

Cooperative Covenants: Good Faith for the Alternative Entity

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Abstract

The implied covenant of good faith and fair dealing has been described as “notoriously unclear,” “cryptic,” “nebulous,” and the “cruellest trick.” But while courts might have been able to accept the uncertainty of the doctrine in the past, that option is becoming increasingly unavailable. Particularly in Delaware, litigation involving the implied covenant is growing in significance: the reason is the rise of alternative entities, such as LLCs and LLPs, which can waive all fiduciary duties, but not the implied covenant. Lacking a clear notion of what the implied covenant demands, the Delaware courts have been hobbled in their attempts to generate a standard commensurate with the much-praised set of precedents the jurisdiction has developed with regard to corporate fiduciary duties. In response, this Article constructs a new theory of the implied covenant of good faith. It builds a simple three-step interpretive framework for resolving disputes over contract interpretation and offers an original conception of what good faith entails.

This Article offers two significant contributions to the law of the implied covenant, particularly in the context of alternative entities. First, it shows that Delaware courts have mistakenly relied on the idea that good faith can be defined in terms of compliance with the hypothetical contract that the parties would have negotiated had they contemplated the facts in question. Although an incoherent doctrine in its current form, this notion of a counterfactual contract can be usefully deployed as a threshold test for determining when the implied covenant is implicated. Second, this Article offers a novel account of the nature of contractual obligation built on what this Article terms “cooperative intent.” Under this theory, the implied covenant operationalizes the commitment inherent in every contract that each party only act from reasons that are compatible with the goals and bounds of the contractual relationship. To enforce this requirement, a court should require that the defendant offer appropriate reasons for its actions. If these reasons are provided, the court should extend to the defendant a presumption of good faith. The opposing party would then have the opportunity to rebut the presumption by producing evidence that the proffered reasons were merely pretextual.

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I. Introduction

Among contract law doctrines, few cause as much ire for courts and academics as the implied covenant of good faith and fair dealing. Ostensibly, the implied covenant—or simply “good faith”—helps courts fill gaps in contracts, a familiar function in contract law.¹ Broadly speaking, its purpose is to avoid the situation in which an apparent gap in the contract puts “one party at the mercy of the other.”² But, while that broad understanding of good faith’s goal has general acceptance, there is essentially no agreement as to how it should impact contract interpretation: scholars have had “very little success in agreeing on standards that might give a court guidance.”³

Good faith has been described as “notoriously unclear,”⁴ “cryptic,”⁵ “nebulous,”⁶ and “[the] cruelest trick.”⁷ But at the same time, few doubt its significance, with some calling it the most important obligation inherent in contract law.⁸ This is a problem and one that has attracted some proposed solutions: from the idea that good faith should be dismissed as a “relic”⁹ to the contention that the implied covenant involves “expansive notions of equality.”¹⁰ Far from a mere academic debate, the role of the implied covenant of good faith has direct consequences for a variety of commercial and organizational relations.

Particularly notable is the centrality of good faith to “alternative entities,” such as the Limited Liability Company (LLC) and Limited Liability Partnership (LLP). Relatively recent innovations, the LLC and LLP have become two of the most popular forms of business organizations. In part, that popularity stems from these entities’ flexibility, as the members of these organizations can waive the fiduciary duties required for corporations and instead have their rights be determined entirely by contract.¹¹ But while fiduciary duties can be waived, the implied covenant of good

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1. See Nicholas R. Weiskopf, *Wood v. Lucy: The Overlap Between Interpretation and Gap-Filling to Achieve Minimum Decencies*, 28 PACE L. REV. 219, 219 (2008).
 2. *Thiem v. Thomas*, 406 A.2d 115, 119 (N.H. 1979).
 3. James J. White, *Good Faith and the Cooperative Antagonist*, 54 SMU L. REV. 679, 680 (2001).
 4. Paul MacMahon, *Good Faith and Fair Dealing as an Underenforced Legal Norm*, 99 MINN. L. REV. 2051, 2051 (2015).
 5. *Mkt. St. Assocs. Ltd. P’ship v. Frey*, 941 F.2d 588, 594 (7th Cir. 1991).
 6. Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619, 619 (1981).
 7. *Id.* at 620.
 8. See, e.g., Robert S. Summer, *Good Faith Revisited*, 46 SAN DIEGO L. REV. 723, 726 (2009) (“I believe there is no obligation in all of the U.C.C. and in general contract law of more overall importance than the general obligation of good faith.”).
 9. Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviving a Revered Relic*, 80 ST. JOHN’S L. REV. 559, 559 (2006).
 10. Emily M.S. Houh, *Critical Interventions: Toward an Expansive Equality Approach to the Doctrine of Good Faith in Contract Law*, 88 CORNELL L. REV. 1025, 1029 (2003).
 11. See 6 DEL. C. §§ 17-101(c), (d); *Id.* §§ 18-101(b), (c); *Dieckman v. Regency GP LP*, 155 A.3d 358, 367 (Del. 2017).

faith (distinct from fiduciary good faith, which is a component of the duty of loyalty¹²) cannot be.¹³ As a result, disputes between members of alternative entities often depend critically on how one conceptualizes and articulates contractual good faith.

Delaware's implied covenant jurisprudence has become the focal point of this litigation. A 2011 empirical study of publicly traded limited partnerships and LLCs found that only one was organized under the law of a jurisdiction other than Delaware.¹⁴ Nearly all of those publicly traded Delaware entities "either totally waive the fiduciary duties of managers or eliminate liability arising from the breach of fiduciary duties."¹⁵ The implications of this development are hard to overstate. As the classic observation goes, the key advantage that Delaware offers corporations "is a highly developed case law that provides not only a useful set of precedents, but also a substantial degree of certainty about legal outcomes."¹⁶ But Delaware's alternative entity law, by allowing waiver of the fiduciary duties, renders that precedent irrelevant—every case dictating the standards of corporate governance, from the infamous *Smith v. Van Gorkom*¹⁷ to the iconic *Stone v. Ritter*,¹⁸ is set aside.

All that is left standing is the implied covenant of good faith and fair dealing, that mysterious doctrine whose contours remain utterly undefined.¹⁹ Particularly with regard to the law of organizations, there is very little case law on its application. Since corporations were always governed by the unwaivable fiduciary duties of care and loyalty, few suits raised and even fewer opinions reached the implied covenant as it applied to business organizations. By necessity, however, this is now changing. In the last few years, numerous class actions have been brought, challenging mergers and other transactions involving alternative entities, alleging breaches of the implied covenant.²⁰

Responding to this influx of litigation and the newfound prominence of the

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12. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).
 13. *Dieckman*, 155 A.3d at 367.
 14. Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 598 n.236 (2012).
 15. *Id.* at 557.
 16. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 484 (1987); Roberta Romano, *Law as a Product. Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280 (1985).
 17. 488 A.2d 858 (Del. 1985).
 18. 911 A.2d 362 (Del. 2006).
 19. *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996) (en banc) ("Although the Covenant is a generally acknowledged principle, its precise contours are not fixed.").
 20. See, e.g., *Brinckerhoff v. Enbridge Energy Co., Inc.*, 159 A.3d 242 (Del. 2017), *as revised* (Mar. 28, 2017); *Gerber v. Enter. Prod. Holdings, LLC*, 67 A.3d 400 (Del. 2013), *overruled by* *Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808 (Del. 2013); *Gerber v. EPE Holdings, LLC*, No. CIV.A. 3543-VCN, 2013 WL 209658 (Del. Ch. Jan. 18, 2013); *In re Encore Energy Partners LP Unitholder Litig.*, No. CIV.A. 6347-VCP, 2012 WL 3792997 (Del. Ch. Aug. 31, 2012); *In re K-Sea Transp. Partners L.P. Unitholders Litig.*, No. CIV.A. 6301-VCP, 2012 WL 1142351 (Del. Ch. Apr. 4, 2012); *In re Atlas Energy Res., LLC*, No. CIV.A. 4589-VCN, 2010 WL 4273122 (Del. Ch. Oct. 28, 2010); *Loneragan v. EPE Holdings, LLC*, 5 A.3d 1008 (Del. Ch. 2010); *Brinckerhoff v. Texas E. Prod. Pipeline Co., LLC*, 986 A.2d 370 (Del. Ch. 2010).

implied covenant, the Delaware Supreme Court has struggled to develop a workable doctrine. In 2017 alone, the Court issued seven opinions on the implied covenant²¹—for comparison, it decided only one that year relating to the duty of care.²² This plethora of cases bespeaks not only the growing importance of the doctrine, but also the interest it has garnered among plaintiffs’ lawyers, hoping to capture value from the uncertainty that persists in this area.²³ This is a situation that demands intervention; the Delaware Supreme Court has come up short.

In a foundational holding on contractual good faith, the Delaware Court endorsed the view that the implied covenant of good faith is associated with adherence to a hypothetical contract—the contract that parties would have entered if they had considered the unprovided-for circumstance.²⁴ As Justice Jacobs of the Delaware Supreme Court has explained, although “this test requires resort to a counterfactual world,” it is still “commonsensical,”²⁵ capturing an intuitive notion of the sort of gap-filling the implied covenant is supposed to achieve. But while it may appeal—at least superficially—to common sense, the idea that the implied covenant can be equated to enforcing a counterfactual contract is fatally incoherent: it introduces insurmountable inconsistencies into the contract doctrine and leads courts toward unpredictable and obfuscated reasoning.

In this Article, I construct an alternative to the theory of good faith as the hypothetical contract, building a simple three-step interpretive framework for resolving disputes over contract interpretation. Central to this theory is the premise that good faith demands adherence to a mode of deliberation consistent with the goals and bounds of the contract. In the first step, one uses the ordinary methods of contract interpretation to determine whether the dispute in question is specifically provided. In the second step, one applies a counterfactual threshold test—derived from the idea of good faith as the hypothetical contract—to determine whether the situation falls

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21. *Kmetz v. Am. Ass’n of Univ. Professors*, 171 A.3d 1116 (Del. 2017); *Clouser v. Doherty*, 175 A.3d 86 (Del. 2017); *Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co. LLC*, 166 A.3d 912 (Del. 2017), *as revised* (June 28, 2017); *Lacombe v. State*, 163 A.3d 708 (Del. 2017); *Brinckerhoff v. Enbridge Energy Co., Inc.*, 159 A.3d 242 (Del. 2017), *as revised* (Mar. 28, 2017); *Dieckman v. Regency GP LP*, 155 A.3d 358 (Del. 2017).
 22. *City of Birmingham Ret. & Relief Sys. v. Good*, 177 A.3d 47 (Del. 2017).
 23. *Cf. Gerber v. EPE Holdings, LLC*, No. CIV.A. 3543-VCN, 2013 WL 209658, at *11 (Del. Ch. Jan. 18, 2013) (noting how the current doctrine on the implied covenant seems to create a “tempting” backdoor to alleging a breach of fiduciary duty).
 24. *Gerber v. Enter. Prod. Holdings, LLC*, 67 A.3d 400, 418 (Del. 2013), *overruled on other grounds by Winshall v. Viacom Int’l, Inc.*, 76 A.3d 808 (Del. 2013). The test had been utilized in other cases, but not articulated as the definitive test to be applied in these contexts. *See ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440 (Del. Ch. 2012), *rev’d*, 68 A.3d 665 (Del. 2013) (discussing the counterfactual test and the development of Delaware’s jurisprudence on the implied covenant more generally).
 25. *Id.* at 418; *see also Winshall v. Viacom Int’l, Inc.*, 76 A.3d 808, 816 (Del. 2013) (“[A] party may only invoke protections of [the] implied covenant of good faith and fair dealing when it is clear from [the] underlying contract that [the] contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate the matter.”).

within the contract or not. If the answer is yes, then the dispute is one that is controlled by the contract yet not specifically provided for. This demands invocation of good faith, which is the third step.

As Step Two, the counterfactual threshold test, makes clear, good faith plays its most critical role when the contract suffers from a particular form of incompleteness: the absence of agreement on the level of specific intentions regarding an unanticipated event that comes into fruition. Lacking specific intentions, there is a desire to fill in the gap through the imposition of some norms, such as reasonableness or fairness. Such an approach is incompatible with the idea that contract is grounded in agreement. I defend a conception of good faith that does not substantively fill the gap, but, instead, places upon the parties a procedural obligation to reason in a manner compatible with the contractual relationship. This theory directs the judge to find a breach of the implied covenant only when the defendant is unable to ground its actions in reasons compatible with the contractual relationship between the parties.

Specifically, at Step Three, the court must determine whether the defendant acted with reasons that are compatible with the contract. I recommend that courts operationalize this inquiry through the following procedure. First, the defendant must offer an explanation for its behavior that appropriately rationalizes its actions within the context of the contractual relationship. If the court determines that this explanation is valid under its interpretation of the contract, then the court should extend to the defendant a presumption of good faith. The burden then falls on the plaintiff to rebut this presumption by providing evidence that the proffered reason is merely pretextual.

This understanding of good faith avoids the pitfalls and inconsistencies of the hypothetical approach, but it shares a core normative orientation. That relationship makes the theory offered here particularly attractive to jurisdictions, such as Delaware, that have developed their case law around hypothetical bargains. Even more persuasively, this procedural conception of the content of good faith makes its application analogous to (though importantly distinct from) types of judgments courts are already comfortable making—specifically determinations of arbitrariness and capriciousness in administrative contexts and findings of breach of fiduciary duties in corporate contexts.

Part I lays the groundwork for this innovative approach by analyzing how commentators and courts have struggled to conceptualize the implied covenant of good faith. In addition to providing a historical account of the doctrine and its relationship to existing literature, Part I introduces the theory of the implied covenant as enforcing the counterfactual contract and discusses its adoption by the Delaware courts. It then analyzes two seminal cases that apply the test, revealing the deeply problematic nature of this conceptualization of the doctrine. The first is an opinion by Judge Posner, offering the most theoretically robust articulation of the test and its normative roots; the second is an opinion by Justice Jacobs of the Delaware Supreme Court generally taken as the leading case for the implied covenant in Delaware. Utilizing this insight, Part II constructs a three-step framework for resolving contract disputes. Central to this approach is a reinterpretation of the doctrine that casts the use of hypothetical contracts as a counterfactual threshold test for when the implied covenant should be invoked. Part III turns to the content of good faith, examining the normative core of the contract to construct a practical understanding of the implied

covenant that can be utilized by courts. This conceptualization of the doctrine demands parties maintain what I refer to as cooperative intent, which involves a commitment to reason in a manner consistent with a purposivist reading of the contract. Part III concludes by summarizing how this framework can be applied by the Delaware courts.

II. Gaps and Delegation: The Problem of Good Faith

A perfect contract is a rarity, perhaps an impossibility. Negotiating parties regularly fail to contemplate all that the future might bring and, as a result, sometimes leave gaps in their agreements. The doctrine of the implied covenant arose in order to address the problem of apparent contractual gaps. But while there is general consensus for what the doctrine is supposed to do, there is little agreement as to how it is supposed to do it. Beginning with the historical origins of the implied covenant, this Part provides an overview of the attempts made by courts and scholars to conceptualize the implied covenant, contextualizing these efforts in broader contract theory. It then introduces and criticizes the notion of the implied covenant as requiring adherence to hypothetical contracts. By providing this background on the counterfactual notion of the implied covenant, this Part lays the foundation for the novel theory of the doctrine offered in this Article.

