has not explicitly violated an express term of the contract.⁴⁶

Against the back-drop of this policy of freedom of contract, the implied covenant of good faith and fair dealing is a potentially potent obligation that the law implies into every contractual relationship. Nevertheless, it is not a grant for courts to do equity or write terms into the parties' contract that do not exist. Rather, Delaware courts apply the doctrine cautiously and only where issues of compelling fairness arise.⁴⁷

³⁷ *Continental Ins. Co. v. Rutledge & Co., Inc.*, 750 A.2d 1219, 1235 (Del.Ct.Ch. 2000).

³⁸ *Id.*

³⁹ See "Sentinel's request to block redemptions denied", CNNMoney.com, August 14, 2007 (U.S. Commodity Futures Trading Commission denies hedge fund's request to block client redemptions as CFTC has no role in such "corporate" matters), available at <http://money.com/2007/08/14/news/companies/sentinel.reut/index.htm>.

⁴⁰ *Continental Ins.*, 750 A.2d at 1235.

⁴¹ *Gelfman*, 792 A.2d at 980.

⁴² *PAMI-LEMB I Inc. v. EMB-NHC, L.L.C.*, 857 A.2d 998, 1016 (Del.Ct.Ch. 2004).

⁴³ *Id.*

⁴⁴ *Continental Ins.*, 750 A.2d at 1234.

⁴⁵ *PAMI-LEMB I*, 857 A.2d at 1015.

⁴⁶ *Id.*

⁴⁷ *Continental Ins.*, 750 A.2d at 1234. See also *Cincinnati SMSA LP v. Cincinnati Bell Cellular Systems Co.*, 708 A.2d 989, 992 (Del. 1998) (courts should be cautious and exacting when asked to imply contractual obligations into a limited partnership agreement from the written text of that agreement). *Corporate Property Associates 14 Inc. v. CHR Holding Corp.*, C.A. No. 3231-VCS, 2008 WL 963048, at *5 (Del.Ct.Ch. Apr. 10, 2008) (citing *Aspen Advisors LLC v. United Artists Theatre Co.*, 861 A.2d 1251 (Del. 2004)) (holding that the use of the implied covenant of good faith and fair dealing to imply

Furthermore, the implied covenant as a contractual obligation does not impose the same substantive and procedural safeguards as do fiduciary duties, including the fiduciary duty of good faith. Rather, the law of fiduciary duty places the burden on the fiduciary to demonstrate under a heightened standard of scrutiny the entire fairness of any self-interested transaction with its entity once the plaintiff has sufficiently pled a breach of any of the fiduciary's duties of loyalty, care or good faith.⁴⁸ Usually this is accomplished by demonstrating that the fiduciary was on both sides of a transaction with its entity, or that it derived a personal benefit not shared with the entity or other limited partners or members.⁴⁹

In contrast, contractual good faith does not impose such a burden. Instead, the burden to prove a breach of bad faith belongs to the plaintiff-limited partner or member, as opposed to being shifted to the otherwise would-be fiduciary Fund Manager to prove the entire fairness of its conduct.⁵⁰ The distinction can be critical and is often outcome-determinative in fiduciary duty litigation.⁵¹

In addition, while the fiduciary duty of good faith, like all fiduciary duties, arguably imposes substantive norms of conduct on the fiduciary due to the nature of its relationship with its beneficiary, contractual good faith is a tool of contract interpretation with no substantive content independent of the terms of the parties' contract.⁵² Thus, the otherwise would-be fiduciary is free to pursue its own interests first, pursuant of course to the terms of the LP or LLC agreement, as would any other party to the contract. Such is the nature of a contractual relationship.

In short, while the implied covenant of good faith and fair dealing is a potent prohibition against bad faith conduct, it does not provide the same substantive or procedural protections as are inherent in fiduciary duties, nor should parties to Delaware LPs or LLCs expect it to do so by default.⁵³ Nevertheless, if these tradeoffs

protections not in the contract, "would be to grant [plaintiff] by judicial fiat, contractual provisions that they failed to secure for themselves at the bargaining table").

⁴⁸ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).

⁴⁹ *In re Boston Celtics Ltd. P'Ship Shareholders' Litig.*, 1999 Del.Ch.LEXIS 166, at *12-13.

