YOUNG CONAWAY STARGATT & TAYLOR, LLP
Attorneys at Law

Fall 2012

Delaware Transactional & Corporate Law Update

Recent Delaware Cases Regarding the Implied Contractual Convenant of Good Faith and Fair Dealing

by John Paschetto and Andy Kostoulas

In three recent decisions, the Delaware Court of Chancery has further developed its jurisprudence regarding the application of the implied contractual covenant of good faith and fair dealing in the context of operating agreements of Delaware limited liability companies ("LLCs") and limited partnerships ("LPs"). The implied covenant can play an important role in the enforcement of Delaware LLC and LP agreements because (unlike fiduciary duties) it may not be eliminated by contract. (6 *Del. C.* § 17-1101(d) (as to LPs), § 18-1101(c) (as to LLCs).) The decisions we discuss below elaborate on the substance of the implied covenant and the circumstances under which it does not provide the basis for a claim.

The Nature of Implied-Covenant Claims: *ASB Allegiance Real Estate Fund*

In *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC,* the court addressed the question whether a claim of implied-covenant breach sounds in contract or tort. (C.A. No. 5843-VCL, 2012 Del. Ch. LEXIS 154 (Del. Ch. July 9, 2012).) The plaintiffs in the case had previously succeeded in obtaining reformation of three LLC agreements pertaining to joint ventures with the defendants. The plaintiffs now sought an order that their legal fees and costs be paid by the defendants, pursuant to fee-shifting provisions in the LLC agreements.

Each of the three LLC agreements provided that a non-prevailing party must reimburse a prevailing party for reasonable fees and costs incurred by the latter in "'any action to enforce the provisions of this Agreement[.]'" (*Id.* at *5 (quoting the LLC agreements).) The defendants appear to have argued, among other things, that the fee-shifting provisions did not pertain to the fees and costs incurred by the plaintiffs in defending against a counterclaim of implied-covenant breach. The defendants' theory was evidently that this counterclaim sounded in tort, not contract.

Rejecting the defendants' argument, the court explained certain differences between a claim for breach of the implied covenant and a claim for breach of fiduciary duty (which is considered a tort claim). Duties under the implied covenant "necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally." (*Id.* at *10.) Accordingly, an "implied covenant claim . . . looks to the past"—the time of contracting. (*Id.* at *9.) By contrast, "[u]nder a fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong" and asks "what duty the law should impose on the parties given their relationship at the time of the wrong[.]" (*Id.* at *8-9.)

Moreover, since a claim of implied-covenant breach "turn[s] on" the contract, "[t]he elements of an implied covenant claim remain those of a breach of contract claim: 'a specific implied contractual obligation, a breach of that obligation by the defendant, and resulting damage to the plaintiff.'" (*Id.* at *22-23 (*quoting Fitzgerald v. Cantor,* C.A. No. 16297-NC, 1998 Del. Ch. LEXIS 212, at *4 (Del. Ch. Nov. 10, 1998)).) Those elements, importantly, do *not* include proof of a "culpable mental state analogous to the *scienter* requirement of fraud and other intentional torts." (*Id.* at *15.)

As the court went on to explain, Delaware caselaw may give the inaccurate impression that a defendant's culpable mental state is associated with implied-covenant claims. This impression may have arisen because (1) a prohibition against fraudulent conduct is a term that would be implied in almost any contract, and (2) proof of fraudulent conduct entails proof of a culpable mental state. Thus, the defendant's mental state may be relevant to a particular type of implied term, but it is not relevant to implied terms *per se*: "Proving fraud represents a specific application of the general implied covenant test, *viz.*, what would the parties have agreed to when bargaining initially?" (*Id.* at *22.)

Limited Partners Required to Establish That They Acted in Good Faith: *DV Realty Advisors LLC*

Policemen's Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC presented the unusual situation of parties seeking a declaratory judgment that they acted in good faith. (C.A. No. 7204-VCN, 2012 Del. Ch. LEXIS 188 (Del. Ch. Aug. 16, 2012).) The plaintiffs, limited partners of DV Urban Realty Partners I L.P., had voted to remove the LP's one remaining general partner after the general partner was repeatedly late in

distributing audited financials as required by the LP agreement (among other alleged defaults). The limited partners then initiated an action against the general partner in the Court of Chancery, seeking a judgment that they had complied with the "good faith" requirement set forth in the LP agreement.

The LP agreement provided that the general partners could be removed by the vote of limited partners holding more than 75% of the LP interests, "'provided that consenting Limited Partners in good faith determine that such removal is necessary for the best interest of the [LP].'" (*Id*. at *9 (quoting the LP agreement).) Because the limited partners were the plaintiffs, the court placed upon them the burden of establishing that they had met this standard. Thus, while the limited partners' conduct would seem to afford little basis for a claimant to establish the *presence* of bad faith, the court's post-trial opinion tackled a more difficult question, whether the evidence established the *absence* of bad faith.