A. Origins of the Doctrine

The implied covenant of good faith is a relative newcomer among contract law doctrines, only gaining wide recognition as a general principle of contract law after the New York Court of Appeals issued its opinion in *Kirke La Shelle Co. v. Paul Armstrong Co.* in 1933.²⁶ The case involved a settlement contract giving the plaintiff half the receipts from a particular play and approval power over all uses of the play other than the “motion picture rights.”²⁷ The contract was drawn up at a time when motion pictures were silent, but now the court was asked to determine how it applied to a situation beyond the contemplation of either party when they reached their bargain—talkies. The non-existence of talkies at the time of contracting meant that the plaintiff retained the rights to the only means for audiences to experience the full story, sound and visuals together, i.e., a stage production. The defendant, without consulting the plaintiff, sold the talkie rights to MGM and the plaintiff sued for breach. While the plaintiff argued that talkies could not have been what was intended by “motion picture” when the contract was formed, the defendant claimed that the object of the parties’ agreement was broader than the rights to silent films. The contract offered no definition of motion pictures, leaving the court with scant textual basis for a decision. Faced with little in the agreement itself to settle the dispute, the court reached for a

26. 188 N.E. 163 (N.Y. 1933); see Steven J. Burton, *History and Theory of Good Faith Performance in the United States*, in *COMPARATIVE CONTRACT LAW* 210, 211 (Larry DiMatteo & Martin Hogg eds., 2015) (discussing *Kirke La Shelle’s* role in the development of the good faith doctrine).

27. *Kirke La Shelle*, 188 N.E. at 165.

broader norm:

[I]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.²⁸

Every contract, in other words, requires that the parties adhere not only to the strictly literal meaning of the text, but also be ready to adapt to unexpected circumstances in order to ensure that the “fruits of the contract” agreed upon is delivered to both parties.²⁹ In this case, the court decided that it could not have been that the contract was entered with the understanding that it would be “render[ed] valueless” to the plaintiff by technological change.³⁰ Since it was determined that talkies—combining sounds and vision—would substantially reduce the value of a revival stage production, the defendant was found to have breached.³¹ The principle established was thus that even in circumstances that were not covered by the actual contract, the court ought not simply leave losses where they lie. Rather, it may look to the broader norms that underlie the contract in order to settle unexpected disputes.

This doctrinal move was a powerful one, transforming the concept of a contract from a mere court-enforced system of jointly designed incentives into a tool for cooperation. Despite the importance of this idea, the implied covenant of good faith did not become either particularly developed or widely used until later in the twentieth century.³² The turning point was the promulgation of the Uniform Commercial Code (U.C.C.) in 1951, which contained several provisions and comments referencing good faith, including one general provision requiring good faith in the performance of every contract.³³ The provision defined good faith as “honesty in fact,” a notion that was controversially vague when it became statutorily part of the commercial law of many jurisdictions with little case law on the subject. Since then, both the revised U.C.C. and the Restatement (Second) of Contracts have adopted some version of the implied covenant of good faith, but neither is more precise. The U.C.C. now defines good faith as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”³⁴ The Restatement offers no definition in its main text, stating only that it is implied in every contract; but in the comments, it explains that good faith, in addition to demanding consistency with expectations, “excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness.”³⁵

On their face, these definitions do not seem to define good faith to be the same

28. *Id.* at 167 (emphasis added).

29. *Id.*

30. *Id.* at 168.

31. *Id.*

32. Burton, *supra* note 26, at 213.

33. E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 671 (1962).

34. U.C.C. §§ 1-201, 2-103 (AM. LAW INST. & UNIF. LAW COMM’N 2003).

35. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (AM. LAW INST. 1981).

thing that the New York Court of Appeals declared in *Kirke La Shelle*. Good faith, in *Kirke La Shelle*, obligated each party to act so as to deliver whatever benefit was bargained over—even if that required actions beyond the particular terms agreed upon. No reference is made to norms outside those generated by the contract itself. In contrast, both the Restatement and the U.C.C.’s definitions refer to ideas of reasonableness and the contracting context—“commercial standards” in the U.C.C. and “community standards” in the Restatement. This has led some commentators, as well as some courts, to adopt conceptions of good faith substantially different from what was offered by the Court of Appeals. The result has been a muddled and unhelpful understanding of good faith’s role in the contract and the courtroom.

B. Good Faith the Relic?

The trend in the academic interpretation of the implied covenant has been to whittle down its relevance. Harold Dubroff, for example, construes the Restatement and U.C.C. in light of the implied covenant of good faith’s history, arguing that it arose in the late nineteenth century as part of a larger effort to push back at the overly textualist and formalist interpretation doctrines that were prevalent at the time in certain jurisdictions.³⁶ According to this understanding, the doctrine of the implied covenant was a legal innovation, created to provide a doctrinal basis for looking outside the explicit wording of the contract without disrupting the court’s highly formalist precedents.³⁷ Dubroff argues that the Restatement and the U.C.C.’s definitions should be read as reflecting that history. Under this view, the implied covenant of good faith is merely the recognition that there are certain contextually implied terms inherent in every contract; the doctrine directs the court towards discovering and enforcing them.³⁸ This understanding has particular support in the U.C.C., which states in the comments that “the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed and enforced.”³⁹

Dubroff’s is a deflated notion of good faith—a pragmatic fix that provides courts a means of looking beyond the written words in order to construct the meaning of the agreement. In this way, it is little more than a repetition of the loosened parole evidence rules adopted by the Restatement and the U.C.C.⁴⁰ For this reason, a court that accepts this meaning of the implied covenant of good faith would likely find its use limited—a conclusion evidenced in Dubroff’s suggestion that the implied covenant of good faith ought to be retired as a “revered relic.”⁴¹

To my knowledge, no court has adopted Dubroff’s view of good faith in its

36. Dubroff, *supra* note 9, at 564-71; accord Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223, 1231-46 (1999) (arguing that good faith should be understood as emerging as a curative for a formalist jurisprudence).

37. See Dubroff, *supra* note 9.

38. *Id.* at 613.

39. U.C.C. § 1-304 cmt (AM. LAW INST. & UNIF. LAW COMM’N 2003).

40. See *id.* § 2-202; RESTATEMENT (SECOND) OF CONTRACTS § 213 (AM. LAW INST. 1981).

41. Dubroff, *supra* note 9, at 559.

entirety,⁴² but some have embraced its spirit. For example, in *Humantech, Inc. v. Caterpillar, Inc.*, the district court provided an in-depth account of good faith that largely accepted Dubroff's narrative.⁴³ In particular, the court suggested that good faith ought to be understood as reflecting the idea that "embracing text while sparing no thought for context can lead an interpreter astray."⁴⁴ This is because enforcement of the literal contract could "produce a senseless contract that no reasonable [person] would sign."⁴⁵ Underlying this claim is the idea that the court ought to enforce the contract as a reasonable person would have understood it; and, since the reasonable person makes inferences based on context, the court may look to that context as well. Grounding good faith in the concept of "reasonableness" invites a different approach to the sort of gap identified in *Kirke La Shelle*. This approach places less emphasis on the specific intentions of the parties, and instead suggests a method of interpretation that avoids finding ambiguities in the contract by seeking out textual, structural, or contextual clues from which a reasonable person might draw inferences.⁴⁶

On a certain level, understanding the implied covenant of good faith as directing the court to interpret the contract in light of a broader, contextually sensitive reasonableness standard may seem like a natural extension of a particular theorization of the doctrine, namely, the "objective theory" of contract. In contrast to "will theory," which sees the obligating power of contract as emerging from the actual intentions and choices of the party, objective theory looks to what a reasonable observer would have understood based upon the parties' words and their context. For example, the Restatement requires only manifestation of assent to form a contract, noting that "[t]he conduct of a party may manifest assent even though he does not in fact assent."⁴⁷ The objective theory of contract is motivated by the desire to protect people's ability to contract by ensuring that they can rely on the external manifestations of their contracting partners, as opposed to having to guess at the inside of their partners' minds. The aim remains to facilitate the agreement as it was specifically intended by the parties, but by adopting the perspective of the reasonable observer, the costs of determining the terms of the contract (or even whether a contract exists) are reduced.

Objective theory is defensible in many circumstances, such as the classic case *Lucy v. Zehmer*,⁴⁸ where a party attempted to get out of a signed contract by claiming he had only signed it in jest; but it cannot be so easily extended to the sort of gaps confronted in *Kirke La Shelle*. Understanding the problems that arise under such a situation for the objective theory similarly elucidate the limitations of Dubroff's approach. When the problem arises because both parties failed to consider the

42. Save, perhaps, those jurisdictions that reject the implied covenant of good faith entirely. See, e.g., *Hux v. S. Methodist Univ.*, 819 F.3d 776, 781 (5th Cir. 2016).

43. *Humantech, Inc. v. Caterpillar, Inc.*, No. 11-14988, 2012 WL 6214371, at *2 (E.D. Mich. Dec. 13, 2012) (discussing Dubroff, *supra* note 9).

44. *Id.* at *5.

45. *Id.*

46. See *id.* at *6 (suggesting that what the court ought to enforce "is the contract and the reasonable inferences that arise from it").

47. RESTATEMENT (SECOND) OF CONTRACTS § 19(3) (AM. LAW INST. 1981).

48. 84 S.E.2d 516 (Va. 1954).

situation that in fact occurred, neither party could have had an original, particular understanding of the contract that would be protected by adopting the reasonableness standard. A party faced with an unanticipated scenario would—lacking specific intentions—know that it was entering an ambiguous area of the contract. While it would be useful to provide parties with some assurance that they can act in gray areas without being found to have breached, demanding caution in such circumstances would not undermine contracting as much as would requiring parties to guess at the earnestness of their partner's manifestations.

At least in cases in which the court is confident a genuine gap in the contract exists (implying neither party relied on a particular meaning of the relevant operative terms), there is little justification for enforcing some "objective" interpretation of the contract just because it is reasonable. This is especially true when multiple, conflicting interpretations are possible. Of course, a contract is never formed with perfectly specific intentions and thus there will always be gaps. But it is not always the case that these gaps are of material importance to the operation of the contract. But, as I will discuss in Part II, these cases, where specific intentions are lacking to a material degree—or, as I will refer to them, cases of unsettled intentions⁴⁹—are precisely the contractual disputes for which the implied covenant of good faith, as a doctrine, is most relevant, but also most difficult.

To set up the later discussion, consider the relationship between this approach to contract interpretation and the Chevron framework for statutory interpretation. In Chevron, the Supreme Court of the United States announced a two-step approach to evaluating an executive agency's interpretation of a statute. In the first step, the court determines whether a statute is ambiguous by asking "whether Congress has directly spoken to the precise question at issue."⁵⁰ To answer this question, the court utilizes tools of statutory interpretation to infer "the intent of Congress."⁵¹ If no clear intention is found, then the statute is held to be ambiguous, at which point, the court proceeds to the second step.⁵² In the second step, the court evaluates the agency's interpretation utilizing a highly deferential standard of reasonableness.⁵³ The underlying theory is that where no clear intention can be read off the face of the statute, the court cannot avoid the difficult task of filling in a gap.⁵⁴ Rather than fill this gap itself, the court infers that Congress "explicitly left [the] gap for the agency," and defers to the agency's

49. By using the term "unsettled intentions" to refer to cases of genuine gaps in the contract, I mean a somewhat narrow understanding of what constitutes a gap. For reasons made apparent in Part II, I use "unsettled intentions" to refer to cases in which the contractual language would change if the parties were made aware of some unanticipated scenario (they are "unsettled" because they are easily changed through the communication of new information regarding epistemic possibility).

50. Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc., 467 U.S. 837, 842 (1984).

51. See *id.* at 842-43.

52. *Id.* at 843

53. See *id.* at 843-44.

54. See John C. Brinkerhoff Jr. & Daniel B. Listwa, *Deference Conservation—FOIA's Lessons for a Chevron-less World*, 71 STAN. L. REV. ONLINE 146, 156 (2018).

construction.⁵⁵

Unsettled intentions in a contract parallel the absence of “precise” congressional intent in the Chevron context; in both circumstances, the text does not document the particular intent needed to resolve the dispute. But in the contract question, the issue of how to resolve the ambiguity cannot be resolved systematically by delegating to one party the role of gap-filler. Both parties, ostensibly, have an equal claim to this delegation. As a result, a court simply cannot fill gaps through the sort of unilateral delegation contemplated by Chevron. While this difference renders inappropriate any simplistic analogy between contracts and statutes, I argue that there is an important relationship between the implied covenant in contracts and deference regimes in the administrative law context.

While step one of Chevron is characterized by a standard interpretive process that is focused on the legal text, at step two the judge’s orientation shift away from the statute and towards the interpreter, that is, the agency. How the interpreter went about filling in the gap becomes determinative of whether the conduct in question is held to be consistent with the law. Specifically, the court attends to both the substantive reasonableness of the agency’s proffered interpretation as well as the procedure by which the agency arrived at that interpretation.⁵⁶ In other words, once a gap in the statute is identified, the court ceases to act as interpreter itself and instead passes judgment on the interpreter—asking, among other things, whether the agency arrived at its interpretation in a properly deliberative matter.⁵⁷

In this Article, I argue that good faith should be conceptualized through a similar gap-filling framework. Initially, the court must make a threshold determination as to whether a gap exists. Then, if such a gap is found, the orientation of the judge’s inquiry shifts away from the contract itself and towards the relevant alleged breacher, asking whether that party went about the process of filling the gap in an appropriate manner. But in order for such an account to be plausible, one must provide a method of both making that threshold finding of a gap and judging the interpretive process of the alleged breacher. As I endeavor to show, both can be found in the modern doctrine.

But before I excavate each of these requirements from the case law, it is necessary to have an understanding of the current conceptual account of the implied covenant that has gained prominence in recent years, in Delaware and beyond. In the next Section, I outline this account, premised on the idea of a counterfactual contract, setting up the discussion in which I explain the faults of this approach and lay the foundation for my own.

55. *Id.*

56. *See* Barnhart v. Walton, 535 U.S. 212, 222 (2012) (“[W]hether a court should give such deference depends in significant part upon the interpretive method used and the nature of the question at issue.”); *see also* United States v. Mead Corp., 533 U.S. 218, 230-31 (2001) (“Thus, the overwhelming number of our cases applying *Chevron* deference have reviewed the fruits of notice-and-comment rulemaking or formal adjudication.”).

57. *See* John C. Brinkerhoff Jr., *FOIA’s Common Law*, 36 YALE J. ON REG. 575, 608-09 (2019) (discussing the view that *Chevron* is an administrative common law doctrine designed to mediate policymaking authority between branches).

C. Good Faith and Incompleteness

Every contract is incomplete. This is an unavoidable product of having infinite possible states in a world where contracting parties have only limited capacity to specify what performance is required in each state.⁵⁸ My focus, however, will be on the particular form of incompleteness: unsettled intentions. By that I mean those gaps in the contract that occur because the parties failed to consider—in a functionally significant manner—how they would want the contract to apply in an unanticipated situation.⁵⁹ Although the concept of an “implied covenant” has arguably been expanded by some courts to apply to a class of cases beyond those involving unsettled intentions, my focus is on this core set of disputes.⁶⁰

A common formulation of good faith requires each party “(1) to honor the reasonable expectations of the contracting parties and (2) to protect the rights of the parties to receive the benefits of the agreement into which they entered.”⁶¹ Steven Burton, in a seminal article, described the protection of “reasonable expectations” as meaning that each party is precluded from using the incompleteness inherent in every contract “to recapture opportunities forgone upon contracting.”⁶² This does not mean that a court should address each instance of incompleteness by adopting the commercial norm. Nor does it mean—as many have mistakenly thought—that courts should judge parties’ actions against communal conceptions of justice or fairness.⁶³ Rather, it directs the court towards interpreting the contract purposively, giving interpretive weight to the idea that a contract “set[s] in motion a cooperative enterprise.”⁶⁴ Having recognized that the contract is a cooperative venture, the “office of the doctrine of good faith is to forbid the kinds of opportunistic behavior” that would undermine the stability of a “mutually dependent, cooperative relationship.”⁶⁵ The difficulty is in translating the general idea that good faith entrenches the notion of a contract as a cooperative venture into a tool for resolving disputes.