⁵⁰ *Fitzgerald*, 1999 WL 182571, at *1 (instructing that the implied covenant of good faith and fair dealing is not implicated simply because a managing general partner made a self-interested invocation of its contractual discretion; rather, it simply removes the burden from the general partner of showing good cause for its action when a genuine dispute arises).

⁵¹ Paul M. Altman and Sriniva M. Raju, *Delaware Alternative Entities And The Implied Contractual Covenant of Good Faith and Fair Dealing Under Delaware Law*, 60 Bus. Law. 1469, 1474 n. 29 (Aug. 2005); Andrew S. Gold, *On The Elimination of Fiduciary Duties: A Theory of Good Faith For Unincorporated Firms*, 41 Wake Forest L.Rev. 123, 132-33 (Spring 2006).

⁵² *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 n.29 (Del. 2005) (citing to *Duquesne Light Co. v. Westinghouse Elec. Corp.*, 66 F.3d 604 (3rd Cir. 1995) for the principle that courts utilize the implied covenant of good faith as an interpretive tool to determine the parties' justifiable expectations, not to enforce an independent duty divorced from the specific clauses of the contract).

⁵³ *Gotham Partners, LP v. Hallwood Realty Partners, LP*, No. Civ. A 15754, 2000 WL 1476663, at *10, n.26 (Del.Ct.Ch.

are understood and the parties carefully and explicitly delineate the scope of their contractual rights and obligations to one another, the covenant can provide a shield to enforce a minimum standard of agreed-upon conduct with which the Fund Manager must comply, albeit in the fact-specific context of the parties' LP or LLC agreement, thereby protecting the expectations of investors and Fund Managers alike.

So What is Bad Faith? There is no exact definition of what constitutes "good faith" under Delaware law. Rather, courts define good faith negatively—*i.e.*, by what it is not, bad faith—which takes on meaning in the particular factual context in which a party's conduct is considered.⁵⁴

Generally, bad faith is more encompassing than fraud, although one who commits fraud would generally be considered to have acted in bad faith.⁵⁵ Unlike fraud, however, which requires knowingly-made false misrepresentations (or omissions) of fact on which the speaker intends that the other party reasonably relies to its detriment, bad faith simply requires a "tortious state of mind."⁵⁶ As more thoroughly explained by the Delaware Supreme Court:

"[f]raud" is distinct from . . . "bad faith." In the legal sense, "fraud" is . . . an intentional perversion of the truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right Conversely . . . "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."⁵⁷

In plain English, conduct in knowing violation or disregard of the other party's contractual rights is "bad faith."⁵⁸ Furthermore, and unlike claims of fraud which must be pled with particularity in litigation, bad faith focuses on the defendant's intent and state of mind and may be averred generally to state a claim.⁵⁹

In contrast, Delaware courts find that if one acts in good faith reliance on the terms of the partnership agreement and does not engage in underhanded, oppressive or opportunistic advantage-taking, consciously in derogation of its partner's or member's rights and reasonable expectations at the time of contract formation, there is no bad faith. This includes self-interested transactions or conduct allowed by the LP or LLC

agreement that may not otherwise be permissible under the common law of fiduciary duty.⁶⁰

Under these principles, Delaware courts have instructed that the following types of conduct constitute, or would if proven constitute, bad faith by a general partner or managing member in breach of the implied covenant of good faith and fair dealing:

- A general partner repudiates valuation formula required by buy-sell provisions of partnership agreement, unilaterally attempts to replace it with formula designed to artificially reduce the buyout price of a limited partner's interest in knowing violation of that investor's rights, and threatens coercive litigation to deprive the investor of the entire value of its investment unless the investor forgoes its withdrawal rights under the partnership agreement.⁶¹

- A general partner excludes investor from fund investment opportunities in retaliation for investor's prior lawsuit against general partner on other matters.⁶²

- Insiders in control of partnership engineer a capital restructuring knowingly designed to deprive outside equity partners of their interest for less than their fair market value.⁶³

- A general and limited partner unilaterally freezes out remaining limited partner from certain operations of the business, and changes the methodology for calculating cash distributions to be made to limited partners and the frequency of such distributions, in apparent violation of the terms of the partnership agreement and other partnership governance documents, after the remaining limited partner refuses general partner's offer to purchase its interest.⁶⁴

In contrast, Delaware courts have found that *no* bad faith existed when:

- A general partner and its owner acquired the interests of other limited partners in a tender offer rather than by way of a sale-and-purchase of the LP's assets that would have triggered an independent appraisal process under the partnership agreement; nothing in the partnership agreement precluded the general partner or its affiliates from making a tender offer, nor was there any evidence to suggest that they did so to circumvent the appraisal process.⁶⁵

- A general and limited partner of cellular telephone venture acquired for its own account licenses for surrounding service areas; while the partnership agreement precluded the general partner from competing with the partnership, it did not preclude limited partners from doing so; defendant, acting in its limited partner capacity, relied on this contractual right in the good

Sep. 27, 2000) (noting that disgruntled parties often assert breach of fiduciary duty in this context, but instructing that it improper to assert a breach of fiduciary duty in order to rewrite the terms of a partnership agreement).

⁵⁴ *E.I. Dupont de Nemours and Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996) (explaining that the phrase good faith is an excluder, a phrase without general meaning of its own which excludes a wide range of forms of bad faith; the phrase takes on meaning in a particular context, usually by way of contrast with the specific form of bad faith actually or hypothetically excluded).

⁵⁵ *Id.* at 438 (describing bad faith as including acts of fraud, deceit or intentional misrepresentation).

⁵⁶ *Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, LP*, 624 A.2d 1199, 1208 (Del. 1993).

⁵⁷ *Id.* at 1208, n. 16.

⁵⁸ *PAMI-LEMB I*, 857 A.2d at 1016.

⁵⁹ *Desert Equities*, 624 A.2d at 1208.

⁶⁰ *United States Cellular Inv. Co. of Allentown, Inc. Allentown v. Bell Atlantic Mobile Systems, Inc.*, 677 A.2d 497 (Del. 1996). See also *Sonet*, 722 A.2d at 325 (noting that where limited partnership agreement authorizes general partner to act according to its own discretion, there is no requirement that the general partner consider the interests of the limited partners in resolution of a conflict of interest).

⁶¹ *PAMI-LEMB I*, 857 A.2d at 1016.

⁶² *Desert Equities*, 624 A.2d at 1208.

⁶³ *Gelfman*, 859 A.2d at 124.

⁶⁴ *RJ Associates, Inc. v. Health Payors' Organization Ltd. P'ship.*, C.A. No. 16873, 1999 Del.Ch.LEXIS 161, at *30-31 (Del.Ct.Ch. July 16, 1999).

⁶⁵ *In re Marriott Hotel Properties, II, Ltd. P'ship Unitholders Litig.*, No. Civ.A 14961, 2000 WL 128875, at *15 (Del.Ct.Ch. Jan 24, 2000).

faith belief that it was in compliance with the terms of the partnership agreement.⁶⁶

■ A limited partner of a cellular telephone venture provides competing personal communications services (“PCS”) in same area as the limited partnership; the non-competition clause of the limited partnership agreement only precluded cellular service competition.⁶⁷

Sole, Complete, or Absolute Discretion or Judgment. Special consideration, therefore, must be given to the increasing trend of parties to LP and LLC agreements to provide that: certain decisions or operations will be left to the “sole”, “absolute” or “complete” discretion or judgment of the Fund Manager; the Fund Manager is entitled to consider only such interests and factors as it desires, including its own interests alone; and the Fund Manager has no duty or obligation to consider any other person’s interests when it exercises its sole discretion or control.⁶⁸ Typical clauses granting such discretion may include the following type of language:

The General Partner will manage all operations and activities of the partnership. The General Partner is authorized to perform all acts that it determines to be necessary or appropriate to carry out the purposes of and to conduct the business of the partnership. In making any such determinations, the General Partner shall be entitled to make such decisions in its sole and complete discretion, and will be entitled to consider only such interests and factors as it desires, including its own interests, and will have no duty or obligation (fiduciary or otherwise) to give any consideration to any interest of or factors affecting the partnership, the limited partners or their assignees, or any other person.

Such contractual provisions represent an explicit departure from the fiduciary duties imposed by the common law on general partners and managing members. Under the law of fiduciary duty, when fiduciaries exercise their control, their decisions must be made according to a fair process. This turns primarily on the extent to which the interests of the limited partners or members were given due consideration in the decision-making machinery.⁶⁹

Under Delaware LP and LLC law, however, parties can contractually eliminate such fiduciary duties, including the Fund Manager’s duty to consider the interests of limited partners or members in resolving conflicts of interest.⁷⁰ As long as the modification or elimination of these fiduciary duties is clear and unambiguous, the exercise of discretion will be upheld even if the result would not be entirely fair as judged through the lens of fiduciary duty law.⁷¹ Nor would a Fund Manager’s exercise of its sole discretion in such a

manner constitute bad faith because the contractual “sole discretion” standard is inconsistent with an expectation that the Fund Manager will govern the entity subject to the identical strictures applicable to corporate boards of directors in control situations.⁷² Parties are presumed to understand the implications of such contractual provisions before entering into the contract.