The court began its analysis by holding that the relevant provision of the LP agreement did not have a gap to be filled by the implied covenant. The provision permitting removal of the general partners specified how the limited partners' "discretion [was] to be exercised" in that regard. (*Id*. at *41.) "[I]f the scope of discretion is specified, there is no gap in the contract as to the scope of the discretion, and there is no reason for the Court to look to the implied covenant to determine how discretion should be exercised." (*Id*. at *43.)

The court next settled on the applicable meaning of "good faith," since the term was not defined in the LP agreement. After discussing the differences between "subjective" and "objective" good faith under Delaware common law, the court selected the definition used in the UCC: "'honesty in fact and the observance of reasonable commercial standards of fair dealing.'" (*Id.* at *50 (*quoting* 6 *Del. C*. § 1-201(20)).) This, the court explained, was "at least as broad of a definition of good faith as that applied to contracts at common law," and since (as the court found) the UCC definition was met by the limited partners' conduct, their conduct necessarily met the common-law definition of "good faith" that the court presumed the parties intended. (*Id*.)

Based on a careful analysis of the record facts surrounding the limited partners' decision to remove the general partner, the court concluded that the general partner's "continuous failure to have the Limited Partnership's audited Financial statements completed in the time prescribed . . . provided [the plaintiffs] with a good faith belief that the [general partner] needed to be removed for the best interest of the Limited Partnership." (*Id.* at *55.) The court rejected the general partner's argument that this was merely a pretext, and that the limited partners' true motivation was self-interested. While some evidence supported the general partner's theory, it was "outweighed by the evidence that the Limited Partners acted" because of the general partner's contractual defaults. (*Id*. at *76-77.)

Parties to an LP or LLC agreement may limit the reach of the implied covenant by expressly defining "good faith."

No Room for the Implied Covenant in LP Agreement Defining "Good Faith": *Encore Energy Partners LP* [1]

Most recently, in *In re Encore Energy Partners LP Unitholder Litigation*, the court relied on an LP agreement's definition of "good faith" in dismissing a claim that the LP's general partner had breached the implied covenant when approving a merger between the LP and an affiliate of the general partner. (Consol. C.A. No. 6347-VCP, 2012 Del. Ch. LEXIS 214 (Del. Ch. Aug. 31, 2012).)

Certain limited partners of Encore Energy sued its general partner (a Delaware LLC), the general partner's board of directors, and the general partner's ultimate parent (Vanguard Natural Resources, LLC) after the general partner approved a merger between Encore Energy and an indirect subsidiary of Vanguard. The merger had been proposed by Vanguard, and the merger consideration—ultimately, three quarters of a unit of Vanguard for each common unit of Encore Energy—was arguably worth less than the market price of an Encore Energy unit before the merger negotiations.

The Encore Energy LP agreement provided that (1) a conflict transaction would be immunized from legal challenge if it received "Special Approval"; (2) Special Approval consisted of approval by a majority of the Conflicts Committee of the general partner's board, "'acting in good faith'"; and (3) "good faith" required that the persons making a determination or taking an action "'believe that the determination or other action is in the best interests of the partnership.'" (*Id*. at *31-33 (quoting the LP agreement).) There being no dispute that the Conflicts Committee had approved the challenged merger, the issue under the express terms of the LP agreement was whether the Conflicts Committee had given such approval in good faith. Thus, as the court framed the issue, the plaintiffs could survive the motion to dismiss by alleging facts from which the court could reasonably infer that the Committee had not acted in good faith as defined in the LP agreement—i.e., that "Defendants subjectively believed that they were acting *against* Encore's interests." (*Id.* at *34.)

The court found that the plaintiffs failed to allege such facts. "At worst, the Complaint alleges that the Conflicts Committee ran a shoddy negotiation process[,]" obtaining little increase above Vanguard's initial offer. This by itself was not enough to establish a belief on the defendants' part that they were acting against the LP's interests. Since the plaintiffs therefore could not show that the defendants had failed to meet the Special Approval standard, the LP agreement shielded the merger from judicial review.

The court next addressed whether the defendants had breached the implied covenant in approving the merger, notwithstanding their compliance with the express contractual standard. The court held that such a claim could not be made out, because the Special Approval provisions did not leave a gap for the implied covenant to fill. Those provisions "indicate[d] an intent contrary to the implied condition of obtaining objectively fair value that Plaintiffs contend inheres in the meaning of Special Approval." (*Id*. at *51.)