From this vague idea, we can set certain outer boundaries, namely that the duty

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58. Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1641 (2003).
 59. For an intelligent discussion of the relationship between different types of gaps and the implied covenant of good faith in Delaware law, see *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, No. CIV.A. 7141-VCL, 2014 WL 2768782, at *17 (Del. Ch. June 12, 2014).
 60. As one district court said, “New York cases have expanded the use of the implied covenant of good faith in a manner other than as a gap-filler.” *In Touch Concepts, Inc. v. Cellco P’ship*, 949 F. Supp. 2d 447, 467 (S.D.N.Y. 2013), *aff’d*, 788 F.3d 98 (2d Cir. 2015).
 61. *Hometown Folks, LLC v. S & B Wilson, Inc.*, 643 F.3d 520, 527 (6th Cir. 2011).
 62. Steven J. Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369, 373 (1980).
 63. Robert Summers, who provided one of the foundational early accounts of good faith, characterized it as a means “to justice and to justice according to law” and “of a piece with explicit requirements of contractual morality, such as the unconscionability doctrine and various general equitable principles.” Robert S. Summer, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 826 (1982) (internal quotation marks omitted).
 64. *Mkt. St. Assocs. Ltd. P’ship v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991).
 65. *Id.*

of good faith is more exacting than the tort obligation not to commit fraud but less than a fiduciary obligation.⁶⁶ In other words, good faith is neither the duty to act in your contracting partner's best interest, nor is it license to act in whatever way would best serve your own. Instead, as Daniel Markovits described, good faith requires each party to respect the relationship forged between them by the contract itself, a relationship "structured around a shared understanding of a voluntary obligation."⁶⁷ In practice, that means honoring the terms agreed upon, either explicitly or implicitly. In many cases, it is this aspect of the implied covenant of good faith that enables the court to decide a case.

For example, breach of the implied covenant of good faith is frequently invoked in agreements involving requirements contracts. These contracts allow the quantity of delivered goods to vary according to the requirements of the buyer's business operations. When the market price for the good falls below the contract price, the buyer may have an economic incentive to alter its requirements. As early as the nineteenth century, courts invoked good faith performance in these contexts to cabin a buyer's ability to take advantage of these circumstances, despite apparent discretion in the literal terms of the agreement.⁶⁸ In *Eastern Air Lines, Inc. v. Gulf Oil Corp.*, for example, the court resolved a dispute over what good faith performance demanded by looking at the parties' past practices and deriving from those practices an implied term of the requirements contract.⁶⁹ Thus, the court determined that the gap was illusory; where it appeared the contract said nothing about the metes and bounds of Eastern Air Lines' discretion, it found the parties' "meeting of the minds" contained further terms, discoverable by looking at the bargaining context. Where this is the case, Dubroff is right: the implied covenant of good faith is doing no extra work.⁷⁰ But not every case can be resolved in this way.

While the court in *Eastern Air Lines* was ultimately able to fill an apparent gap by finding an implied acceptance of the airline's actions, such a search for implied terms would be futile in cases like *Kirke La Shelle*, involving contingencies beyond the contemplation of the parties. Where the lack of specific intention prevented the formation of agreed upon terms, how is the "shared perspective of the contract" supposed to settle such a dispute?⁷¹ One solution is to look beyond the actual world—as evidenced by the contract and its context—and into the hypothetical world. In *Market Street Associates v. Frey*,⁷² Judge Posner attempts precisely such a move, constructing a counterfactual model of the contract in order to determine how the court should enforce the parties' agreement in an unforeseen situation.

As explained in the next Section, Judge Posner suggests that the role of the implied

66. *Id.* at 593-95.

67. Daniel Markovits, *Good Faith as Contract's Core*, in *PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW* 273, 292 (Gregory Klass et al. eds., 2014).

68. Burton, *supra* note 26, at 212-13 (discussing early cases invoking the implied covenant of good faith in relation to requirements contracts).

69. *Id.*

70. See discussion of Dubroff, *supra* note 9 and accompanying text.

71. See Markovits, *supra* note 67, at 293.

72. 941 F.2d 588 (7th Cir. 1991).

covenant of good faith is “to give the parties what they would have stipulated for expressly if at the time of making the contract they had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero.”⁷³ This approach has been criticized⁷⁴ and labeled “idiosyncratic,”⁷⁵ but it cannot be so easily discarded. Delaware law adopted an essentially identical formulation of good faith, defining the implied covenant as “implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them.”⁷⁶ This counterfactual approach has provided the foundation for its doctrine governing LLCs and LLPs—including companies that are worth billions and publicly traded⁷⁷—making, what might be conveniently called, “Posnerian” good faith of critical importance in the modern economy.⁷⁸

And it is not only the Delaware courts. Courts in Utah⁷⁹ and Pennsylvania,⁸⁰ among others, have also adopted this counterfactual standard.⁸¹ Presumably, these courts are drawn to the standard for the same reason as are the Delaware courts: it takes a conceptually difficult situation and converts it into something “commonsensical.”⁸² Consider once again the Chevron comparison introduced in the

73. *Id.*

74. See Dubroff, *supra* note 9, at 590; Markovits, *supra* note 67, at 286.

75. Burton, *supra* note 26, at 217.

76. Gerber v. Enter. Prod. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013), *overruled on other grounds by* Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013); see also Winshall, 76 A.3d at 816 (“[A] party may only invoke protections of [the] implied covenant of good faith and fair dealing when it is clear from [the] underlying contract that [the] contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate the matter.”). The underlying intuition of the implied covenant as enforcing a hypothetical bargain can be seen in *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 880 (Del. Ch. 1986). The current articulation of the test can be traced to *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436 (Del. 1996), which cited Judge Posner’s opinion, see *id.* at 443 (quoting *Market St. Assoc.*, 941 F.2d at 595).

77. See, e.g., Fortress Investment Group LLC, Form S-1, SEC (Nov. 2006), <https://www.sec.gov/Archives/edgar/data/1380393/000095013606009310/file1.htm>.

78. As already noted, because Delaware law allows for the waiver of all fiduciary duties but not the implied covenant, the only constraints applicable to alternative entities formed under Delaware law are those provided in the organizational agreements themselves and the implied covenant. See discussion *supra* notes 14-19 and accompanying text.

79. *Young Living Essential Oils, LC v. Marin*, 266 P.3d 814, 816 (Utah 2011) (“[The implied covenant of good faith’s] significance lies in its function of inferring as a term of every contract a duty to perform in the good faith manner that the parties surely would have agreed to if they had foreseen and addressed the circumstance giving rise to their dispute.”).

80. *Hanaway v. Parkesburg Grp., LP*, 132 A.3d 461, 473 (Pa. Super. Ct. 2015) (citing Gerber v. Enter. Prod. Holdings, LLC, 67 A.3d 400, 418 (Del. 2013) (“[A]n implied covenant seeks to enforce the parties’ contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them.”).

81. See, e.g., *Knudsen v. Lax*, 842 N.Y.S.2d 341, 348 (N.Y. Co. Ct. 2007); *Metro. Ventures, LLC v. GEA Assocs.*, 717 N.W.2d 58, 69 (Wis. 2006).

82. Gerber, 67 A.3d at 418.

previous Section. To solve the delegation problem of who should fill the gap, the counterfactual method imagines both parties cooperatively resolving the ambiguity. In a sense, it seems like the perfect resolution. Unfortunately, despite its appeal, this notion of employing the counterfactual counterparts of the parties to resolve the dispute on their own is unworkable. In the Section that follows I explain why this is the case by considering Judge Posner's reasoning in *Frey*. Although I ultimately reject this counterfactual test, it is not without virtue. In Part II, I return to the intuitions underlying the counterfactual standard to build a framework for good faith performance that better aligns with the law.

D. Enforcing the Counterfactual Contract

The approach articulated by Judge Posner and adopted by courts in Delaware and elsewhere seeks to enforce a counterfactual contract. As this Section describes, such an approach is incompatible with both contract law and theory. This Section outlines in broad terms the theoretical shortcomings associated with the "Posnerian" approach to the implied covenant. I begin by addressing Judge Posner's opinion in *Frey*, offering an overview of the facts of the case and the decision. I then address the theoretical failings of Judge Posner's opinion from the perspective of ensuring normative coherence in contract law. Finally, I examine how the Delaware courts have utilized this deeply flawed doctrine, revealing the inconsistencies that this conceptualization of the implied covenant has introduced into the jurisdiction's contract law.

i. Toward a "Posnerian" Good Faith

In *Frey*, General Electric Pension Trust entered into a sale-leaseback arrangement with J. C. Penney Company, Inc., which owned some real estate.⁸³ As per the agreement, J. C. Penney sold the property to the pension fund, but retained a long-term lease.⁸⁴ Within the contract was a provision, paragraph thirty-four, entitling the lessee, J. C. Penney, to financing from the lessor, the pension trust, at a reasonable rate negotiated in "good faith."⁸⁵ In case the negotiations failed, the contract provided that the lessee could repurchase the property at a price "roughly equal" to the price it sold it to the pension fund, adjusted by a specified factor.⁸⁶ Twenty years after the original transaction, the lessee sought financing from a third party for certain improvements. The third party was unwilling to lend the funds without a mortgage on the property, which the lessee was unable to provide as it was not the owner of the real estate. The lessee then sought to repurchase the real estate. The lessor pension trust returned with an asking price of \$3 million, which the lessee considered "much too high."⁸⁷

A month later, the lessee sent a letter to the lessor formally requesting financing for the improvements. Failing to receive a response, the lessee sent another request one

83. *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 590 (7th Cir. 1991).

84. *Id.* at 591.

85. *Id.*

86. *Id.*

87. *Id.*

month later. Neither letter made reference to paragraph thirty-four nor to the fact that failure to provide financing would trigger the repurchase provision. The lessor responded, declining to provide the funding, and the lessee, one month later, sent a letter stating that it was exercising the option provided by paragraph thirty-four to repurchase the property according to the price specified in the terms, which worked out to be only \$1 million. The lessor refused to sell, and the lessee sued for specific performance.⁸⁸

The district court granted summary judgment for the lessor pension trust on the grounds that the lessee had violated the implied covenant of good faith by failing to mention paragraph thirty-four of the contract in the correspondence with the lessor when requesting the financing. Underlying this decision was the judge's inference that the lessee did not actually want the financing from the lessor pension trust, but rather, "it just wanted an opportunity to buy the property at a bargain price and hoped that the pension trust wouldn't realize the implications of turning down the request for financing."⁸⁹ On appeal, the Seventh Circuit reversed the district court's grant of summary judgment, remanding the case for fact-finding on the question of whether the lessee intended to "trick the pension trust" by not mentioning paragraph thirty-four.⁹⁰

Writing for the court, Judge Posner argued that if such trickery was the intent, then the lessee had engaged in "the type of opportunistic behavior in an ongoing contractual relationship that would violate the duty of good faith performance."⁹¹ Such a conclusion is supported by a construal of the facts in which the lessee intentionally did not mention paragraph thirty-four, hoping the other party would fail to notice the term and allowing the lessee then to demand the property at a below market price. Although a plausible story, Judge Posner notes that it is not the only one that could be supported by the facts presented in the pleadings and that one more favorable to the lessee is available, i.e., that it "honestly, reasonably, and without ulterior motive" sought financing from the lessor, innocently leaving out mention of the repurchase provision.⁹² Given the standard for summary judgment, which is in favor of the nonmoving party, the plausibility of such a set of facts required overturning the lower court's decision.

After providing an overview of some of the central literature and cases on the implied covenant of good faith, Judge Posner makes the following two comments—intertwined in their presentation, but significantly different. First, he notes the relationship between good faith and contract interpretation, suggesting that the implied covenant of good faith is another formulation of the interpretive norm that deems every contract "to contain such implied conditions as are necessary to make sense of the contract."⁹³

88. *Id.* at 592.

89. *Id.* at 596.

90. *Id.* at 597.

91. *Id.*

92. *Id.*

93. *Id.* at 596.

Read broadly, this statement captures the idea that the doctrine of good faith directs the court not to interpret the contract in a mechanical way, but rather to support the purpose of the parties, however that may be divined. This view of good faith as imposing additional conditions beyond the express language of the contract, but within its meaning and without contradicting the understood meaning of the express terms, is the baseline for different accounts of good faith—a reflection of the idea that good faith protects the reasonable expectations of the parties and no more than that.⁹⁴

Judge Posner's second, more controversial, comment relates to this issue of extracting what conditions ought to be understood as implied by the contract. Seeing the problem of implied conditions as arising from the "unpredictability of the future at the time the contract was made," Judge Posner suggests, as already alluded to, that good faith ought "to give the parties what they would have stipulated for expressly if at the time of making the contract they had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero."⁹⁵ The underlying thought is reasonable. If good faith is merely the excavation of contract terms covering situations that the parties failed to consider, it is natural to imagine the hypothetical contract that would have arisen had the parties contemplated such occurrences. If taken seriously, however, reliance on such hypothetical reasoning generates deep conceptual conflicts.

ii. Deeper Than Doctrine

One way of understanding the error in Judge Posner's framework is in terms of contract doctrine. To judge the lessee's behavior against such a counterfactual term must be wrong. If good faith requires adherence to this counterfactual, more idealized contract, then it "adds to the substantive content of every contractual obligation."⁹⁶ This would contravene the doctrine, which holds, as articulated in the U.C.C., that the requirement of good faith "does not support an independent cause of action" and

94. This understanding is reflected, for example, in both Delaware and Arkansas law, which holds that the implied covenant of good faith is a method of gap-filling that cannot negate the terms that actually appear in the contract. *Bank of Am., N.A. v. JB Hanna, LLC*, 766 F.3d 841 (8th Cir. 2014); *Fisk Ventures, LLC v. Segal*, No. CIV.A. 3017-CC, 2008 WL 1961156, at *10 (Del. Ch. May 7, 2008). As is discussed in Part III, courts wrongfully assume that this means that the implied covenant cannot set limits on how bargained-for rights are to be exercised.

95. *Id.* Note that this statement of the test cannot be taken at face value. Although Judge Posner says "complete knowledge" of the future, this cannot be likened to the parties traveling back in time with certainty regarding the contingency that will arise. Instead, we must imagine the parties counterfactually having complete information about all the *epistemic possibilities*. The reason for this qualification is fairly straightforward. Many contracts effect wagers between the contracting parties. For example, A might sell stock to B because A believe the price will go down while B believes it will go up. But if both parties knew whether or not the price would go up, then the contract would not be formed. The counterfactual contract would thus be a non-existent one. This cannot be what Judge Posner had in mind. Rather, he must have been referring to a hypothetical in which the parties are aware of every possible contingency and assign some probability, however minimal, to each.

96. Markovits, *supra* note 67, at 288.

“does not create a separate duty of fairness and reasonableness which can be independently breached.”⁹⁷ Thus, it cannot be that good faith requires enforcing the more idealized contract, with its additional terms requiring the lessee to explicitly reference paragraph thirty-four.

But the reasoning goes deeper than doctrine. To enforce a contract other than that which the parties agreed upon would countermand the very premise of contractual obligation. The essence of contract—that which makes it distinct from public social planning—is that it is a private ordering. Such private ordering would be unnecessary for beings who could transact with one another perfectly and costlessly; such transactors would know each other’s preferences and intentions without being told, enabling each person to make the most efficient choice in every circumstance without engaging in unnecessary and costly contracts.⁹⁸ Thus, the very act of forming a contract is to depart from the ideal.⁹⁹ Yet, imagine if two beings, though capable of perfect, costless transactions, decided to form a contract.¹⁰⁰ A suboptimal behavior, for sure, but should one thus view it as non-binding? I think not. I suspect that the fact that such beings are capable of perfect reasoning strengthens the case for respecting the obligating power of the agreement, since it suggests that the decision to contract was the action of an accountable agent.

That is because contracts generate obligation not through their optimality, but through the fact that they are agreed to by the parties. That is the idea at the heart of the “will theory” of contract already described. Thus, if a judge were to substitute terms that the parties actually intended to apply with some other set of terms that, in the judge’s assessment, they *ought* to have intended, such a judge could no longer be said to be interpreting and enforcing the contract. Instead, it would be *inventing* a contract.¹⁰¹ I will return to this point—particularly the relationship between the source of a contract’s obligation and the nature of its interpretation—below,¹⁰² but for now it is enough to understand that the implied covenant cannot be an excuse to replace the actual contract with a counterfactual one.

