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The Implied Covenant of Good Faith and Fair Dealing:
Does It Protect Members of Delaware LLCs?

By Lewis H. Lazarus and Jason C. Jowers

The one duty that parties cannot waive in a Delaware limited liability company (LLC) agreement is the duty to act consistently with the implied contractual covenant of good faith and fair dealing. The governing statute, 6 *Del. C.* § 18-1101(c), provides that "the member's or manager's or other person's duties," including fiduciary duties to the extent they are otherwise owed, "may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing." The Delaware Supreme Court's three to two decision in *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010), raises two issues regarding Delaware's application of the implied covenant. First, while the traditional test of when to apply the covenant, in part, asked whether the parties at the time of formation would have proscribed the conduct had they thought to negotiate about that conduct, the *Nemec* majority limits the application of the implied covenant to situations where the parties could not have anticipated, rather than simply failed to consider, the conduct later sought to be proscribed. Second, although *Nemec* did not involve an LLC dispute, the majority's opinion illustrates limitations on the ability of members of LLCs to use the implied contractual covenant to police the exercise of an LLC manager or managing member's discretion. We begin by explaining the pre-*Nemec* standard, then examine the *Nemec* decision, and conclude by discussing *Nemec's* implications for practitioners advising members and managers of Delaware LLC's.

The Pre-*Nemec* Standard of the Implied Covenant

To prove a breach of the implied covenant of good faith and fair dealing under Delaware law, a plaintiff must allege: (1) implied contractual terms; (2) a breach of the implied terms; and (3) damages. Although that general standard is easily articulated, the circumstances in which terms may be implied are not clear. As former Chancellor Chandler observed, "the exact contours of the implied covenant of good faith and fair dealing are not always easily discernable in the case law. This is partly driven by the fact-intensive nature of the doctrine. Courts routinely invoke the specific contours of the covenant that are relevant to the case at hand without attempting to articulate an all-encompassing definition that could be applied to any factual circumstance."

The Delaware Supreme Court has found that courts should imply obligations using the implied covenant in "rare" cases. The court also has said that implying terms pursuant to the implied covenant is a "cautious enterprise." Although difficult to define for all circumstances, decisions from the Delaware courts provide some guidance. First, the implied covenant is not a free-floating duty divorced from the language of the contract. Instead, it prohibits acts by one party that deprive another of the fruits of the bargain, even though the challenged conduct is not expressly prohibited by the agreement. Second, a plaintiff must allege the breaching party's actions were motivated by an improper purpose reflecting bad faith. Third, an implied obligation may not prohibit acts that the terms of the parties' agreement expressly permit. This is true even when the act expressly permitted favors one party's interests. A Delaware court will not hesitate to enforce a contract that in hindsight proves to be a bad bargain for one of the parties. Delaware courts protect the parties' reasonable expectations at the time of contracting. The difficult issue with which the courts continue to grapple is how to determine those reasonable expectations.

Prior to *Nemec*, in the right set of factual circumstances, the implied covenant could apply as a potential gap-filler for situations parties had not considered at the negotiating table, and thus were not expressly addressed in the contract. In *Cincinnati SMSA Ltd. Partnership v. Cincinnati Bell Cellular*, 708 A.2d 989, 992 (Del. 1998), a case involving the interpretation of a partnership agreement, the Delaware Supreme Court stated that "[i]n cases where obligations can be understood from the text of a written agreement but have nevertheless been omitted in the literal sense, a court's inquiry should focus on 'what the parties likely would have done *if they had considered* *the issue involved.*'" (Citations omitted and emphasis added). More recently, the Delaware Supreme Court reiterated this standard and stated that "[o]nly when it is clear from the writing that the contracting parties 'would have agreed to proscribe the act later complained of . . . *had they thought to negotiate with respect to that matter*' may a party invoke the covenant's protections." *Dunlap v. State Farm Fire and Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) (quoting *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 880 (Del. Ch.1986)) (emphasis added). Based on these cases and their progeny, it appeared a party could use the implied covenant to fill gaps in an agreement so long as the parties had not considered the issue at the time of contracting, the challenged conduct was not expressly permitted by the agreement, and the failure to imply terms prohibiting the conduct would deprive one party of the benefit of the bargain. Courts determined the parties' reasonable expectations by asking what they would have bargained for had they considered the issue at the time of the negotiation of the agreement. As discussed next, *Nemec* asks a different question, i.e., could the parties have anticipated the issue at the time of contracting, and thus arguably limits the circumstances in which the courts may imply a covenant for which the parties did not expressly bargain.

Limits to the Implied Covenant Doctrine in *Nemec*

In *Nemec*, former officers of Booz Allen, a Delaware corporation, brought claims against the corporation for breach of the implied covenant of good faith and fair dealing. The company compensated the former officers, in part, through annual grants of stock rights that were convertible into common shares. Under the stock plan, each retired officer had a "put" right for the first two years after retirement to sell his or her shares back to the company at book value. After the first two years, the company had a right to repurchase the shares at book value. In 2008, Booz Allen sold its government service business to the Carlyle Group for $2.54 billion. Prior to the transaction, the directors caused Booz Allen to repurchase the stock of the two former officers at book value. Had the officers been allowed to hold the shares through the time of the transaction with the Carlyle Group, they would have received $60 million dollars more for their stock.

