

DELAWARE BUSINESS COURT INSIDER

September 11, 2013

An **ALM** Website

The Meaning of Contractual Good Faith



***Joel Feuer and Benyamin Ross
Delaware Business Court Insider***

Since the Delaware General Assembly made it clear that default fiduciary duties apply to managers and controlling members of limited liability companies, the attention of the Delaware courts has returned to a set of related questions for both partnerships and LLCs:

- How are fiduciary duties disclaimed and how are they displaced?
- When fiduciary duties are contractually displaced by other standards, how are those standards to be interpreted?
- Who bears the burden of proof?

In *DV Realty Advisors LLC v. Policemen's Annuity and Benefit Fund of Chicago*, 2013 Del. LEXIS 430 (Del. August 26, 2013), the Delaware Supreme Court addressed the second question and provided a standard for contractual "good faith" where that standard has not been further defined in the partnership agreement. *Policemen's Annuity* evidences the court's preference to read contractual provisions in partnership and LLC agreements through the prism of common-law standards, including concepts associated with fiduciary duties.

Background and the Court of Chancery Decision

In *Policemen's Annuity*, the limited partners (LPs) of a Delaware limited partnership sought a declaration that their removal of the partnership's general partner (GP) was valid. The partnership's limited partnership agreement (LPA) granted the GP broad discretion to manage the everyday affairs of the partnership. The LPA required the GP to distribute audited financial statements on a timely basis. The GP repeatedly failed to do so.

The GP argued that the LPs did not meet the express and implied requirements of the LPA governing removal of the GP. The removal provision provided that the LPs could remove the GP "without cause by an affirmative vote ... of the LPs holding in excess of 75 percent of the partnership interests; provided that consenting LPs in good faith determine that such removal is necessary for the best interest of the ... partnership."

The LPA did not define good faith. Because the LPA stated that it was "made pursuant to and [was to] be governed by the laws of the state of Delaware," the Court of

Chancery presumed that the parties intended to adopt Delaware's common-law definition of good faith as applied to contracts. The court adopted the definition of good faith in Section 1-201(20) of the Delaware Uniform Commercial Code (UCC), which defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing." The court reasoned that because the UCC definition is at least as broad as the definition of good faith applicable to contracts at common law, if the LPs could satisfy the UCC definition, then the LPs would necessarily satisfy the common-law definition. The court found that the GP's continuous failures to deliver timely financial statements provided the LPs with a good-faith belief that the GP needed to be removed, even under the more stringent UCC definition of good faith.

The Delaware Supreme Court Decision

The Delaware Supreme Court rejected the application of the UCC definition of good faith to the LPA. Instead, the court reiterated its obligation to construct the over-

all scheme of a partnership agreement to determine the values that the contractual duty of good faith sought to protect. The court found that the term good faith was used in the context of ensuring the LPs did not arbitrarily or capriciously remove the general partner.

Explicitly employing Aristotelian logic, the court defined good faith by reference to its opposite: bad faith. Bad-faith conduct, in this case, was measured against the same formula describing conduct that falls outside business judgment protection: an action so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith. The Delaware Supreme Court described this good-faith standard as purely subjective, and rejected the Court of Chancery's application of a standard that included both subjective good faith — "honesty in fact" — and an element of objectivity — "reasonable commercial standards of fair dealing" — as provided in the UCC.

Applying this standard, the Delaware Supreme Court affirmed the Court of Chancery's judgment, finding that the GP's continuous failures to provide financial statements provided the LPs with a good-faith belief that the GP needed to be removed for the best interest of the partnership.

Contractual Good Faith and the Covenant of Good Faith and Fair Dealing

The LPA's use of "good faith" in the removal provision resulted in the application of an easily-satisfied subjective test. If the

removal provision had not specified a good-faith standard at all, then applying the reasoning of a prior Court of Chancery case, *Wilmington Leasing v. Parrish Leasing, L.P.*, 1996 Del. Ch. LEXIS 123 (Del. Ch. Sept. 25, 1996), the covenant of good faith and fair dealing would have applied. Under that test, the limited partners' removal of the GP would have been measured by whether the removal was exercised reasonably and in good faith (i.e., applying an objective reasonableness standard). Thus, one consequence of *Policemen's Annuity* is that by specifying a good-faith standard, a laxer subjective test may be applied; by not specifying any standard, the covenant of good faith and fair dealing may be applied, potentially resulting in the stricter objective standard.

Other Considerations

Policemen's Annuity should remind practitioners that contractual standards in partnership and LLC agreements may be viewed through a lens that applies standard corporate-law tests. For example, an "arm's length" or "fair transaction" standard in such an agreement may be interpreted as requiring satisfaction of an entire fairness standard, including both prongs of having a fair process and a fair result. In *Gatz Properties LLC v. Auriga Capital*, 2012 Del. Lexis 577 (Del. Nov. 7, 2012), the Delaware Supreme Court stated that to impose fiduciary standards of conduct as a contractual matter, there is no requirement in Delaware that an LLC agreement use magic words, such as "entire fairness" or "fiduciary duties." The

preference to apply corporate-law tests can cut either way: While undefined "fair" might invoke the seemingly higher standard of entire fairness, undefined "good faith" might invoke a subjective test in partnership and LLC agreements that is satisfied more easily than its counterpart standard applied in commercial contexts. Of course, to generally avoid confusion, ambiguity and unintended consequences, practitioners may explicitly specify which form of "fairness" or "good faith" is applicable.

Joel Feuer is a partner of Gibson, Dunn & Crutcher. He has handled a broad range of complex business litigation, including securities litigation and claims arising out of corporate transactions.

Benyamin Ross is an associate with the firm. He advises companies, private equity and venture capital firms, and individuals in mergers and acquisitions, equity investments and joint ventures.