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Delineating the Implied Covenant and Providing for "Good Faith"

Daniel S. Kleinberger

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Abstract

This column considers whether an operating or partnership agreement can delineate the implied contractual obligation, comparing ULLCA and the Delaware Act, and then warns of the dangers of carelessly imposing by contract an express requirement of "good faith."

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Delineating the Implied Covenant and Providing for "Good Faith"

Daniel S. Kleinberger, Mitchell Hamline School of Law

We begin with ULLCA, because the answer to the delineation question appears straightforward under the uniform act. This column quotes from ULLCA (2013), text and comments, but the analysis applies equally to ULLCA (2006), sometimes informally referred to as "RULLCA" or "Re-ULLCA," and also to ULLCA (1996), the first uniform LLC act.

ULLCA (2013), Section 105(c)(6) states that, while an operating agreement may not "eliminate the contractual obligation of good faith and fair dealing under Section 409(d)," the agreement "may prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured." The official comment provides several examples, including this one:

> EXAMPLE: The operating agreement of a manager-managed LLC gives the manager "sole discretion" to make various decisions. The agreement further provides: "Whenever this agreement requires or permits a manager to make a decision that has the potential to benefit one class of members to the detriment of another class, the manager complies with Section 409(d) of [this act] if the manager makes the decision with:
>
> a. the honest belief that the decision:
>
> i. serves the best interests of the LLC; or
> ii. at least does not injure or otherwise disserve those interests; and
>
> b. the reasonable belief that the decision breaches no member's rights under this agreement."
>
> This provision "prescribes[s] the standards by which the performance of the [Section 409(d)] obligation is to be measured."

Under Delaware law, the delineation question requires a different and more complicated analysis. The conceptual answer is "not possible," but the practical answer is "can do." Under Delaware law, the implied covenant acts as a special type of "gap filler," a process of interpolation implied by law: "An implied covenant claim … [asks] what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting." *Gerber v. Enter. Prods. Holdings, LLC*, 67 A.3d 400, 418 (Del. 2013) (quotation marks and citations omitted).

By its nature, this approach is invariable. The law supplies the gap-filling methodology, which no agreement has the power to change. For instance, an operating agreement may not provide that "a manager's act in any manner pertaining to this agreement satisfies the implied covenant of good faith and fair dealing if the person asserting a breach of the implied covenant had at the time of contracting reason to know that the agreement could reasonably be interpreted to authorize the act."

However, a Delaware operating or partnership agreement can reign in the implied covenant by avoiding gaps. Consider the above example from the ULLCA comments, revised as follows:

> Whenever this agreement requires or permits a manager to make a decision that has the potential to benefit one class of members to the detriment of another class, ~~the manager complies with Section 409(d) of [this act]~~ the manager's decision is binding and breaches no duty to the company or its members, if the manager makes the decision with:
>
> a. the honest belief that the decision:
> i. serves the best interests of the LLC; or
> ii. at least does not injure or otherwise disserve those interests; and
>
> c. the reasonable belief that the decision breaches no member's rights under this agreement."

Although "[n]o contract, regardless of how tightly or precisely drafted it may be, can wholly account for every possible contingency," *Allen v. El Paso Pipeline GP Co., L.L.C.*, No. CIV.A. 7520-VCL, 2014 WL 2819005, at *11 (Del. Ch. June 20, 2014) (internal quotations and citations omitted), opportunistic conduct brings Delaware's implied covenant into play. The ULLCA example as revised leaves scant, if any, room for such conduct. Thus, while under Delaware law "safe harbor" provisions cannot be upheld, in the language of ULLCA (2013) § 105(c)(6), as "prescrib[ing] the standards …by which the performance of the obligation [of good faith and fair dealing] is to be measured," safe harbor provisions can render the implied covenant inapposite if carefully drafted and sensibly invoked.

For example, in the author's opinion, it was not sensible to rely on a Special Approval valuation process that had ignored two assets of the company, which were arguably quite substantial. Gerber v. Enter. Prod. Holdings, LLC, 67 A.3d 400, 422–23 (Del. 2013).

Care is also required when an operating or partnership agreement imposes an express requirement of "good faith." Left undefined, the phrase is a minefield for parties and a godsend for litigators—as exemplified in *Policemen's Annuity and Benefit Fund v. DV Realty Advisors LLC* ("Policemen's Annuity"). The case arose from a limited partnership agreement that permitted the limited partners to remove the general partner:

> without Cause by an affirmative vote or consent of the Limited Partners holding in excess of 75% of the [Limited] Partnership Interests then held by all Limited Partners; provided that consenting Limited Partners in good faith determine that such removal is necessary for the best interest of the [Limited] Partnership.

The agreement did not, however, define the term. Policemen's Annuity No. CIV.A. 7204-VCN, 2012 WL 3548206 at *12-13 (Del. Ch. Aug. 16, 2012).

Both the Chancery Court and Delaware Supreme Court addressed the definitional omission, but each used a different approach and reached a different definitional conclusion. The Chancery Court, 2012 WL 3548206, at *13, used an *a fortiori* analysis to resolve the case without actually deciding on a definition:

> The conduct of the Limited Partners in this case does not approach the sort of unreasonable conduct that is necessarily undertaken in bad faith. A test is nevertheless required; the Limited Partners' conduct must be analyzed under some rubric. … The definition prescribed in [Delaware's Uniform Commercial Code] § 1–201(20) ["honesty in fact and the observance of reasonable commercial standards of fair dealing"] is at least as broad of a definition of good faith as that applied to contracts at common law, and… the Limited Partners can meet the [the broader] definition…. Thus, the Limited Partners necessarily satisfy Delaware's common law definition of good faith as applied to contracts, which is the definition of good faith that the Court presumes was adopted in [the limited partnership agreement].

The Delaware Supreme Court flatly rejected the lower's court methodology, substituting a standard far more easily met. Relying on one of its own decisions, the court held that the limited partners' "determination will be considered to be in good faith unless the Limited Partners went 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'" *DV Realty Advisors LLC v. Policemen's Annuity & Ben. Fund of Chicago*, 75 A.3d 101, 110 (Del. 2013) (quoting Brinckerhoff v. Enbridge Energy Co., Inc., 67 A.3d 369, 373 (Del.2013)).

An Oregon case provides another example. *U.S. Genes v. Vial*, 923 P.2d 1322 (Ore. App. 1996) concerned a contract that expressly required the parties "to engage in good faith and in fair dealing with respect to the other at all times during the term of this agreement." The contract did not define the "good faith and … fair dealing," and the trial court decided "to treat the express good faith provision in the contract as equivalent to the covenant of good faith and fair dealing that is implied in every contract." The Oregon Court of Appeals reversed, stating that that decision was "[t]he source of the court's error" and holding that the "express and implied covenants of good faith cannot be equated."

That holding makes good sense; equating the express with the implied would render the express term surplus. However, half a page further in the decision, the appellate court *interpreted the express term according to one scholar's famous gloss on the implied covenant*.

The moral of these stories is clear—never use the phrase "good faith" in an operating or partnership agreement without carefully defining the term.