One point of clarification is in order. The argument that contracts form through

97. U.C.C. § 1-304 cmt. 1 (AM. LAW INST. & UNIF. LAW COMM’N 2003).

98. See Markovits, *supra* note 67, at 289.

99. *Id.* at 288.

100. That they would not do so does not prevent us from considering the counterfactual in which they do.

101. In one sense, this critique is an extension of a criticism made of the theory of efficient breach. Although some schools of thought are comfortable inferring the existence of contractual *terms* on the basis of efficiency, no one will accept inferring the existence of the contract itself because such a contract would be efficient. As Professors Markovits and Schwartz put it, “There are no analogous doctrines of efficient conversion or efficient theft.” Daniel Markovits & Alan Schwartz, *The Myth of Efficient Breach: New Defenses of the Expectation Interest*, 97 VA. L. REV. 1939, 1945 (2011). This is a “theoretical lacuna” that cannot be papered over. *Id.* That does not mean that a theory that seeks to imply terms based on efficiency cannot be justified, but rather any account that seeks to do so must grapple with the fact that contracts generate their normative legitimacy through agreement. The framework that I offer here provides such a means of accommodating efficiency concerns within a normatively coherent approach.

102. See *infra* Part III.

agreement and not optimality does not sound directly in the register of classic “law and economics.” Instead, the argument—and this Article, more generally—sounds in the literature that looks more deeply at the philosophical conceptions underlying the current doctrine.¹⁰³ With such a cross-paradigm criticism, there comes the risk of disconnect, as each side offers arguments that do not respond to the other. Certainly, there have been instances of disconnect in the recent contract theory literature, particularly between those whose conceptual commitments lie with the law-and-economics school and those for whom a philosophical tradition is primary.¹⁰⁴ Given that Judge Posner is himself not one to place much credence in the language of philosophy,¹⁰⁵ it is reasonable to ask what purchase the criticism leveled here has.

The primary response is that this criticism is pivotal towards the development of the normatively coherent conception of the implied covenant offered in Part III, that is, a construction of contractual good faith that is consistent with the core principles underlying contract law doctrine. Contracts are legal mechanisms whose function are backed up by the state and its threat of coercion. In our liberal society, the legitimacy of the coercive power depends on justification. The deformation of contract law through ill-considered doctrinal developments undermines those justifications and, as a result, undercuts the legitimacy of the judicial enforcement of that law. Here, the primary justification offered in favor of the “Posnerian” implied covenant is that it forwards efficiency goals. Setting aside the question of whether it truly does serve that end (and my view is that it does not),¹⁰⁶ efficiency alone cannot justify the adoption of a legal construct that runs roughshod over the core notions underlying contracts.¹⁰⁷ At the very least, the demand for theoretical consistency places boundaries on the development of the law.

Numerous jurisdictions, including Delaware, have embraced the notion of the

103. See, e.g., Robin Bradley Kar & Margaret Jane Radin, *Pseudo-Contract & Shared Meaning Analysis*, 132 HARV. L. REV. 1135 (2019) (offering a theory of contract interpretation derived from the work of language philosopher Paul Grice). That is not at all to say that this more philosophical tradition is new—far from it. See IMMANUEL KANT, *METAPHYSICS OF MORALS* 37 (Mary Gregor ed. & trans., 1996) (1797).

104. Compare, e.g., Margaret Jane Radin, *Of Priors and of Disconnects*, 127 HARV. L. REV. F. 259, 260 (2014) (“In short, I think Boardman’s priors have led her not only to misinterpret the major thrust of [my book] but also to misunderstand many of its details. . . . I suggest that these priors, which are common in contemporary American legal thought, distort and obscure central issues relating to contract theory and practice.”), with Michelle E. Boardman, *Consent and Sensibility*, 127 HARV. L. REV. 1967 (2014) (reviewing MARGARET JANE RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW* (2013)).

105. See Richard A. Posner, *Law and Economics Is Moral*, 24 VAL. U. L. REV. 163, 166 (1990) (“I do not derive my economic libertarian views from a foundational moral philosophy such as the philosophy of Kant, or Locke’s philosophy of natural rights, or utilitarianism, or anything of that sort. I regard moral philosophy as a weak field, a field in disarray, a field in which consensus is impossible to achieve in our society.”).

106. In an unpublished manuscript, I demonstrate that the counterfactual approach is inconsistent with the goal of maximizing the joint surplus of the contractual bargain.

107. See Kar & Radin, *supra* note 103, at 1160-62.

implied covenant of good faith as the enforcement of the counterfactual contract.¹⁰⁸ In doing so, they have adopted a notion of the implied covenant that is inconsistent with the basic principles of contract law and threatens the bargains reached by contract parties. Especially given the importance placed by Chief Justice Strine of the Delaware Supreme Court on ensuring that the doctrine is conceptually coherent on a theoretical level, the problems raised here with the current reliance on hypothetical contracts ought to elicit concern.¹⁰⁹ Indeed, an examination of *Gerber*—the seminal case in Delaware’s case law on the implied covenant of good faith as it applies to alternative entities, such as LPs, LLCs, and LLPs—displays the inconsistencies of this approach perhaps even more clearly than *Frey*.

To greatly simplify, the facts of *Gerber* were as follows: a limited partnership (LP) agreement authorized the general partner complete discretion to restructure the company (through mergers, sell-offs, etc.), so long as the general partner obtained a “fairness agreement” from a competent expert stating that the restructuring is fair to the limited partners.¹¹⁰ The general partner engaged in a number of transactions that would be considered conflicted under fiduciary law, including, most relevantly, the merger of the LP into a larger company—a deal that resulted in the limited partners receiving units of the larger company in exchange for their units of the original LP.

In apparent satisfaction with the terms of the LP agreement, the general partner obtained the required fairness opinion, which concluded that the merger offered a fair price. However, the limited partners alleged that the fairness opinion failed to consider the value of certain derivative claims held by the limited partners arising from earlier transactions carried out by the general partner that would be eliminated were the merger to be carried out, as it was. Because the price did not reflect the value of the claims, the limited partners alleged that they received less than fair value for their units. Further, they argued that the general partner intentionally engaged in this merger to eliminate their claims and obtained the inadequate fairness opinion expressly for this purpose. These actions, they alleged, violated the implied covenant of good faith.¹¹¹

Although the Chancery Court dismissed the claim, the Supreme Court reversed. After explaining that the implied covenant required enforcing “those terms that the parties would have agreed to during their original negotiations if they had thought to address them,”¹¹² the Court stated that the general partner had violated such a counterfactual term. While the limited partnership agreement “does not prescribe specific standards for fairness opinions, we may confidently conclude that, had the parties addressed the issue at the time of contracting, they would have agreed that any

108. See *Gerber v. Enter. Prod. Holdings, LLC*, 67 A.3d 400 (Del. 2013); see also JONATHAN R. MACEY ET AL., *THE LAW OF BUSINESS ORGANIZATIONS* 979-83 (13th ed. 2017) (discussing *Gerber* and the implied covenant of good faith).

109. See Jonathan R. Macey & Leo E. Strine, *Citizens United as Bad Corporate Law* 4 (Dec. 17, 2018) (unpublished manuscript) (discussing the importance of having a theoretically consistent conception of the corporation across areas of the law).

110. *Gerber*, 67 A.3d at 406-8.

111. *Id.* at 409.

112. *Id.* at 418.

fairness opinion must address whether the consideration received [for the derivative claims in question] was fair."¹¹³ Thus, the general partner violated the implied covenant by failing to obtain an expert opinion that met the specifications delineated *ex post* by the Court.

The Court also explained that relying on such a fairness opinion was "arbitrary and unreasonable conduct that the implied covenant prohibits,"¹¹⁴ but herein lies the problem. The fact that the parties would have contracted to require the counterfactual term does not in and of itself imply that the general partner was unreasonable for relying on the fairness opinion that was obtained. It is at least conceivable that the general partner may have a reason compatible with the underlying partnership agreement for carrying out the transaction without the expert opinion addressing consideration for those derivative claims.

Consider the fact that the LP agreement broadly waived fiduciary duties and provided only slim bases upon which the limited partners could assert a derivative claim. Plausibly, this reflects an intention to avoid generating potentially troublesome derivative suits that drain value from the company. If that is a goal of the LP agreement, then one could argue that it would be consistent with the structure of the agreement to allow the general partner to take actions to extinguish potential derivative claims through merger transactions except in those cases in which there is specific language restricting that discretion. This would be akin to the broad discretion given to corporate directors to block derivative claims asserted by shareholders. In other words, the lack of specificity in the LP agreement about the need for a fairness opinion to address derivative claims might be viewed as an added level of protection, on top of the waiver of fiduciary duties, against suits by unitholders. Thus, the general partner might have legitimately interpreted the agreement's failure to address such derivative claims as intending to provide it with the flexibility to structure the company's affairs

Without further details, we cannot know whether such an inference by the general partner would be reasonable given the particularities of the contract, but its very possibility reveals the inadequacy of the Court's statement that the failure to adhere to the counterfactual contract implies unreasonableness. I grant that there is something intuitively plausible about the sort of reasoning in which the Court engages; further, I acknowledge the limitations of the alternative theory of the case in which the general partner extinguished the derivative claims in good faith. But, nonetheless, a key step is missing from the court's decision. In the following two Parts, I articulate what that step is.

Failure to adhere to the counterfactual contract cannot, on its own, establish that a party to a contract is unreasonable; nor can the courts serve the delegatory function Judge Posner sought by enforcing hypothetical terms.¹¹⁵ But that does not mean that both the Delaware courts and Judge Posner are wholly misguided in their accounts of

113. *Id.* at 421.

114. *Id.* at 420.

115. See Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1582-83 (2005).

the implied covenant of good faith. In the following Parts, I articulate an account of the implied covenant that centers around an intuition underlying the decisions in *Frey* and *Gerber*: the idea that counterfactual reasoning can serve as a threshold test for the invocation of good faith.

III. Constructing the Three-Step Framework

Although good faith cannot demand adherence to a counterfactual contract, counterfactual reasoning can be utilized to determine when good faith is at play. In this Part, I offer a three-step model for contract interpretation that organizes the relevant doctrine and offers normative coherency to an unruly area of law. In this model, the counterfactual contract is used as a threshold test, guiding the decision maker as to when a dispute ought to be resolved through the invocation of good faith and when the dispute simply falls outside of the contract. Section A introduces the three-step approach and its underlying justificatory model. Section B outlines Step Two of the approach, the application of the counterfactual threshold test, explaining how it would be applied by discussing an example from Delaware case law and arguing for why the test is normatively superior to Posnerian counterfactual approach currently utilized by the Delaware courts. Finally, Section C provides the crucial bridge to Part III by explaining what it is that the three-step framework demands of Step Three.

A. Contract as Center and Periphery

When parties enter into a contract, they have generally agreed on what the contract requires in a host of contemplated contingencies. As a result, the contract will reflect a body of what are often referred to as “specific intentions.” The terms of the agreement are drafted to communicate these intentions, and it is the role of the ordinary methods of contract interpretation to uncover what these specific intentions are. The precise methods vary by jurisdiction, but generally encapsulate three broad methods of extracting meaning from the contractual agreement.

First, and most basic, is the text itself (the classic “four corners” rule of the common law).¹¹⁶ Second is extrinsic evidence, suggesting terms that the parties understood to have been agreed to, even if not reflected in the text. This involves evidence of both promises exchanged during negotiation—considered through the parol evidence rule¹¹⁷—and things like trade custom, that is, shared understandings of how the contract would be enforced, based on the environment within which it is negotiated.¹¹⁸ Finally, the third method by which the terms of a contract are

116. *Krauss v. Utah State Dep’t of Transp.*, 852 P.2d 1014 (Utah App. 1993) (“Courts first look to the four corners of the agreement to determine the intentions of the parties.”).

117. *See Masterson v. Sine*, 436 P.2d 561, 563 (1968) (“The requirement that the writing must appear incomplete on its face has been repudiated in many cases where parol evidence was admitted ‘to prove the existence of a separate oral agreement as to any matter on which the document is silent and which is not inconsistent with its terms’—even though the instrument appeared to state a complete agreement.”).

118. *See, e.g.*, UCC § 2-309 cmt. 1 (stating that the commercial standards can be looked at for

determined is default rules, substantive presumption regarding how the contract is to be enforced that are assumed to be intended by the parties absent evidence to the contrary.¹¹⁹ These default rules can be either court-made or legislated.¹²⁰ Utilizing tools drawn from each of these three “buckets,” courts construct the meaning of the contract, determining what are the terms to which the parties agree. This is the first step of any contract case. As such, extracting the specific intentions of the parties through the ordinary means of statutory interpretation constitutes Step One of this Article’s framework.

But the agreed upon terms, extracted in Step One, do not exhaust the relevance of the contract. As reflected in the discussion of the implied covenant in Part I, courts generally assume that the contract generates obligations even in unanticipated scenarios—those sets of facts that the specific intentions do not reach. If that were not the case, then the *Gerber* Court, for example, would have had no reason to ask what terms “the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting.”¹²¹ Even where the parties had “unsettled intentions,” obligations lie. This, I explain, is the sphere of the implied covenant of good faith.

To understand good faith, then, is to know that a contract is not one thing, but two. Its center is generated by specific intentions, uncovered through interpretation as it is normally conceived, including both textualist and contextualist methods (e.g., analyzing words, their standard usages, etc.).¹²² Around that center is a periphery where specific intention runs dry but contractual obligation remains—a protective border unavoidably formed, as elaborated in the Part III, because of the sort of thing a contract is. That is the realm of good faith. *Figure 1* illustrates this structure. Part III describes what it means to resolve disputes that falls within the realm of the implied covenant.

“criteria as to reasonable time,” and that an agreement to a “definite time” may be implied by “usage of trade”).

119. For an overview of the role of default rules, see Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule of Project*, 102 VA. L. REV. 1523 (2016). Generally speaking, default rules provide the terms that the parties are presumed to have intended unless the contract provides otherwise. In that sense, they are very similar to substantive canons in the statutory interpretation context. See Daniel B. Listwa & Charles Seidell, Note, *Penalties in Equity: Disgorgement After Kokesh v. SEC*, 35 YALE J. ON REG., 667, 688 n.151 (2018) (comparing “clear statement rules” for statutes to default rules in contracts); see also Daniel B. Listwa, Comment, *Uncovering the Codifier’s Canon: How Codification Informs Interpretation*, 127 YALE L.J. 464, 471 (2017) (describing the relationship between the statutory interpretation canons and the common law of contracts).
120. See Schwartz & Scott, *supra* note 119, at 1546-551 (discussing different sources of default rules).
121. *Gerber v. Enter. Prod. Holdings, LLC*, 67 A.3d 400, 418 (Del. 2013), *overruled on other grounds by Winshall v. Viacom Int’l, Inc.*, 76 A.3d 808 (Del. 2013).
122. I include consideration of default rules within “contextualist methods” because such rules form the background against which parties contract.

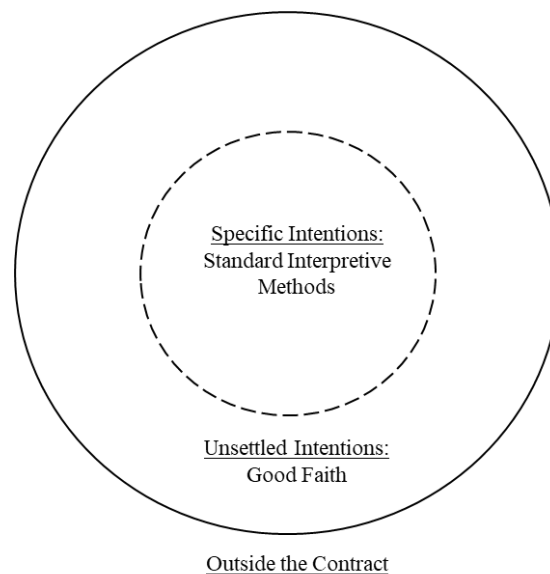


Figure 1: Contract as Center and Periphery

But before a court can turn to the implied covenant, it must first be able to determine whether the dispute is one for which the contract generates any relevant obligations at all. In other words, after a court determines—through Step One—that the dispute arises from a scenario unanticipated by the parties at the time of negotiation, it must decide whether it falls within the realm of unsettled intentions or outside the contract all together. This determination is Step Two—and, as explained in the next Section, it is defined by the application of a counterfactual threshold test. In other words, from this concept of contract as center and periphery, a useful framework for resolving contract disputes can be constructed. I outline here each of its three steps, with the remainder of the Article explaining and justifying the two that are novel, Steps Two and Three. The three-step framework is illustrated in *Figure 2*.