The court then held in the alternative that the implied-covenant claim was also barred because the LP agreement provided that any act by the general partner in reasonable

reliance on the advice of an investment banker would be "'conclusively presumed to have been done . . . in good faith[.]'" (*Id*. at *56 (quoting the LP agreement).) In approving the merger, the Conflicts Committee relied on a fairness opinion provided by Jefferies. Therefore, in line with recent precedent, the court dismissed the implied-covenant claim for the independent reason that such a claim could not survive where the defendant is conclusively presumed to have acted in good faith. (*Id*. at *57-58 (*citing Gerber v. Enter. Prods. Holdings, LLC*, C.A. No. 5989-VCN, 2012 Del. Ch. LEXIS 5 (Del. Ch. Jan. 6, 2012); *In re K-Sea Transp. Partners L.P. Unitholders Litig*., C.A. No. 6301-VCP, 2012 Del. Ch. LEXIS 67 (Del. Ch. Apr. 4, 2012)).)

Encore Energy Partners provides further support for the view that, at least within certain bounds, parties may limit the reach of the implied covenant by expressly defining "good faith." If the parties to the LP agreement at issue in *DV Realty Advisors* had taken that approach instead of leaving "good faith" undefined, they might have avoided or curtailed the searching analysis undertaken by the court. In addition, *DV Realty Advisors*, together with *ASB Allegiance Real Estate Fund*, sheds light on the meaning of "good faith" and how implied-covenant claims fit within Delaware jurisprudence.

---

[1] Certain defendants in *Encore Energy Partners LP* were represented by Young Conaway Stargatt & Taylor, LLP. The views expressed herein are those of the authors alone and should not be taken as representing the views of Young Conaway or its professionals or clients.

2012 Amendments to the Delaware Limited Liability Company Act and Limited Partnership Act

by John J. Paschetto

Effective August 1, 2012, the Delaware legislature has amended the State's laws governing limited liability companies ("LLCs") and limited partnerships ("LPs") to require that additional information be provided in connection with certain filings with the Delaware Secretary of State. The amendments have also clarified the time as of when LLC and LP agreements may be made effective and further modified the scope of the defense of usury, among other changes.

Address for Mailing of Process When a Delaware Entity Transfers to a Non-U.S. Jurisdiction

The Delaware LLC Act (6 *Del. C.* §§ 18-101–18-1109) and the Delaware LP Act (6 *Del. C.* §§ 17-101–17-1111) permit Delaware LLCs and LPs to transfer to non-U.S. jurisdictions. (6 *Del. C.* §§ 18-213, 17-216.) When a Delaware entity transfers to a non-U.S. jurisdiction and does not elect to continue its existence in Delaware, it must file with the Delaware Secretary of State a certificate of transfer, in which, among other things, it appoints the Secretary of State as the entity's agent to accept service of process and provides an address to which process will be forwarded by the Secretary of State. (6 *Del. C.* §§ 18-213(b)(6)-(7), 17-216(b)(6)-(7).) As the required forwarding address, entities have often used the address of their registered agent in Delaware, notwithstanding that in many cases an entity's registered agent ceased to serve as such upon the entity's transfer out of the State.

To prevent such errors in the future, the LLC Act and LP Act have been amended to require that whenever an LLC or LP provides its registered agent's address as the forwarding address in a certificate of transfer, the certificate of transfer must be accompanied by the written consent of the entity's registered agent to the use of its address for that purpose. (6 *Del. C.* §§ 18-213(b)(7), 17-216(b)(7).) This new filing requirement will help ensure that process served on the Secretary of State as the statutory agent for a transferred entity will ultimately reach the entity.

Restrictions on Names of LLCs and LPs

The amendments bring the LLC and LP Acts into conformity with the Delaware General Corporation Law (the "DGCL") regarding the use of the word "bank" in an entity's name. Like the DGCL (*see* 8 *Del. C.* § 102(a)(1)), the LLC and LP Acts now prohibit the use of "bank" or "any variation thereof" in an entity's name, unless the entity is regulated under Delaware or federal banking laws, or "bank" is used in a context that clearly does not refer to "banking business" and is not "likely to mislead the public . . . or to lead to a pattern and practice of abuse[.]" (6 *Del. C.* §§ 18-102(5), 17-102(5).)

In addition, the LP Act has been amended to require that a limited liability limited partnership (an "LLLP") change its name if it ceases to be an LLLP. When an LLLP cancels its statement of qualification (i.e., the filing through which it became specifically a *limited liability* LP) but continues to exist as a Delaware LP, its name must, at the same time, be changed in its certificate of limited partnership such that it no longer appears to be an LLLP. (6 *Del. C.* § 17-214(c).)

Limitation on the Defense of Usury

Since 1994, the LLC Act and the LP Act have provided that no obligation of a member or manager to an LLC, or of a partner to an LP, "shall be subject to the defense of usury[.]" (6 *Del. C.* §§ 18-505, 17-505.) The amendments have added the further provision that the defense of usury may not be raised against obligations *between* the members or managers of an LLC, or the partners of an LP. (*Id*.)