The implied covenant of good faith and fair dealing, however, subjects such grants of discretion to a sliding scale of review. Where either the definition or the declaration of the occurrence of a condition is left to the sole discretion of the invoking party, that discretion must be invoked reasonably and in subjective good faith.⁷³ In short, if a party is given discretion in determining whether a condition has in fact occurred, that party must use good faith in making that determination.⁷⁴ Furthermore, even if the grant is one of sole or complete discretion, if the terms of the LP or LLC agreement require that the Fund Manager exercise its discretion in the reasonable belief that it is not doing so inconsistently with the overall purposes of the partnership, its motivations and the actual exercise of that discretion may be scrutinized.⁷⁵

In contrast, if the conditions under which a party can exercise its sole discretion are expressly defined, and the conditions occur, other parties to the contract are on clear notice that upon the occurrence of those conditions the invoking party reserved for itself the choice whether or not to act.⁷⁶ While the subsequent result may appear unfair, it cannot be said that the other parties were misled concerning the invoking party’s right to exercise its discretion. Furthermore, absent fraud, the invoking party’s motivation is of little relevance because a party to a contract is free to pursue its economic interests through the application of conditions intended to limit the cost of proceeding. Exercising its right to pursue that course does not infringe upon other parties’ contractual rights.⁷⁷

⁷² *Gotham Partners*, 2000 WL 1476663, at *11.

⁷³ See, e.g., *Wilmington Leasing, Inc. v. Parish Leasing Co.*, L.P., C.A. No. 15202, 1996 Del.Ch.LEXIS 123, at *4-8 (Del.Ct.Ch. Sep. 25, 1996) (grant of discretion to limited partners to remove general partner if they determined it had failed or was unable to perform satisfactorily was subject to implied requirement that limited partners exercise their discretion reasonably and in good faith to prevent them from maliciously or unreasonably removing the general partner even if it were performing satisfactorily).

⁷⁴ *Id.*

⁷⁵ *Gelfman*, 859 A.2d at 114-16 (finding where terms of LP agreement granted general partner complete discretion in the issuance of new partnership units but that it could not exercise its discretion in gross negligence, in willful and wanton misconduct, or in a manner it reasonably believed to be inconsistent with overall purposes of the partnership, the general partner’s grant of new units to insiders, directors and favored insiders at the expense of outside investors was subject to good faith review; general partner’s issuance of new shares to directors as a *quid pro quo* to obtain their approval of management’s plan to dilute outside investors for less than fair market value was an improper purpose under the LP and constituted bad faith).

⁷⁶ *Gilbert v. El Paso Co.*, 490 A.2d 1050, 1055 (Del.Ct.Ch. 1984), *aff’d* 575 A.2d 1131 (Del. 1990).

⁷⁷ *Id.* (finding no breach of contract where defendant made tender offer for target company, its offer clearly stated that if the target company’s management took specified steps to resist the offer defendant reserved the right in its sole judgment

⁶⁶ *United States Cellular Inv. Co. of Allentown*, 77 A.2d at 504 (no bad faith usurpation of corporate opportunities under such circumstances where only intentional but not bad faith conduct was alleged, and against backdrop where plaintiff had engaged in laches).

⁶⁷ *Cincinnati SMSA LP*, 708 A.2d at 992-93.

⁶⁸ See, e.g., *Gelfman v. Weeden Investors, L.P.*, 792 A.2d at 985 (similar contractual provision); *Gotham Partners*, 2000 WL 1476663, at *6 (same).

⁶⁹ *Miller*, 2001 WL 1045643, at *10.

⁷⁰ *Sonet*, 722 A.2d at 325.

⁷¹ *Id.* at 324-35. See also *Gelfman*, 792 A.2d at 987 (instructing that the parties’ contractual standard would not subject the general partner to liability for the exercise of its discretion on the matter at issue simply because the result produced would not be entirely fair).

