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# Corporate Governance Group Client Alert

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## DELAWARE COURT RULES THAT AGREEMENT TO NEGOTIATE IN GOOD FAITH MAY CREATE BINDING OBLIGATION

*But refuses to disregard “plain meaning” of one-sided contract provision*

In *Great-West Investors LP v. Thomas H. Lee Partners, L.P.*,<sup>1</sup> the Delaware Court of Chancery recently confronted a formulaic adjustment in a limited partnership agreement that is automatically triggered if, following “good faith” negotiations, the general and special limited partner cannot agree on an alternative arrangement. Read literally, this adjustment would produce a decidedly one-sided result favoring the general partner at the expense of the limited partners.

The Court dismissed the special limited partner’s request for declaratory relief in part, refusing to adopt an interpretation that it saw as being at odds with the provision’s “plain meaning.” On the other hand, the Court refused to dismiss two aspects of the special limited partner’s lawsuit: *first*, a claim that the general partner failed to negotiate an alternative arrangement in “good faith” as required by the limited partnership agreement, and *second*, a claim for reformation of the provision due to either mistake or fraud. This ruling should offer the special limited partner some hope – and leverage in settlement negotiations with the general partner – that it may be able to overcome the clear, but arguably unfair and unintended, contract language.

### **Background**

Thomas H. Lee Partners, L.P. (the “Partnership”) is a well-known and successful private equity firm. Great-West Investors LP acquired a 24.875% limited partner interest in August 2007 from Putnam Investments, Inc. and, as such, became the Partnership’s “Special Limited Partner.”

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<sup>1</sup> C.A. No. 5508-VCN (Del. Ch. Jan. 14, 2011).

Under the terms of the Partnership's limited partnership agreement, certain of the limited partners – including the Special Limited Partner – are required to make “Expense Assumption” payments that are in turn used by the Partnership to compensate an affiliate of Thomas H. Lee Advisors, LLC (“THL”), the Partnership's general partner, for managing the Partnership's funds. Section 12.2 of the limited partnership agreement provides a formula for calculating the Expense Assumption, but only through the end of 2009.

To address the lack of a formula post-2009, Section 12.2(c) of the limited partnership agreement provides that “the General Partner and the Special Limited Partner shall negotiate in good faith toward an agreement upon the ... expense payable pursuant to Section 12.2” beginning in 2010. If THL and the Special Limited Partner are not able to agree on a new Expense Assumption, however, this section also contains a default escalator that provides for an automatic “increase on January 1 of each year, commencing on January 1, 2010, by an amount equal to the product of 1.05 multiplied by the Expense Assumption in effect during the preceding year.”

During the weeks before Great-West's purchase of its interest from Putnam, each company's attorneys sought clarification regarding this potential automatic increase in the Expense Assumption. Despite the actual wording of the formula, Putnam's outside counsel told Great-West that the default escalator, if triggered, would result in a much lower “5% annual increase in the amount of the Expense Assumption.” Initially, counsel for the Partnership “allegedly acknowledged that the provision was intended to ‘effect a 5% increase and agreed to clarify the provision to make such intent more explicit.’” However, a subsequent email from the Partnership's counsel advised that the Partnership “is not interested in making any changes to the agreement related to the expense assumption amount at this time. Clearly [the parties] need to have a negotiation about those provisions, but not at this time/in this forum.”

Despite this lack of consensus on the meaning of the default escalator, Great-West closed its purchase from Putnam without insisting on a change. Subsequently, Great-West sought to negotiate an agreement with THL for the allocation of expenses for years following 2009, but terminated those discussions when “TH Lee instead proposed to Great-West ‘scenarios whereby Great-West Investors would have to relinquish all or a material part of its [nearly] 25% stake as the Special Limited Partner on economically unreasonable terms.’” In support of this position, and contrary to the previous discussions among counsel, THL argued that the default escalator means what it literally says in providing “for an annual 105% increase in the Expense Assumption amount instead of an annual 5% increase.”

Because the parties had not reached agreement by the end of 2009, THL triggered the default escalator and fixed the Expense Assumption for 2010 at “\$97,791,853, representing an increase of \$50,088,510 over the 2009 Expense Assumption.” Because the limited partnership agreement provided that any portion of the expense reimbursement received in excess of THL's actual expenses would be turned over to THL and others, Great-West recognized that this increase in the Expense Assumption “would wipe out its 25% share of the Partnership's Fee Income almost immediately, and would exceed the total income of the Partnership beginning in 2013.”

Accordingly, in response to THL's triggering of the default escalator, Great-West sought a declaration by the Court of Chancery “that the limited partnership agreement does not require it to pay a fee that more than doubles every year.” Great-West also asserted claims for “specific performance of the agreement as it

interprets it, breach of contract, breach of fiduciary duty, and breach of the implied covenant of good faith and fair dealing” or, in the alternative, “reformation of the agreement for mistake or fraud.” THL countered with a motion to dismiss all of Great-West’s claims.