The plaintiffs claimed that the timing of the repurchase shortly before the transaction with the Carlyle Group breached the implied covenant. The *Nemec* court initially states that "[t]he implied covenant of good faith and fair dealing involves a 'cautious enterprise,' inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated." At first reading, this language appears to echo the standard discussed in *Cincinnati* and *Dunlop*. The plaintiffs in *Nemec* argued that no one at the time of the negotiation of the stock plan anticipated that part of the company would be sold. Rejecting this argument and clarifying the standard, the Delaware Supreme Court found that "[t]he implied covenant only applies to developments that could not be anticipated, *not developments that the parties simply failed to consider* . . . ." (Emphasis added). Moreover, the court found that "[a] party does not act in bad faith by relying on contract provisions for which that party bargained where doing so simply limits advantages to another party." Under this standard, the court found that Booz Allen had not breached the implied covenant by exercising the company's bargained for right to repurchase the former officers' shares. Given the wording of the Delaware Supreme Court's standard, drafters of contracts, including LLC operating agreements, must carefully consider developments that may be anticipated at the time they are sitting at the bargaining table, and determine whether the agreement should address those anticipated situations. Parties should not expect a court to use the implied covenant to reform an agreement that is silent on an issue that the parties could have anticipated, but failed to consider.

Post *Nemec*: Exercising Discretion in Good Faith

Prior to *Nemec*, the Delaware courts had found that the implied covenant of good faith and fair dealing prohibited "arbitrary and unreasonable conduct" by one party that prevented the counter-party from enjoying the benefit of its bargain. Out of this rule arose a line of Delaware cases holding that where the parties' agreement grants one contracting party discretion to act, that party must exercise such discretion in good faith. Because parties may waive fiduciary duties in the LLC agreement, the requirement that managerial discretion be exercised in good faith appeared to create an important tool to limit manager misconduct.

The Court of Chancery's holding in *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, 2009 WL 1124451 (Del. Ch. Apr. 20, 2009) illustrates the application of the requirement that a party exercise discretion in good faith to protect the reasonable expectations of a member of a Delaware LLC. Bay Center brought an action against Emery Bay PKI (PKI) for, among other things, breach of the implied covenant of good faith and fair dealing in the Emery Bay LLC Agreement. Bay Center and PKI formed Emery Bay to develop a condominium project. The LLC agreement named PKI as the managing member. The LLC agreement allowed PKI to manage the affairs of the LLC, and it also contemplated that PKI would be responsible for the condominium project. PKI then designated an affiliate, Emery Bay ETI (ETI), as the development manager, which signed the development management agreement outlining the responsibilities for developing the project. Plaintiff alleged mismanagement and poor financial performance that injured the condominium development project.

Under the terms of the LLC agreement, PKI had the "power and authority" to: (1) cause the development manager to perform its obligations; (2) perform or cause to be performed Emery Bay's obligations under any agreement; and (3) "take all proper and necessary actions reasonably required" to cause Emery Bay to carry out the provisions of loan commitments or other contracts. Bay Center alleged that these provisions, in conjunction with the statement in the LLC agreement that PKI "shall manage" the affairs of the LLC, created an express obligation for PKI to meet the LLC's loan obligations and to ensure the development manager carried out its obligations if the development manager failed to perform. PKI argued that these provisions empowered but did not require PKI to take action. Alternatively, if the court found there was any ambiguity in PKI owing an express obligation, Bay Center claimed that the implied covenant of good faith and fair dealing required PKI to exercise discretion, its "power and authority," in good faith. PKI moved to dismiss the implied covenant claim, but not the express breach of contract claims.

Denying the motion to dismiss, the court found that where an LLC agreement grants a manager discretion, that discretion must be exercised in good faith. Analogizing to the corporate context, then Vice Chancellor, now Chancellor, Strine explained that "[p]art of corporate managers' proper performance of their contractual obligations is to use the discretion granted to them in the company's organizational documents in good faith." The court found that PKI was obligated to manage the LLC, and that it had discretion to ensure that the development manager performed its duties. PKI had to exercise this obligation and discretion in good faith. It could not take arbitrary or unreasonable action that prevented Bay Center from receiving the fruits of the bargain. In this case, Bay Center contributed the real estate in exchange for PKI's proper management of the enterprise. The court found that Bay Center had alleged that PKI failed to carry out this task. Furthermore, the court found that Bay Center had alleged that PKI had acted in bad faith, i.e. with an improper purpose, because the conduct at issue was self-interested. PKI misdirected loan funds to its advantage, and the decision not to enforce the development management agreement was conflicted because the same party controlled Emery Bay and the development manager. Accordingly, the court refused to dismiss the implied covenant claim.