As such, while the contractual allocation of sole discretion may free Fund Managers to efficiently address and optimize the hedge fund's or their own economic or long-term interests when dealing with the conflicting interests or demands of a particular investor or group thereof, the Fund Manager's discretion will be upheld as long as the exercise of that discretion is consistent with the explicit terms of the grant, even if the results are not entirely fair as viewed through the lens of fiduciary duty law.

Competition and Outside Activities. Also increasingly popular in LP or LLC agreements are provisions that permit the Fund Manager, or others who would normally owe fiduciary duties to the entity, to engage in outside activities, including competition with the LP or LLC in defined circumstances⁷⁸, or the conduct of business directly with portfolio companies and independent of the LP or LLC.⁷⁹

Under the common law of fiduciary duty, a Fund Manager may not compete with its LP or LLC and thereby accrue a benefit to itself that rightly belongs to the entity and ultimately the entity's partners or members on a residual equity basis. At a minimum, if a general partner, managing member or other fiduciary wishes to pursue such a corporate opportunity on its own behalf, it must fully disclose the opportunity and receive permission to do so, even if it believes that the entity does not have the financial resources or desire to pursue the opportunity itself.

In contrast, however, such competition is clearly permissible under Delaware alternative entity law if provided for as part of the LP or LLC Agreement. Thus, where a LP or LLC agreement explicitly authorizes the Fund Manager and/or its affiliates to compete with the LP or LLC, or to engage in independent business activities with portfolio companies, the limited partners or members will later be precluded from maintaining a claim for usurpation of partnership or corporate opportunity as such conduct was clearly anticipated by the parties.⁸⁰

Furthermore, where a Delaware general partner is also a limited partner, and the LP agreement permits limited partners to engage in competing activities, such persons have been able to successfully argue under Delaware law that they were acting as a limited partner and thus were entitled to pursue such opportunities on

their own behalf in that capacity.⁸¹ They have done so on the basis of Section 17-1101(e) which provides:

Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.⁸²

In short, when a party acts in good faith reliance on the terms of a LP or LLC agreement, even if it has acted intentionally, it will not be liable for breach of the agreement. However, these clauses must be reasonably susceptible to an interpretation that might support the act taken in order to afford a good faith harbor.⁸³

If parties to LP or LLC agreements contemplate allowing competition or independent business activities with portfolio companies by any party to the venture, they should specifically contract the permissible boundaries of such conduct. This includes express contractual provisions addressing competition that would constitute self-dealing or a conflict-of-interest by a Fund Manager if they expect such activities to be precluded.

Exculpation Clauses. Most LP and LLC Agreements contain provisions limiting a Fund Manager's liability to intentional (not negligent) misrepresentations or omissions, willful or intentional misconduct, or gross negligence, even when lesser states of culpability such as negligence may otherwise suffice.⁸⁴ Typical provisions in an LP or LLC agreement might include:

Neither the General Partner, its partners, nor any of their respective officers, directors, employees, shareholders, agents affiliates and other representatives shall be liable, responsible or accountable in damages or otherwise to the partnership or any of the partners, successors, assignees or transferees for any act or omission performed or omitted by them on behalf of the partnership and in a manner reasonably believed by them to be within the scope of the authority granted to them by this Agreement except when such action or failure to act constitutes gross negligence, fraud or willful misconduct.

Such provisions for limitation of liability are fully consistent with Delaware LP and LLC law, which provides:

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 or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided that a

to withdraw its offer, management resisted even though a majority of the target company's shareholders accepted the tender offer, and defendant then withdrew its tender offer and submitted a new one after it reached an agreement with the target company's management changing terms).

⁷⁸ See, e.g., *Cincinnati SMSA*, 708 A.2d at 992-93 (prohibiting limited partners from competing with the limited partnership in cellular communications services, but not other types of personal communications services); *U.S. Cellular Inv. Co. of Allentown*, 67 A.2d at 504 (permitting limited partners, including general partner which was also a limited partner, to compete with partnership in surrounding service areas).

⁷⁹ See, e.g., *Continental Ins.*, 750 A.2d at 1237-37 (permitting general partner to advise other ventures and to receive fees from portfolio companies as long as it did not engage in self-dealing).

⁸⁰ *Sonet*, 722 A.2d at 322 (citing to *Kahn v. Icahn*, C.A. No. 15916, 1998 WL 832629 (Del.Ct.Ch. Nov. 12, 1998) for same).