As just described, in Step One the court utilizes traditional methods of contract interpretation to discern the meaning of the text. These methods can be quite diverse. Beyond doctrines like the parol evidence rule, default rules—including those that add substance to the contract—also fall into this category. If, utilizing those methods, one determines that the text provides for a resolution to the dispute—e.g., the contract says that party *x* must do *y*, and *x* did not do *y*—then one’s inquiry is complete. If, however, the contract, as interpreted, does not provide for the particular contingency at issue—*x* did *y*, but the contract says nothing about whether *y* is allowed or not—then there are two possibilities, representing two categories the action at issue could fall into.

- (1) The disputed action is simply outside of the scope of the contract. For example, whether a construction worker has chicken or steak for dinner is an issue entirely uncontrolled by the terms of her employment contract. If this is the case, the action is not controlled by the contract and no liability for a contract

violation can be placed on the defendant.

- (2) The action remains controlled by the contract, even though there is a gap. For example, in *Frey*, although the contract did not specify whether the lessee had to invoke paragraph thirty-four in the financing request, the contract was still understood as regulating the behavior.¹²³ In this second possibility—where there is a gap, but the contract still controls—good faith is applied to determine what is allowed and what is not.

Step Two determines which of these two categories applies. If upon asking the counterfactual of whether the parties would have altered the contract to address the question at issue had they been aware of it, the answer is *no*, then the dispute falls into category 1 and no further inquiry is required. If, however, the answer is *yes*, the dispute falls into category 2 and the interpreter must progress to Step Three: the application of good faith. In the remainder of this Part, I explain the justification for Step Two, the counterfactual threshold test, and then begin laying the groundwork for a theory of what the application of Step Three should look like.

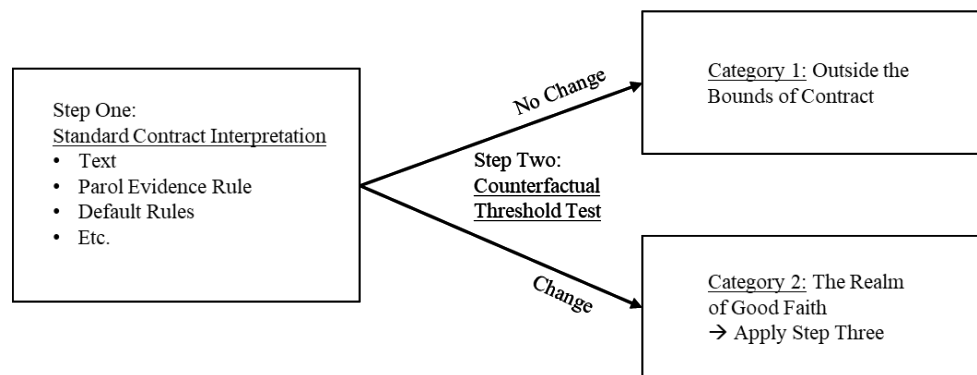


Figure 2: Three Step Model of Contract Interpretation

B. The Counterfactual Threshold Test

Stated most simply, the counterfactual threshold test directs the judge to ask the following: if the parties had known that the defendant *might* do action *x*, would they have modified the contract to address explicitly that possibility. If the answer is “yes,” then there is an unintentional gap in the contract and good faith governs. If the answer is “no,” then the action is uncontrolled by the contract and no liability can be placed upon the defendant. To understand why, consider, once again, the facts of *Frey*.

If we assume that the requirement of directly referencing paragraph thirty-four would truly be as cost efficient as it appears (and that the parties are efficiency maximizing), then the fact that it was not included explicitly in the contract provides evidence that the parties had failed to contemplate that this sort of situation could arise. The counterfactual exercise reveals to the judge that she or he cannot simply seek

123. See *supra* Section I.D.a.

out some particular intention, articulated or not, within the original “meeting of the minds” that would mechanically dictate how this case should come out. Thus, asking what the parties would have done had they thought about this circumstance serves to inform the judges of the necessity of importing into her reasoning sets of norms or interpretive methods that differ from those utilized to “discover” the actual intentions of the parties.

In practice, this would mean recognizing that the apparent grant of discretionary action afforded by the contract’s failure to assert limits on whether the disputed behavior is in breach of contract is only illusory, inviting the judge to set limits—a task that could be labeled the imposition of the implied covenant of good faith.¹²⁴ The counterfactual consideration Judge Posner and the Delaware courts invite thus serves as a threshold analysis for the application of the good faith doctrine.

In contrast, consider a circumstance in which the parties, when counterfactually alerted to the possibility of the action in dispute, elect not to alter the contract. In this circumstance, the grant of discretion should be understood as intentional and thus no further contractual limitations should be implied. This is because, if the parties, when hypothetically made aware of the unanticipated situation, do not view it to be necessary to alter the contract, it is reasonable to assume that they trust the court’s standard interpretive tools to reach the intended decision.¹²⁵ Therefore, if the court, when applying the first step in this framework—that is, interpreting the contract using standard interpretive methods—determines that the contract does not provide for the particular contingencies, the court can conclude that the parties intended for the contract not to apply. The counterfactual analysis, thus, picks out precisely those cases that cannot properly be reached by these “conventional” interpretive methods.

Identifying the counterfactual threshold test as the appropriate means of determining whether the implied covenant applies does not itself fully describe how it is to be applied. In order to decide what would occur in a counterfactual situation, one must construct a model of the world as it is. To apply the test, one then modifies that model by introducing the counterfactual (here, contemplation of the facts underlying the current dispute) and then “runs” the model and observes the result. One obvious implication is that the observed result may well be contingent on the method by which the underlying model of the world is constructed. Thus, if two judges make different assumptions about the facts of the world, they could come out differently.

This is not particularly problematic for the framework offered here—as its purpose is not to dictate results, but rather to provide a structure through which courts can reason about the implied covenant in an analytically coherent way. Further, disagreement about hypotheticals as a result of differing priors is familiar to both judges and lawyers, as it is embedded in our legal culture’s reliance on “hypos” as a

124. How those limits would be defined would then be a question regarding the content of the implied covenant of good faith. I address this *infra* Part III.

125. From this idea we can derive some notion of the change in the contract that is relevant to the counterfactual test. For a change to be meaningful, it must suggest that the parties thought that the contract, absent the change, would have dictated an undesirable effect.

mode of practical reasoning.¹²⁶ But understanding this potential disagreement is important for judges as they make choices about the methods by which they construct the underlying models: by choosing different assumptions about the world, they can expand or contract the number of cases that fall within the sphere of the implied covenant of good faith.

An example from a recent Delaware case illustrates this dynamic. In *Aspen Advisors LLC v. United Artists Theatre Co.*,¹²⁷ creditors of an insolvent film distribution company, United Artists, accepted warrants entitling them to purchase seven percent of the company's stock at a relatively low price.¹²⁸ The express terms of the warrant provided that if the corporation merged prior to their exercise of the warrants, the creditors would be entitled to the value of the property to which they would have been entitled had they exercised their warrants immediately beforehand. The defendant, the controlling shareholder, independently acquired interests in a number of other theater companies and consolidated these holdings into Regal Entertainment Group, a single distribution giant that was viewed as having strong prospects.¹²⁹ To add United Artists to Regal Entertainment, the defendant effected a short form merger. This involved the defendant, along with a few others, executing an agreement (the "Exchange Agreement"), through which they traded stocks and warrants for equity in Regal Entertainment.

The plaintiffs were not parties to the Exchange Agreement, and, as a result their warrants were exchanged for a value that, they alleged, was significantly less than the value of the equity in Regal Entertainment that the defendant received in exchange for his share of United Artists.¹³⁰ Based on this, they claimed that their exclusion from the Exchange Agreement constituted a violation of the implied covenant of good faith.

In making their claim, the plaintiffs argued that if they had contemplated the prospect of the Exchange Agreement, they would have negotiated for a right to participate. To support this claim, they made a statement about the underlying understanding they alleged to have had when they reached the agreement with the defendant providing them with the warrants. Specifically, they said that "they and other subordinated creditors took comfort in the fact that the Warrants they received were identical to those received by the [United Artists] Holders, thereby guaranteeing that the plaintiffs' Warrants would receive the same protection as [the defendant] had secured for himself."¹³¹ Although they acknowledged that they had not explicitly negotiated for such identical "protections," they expected that the contract agreed to would have this effect. As such, if they were made aware of the possibility of something like the Exchange Agreement, their sense of "comfort" would have been undercut and they would not have entered the contract as is.

126. See Natalie Stoljar, *Vagueness, Counterfactual Intentions, and Legal Interpretation*, 7 LEGAL THEORY 447, 447-465 (2001).

127. 843 A.2d 697 (Del. 2014).

128. *Id.* at 700.

129. *Id.* at 702.

130. *Id.* at 704.

131. 843 A.2d at 700.

The Chancery Court disagreed, interpreting the contract as evincing a deliberate distribution of “contractual freedom” between the parties.¹³² Then-Vice Chancellor Strine explained that he understood the contract as intentionally granting “the plaintiffs certain rights in the event of particular transactions (such as mergers and, if they had exercised their warrants, certain changes of control),” while denying them rights with regard to transactions that fall out of those defined classes.¹³³ Given this understanding of the contract, he disagreed that the parties would have negotiated differently had they contemplated the particular scenario that arose, characterizing the plaintiffs as attempting to obtain, “by judicial fiat, contractual protections that they failed to secure for themselves at the bargaining table.”¹³⁴

Underlying Vice Chancellor Strine’s analysis is a rejection of the plaintiffs’ depictions of themselves as naively taking comfort in the superficial similarities of the formal protections the contract granted to both them and the defendant, the controlling shareholder. As sophisticated parties, they must have known the rights provided in the warrants would not prevent a controlling shareholder from obtaining for himself a superior payoff in at least some contingencies—and, as such, that risk must have been already accounted for in the terms of the contract.¹³⁵

In discussing a different case, Professor Bainbridge has objected that this mode of interpretation essentially amounts to assuming that any given gap in a contract is because the parties “decided to leave the contract silent.”¹³⁶ If this is the case, then no implied covenant claim can succeed, because the court will assume in every case that the relevant contingency was already considered by the parties and thus that the counterfactual threshold test would yield no change in the contract. I contend, however, that this is too uncharitable an interpretation of the type of reasoning underlying opinions like *Aspen Advisors LLC*. Whether an opinion is explicit on the matter or not, the judge is assessing the parties, including their relative sophistication, in order to make a determination of whether the dispute before the court is truly of the sort that, if considered, would have led to a change in the contract. This involves looking both at the parties themselves and the nature of the contract, such as how detailed it is.¹³⁷

132. *Id.* at 707.

133. *Id.*

134. *Id.*

135. Recall that the purpose of the counterfactual test is to identify gaps resulting from a party’s failure to contemplate a particular contingency, not to correct for one party’s bad gamble. *See supra* note 95.

136. Stephen Bainbridge, *What’s the Point of the Implied Covenant of Good Faith? Other than Generating Fees for Lawyers?*, PROFESSORBAINBRIDGE.COM (Mar. 31, 2015), <http://www.professorbainbridge.com/professorbainbridgecom/2015/03/whas-the-point-of-the-implied-covenant-of-good-faith.html> (arguing that Delaware’s test for the implied covenant “makes no . . . sense” and suggesting that, because courts assume silence is intentional, the doctrine is nothing more than “a judicially created tax on transactions for the benefit of lawyers”).

137. *See* *Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC*, 112 A.3d 878, 897 (Del. 2015), *as revised* (Mar. 27, 2015) (“When a court implies a term in a contract, much less one as detailed as the Purchase Agreement, it must be very careful.”).

That said, it is not the case that the Delaware courts, when presented with a breach of implied covenant claim, construct their model of the parties based only on the facts before them. Rather, they start with a strong presumption that silence on a matter is intentional and thus the hypothetical bargain would not differ from the present contract. As one federal court observed, the Delaware courts only seem to find that counterfactual test would generate a different contract “when the contract is truly silent with respect to the matter at hand, and when the expectations of the parties were so fundamental it is clear that they did not feel it was necessary to negotiate them.”¹³⁸ Underlying this presumption is a policy decision that the implied covenant should only be applied “rarely, and only in narrow circumstances.”¹³⁹ The Delaware Supreme Court has said that its invocation should “turn[] on issues of compelling fairness.”¹⁴⁰

It is sensible to restrict the cases where a breach of the implied covenant is found to those that involve particularly egregious facts. This limited approach might be justified, for example, by a judgment that false negatives in determining that a breach has occurred are, on the whole, less damaging to economic efficiency than false positives, because false negatives make litigation less attractive to plaintiff and encourage more specific contract drafting. Through such reasoning, one might be able to square the Delaware courts’ commitment to a view of the implied covenant as a “cautious enterprise”¹⁴¹ with Judge Posner’s underlying idea that courts should calibrate the availability of the doctrine in order to encourage efficient contract drafting.

The problem is that, however justifiable the end goal of restricting successful claims of breach of the implied covenant is, the Delaware courts’ current analytical structure obscures the courts’ actual reasoning. By erecting a strong presumption that the parties intended for the contract to be silent and then adjusting the presumptions strengths based on concerns, such as fairness, the court is hiding the fact that it is not merely engaging in the counterfactual analysis that it claims that it is doing. Rather, it is deploying more nuanced and sophisticated analysis—all of which, however, is unseen in the final opinions. The reason the Delaware courts do this is quite simple. The “Posnerian” counterfactual test, which identifies a breach of the implied covenant in *every case* in which the hypothetical bargain would differ from the actual contract, locates breaches in far too many cases.

Here, then, we see one of the important advantages of the three-step framework offered in this Article. In this framework, finding a difference between the counterfactual bargain and the actually negotiated contract does not imply that there has been a breach of the implied covenant; instead, it merely identifies the dispute as a *candidate* for finding such a breach. One must then proceed to the third step in order to assess whether such a breach is in fact present. As will be outlined in Part III, Step

138. Langley v. Chase Bank USA, N.A., No. 3:10-CV-587-O, 2010 WL 8266202, at *2 (N.D. Tex. Aug. 18, 2010) *aff’d sub nom.* Langley v. Chase Bank USA NA, 430 F. App’x 312 (5th Cir. 2011).

139. Allied Capital Corp. v. GC-Sun Hldgs., L.P., 910 A.2d 1020, 1032 (Del. Ch.2006).

140. Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co., 708 A.2d 989, 992 (Del.1998).

141. Nemec v. Shrader, 991 A.2d 1120, 1125 (Del. 2010).

Three involves the sort of analysis that—I argue—Delaware courts are often already doing *sub rosa*. The three-step approach puts this analysis in a coherent framework, allowing for the rational development of the case law.

In the remainder of this Part, I consider in greater depth the theoretical relationship between each of the three steps. In doing so, I provide greater clarity regarding what it is that the third step must do. Then, in Part III, I build on this account to articulate the content of the third step, that is, my affirmative account of what the implied covenant of good faith and fair dealing demands.

C. Gaps, Intentions, and Interpretation

Consider how this threshold test helps resolve the delegation problem identified in relation to the *Chevron* framework—that is, the problem caused by the fact that the *Chevron* analogy cannot be maintained.¹⁴² Recall that where unsettled intentions exist, the contract is ambiguous with regard to the proper resolution of the dispute. The court is thus thrust in the position of determining liability even though the parties had not settled the question. Further, unlike in the statutory context, the court cannot simply defer to one of the parties as the one delegated to fill any gaps that may arise. In this context, the counterfactual threshold test provides a significant benefit, by extricating the court from at least one set of these types of problem.