The *Nemec* opinion casts doubt as to whether a court following its rationale would necessarily reach the same result in *Bay Center*. The agreement at issue in *Nemec* permitted rather than required the company to repurchase the former officer's shares. Accordingly, when the company authorized the repurchase of shares, the Booz Allen directors were arguably exercising the company's discretion under the contract to decide if and when to repurchase the former executive's shares. Consequently, the dissenting justices argued that the line of Delaware cases finding that discretion must be exercised in good faith should prevent the plaintiffs' claims from being dismissed. Rejecting this argument, the majority found that the discretion line of cases did not apply in *Nemec* because Booz Allen had a specific right to take the action it did, i.e., to repurchase the shares, and thus exercised no discretion. Disagreeing with that narrow understanding of "discretion," the dissenting justices explained: "The Company's decision whether or not to redeem was discretionary, in the sense that Booz Allen, as the right holder was not *obligated* to redeem the shares at the time it chose to do that. Exercising a contractual right under circumstances detrimental to the counterparty and where the right holder has nothing to gain, is arguably not in good faith, unless the contract expressly allows the exercise for any (or even no) reason." The facts of *Nemec* and the arguments raised by the *Nemec* dissent suggest that a majority of the Delaware Supreme Court would support using the implied covenant to limit managerial discretion only where discretion exercised by a manager could not be construed as an act that was expressly permitted.

Post-*Nemec*: Careful Drafting of LLC Agreements is Critical

In light of the Delaware Supreme Court's decision in *Nemec* and the limitations placed on the implied contractual covenant through prior case law, what protection does the implied covenant offer a member of an LLC, and conversely what risks does it present for a defendant manager or managing member of an LLC, where the parties in their LLC agreement have waived fiduciary duties and the contract provides the manager with discretion to carry out a designated act?

As noted above, under Delaware law, the implied covenant is, at best, a weak tool for plaintiffs. It cannot be used as an amorphous or free-floating duty detached from the contract itself. It cannot be used paternalistically to rewrite provisions that, in hindsight, advantage one party over the other. It cannot be used to prohibit acts that are expressly permitted by the parties' bargained for agreement. Furthermore, because *Nemec* makes clear that "[t]he implied covenant only applies to developments that could not be anticipated, not developments that the parties simply failed to consider," parties must be vigilant in negotiating express terms regarding any significant developments that could be anticipated at the time of contracting. Although much will turn on how future decisions interpret the above quoted language, developments like change of control transactions or the sale of a division of a company often can be anticipated, particularly by sophisticated parties, and parties proceed at their own risk if they do not reflect in their operating agreement the treatment they expect in the event of such developments.

In the LLC context specifically, it is well-settled that the implied covenant cannot revive fiduciary duties expressly waived in the operating agreement. Furthermore, although *Bay Center* and similar cases offer some comfort to members of LLCs that the implied covenant may protect them even when fiduciary duties have been waived, it is uncertain after *Nemec* whether the Delaware Supreme Court will permit a claim based on the implied covenant if the parties expressly bargained that management has sole discretion to determine how to operate the LLC. LLC agreements often are drafted that way, allowing discretion to carry out or delegate to others the company's ordinary operations with member majority approval only necessary for specified major transactions. One could argue based on *Nemec* that the parties negotiating an LLC agreement, particularly where they are sophisticated parties, are perfectly capable of determining what, if any, limitations to place on a manager's authority. Furthermore, extending the majority's logic in *Nemec*, one could argue that PKI in *Bay Center* had been contractually granted the "power and authority" to manage certain aspects of the condominium project and simply exercised its contractually granted right to determine if, when, and how to exercise that contractually granted "power and authority." Since a majority of the Delaware Supreme Court appears to have a narrow view of what is an exercise of discretion versus an expressly permitted act, counsel to members of LLC must be cautious in placing too much weight on the implied covenant to police manager misconduct based on discretionary acts.

Conclusion

In light of the uncertainty in the vitality of the discretion line of cases following the Delaware Supreme Court's apparent narrowing of the reach of the implied covenant in *Nemec*, careful drafting of LLC agreements is more critical than ever. Even under the pre-*Nemec* case law, plaintiffs rarely succeeded on implied covenant claims. In a post-*Nemec* world, stating a breach of the implied covenant claim likely will prove even more difficult. Parties and their counsel should carefully consider at the time of formation whether managers should owe fiduciary duties to account for the uncertainty of whether the implied covenant of good faith and fair dealing will rectify future wrongs that the parties did not expressly anticipate in their contract. Although parties may reflexively believe that it is better to agree in the LLC agreement that neither party owes the other fiduciary duties, such belief may prove short-sighted given the limitations on the implied covenant of good faith and fair dealing to remedy an alleged wrong. Based on *Nemec*, the question of what terms should be added to an agreement to govern potential misconduct could be called the $64 million question.

Lewis H. Lazarus is a partner and Jason C. Jowers is an associate at Morris James LLP in Wilmington, Delaware.