⁸¹ *U.S. Cellular Inv. Co. of Allentown*, 677 A.2d at 504 (finding no breach of contract by general partner that pursued competing opportunity in its capacity as a limited partner as permitted under partnership agreement).

⁸² 6 Del.C. § 17-1101(e). See also Section 18-1101(d) of the Delaware LLC Act provides the same for members and managers of LLCs. 6 Del.C. § 18-1101(d).

⁸³ See, e.g., *Continental Ins.*, 750 A.2d at 1239-40 (instructing that a general partner cannot wrongly rely in good faith on a misinterpretation of a contract clause if it is subject to only one plausible interpretation, and therefore finding that while the partnership agreement permitted the general partner to embrace other business opportunities it did not authorize self-dealing).

⁸⁴ See, e.g., *Anglo-American Security Fund*, 2006 WL 1494360, at *4 (finding no liability for negligent disclosure where partnership agreement provided for higher levels of culpability).

partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.⁸⁵

Thus, parties will be held to the contractual standards of liability they negotiate, with the exception of liability for a breach of the implied covenant of good faith and fair dealing which may not be limited or waived.

A Fund Manager cannot, however, exculpate itself from liability for intentional (*i.e.*, fraudulent) or willful misconduct in violation of a LP or LLC agreement which is invalid under Delaware law.⁸⁶ Similarly, contractual provisions implicitly or explicitly attempting to avoid application of the Securities Exchange Act of 1934, the Investment Advisors Act, or the Delaware Securities Act, such as for fraud, or any rule or regulation thereunder, are void as a matter of statute.⁸⁷

⁸⁵ 6 Del.C. § 17-1101(f). *See also* 6 Del.C. § 18-1101(e) (providing same with respect to members and managers of LLCs).

⁸⁶ *See, e.g., Ishimaru v. Fung*, No.Civ.A 929, 2005 WL 2899680 (Del.Ct.Ch. Oct. 26, 2005) (provision of LLC agreement exculpating managing member from conduct other than fraud, gross negligence, willful misconduct, or intentional breach of LLC agreement did not insulate manager against willful misconduct by taking proprietary information belonging to LLC for his personal use); *Abry Partners V*, 891 A.2d at 1062-65 (holding plaintiff's claim for rescission of its purchase agreement based on claim for fraudulent inducement against defendant private equity firm was not precluded despite broad indemnity and exculpation provision in purchase agreement and acknowledging that while recklessness, gross negligence, or negligence could be released, it is against Delaware public policy for a party to contractually insulate itself against its own lies and fraudulent inducement of a contract).

⁸⁷ *See, respectively*, Section 29(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(cc)(a); Section 215(a) of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-15(a); 6 Del.C. § 7323(g).

Conclusion—Careful Contracting is a Must. In short, Delaware alternative entity law offers hedge funds maximum flexibility in tailoring the duties of their Fund Managers to their investors in order to boost economic efficiency. There are, however, risks for all parties in effectively negotiating their rights and obligations under the LP or LLC Agreement. Failure to carefully consider and negotiate the terms of those agreements at the time of fund formation and/or investment may lead to confusion and unreasonable expectations at the worst of times, *i.e.*, when the fund undergoes significant market stress and suffers investment losses. Unfortunately, all too often it is only then that the parties begin to analyze and appreciate the subtleties of the LP or LLC Agreement as well as the nature and scope of their contractual duties, rights and powers through the exercise of discretion. At that point, it is usually too late to amend the agreement to respond to specific investor concerns in such a way that it would substantially alter the agreed balance of risks and rewards at the expense of other investors or the Fund Manager. Thus, the only course that provides predictability for all parties concerned is strict adherence to the terms of the agreement.

Accordingly, precise drafting of the LP or LLC agreement, with either the input of prospective investors or at least mindful of the concerns outlined above, protects both Fund Managers and their investors from misunderstandings regarding their rights and responsibilities toward one another. A Fund Manager's obligations will be defined by the explicit terms of those agreements, and Delaware courts are engaging in detailed analyses to determine and enforce the scope of such contractually-created and defined obligations. It should be anticipated that the minimum standards of commercially reasonable conduct applied to hedge funds will increasingly coalesce around the parties' reasonably shared expectations created by the terms of their LP and LLC agreements, and the good faith-bad faith standards that govern their relationships.