Specifically, if the court—utilizing its standard interpretive method—determines that there is no specific intention to be found in the contract and the threshold test reveals that the parties would not alter the contract, the delegation problem is solved—no liability is imposed. The counterfactual threshold test, thus, helps resolve some aspects of the delegation problem, but not all of them. Where the parties *would* change the contract, some further decision tool is required.

Contemplating the counterfactual threshold just described, we could question whether all the cases that would trigger hypothetical reconsideration are really best understood as the result of “unsettled intentions.” Returning to *Frey*, we might think that both parties did, in fact, have a relevant settled understanding that neither would engage, say, dishonestly. The question then becomes the more generically interpretive question of whether the particular behavior at issue (failing to reference paragraph thirty-four) falls within a broader category (dishonesty). Determining whether the lessee’s behavior is a particular instance of dishonesty within the parties’ understanding is made problematic by the admission that—as the counterfactual reasoning suggests—they likely had not anticipated this situation arising. This reflects the fact that instances of incompleteness in contract can never unambiguously be categorized as one type or another. In *Frey*, then, we can understand the situation as one where the agreement provides some guiding norms, that is, that the parties will deal honestly with each other, but fails to settle this particular dispute. The judge’s role is then to assess whether this gap was adequately bridged—did the parties properly extend the vague, unparticularized principles that were agreed upon to their actual behavior?

Taking seriously the idea that freedom of contract requires enforcing the actual

142. See *supra* note 50-55 and accompanying text.

agreement reached by the parties and not inserting or substituting outside norms, it is not readily apparent how a judge is to assess whether this gap has been bridged. While she may have her own notions of what appropriate behavior is, it is not necessarily the case that this captures the intentions of the parties. One way we might read Judge Posner's characterization of good faith in terms of counterfactual reasoning is as an attempt to enlist the parties themselves in resolving this gap. Faced with a situation that the parties failed to anticipate, the judge may ask how, if they had thought about it at the time of contracting, they would have wanted it resolved. This is what I described earlier as an attempt to avoid the delegation problem by having both parties work together—counterfactually—to resolve the dispute.¹⁴³

In the good faith context, this counterfactual must be distinct from asking what the contract would have looked like if the parties had contemplated such an outcome. Rather, the counterfactual must refer to a world in which the parties are both locked into those terms actually agreed upon in the contract but also somehow abstracted enough from their positions so as to enable agreement. This latter restriction is crucial. If each party were given the opportunity to sit as its own judge, the natural thought is that no consensus could be formed—each party would simply rule in the way that most favors its own position. Without agreement, even of the counterfactual kind, there would be no motivation for choosing one resolution over the other.

The problem for Judge Posner and the Delaware courts is then to construct a counterfactual world that abstracts from the particularities of the parties to allow agreement, but does so without eliminating all resemblance to the actual parties—for if the resolution is to have any claim to normative bite, there must still be some sense in which this counterfactual agreement can be justifiably thought to emerge from the parties themselves. Having constructed this abstracted character, the role of the judge would be to inhabit the hypothetical perspective, situating herself in space that is both “in the shoes of the parties” and apart from either's particular perspective. In fact, we might consider this synthetically constructed point of view to be the very “shared perspective of the contract” which Markovits sought.

That conclusion would be premature, as this approach cannot function without the insertion of norms beyond that of the contract itself. As was explained in Part I, to enforce counterfactual terms of a contract is to impose a contract without normative authority. The only source of authority in a contract is the agreement and in the case of the counterfactual term the fact that it is counterfactual implies that the parties never agreed to it. Thus, any attempt to justify the authority of a counterfactual term would

143. On a conceptual level, this notion of counterfactual reasoning is a common tool for Judge Posner, who advocated a similar account for statutory interpretation, suggesting that judges should imagine themselves in the legislature's place and creatively reconstruct what it would have done had it anticipated the particular circumstances that arose. See Richard A. Posner, *Statutory Interpretation: In the Classroom and in the Courtroom*, 50 U. CHI. L. REV. 800, 817-20 (1983). Judge Posner also, at times, applied this approach from the bench, such as when he argued that the court should construe a drug-related sentencing statute in light of what he took to be evidence that Congress did not know and thus had not thought about the way LSD is actually sold. See *United States v. Marshall*, 908 F.2d 1312, 1333 (7th Cir. 1990) (Posner, J., dissenting), *aff'd sub nom.* *Chapman v. United States*, 500 U.S. 453 (1991).

have to rely upon principles other than agreement, the obligating core of contract. What is needed is a method that “fills gaps,” but does so without looking outside of the nature of the contract. Seeking such a gap filler is futile. Instead, as I will explain, the judge ought to determine whether the parties reasoned in a way that is compatible with the underlying contractual relationship.

While we may accept as good faith’s lodestar the contract formed by the parties’ intentions,¹⁴⁴ the question remains as to how good faith is to aid enforcement in situations the parties’ specific intentions never reached. Recall that those are the cases that at least some jurisdictions consider to be the central concern of the implied covenant of good faith. That is the question that I will next answer—offering an insight into the nature of contracts and contract interpretation in the process. Markovits’s argument does not look to this problem. In his account of good faith, the courts that wish to constrain the invocation of good faith to these particularly difficult cases are confused if they believe good faith can be cabined to the class of cases where specific intentions run short, as good faith is the core of what makes a contract, a contract.¹⁴⁵ Good faith—as the protection of each parties’ “reasonable expectations”—refers to the very relationship that defines what it means for two parties to be in a contract.¹⁴⁶ Thus, as an interpretive tool, the implied covenant directs the court to enforce the contract by blocking opportunistic behavior that would threaten the success of the “mutually dependent, cooperative relationship.”¹⁴⁷ Whether or not there is a gap in the parties’ intentions is beside the point.

This leads Markovits to the idea that good faith “is a practical analog to the principle of charity in interpretation of theoretical communications,” an interpretive norm that “requires placing a favorable gloss on what has been said.”¹⁴⁸ By analogy, good faith demands a mode of interpretation that construes the text so as to support the intentions of the parties—a private analog to purposivism in statutory interpretation. This, recall, is what I referred to as the baseline understanding of good faith when I outlined Judge Posner’s opinion in *Frey*.¹⁴⁹ This understanding of the implied covenant motivates an overall approach to interpretation, but it also means “good faith cannot add much to deciding close cases: although the duty of good faith in performance requires the parties to respect each other’s reasonable contractual expectations, good faith cannot be called on to identify the reasonable expectations in terms of which it is defined.”¹⁵⁰ Therefore, in situations of incompleteness such that the parties failed to form expectations regarding how the contract is to apply in some unanticipated situation, the implied covenant of good faith provides no special method for resolution.

While I agree that good faith can be fruitfully understood as the normative core

144. See Markovits, *supra* note 67, at 286.

145. *Id.* at 292.

146. *Id.*

147. *Id.* at 294.

148. *Id.* at 289-90.

149. See *supra* Section I.0.

150. Markovits, *supra* note 67, at 291.

of contract, I believe the doctrine does offer a unique frame for resolving contractual disputes that is of particular relevance to at least some close cases, specifically, those triggered by the counterfactual analysis I have already discussed. As the following Part explains, good faith demands adherence not to the specific rights negotiated by the parties but to a mode of reasoning dictated by the nature of the contractual relationship. Rather than serving as a substantive gap-filler, good faith generates procedural demands on the reasoning of the parties. In practice, this shifts the court's inquiry from asking whether the party arrived at the correct interpretation of the contractual terms to asking whether the party went about the process of interpreting the contract with the proper intent.

VI. Step Three: Good Faith and Contractual Integrity

Step Three of the framework described in the previous Part involves assessing the allegedly violative action against the implied covenant of good faith. But what does good faith demand? As already argued, it cannot add content of the contract. Further, as the three-step model makes clear, it cannot merely look to the specific intentions that sit at the center of the contract. In this Part, I argue that good faith involves enforcing the obligation generated by the very nature of the contractual relationship. That relationship demands that each party be able to give reasons for their actions, and it is in assessing those reasons that the courts enforce the implied covenant of good faith. This account of the implied covenant, though conceptually novel, resonates with Delaware's current doctrine and offers a path towards bringing coherence to an important yet unruly area of law.

A. "Making Sense" of Text: Interpretation of Contracts

Central to the question of what good faith demands is the question of what is means—in Judge Posner's words—to "make sense of the contract."¹⁵¹ As Ronald Dworkin explicated, to "make sense" of an object of interpretation is to impose "purpose on an object or practice in order to make of it the best possible example of the form or genre to which it is taken to belong."¹⁵² Thus, interpretation requires a notion of purpose. For a rule of law, the purpose is, at least in part, to generate obligation through its political authority. Thus, an interpretation makes sense of a law if it constructs it so as to be consistent with that which gives it political authority. A construction that is consistent with the law's source of normativity can be said to reinforce its "integrity."¹⁵³ Dworkin defined integrity of public law in terms of being produced in accordance with a set of substantive principles. This gives rise to an interpretive norm of integrity that seeks to construe statutes so as to cohere with those principles.

Like public law, contracts are normative objects. As such they too must be interpreted in such a way as to reinforce their "integrity." To do so, we must first

151. *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 596 (7th Cir. 1991).

152. *Id.* at 54.

153. RONALD DWORIN, *LAW'S EMPIRE*, 338 (1986).

understand that which gives rise to the contract's normativity. In this Section, I offer an account of "contractual integrity," building out a theory that will ultimately enable me to explain how to apply good faith in contract interpretation. Put another way, these Sections describe what a contract *is* in a normatively thick way. Like how one can derive a substantive interpretive norm from this conception of what a statute is, in the manner of Dworkin or Henry Hart and Albert Sacks,¹⁵⁴ such an understanding of the nature of contracts provides insight into how to enforce them. The answer I offer is that a contract generates a relationship between the parties that demands that each engage in a process of shared reasoning, which I call accommodative deliberation. The role of the judge then is to enforce this procedural requirement by ensuring that the defendant can provide reasons, compatible with the contractual purpose, for the challenged action.

i. Contract as Coercion

The integrity approach to making sense of a statute requires an understanding of what gives the law its normative force—how is it that the law claims its authority? Analogizing this approach to good faith in contract similarly requires understanding the obligating force of a contract. This is where the Court of Appeals' ambitious declaration in *Kirke La Shelle* is particularly important. One way to conceive of a contract is as merely a tool of coercion, wielded to achieve some end. Consider, for example, eBay's "Money Back Guarantee" system, which, in the case a buyer fails to receive an item or the delivered item is not what was listed, will, after confirming the buyer's claims, refund the buyer the price of the item unless the seller and buyer are able to come to a resolution on their own.¹⁵⁵ As part of this system, PayPal, the payment operator for eBay, will hold in escrow the buyer's funds until delivery is confirmed in order to facilitate the refund.¹⁵⁶

Imagine—although this is not actually the case—that this "Money Back Guarantee" gives the buyer total discretion to press a button transferring her the refund. Obviously, this would give her great power over the seller, since it would enable her to reclaim any payment she made even after she receives the item. Further, imagine there is no way for the seller to dispute the buyer's claim that the item was not delivered as described. The system is far from ideal from the seller's point of view, but that does not mean he will not use it. Instead, he might adopt certain practices, such as refusing to do business with buyers who have a reputation for seeking refunds dishonestly, so as to make the system better serve his needs. This simplified "Money Back Guarantee" facilitates certain trades that might not otherwise occur by creating

154. See William N. Eskridge, Jr. & Philip P. Frickey, *The Making of the Legal Process*, 107 HARV. L. REV. 2031, 2039-41 (1994) (describing how an understanding of the process by which statutes are produced and gain their legitimacy dictates the manner by which they should be interpreted).

155. *Money Back Guarantee*, EBAY, <http://pages.ebay.com/help/policies/moneyback-guarantee.html>.

156. For a discussion of eBay's system as a method of providing remedies to consumers, see Amy J. Schmitz, *Remedy Realities in Business-to-Consumer Contracting*, 58 ARIZ. L. REV. 213 (2006).

new mechanisms for carrying out and policing the exchange. Further, it does not rely on any sort of sophisticated third-party system to serve some interpretive function.

Courts could treat contracts as though judges were the operators of this simplified version of eBay's system. They could merely execute in the most literal fashion whatever the terms of the agreement are, giving little heed to whether the contract was functioning as intended. In fact, such a system might be preferred by some highly sophisticated contracting parties, who could benefit from their ability to efficiently utilize (or manipulate) contracts in their favor. This approach would require some interpretation by the courts, but there would be no deep difficulty in determining what the court should do in contingencies unanticipated by the parties. It could simply adopt some arbitrary default rule, such as leaving losses where they lie. There would be no need for the concept of good faith because there would be no need for *anything* in particular. Contract as tool is normatively inert.

ii. Contract as Reason

The New York Court of Appeals in *Kirke La Shelle* did not accept that contracts are mere tools. There, the court explicitly recognized the implied covenant of good faith as a source of obligations that are both beyond the specifically intended terms of the parties but also wholly internal to the contract itself. The court recognized the contract as generating a relationship of obligation not defined exclusively by the parties' specific intentions. Since contracts only bind to the extent the parties agree to them,¹⁵⁷ the court's invocation of the implied covenant of good faith necessitates conceptualizing the act of contracting as inherently involving a commitment to that relationship. This conceptualization of the contract, made doctrinal through the acceptance of the implied covenant of good faith, I argue, motivates Markovits's explication of contract as a "shared perspective" as well as Judge Posner's description of it as a "cooperative venture." Put another way, the doctrine of good faith defines contracts as objects that invite interpretation as sources of authority; and that authority rests upon the promissory relationship that has come to be associated with contract.

The nature of this relationship is ultimately the seat of good faith. A contract is a promise.¹⁵⁸ Its normative roots lie within the promissory relation. By promising to do ϕ , "the promisor transfers his or her right to act" other than as promised.¹⁵⁹ As a result, the promisor is bound to act, at least with regard to ϕ -ing, not directly from her own reasons, but mediated through those of the promisee.¹⁶⁰ Where that promise involves

157. See *supra* note 96.

158. RESTATEMENT (SECOND) OF CONTRACTS § 1 (AM LAW INST. 1981)

159. Seana Shiffrin, *Promising, Intimate Relationships, and Conventionalism*, 117 PHIL. REV. 481, 517 (2008).

160. Ultimately, her own reasons lie beneath the promisees's in that she has reason to be bound by her promises. It is a distinct question to ask what obligates a person to be bound by her promises. Under my preferred understanding, the explanation lies with the idea that adhesion to certain forms of reasoning are necessary in order for a person to constitute herself as an agent. See CHRISTINE M. KORSGAARD, SELF-CONSTITUTION: AGENCY, IDENTITY, AND INTEGRITY 102 (2009). A closely related understanding of the normative source of promissory obligation finds it in the nature of the relationship formed through

some coordinated activity, this transfer, as Seana Shiffrin explains, involves “a consolidation of the power to determine what the two parties will do, it enables a fully-first personal perspective on joint activity.”¹⁶¹ In other words, as a result of the promise, one only needs to reason from the perspective of the promisee in order to determine that there is reason to perform ϕ . Just from the fact that from the internal reasoning of the promisee there is reason to ϕ , the promisor is obligated to do it. In this way, a promise, at its most basic form, does not bind the promisor to act; rather, it binds her to respect, in a very intimate way, the reasoning of the promisee.