### *The Court’s Analysis*

#### *Declaratory Relief*

In evaluating Great-West’s petition for declaratory relief, the Court indicated that when interpreting a contract, its role is to “effectuate the parties’ intent.” To do so, however, “[t]he true test is not what the parties to the contract intended it to mean, but what a reasonable person in the position of the parties would have thought it meant.” Great-West argued that the language of the default escalator is “at least ambiguous” and that “extrinsic evidence” supported its argument that the provision provided for only a “5% annual increase.” The Court found no such ambiguity, and concluded that the “plain meaning” of the agreement supported THL’s position that the Expense Assumption would increase by “105% of the previous year’s Expense Assumption.”

The Court also rejected Great-West’s argument that the allegedly “unconscionable and absurd result” produced by THL’s interpretation of the default Expense Assumption rendered the language ambiguous. In this connection, the Court emphasized that one party’s displeasure with the outcome of a bargain “does not render it ambiguous if the result is required by the plain language of the contract,” and admonished that “parties are free to make bad bargains.”

Accordingly, the Court granted THL’s motion to dismiss this aspect of Great West’s plea for declaratory relief.

#### *Breach of Contract*

Great-West also claimed that THL breached Section 12.2(c) of the limited partnership agreement “by failing to negotiate in good faith toward an agreement on the allocation of ... expenses” after 2009. To address this breach, Great-West sought both specific performance of the covenant to negotiate in good faith and damages.

THL, while claiming that it had engaged in good-faith negotiations, argued that “under Delaware law, courts will not order specific performance of agreements to negotiate in good faith.” The Court conceded that “the problems with ordering parties to negotiate in good faith are significant.” Nevertheless, and contrary to THL’s argument, the Court ruled that “an agreement to negotiate in good faith may be binding under Delaware law ... and specific performance could, in theory, be an appropriate remedy for breach of such a provision.” Because the Court concluded that, at trial, Great-West might be able to demonstrate that good faith negotiations did not take place, the Court denied THL’s motion to dismiss Great-West’s breach of contract claim.<sup>2</sup>

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<sup>2</sup> The Court did, however, dismiss related extra-contractual remedies sought by Great-West. With respect to Great-West’s claim that THL “breached its fiduciary duties to Great-West by failing to negotiate in good faith,” the Court explained that “fiduciary claims arising out of the same facts that underlie the contract obligations” are “superfluous.” Moreover, with respect to THL’s alleged breach of the implied covenant of good faith and fair dealing, the Court observed that the implied covenant “only applies where a contract lacks specific language” and does not apply where, as here, the parties’ obligations and rights are “expressly governed by contract.”

### *Reformation*

In response to Great-West's plea for reformation of the automatic default escalator in the limited partnership agreement, the Court explained that reformation of contracts is available "only when the contract does not represent the parties' intent because of fraud, mutual mistake, or, in exceptional cases, a unilateral mistake coupled with the other parties' knowing silence." Great-West based its claim for reformation on all three of these possible theories.

Viewing the facts in the "light most favorable" to Great-West as required when ruling on a motion to dismiss, the Court ruled that "Great-West has adequately alleged a mutual mistake claim." The Court based this conclusion on Great-West's assertion that its mistaken interpretation of the default escalator was in fact consistent with THL's own interpretation "at the time," as evidenced by the failure of THL's counsel to retract its written representation that the default escalator had the meaning ascribed to it by Putnam's counsel.

According to the Court, to prove unilateral mistake, Great-West must "show that it was mistaken," that THL "knew of the mistake but remained silent," and that "the parties had come to a definite agreement that differed materially from the written agreement." Accepting (for purposes of the motion before it) Great-West's allegation that there "was no reason for it to have known of its mistake" when executing a subsequent amended limited partnership agreement, the Court also denied THL's motion to dismiss this aspect of Great-West's reformation claim.

Finally, the Court noted that while Great-West may encounter difficulty at trial in fully establishing each of the elements of fraud, Great-West had adequately – "if only barely" – stated a claim for fraud. Specifically, the Court acknowledged that Great-West had identified "three alleged misrepresentations" by the Partnership's counsel that "would reasonably have left it with the impression" that THL had agreed that the default escalator actually was intended to effect an "annual 5% escalator in the Expense Assumption" and "would negotiate to implement that intention after Great-West became the Special Limited Partner." On this basis, the Court denied THL's motion to dismiss Great-West's claim for reformation on the basis of fraud.

### *Conclusion*

The annual escalator clause for expense reimbursement in the THL limited partnership agreement, read literally, does seem plain on its face and, if fully implemented, would have a severely unfavorable impact on Great-West's investment in the Partnership. And the record shows that Great-West certainly was aware of this when it purchased its stake in the Partnership. However, perhaps in reliance on the email from counsel for the Partnership indicating that THL would be willing to negotiate a revision in the future, Great-West did not then insist that the provision be amended.

Thus, it is interesting to note that while the Court was not prepared to support an interpretation different from the "plain meaning" of the limited partnership agreement – even in the face of a potentially "unconscionable and absurd result" – the Court nevertheless gave Great-West a chance to have its day in court by denying certain aspects of THL's motion to dismiss. While no substitute for careful and precise contract drafting, by giving a green light to Great-West to continue with its claims against THL for breach of the covenant to negotiate in good faith and for reformation of the limited partnership agreement, the Court has provided Great-West with enhanced leverage to negotiate with THL for better terms.

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