A contract differs from the standard promise in that it generates for the promisee not only a moral authority to demand performance from the promisor, but also a legal right.¹⁶² But it is not all promises that can generate contractual rights. One doctrinal requirement is reciprocity, as reflected in the need for consideration.¹⁶³ Thus, for a contract to be enforceable, it cannot involve the sort of unilateral transfer to the promisee described above. Rather, the parties must engage in a mutual exchange of rights. Each party gains authority over the ends of the other, generating a relationship of mutual respect.¹⁶⁴ Given the reciprocal nature of this exchange, it no longer falls within the authority of either to exercise their reasoning without regard to the authority of the other as mediated by the contract. As a result, the “fully-first personal perspective” that Shiffrin identifies as underlying promise is, in the case of contract, not entirely aligned with the independent reasoning of either, but rather shared between the two, and structured by the terms of the agreement. No one literally occupies this shared perspective; instead, the parties engage with it by acting only from those reasons that are compatible with the bargain reached. The contract binds the parties not only to the terms of the agreements themselves, but also to a procedure of reasoning, specifically one which demands that the parties check their reasons for action against the joint project of the contract.¹⁶⁵

promise, marked by recognition, and the role that relationship has in generating a sense of agency. See Daniel Markovits, Promises Made Pure (unpublished manuscript). These do not necessarily differ and are distinctive largely in whether one takes interpersonal recognition to be necessary for the self-constitution of the agent. For the purposes of this Article’s discussion, these issues can be bracketed.

161. Shiffrin, *supra* note 159, at 516.

162. See Markovits, *supra* note 67.

163. RESTATEMENT (SECOND) OF CONTRACTS § 71 (AM LAW INST. 1981).

164. Markovits characterizes the relationship between contracting parties as akin to Hegelian recognition. See Markovits, *supra* note 67.

165. Such an account of the “shared perspective” as existing primarily through agent’s procedural engagements with certain shared forms of reasoning has also been deployed to explain the nature of legislative “intent.” See Victoria F. Nourse, *Elementary Statutory Interpretation: Rethinking Legislative Intent and History*, 55 B.C. L. REV. 1613 (2014) (drawing from CHRISTIAN LIST & PHILIP PETTIT, GROUP AGENCY: THE POSSIBILITY, DESIGN, AND STATUS OF CORPORATE AGENTS (2011)). For an account that goes in the opposite direction, explaining how the notion of the agent should be understood procedurally in a way analogous to the state, see CHRISTINE M. KORSGAARD, *supra* note 160, at 102 (2009). The approach that I am suggesting here lies between two ends of a spectrum, as I argue for a notion of the “contractual perspective” that is for the contracting parties what the “agential perspective” is for the individual and the “legislative perspective” is for the state or legislature.

A picture of this shared reasoning can be found in Michael Bratman's conception of joint activity.¹⁶⁶ For us to build a house together, our interrelated activities must be structured and organized by an "intentional structure," which helps coordinate "not only our interconnected activities, but also our associated planning, bargaining, and shared deliberation."¹⁶⁷ Building a house requires numerous cooperative activities. I may need to lift one end of a piece of lumber while you lift the other end. In forming the intention to build the house, I do not intend specifically to lift the left side of the lumber; rather I generate that more specific intention as part of an accommodative mode of intention formation as I see you reach for the right end. Bratman explains this phenomenon as follows: "[M]y intention that we [undertake some task] by way of your analogous intention and meshing subplans imposes rational pressure on me, as time goes by, to fill in my subplans in ways that fit with and support yours as you fill in your subplans; and vice versa."¹⁶⁸ The formation of a joint plan necessarily involves an intention to generate more specific subplans in a way that is deferential to the other so far as is necessary for the fulfillment of the shared project.

In other words, by committing to carry out some joint activity without another person, one does not simply agree to accomplish any particular set of actions. One must also agree, implicitly, to engage cooperatively with the other to fulfil the underlying goal. Thus, an agreement to carry out some joint activity involves not only a "meeting of the minds" regarding a number of specific intentions, but also an implicit commitment to maintain what I shall call "cooperative intent," which is the state of mind associated with engaging in the accommodative mode.

Contract creates obligation from what is otherwise demanded by the formation of a joint intention. By forming a contract, one is required to engage in the sort of shared deliberation that Bratman describes—that is, to maintain cooperative intent—regardless of whether one maintains the underlying intention. But the nature of this deliberation is tightly confined, as it must be undergone in such a way as to reflect the formal relationship of recognition that is generated by the contract. This implies that even in pursuit of the joint goal, no party may be required to give up those rights specifically granted as part of the contractual bargain. On the other hand, it also means the parties must be prepared to engage in accommodative deliberation as is necessary to achieve the shared goal. There may be tensions between these two sets of obligations—to adhere to the particular rights granted by the contract and to adapt to achieve the joint goal—and it is in finding the right balance between the two that proper interpretation of the implied covenant lies.

iii. Good Faith as Acting from Reason

From the conclusion that contracts demand adherence to a relationship grounded in cooperative intent, the implied covenant of good faith can be understood as mandating that parties act from reasons compatible with the ends of the contract. This follows from the fact that contracts are wholly private in their formation. Their

166. See Michael E. Bratman, *Dynamic of Sociality*, MIDWEST STUD. PHIL., Sept. 2006, at 1.

167. *Id.* at 2.

168. *Id.*

authority emerges from the relationship of mutual recognition described above. Therefore, the integrity of the contract lies within the maintenance of this relationship. In most cases, that would mean simply enforcing the specific terms intended by the parties; however, where the parties failed to form a specific intention about the matter at hand, one would seem to be left with the bare contractual relationship upon which to base a decision. But while bare, it is not normatively inert. The contractual relationship demands from each party that it only act from reasons compatible with the contract. This expands the set of grounds upon which a judge may rule by empowering her to find contract violations not only where explicit terms have been breached, but also where a party failed to reason as the contractual relationship demands. It is judgments based on this very set of grounds—the reasoning of the parties—that can best be associated with the concept of the implied covenant of good faith.

Substantively, this means that when judging a party's action, the judge ought to ask whether the party acted either in accordance with a particular right granted by the contract, which would provide a legitimate reason in and of itself, or whether the party's action can be justified from the perspective of the shared deliberation necessitated by the contractual obligation. These two sets of reasons can be associated with Step One, the standard interpretive methods, and Step Three, good faith, respectively.

For example, consider the two actors, A and B, building a house, as discussed in the previous subsection. Imagine that they had a contract to work together on this house and, in this contract, among other things, a particular date and time is set to begin building and A is instructed to bring all the necessary materials. Suppose the day arrives and A appears without any of the materials. That would be a facial violation of the contract, identified through the plain meaning of the text and thus resolvable at Step One. But now suppose that B arrives extremely inebriated, impairing his ability to contribute equally to the workload. Does this constitute a violation of the contract? Assume the contract does not say anything about the required degree of sobriety among the parties, as the parties did not even contemplate that being an issue. Without language in the contract, the question of whether this is a violation must proceed past Step One. Further, note that there is surely no reason compatible with the contract's ends that would justify arriving inebriated—so B would be found to have violated good faith if this proceeds to Step Three. Thus, Step Two, the counterfactual threshold test, is critical. Only if the parties would have modified that contract if they had contemplated the question of arriving inebriated would B's action be found to be a violation.

The house building example is a caricature of a contract dispute, but the same principles apply to something more sophisticated. Consider, once again, Judge Posner's opinion in *Frey*.¹⁶⁹ There, the contract did not specify that the lessee had to note paragraph thirty-four when sending the letter. This might lead one to conclude that the contract granted the lessee the right to refrain from mentioning it. But should this grant of discretion truly be understood as having been part of the intended

169. *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 590 (7th Cir. 1991).

structuring of the contractual relationship? If the parties lacked specific intentions on the matter and it is the sort of thing not broadly compatible with the achievement of the contractual joint project, the answer is likely no. The counterfactual mode of reasoning allows one to check the veracity of these assumptions, uncovering the intentions of the parties by testing the durability of the contract once the parties are hypothetically made aware of the previously un contemplated scenario. For the reasons discussed earlier, it is likely that the parties would not have let such a discretionary grant stand if they had been aware of the problem. Thus, the apparent grant of discretion was not due to an exercise of the parties' agency. Rather, it was an incidental and accidental feature. Given that the authority of the contract emerges from the intentional transfer of rights undertaken by the parties in their capacities as agents, such incidental grants ought not be given authority. The question then becomes whether the lessee acted in a way that is compatible with shared deliberation—did it act with cooperative intent?

Judge Posner remanded to the lower court for further proceedings to determine not *how* the lessee acted, but *why* it did—did it fail to mention paragraph thirty-four as an intentional ploy to repurchase the property at a rock-bottom rate or was it merely an unintentional oversight?¹⁷⁰ By clarifying the motivations for the lessee's behavior, one can then determine whether the lessee acted from reasons compatible with the shared deliberation of the contractual relationship—that is, with the proper cooperative intent. While acting with the intention to deceive cannot be justified from the shared perspective, a simple oversight might be, particularly if, from a reconstruction of the underlying contractual relationship, one is able to derive an understanding of the level of risk each party assumed by joining the contract.

Thus, despite having arrived at the decision through what I have shown to be faulty reasoning, Judge Posner clearly grasped what role good faith is to play in the context of a contract dispute. Once the dispute was found to fall within the domain of the implied covenant, whether or not the defendant actually breached the contract turned not only on the meaning of the contract, but also the defendant's intentions. On one level, this is a surprising result, because it turns a question that is generally considered purely one of law—how the court should interpret a gap in the contract—and makes its resolution depend on a factual finding about the defendant's state of mind. However, it is a standard—if poorly understood—part of contract doctrine that good faith demands that the alleged breacher have acted with the proper intentions. Indeed, in his 1980 article, Steve Burton surveyed the cases invoking good faith performance and found that most states adhered to a two-step formula: the first step was an objective inquiry interpreting the contract, while the second step looked toward the subjective intent of the alleged breacher, essentially asking—to generalize to some degree—whether it acted from the right reasons.¹⁷¹ This is an inquiry that closely parallels the framework that has been offered here.

The analysis that I have provided thus fits tightly with the doctrine, while providing it with firmer normative grounding. While others have presented

170. *Id.* at 547.

171. *See* Burton, *supra* note 62, at 391.

justifications for good faith that characterize it as giving enforcement to implied terms for demanding specific kinds of reasons, what I have offered here is unique in that it derives the need for reasoning from the nature of the contractual relationship,¹⁷² rather than the specific intentions of the parties, thus escaping the normative problems that arise in the context of incompleteness.

B. Reasoning Giving and Deference

While the previous Section set out the argument that the implied covenant demands that one maintain cooperative intent, it remains to be seen exactly how a court should enforce this requirement. In this final Section, I argue that courts should do so by extending to parties a presumption of good faith so long as they can offer reasons for their actions that are compatible with the goals of the contract. The adverse party would then be able to rebut that presumption by providing evidence that the proffered reasons are merely pretextual. As will be made clear, the type of inquiry is one with which courts are very familiar, as it is essentially a form of arbitrary and capricious review. After explaining how the content of the implied covenant translates into a decision rule, I outline first in the abstract and then through an example how the three-step framework would be applied by a court.

i. Judging Reasons

At Step Three of the interpretive framework, a court determines whether the defendant's action is violative of the contract by assessing whether the party acted with cooperative intent. To have cooperative intent, a party must intend to act within the accommodative mode of deliberation that the contractual relationship demands. A party satisfying this requirement must be able to rationalize its behavior in a manner that is appropriate within the context of the contractual relationship. The role of the court then becomes to judge whether the proffered reasons are legitimate. In other words, the defendant must offer an account of its reasons for its actions; the court then assesses this account. But in making the assessment, the court must not substitute its own judgment about what the contract should require, since the contractual relationship leaves that in the hands of the parties. Instead, the court must determine whether the defendant's account is properly framed by the terms of the contract.

Central to that analysis is whether the defendant's account considers whatever criteria or standards the court reads the contract as implying. Note that this brings two different forms of substantive reasoning into the third step of the implied covenant framework. First, a form of substantive assessment is required to determine that the reasons are actually responsive to the concerns that they assert themselves to be. This is a key determination that can be done with varying degrees of deference. Second, there is the question of ascertaining the ends, criteria, standards, etc. of the contract to which the reasons must respond.

This second substantive determination captures a notion that is already under the surface of Delaware's doctrine addressing the implied covenant, namely the idea of

172. See, e.g., Burton, *supra* note 26, at 218.

judging the defendant against the “spirit” of the contract. As I explained earlier, the underlying contractual relationship requires a mode of accommodative deliberation that is consistent with what amounts to a purposive understanding of the contract.¹⁷³ Thus, reasoning about the obligations generated within the sphere of the implied covenant demands a form of practical reasoning that looks beyond merely extracting the terms reached through agreement on the level of specific intention and towards something that might be thought of as the contract’s “plan.”¹⁷⁴ This link between the implied covenant and the broader notion of “the spirit of the agreement” is made frequently in the Delaware case law, but rarely operationalized.¹⁷⁵ For example, some opinions direct that the implied covenant requires parties to adhere to the “substance” of the contract, and not just the “letter.”¹⁷⁶ This captures the idea that one must look beyond the text, but gives little guidance as to what one should be looking for.

Fittingly, it is *Gerber*, the case that endorsed the flawed “Posnerian” counterfactual test, that contains the best articulation of the standard by which the reasons should be judged. It notes that the implied covenant demands “faithfulness to the scope, purpose, and terms of the parties’ contract.”¹⁷⁷ Although this statement appears as part of the justification for enforcing the hypothetical bargain, it should instead be understood as providing its own legal standard—the substantive standard by which the reasons should be judged at Step Three. In other words, at this stage of the analysis, the court should assess whether the reasons offered are consistent with a purposivist treatment of the contract that seeks to measure “faithfulness” to the contract’s spirit by synthesizing the scope, structure, and terms of the agreement in order to construct its overall plan.

This is a form of review to which courts are well-suited. Essentially, it demands assessing whether a defendant’s action is “arbitrary or capricious.” In this way, it is very similar to a whole host of judicial review formats in both the corporate and federal agency arenas. To draw an illustration from administrative law, consider judicial review of actions that are committed to agency discretion. While the decisions about whether to promulgate any particular rule, for example, are generally committed to agency discretion, in *Massachusetts v. EPA*, the Supreme Court held that the EPA needed reasons for declining to regulate carbon dioxide and that those reasons had to respond to the particular health and welfare standard that the Court identified in the statute; finding the reasons offered did not respond to that standard, the decision not

173. See *supra* text accompanying notes 148-150.

174. I intend here to evoke the textually focused purposivism underlying Chief Justice Roberts’s notion that “[a] fair reading of legislation demands a fair understanding of the legislative plan.” *King v. Burwell*, 135 S. Ct. 2480, 2496 (2015).

175. See, e.g., *Chamison v. HealthTrust, Inc.*, 735 A.2d 912, 920 (Del. Ch. 1999), *aff’d*, 748 A.2d 407 (Del. 2000). Language from *Chamison* has been frequently relied upon by the Chancery Court. See, e.g., *Amirsaleh v. Bd. of Trade of City of New York, Inc.*, No. CIV.A. 22820CCI, 2008 WL 4182998, at *7 & n.41 (Del. Ch. Sept. 11, 2008); *Bakerman v. Sidney Frank Imp. Co.*, 2006 WL 3927242, at *19 & n.114 (Del. Ch. Oct. 16, 2006).

176. *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 444 (Del. 2005).

177. *Gerber v. Enter. Prod. Holdings, LLC*, 67 A.3d 400, 419 (Del. 2013) (emphasis omitted), *overruled by Winshall v. Viacom Int’l, Inc.*, 76 A.3d 808 (Del. 2013).

to regulate was held to be “arbitrary and capricious.”¹⁷⁸ That this sort of judicial review would resemble the invocation of good faith makes sense.¹⁷⁹ In both cases, the court is finding the defendant to have some bounded form of discretion.

Note, however, that one significant difference between Step Three review and review of agencies is that in the agency context, the determination of arbitrary or capricious is made upon a contemporaneous record—meaning that agencies are obligated to generate records documenting the reasons they were acting at the time the decisions were being made.¹⁸⁰ This is an obligation understood to be derived from a statute, the Administrative Procedure Act.¹⁸¹ In contrast, unless specified otherwise, contracts do not demand contemporaneous records; rather, they merely demand that each party be prepared to offer genuine reasons when so requested by their contracting partner—including in the context of a judicial proceeding. That means that judges may have to defer to post-hoc rationalizations offered by defendants in the context of litigation, unless the plaintiff is able to produce evidence refuting that the reasons proffered by the defendant are not genuine. In practice, this means that once a defendant has provided a plausible explanation for its alleged breach, the court should extend to that defendant a presumption that she acted with cooperative intent, placing the burden on the plaintiff to prove otherwise.

In fact, the sort of deferential judicial review just described can be identified within some of the case law applying good faith in contract disputes. For example, the Supreme Court of New Jersey, in *Wilson v. Amerada Hess Corp.*, interpreted the duty of good faith as requiring that each “party exercises its discretionary authority arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonably expected fruits under the contract.”¹⁸² This requires first, in Step One, interpreting the contract to determine what the “expected fruits” are, and then assessing whether the reasons proffered respond to those expectations in a manner that is not arbitrary, unreasonable, or capricious. Additionally, in that same opinion, the N.J. Supreme Court noted that an action would clearly fail by this standard if the plaintiff could establish “bad motive” on the part of the defendant, i.e., that the defendant acted “with the specific intent to impair the ability” of the partner to the contract to realize its negotiated expectations.¹⁸³ While not all good faith-related cases can so clearly be integrated into the three-step framework advocated by this Article, cases like *Wilson* provide precedents that other courts can turn to as they calibrate the level and forms of deference parties will be accorded when applying the implied covenant of good faith.

Another point of comparison is with fiduciary duties and the business judgment

178. See *Massachusetts v. E.P.A.*, 549 U.S. 497, 498 (2007).

179. For a broader discussion of the role of good faith in judicial review of agency action, see Daniel B. Listwa & Lydia K. Fuller, Note, *Constraint Through Independence*, 129 YALE L.J. (forthcoming 2019).

180. See *Sec. & Exch. Comm’n v. Chenery Corp.*, 318 U.S. 80, 87 (1943).

181. See Note, *Rationalizing Hard Look Review After the Fact*, 122 HARV. L. REV. 1909, 1922 (2009).

182. *Wilson v. Amerada Hess Corp.*, 773 A.2d 1121, 1130 (N.J. 2001).

183. *Id.* at 1131.

rule.¹⁸⁴ Under Delaware law, there are two fiduciary duties—the duty of care and the duty of loyalty.¹⁸⁵ When faced with an allegation that a director breached a fiduciary duty, the court extends to the directors the presumption of the business judgment rule (BJR), a deferential standard that assumes that the director acted in a manner consistent with the ends of the corporation.¹⁸⁶ Thus, the BJR functions similarly to the implied covenant, which extends to the defendant deference on the issue of whether she acted in a manner consistent with the contract. The primary difference—and the reason that the fiduciary duty is more burdensome—is that the BJR can be refuted by a wider variety of circumstances, which emerge from particular additional requirements placed upon a fiduciary.¹⁸⁷

For example, in *Caremark*, the Court of Chancery held that the BJR could be refuted if it is shown that the director failed to establish “a corporate information gathering and reporting systems.”¹⁸⁸ Thus, in order to gain deference, the directors must meet a fairly robust procedural requirement. This is a common analytical structure in fiduciary standards, which makes deference contingent on completing particular processes, such as a vote by disinterested shareholders or the creation of an independent committee. In contrast, no such additional constraints exist in the contract context. Judges may not place upon the parties any terms beyond what are set out in the contract. Thus, so long as the defendant is found to have satisfied the terms as understood in Step One of the analysis, the decision will be granted the requisite level of deference in Step Three.

The additional procedural demands associated with the fiduciary context does not wholly describe the difference between Step Three and the application of the business judgment rule. Among other things, whereas the business judgment rule is a presumption that there was a satisfactory reason for the action of the board, Step Three demands that the defendant affirmatively offer reasons for the action that justify it as compatible with the contractual relationship. Further, the reasons offered must be tailored to the circumstances of the contract and cannot be of the generic sort that would apply to shareholder class actions or derivative suits, such as that the action was determined to be profit maximizing. Still, the type of inquiry demanded is one that is familiar to the courts. As such, courts should not have difficulty implementing each of the steps of the framework I have offered.

184. For an excellent explanation of the business judgment rule as intending to promote better decision-making, see Nicholas Walter, *The Utility of Rational Basis Review*, 63 VILL. L. REV. 79, 119-22 (2018).

185. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

186. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996).

187. By “primary difference,” I refer to how these two concepts are applied in practice. It is beyond the scope of this Article to provide a more theoretical analysis of the relationship between fiduciary good faith and contractual good faith. Note, however, that Vice Chancellor Laster’s argument that the “temporal focus is critical” offers a promising route that is consistent with the theory set out in this Article. See *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*, 50 A.3d 434, 440 (Del. Ch. 2012), *rev'd*, 68 A.3d 665 (Del. 2013).

188. *Caremark*, 698 A.2d at 961.

ii. Applying the Framework

The central value of the framework laid out in this Article is that it provides an analytically coherent conception of the implied covenant and its relationship to contract interpretation more broadly. In that sense, the heart of this Article is a theoretical project. But, as has already been made clear, one of the virtues of the approach developed here is that it also provides a straightforward and systematic methodology by which judges ought to reason through a claim that the implied covenant has been breached. In this Section, I summarize how the framework is to be applied, first in the abstract and then in relation to an example from Delaware.

For a plaintiff bringing a claim of breach of the implied covenant, Step One provides the first hurdle. The mere exercise of a contractually provided right can never, on its own, amount to a breach of contract, nor a breach of the implied covenant more specifically.¹⁸⁹ Thus, the plaintiff must provide a set of facts that at least suggest circumstances unanticipated by the contract, given the terms as they are interpreted by the court. If this is accomplished, the analysis progresses to Step Two. Here, the plaintiff must argue that if the parties had contemplated the facts presented by the case, the contract would have come out meaningfully different.¹⁹⁰ The judge assesses this argument by “modeling” the relevant bargain, a form of practical reasoning that may involve, for example, various presumptions about the relative sophistication of the parties.¹⁹¹

If the judge agrees that the counterfactual contract would have come out differently, then the dispute falls within the sphere of the implied covenant. The defendant’s action must be defensible for reasons compatible with the underlying ends of the contract. It falls on the defendant to offer these reasons, but once produced, they are given deference by the court in the form of a presumption of cooperative intent.¹⁹² But while deference is due, not all reasons are acceptable. The court must assess whether the defendant’s reasons are consistent with the “spirit” of the contract, an analysis that involves a purposivist form of interpretation already familiar to the Delaware courts. If the reasons are so consistent, and the plaintiff is unable to rebut that they are sincere, then the claim of breach fails.

Each of these steps allows for variation depending on such factors as the presumptions adopted by the courts, the interpretive methods used, and the amount of deference determined to be due. This variation is appropriate, particularly as courts calibrate their respective jurisdictions’ doctrines to achieve various systemic values, such as the optimal balance between providing judicial remedy and incentivizing litigation, and other efficiency-based concerns. For this reason, it is not possible to say

189. *Fisk Ventures, LLC v. Segal*, No. CIV.A. 3017-CC, 2008 WL 1961156, at *10 (Del. Ch. May 7, 2008).

190. Here “meaningfully” refers to changes that suggest that the parties intended a result other than what would have been understood to be the agreed upon result dictated by the original contract, given the relevant interpretive methods of the law applicable to that contract. *See supra* note 125 and accompanying text.

191. *See supra* note 135 and accompanying text.

192. These reasons, so long as they do not involve additional facts, could be offered in the context of a motion to dismiss.

precisely how the framework ought to be applied in any particular case. That said, exploring an example is instructive, particularly in so far as it highlights the practical implications of this approach as it compares to the current method used by the Delaware courts.

Consider the facts of *Fisk Ventures LLC v. Segal*,¹⁹³ a relatively recent case but one that predates Delaware's commitment to analyzing the implied covenant in terms of the counterfactual contract. Genitrix LLC was a Delaware LLC founded by Dr. Segal, the defendant, to develop and market biomedical technology.¹⁹⁴ Equity in the company was allocated between three classes of members, Classes A, B, and C. Power in the LLC was divided between the Class A and Class B members, with Class C investors mostly passive. Segal retained a majority of the Class A membership, while one of the plaintiffs, Fisk Ventures, controlled a majority of Class B, through a couple of vehicles.¹⁹⁵ The LLC distributed power in such a way that neither of these parties could approve an action without the other. As the Chancery Court explained, "the LLC Agreement was drafted in such a way as to require the cooperation of the Class A and B members."¹⁹⁶

After running off the funding provided by the investors, Genitrix soon found itself in financial straits. Eventually it was left with no employees other than Segal, no office, no funds, and no revenue.¹⁹⁷ The cause of its woes was an inability to bring in new investors. The reason, Segal alleged, was the Class B investors' unwillingness to suspend their "Put Right"—the effect of which, if exercised, would subrogate any new investors' claims.¹⁹⁸ Segal alleged that the term was a "deal killer," in the eyes of new investors.¹⁹⁹ Unable to find new investors or reach any agreement with the Class B investors, the company came to a standstill and, eventually, the Class B members filed for dissolution. Segal filed a counterclaim that Fisk violated the implied covenant.²⁰⁰

The crux of Segal's claim was that Fisk breached the implied covenant by blocking every financing opportunity proposed by Segal—primarily by refusing to suspend its Put Right—driving the company to failure.²⁰¹ More specifically, Segal seemed to argue that Fisk used the Put Right as a sword, refusing to accede to any financing proposal that did not shift greater equity and power into the hands of the Class B members. The Chancery Court disposed of this claim in short order, noting that the contract did not provide Segal with "the right to unilaterally decide what fundraising or financing opportunities the Company should pursue."²⁰² In contrast, it explicitly provided Fisk with the Put Right, and the "mere exercise of one's contractual rights, without more,

193. *Fisk Ventures, LLC v. Segal*, No. CIV.A. 3017-CC, 2008 WL 1961156 (Del. Ch. May 7, 2008)

194. *Id.* at *2.

195. *Id.*

196. *Id.*

197. *Id.* at *6.

198. *Id.* at *4.

199. *Id.*

200. *Id.* at *10.

201. *Id.*

202. *Id.*

cannot constitute” a breach of the implied covenant.²⁰³ With this conclusion, Segal’s claims were dismissed.

It is surely plausible that the breach allegations were rightfully dismissed, but this analysis is markedly unsatisfying when thought of in the context of the framework offered here. The voting structure was such that the parties would have to cooperate in order to make the sort of decisions that would maximize the value of the company. In the scenario in which the company desperately needed new funds, the existence of the Put Right severely undercut the ability to cooperate. In particular, the necessity of suspending the right implied that any new funding would come at a much higher cost to the Class B members than it would to the Class A members. As a result, it was not necessarily the case that both Class B and Class A members would share proportionally in any gains from bringing in new investors. Such an imbalance of incentives, combined with the veto power granted to the Class B members, set up the company for collapse by failing to align the decisionmakers’ incentives with the goal of maximizing the value of the company as a whole.

Such a flawed structure suggests that the parties would not have contracted for the LLC Agreement as-is had they contemplated the sort of facts that this case presented. Thus, the case proceeds past the second step and to the third. At Step Three, Fisk must be able to offer reasons, compatible with the “spirit” of the contract, for refusing to agree to suspend its Put Right, despite Segal’s assertion that no other option would allow the company to continue functioning. Importantly, a blanket statement that the contract provides the Class B members with a veto is an insufficient reason, since it was the effect of that very veto that was unanticipated. Rather, Fisk must be able to provide a reason compatible with the larger plan that the LLC Agreement can be understood to encapsulate.

One possible approach is to couch the veto in a broader understanding of the relationship underlying the LLC Agreement. The fact that both Fisk and Segal essentially wielded vetoes suggests an intention that neither’s business judgment be able to trump the others. This bespeaks a relationship where one party cannot obligate the other to act merely by asserting, as the court put it, that “its approach is superior or in the best interest of the Company.”²⁰⁴ Thus, Fisk can argue that its refusal to agree to Segal’s proposals emerged from difference regarding proper business judgment—for example, if Fisk thought Segal’s management so bad so as to make no option but dissolution viable. Given the deferential stance I have argued that courts should take when assessing reasons at Step Three, this sort of reason would likely be adequate to satisfy that no breach of the implied covenant has taken place absent affirmative evidence of a more nefarious motive.

The result of this analysis is the same as the actual conclusion that the Chancery Court reached, but consider what outcome would have been demanded if the court had instead utilized the counterfactual test that has come to define modern implied covenant case law. As argued above, it seems implausible that the parties would have signed on to this LLC Agreement if they had understood how fatally flawed it was;

203. *Id.*

204. *Id.* at *9.

but under the modern Delaware test, the very fact that the parties would not have counterfactually agreed to it would mean that a breach of the implied covenant occurred. This result runs counter to what seems to be the appropriate outcome. And yet, this is the result the modern Delaware approach would produce if strictly applied—a symptom of the crudeness of the counterfactual test.

In practice, it is highly likely that the Delaware court would have fudged the application of the counterfactual test, invoking other considerations in a *sub rosa* manner, in order to find no breach of the implied covenant. But that is precisely one of the significant faults of the current system: by hiding the true considerations underlying decisions, it impedes the development of a rational and coherent case law.

Given the newfound importance of the implied covenant as alternative entities form with fiduciary duties waived, Delaware cannot settle for a doctrine that lacks clear reasons and analytical structure—even if it gets the results right most of the time. What makes Delaware so attractive a jurisdiction within which to organize one's business is the quality of its precedents and its expert judges.²⁰⁵ A doctrine of the implied covenant that relies largely on *sub rosa* reasoning would undercut these qualities, ultimately undermining one of the central features of the Delaware legal system. The framework presented by this Article offers a solution—an approach rooted in the history of the implied covenant, derived from the nature of contract, and resonant with Delaware's broader doctrine.

V. Conclusion

The three-step framework for contract interpretation defended in this Article—combining a counterfactual threshold test with an understanding of implied covenant as demanding cooperative intent—provides a normatively grounded and analytically coherent approach to resolving contract disputes. It resonates with the doctrine and brings greater conceptual clarity to what has long been a mysterious idea. Good faith need not be “cryptic,”²⁰⁶ nor does it need to be cast aside as a “relic”²⁰⁷ of a more primitive time. Rather, the implied covenant of good faith, as the normative roots of the contract, ought to be recognized an essential source of legitimacy for courts seeking to bridge the inevitable gaps, facilitating the realization of the contract's fruits. The approach defended here facilitates the implied covenant of good faith serving that purpose.

Specifically, the implied covenant ought to be understood as operationalizing the demand that each party to a contract uphold its commitment to act only for reasons that are compatible with the contractual relationship. In practice, this means that alleged breachers must be able to rationalize their actions by reference to the bounds and goals of the contract. Once this is done, courts should extend to them a presumption of good faith that can be rebutted only if the adverse party establishes that the proffered explanation is merely pretextual. Under this procedure, when a dispute falls within the scope of the implied covenant, the role of the court shifts from

205. See Macey & Miller, *supra* note 16, at 484.

206. *Mkt. St. Assocs. Ltd. P'ship v. Frey*, 941 F.2d 588, 594 (7th Cir. 1991).

207. Dubroff, *supra* note 9, at 589.

interpreting the contract itself toward essentially judging the intent of the interpreter, that is, the alleged breacher.

For the Delaware courts, adopting the three-step framework and the concept of cooperative intent would not merely rectify the analytical inconsistencies that plague the approach set out in *Gerber*; it would also facilitate reasoning about the implied covenant in a manner that makes clear what is guiding the court's decision making. Unlike the flawed "Posnerian" approach, this Article's framework does not rely on *sub rosa* considerations. Given the critical role Delaware's coherent and predictable precedent plays in ensuring the jurisdiction's continued ascendancy in corporate law, this is no small factor. In today's world, where alternative entities are of increasing dominance, precedent regarding the application of the implied covenant is of foremost importance. The framework offered here ensures that precedent is generated in a coherent and accessible manner.