Effective Time of LLC and LP Agreements

The amendments have clarified provisions of the LLC and LP Acts regarding the time as of when an LLC or LP agreement may be made effective. Previously, the Acts stated that the agreement may be made effective as of the "formation" of the LLC or LP. (6 *Del. C.* §§ 18-201(d), 17-201(d).) This language was a potential source of confusion because it could be taken to imply that the "formation" of an LLC or LP is independent of the existence of its LLC or LP agreement. In fact, an LLC or LP agreement must be in place for the entity to be considered properly formed. (6 *Del. C.* §§ 18-201(b), (d), 17-201(b), (d).)

Sections 18-201(d) and 17-201(d) have therefore been amended to state that an LLC or LP agreement may be made effective not as of the entity's "formation," but rather as of the time when the associated certificate of formation (in the case of an LLC) or certificate of limited partnership (in the case of an LP) became or becomes effective. These sections now more accurately reflect what was already the law, i.e., an LLC or LP is formed when two conditions are met: an LLC or LP agreement is in place, and a certificate of formation or certificate of limited partnership has been filed and is effective.

Standing to Apply to the Court of Chancery to Wind Up an LLC

The section of the LLC Act related to winding-up has been amended so that it no longer enables the personal representative or assignee of a manager (as opposed to that of a member) to apply to the Delaware Court of Chancery to wind up an LLC. (6 *Del. C.* § 18-803(a).) Thus, an application to the Court for winding-up may now be made only by a member, a member's personal representative or assignee, or a manager.

Similarly, the section of the LLC Act that primarily governs "series" LLCs[1] has been amended to provide that an application to the Court of Chancery for the winding-up of a series may be made by a member, a member's personal representative or assignee, or a manager, in each case if the applicant is associated with the series. (6 *Del. C.* § 18-215(l).) Previously, a manager associated with a series was not specified as having standing to seek winding-up.

Other Amendments

A number of statutory sections relating to mergers, consolidations, and conversions have been amended to require that the related filing with the Delaware Secretary of State specify the type or types of entities involved. Thus, the type or types of entities must now be specified in a certificate of merger or consolidation of a Delaware LLC with an LLC or other entity (6 *Del. C.* § 18-209(c)(1)), a certificate of conversion of an entity other than a Delaware LLC to a Delaware LLC (6 *Del. C.* § 18-214(c)(2)), a certificate of merger or consolidation of a Delaware LP with an LP or other entity (6 *Del. C.* § 17-211(c)(1)), and a certificate of conversion of an entity other than a Delaware LP to a Delaware LP (6 *Del. C.* § 17-217(c)(2)). Furnishing this additional information in the specified filings will streamline the Secretary of State's task of preparing certified copies of such filings.

[1] A "series" LLC is, briefly, an LLC that has one or more series of members, managers, LLC interests, or assets. (6 *Del. C.* § 18-215(a).) The establishment and maintenance of a series in accordance with the standards set forth in § 18-215(b) can have desirable legal consequences under § 18-215.

About the Update:

The Delaware Transactional & Corporate Law Update is published by the Business Planning and Transactions section of Young Conaway Stargatt & Taylor, LLP.

Young Conaway, based in Wilmington, Delaware, is among the state's largest law firms, with over 100 attorneys in 10 practice sections that include bankruptcy, corporate, intellectual property, employment law, tax, banking and real estate practices.

The Business Planning and Transactions section handles matters arising at every stage in the formation, growth and development of corporations, limited liability companies, limited partnerships, statutory trusts and other types of entities, including those formed as special purpose entities in securitization and other structured transactions. The section's attorneys combine experience in Delaware corporate law, alternative-entity law, tax, commercial transactions and bankruptcy reorganizations.

To receive a complimentary subscription to this publication, please send an e-mail with your contact information to info@ycst.com or visit our web site at www.YoungConaway.com. To opt out of an e-mail subscription, please send your name and e-mail address with "unsubscribe to bpt newsletter" in the subject line to info@ycst.com.

Members of the Business Planning and Transactions Section

cgrear@ycst.com
302.571.6612

Craig D. Grear, Partner. Mr. Grear has made numerous presentations nationally and internationally on a variety of Delaware business law topics, including alternative entities and Delaware holding companies. He is a 1989 graduate of Georgetown University Law Center.

jhughes@ycst.com
302.571.6670

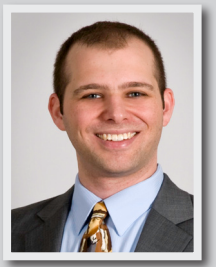
James P. Hughes, Jr., Partner. Mr. Hughes has litigated numerous matters in the Delaware Court of Chancery and served as in-house counsel at an Internet company. He is a 1992 graduate of the University of Pennsylvania Law School.

jpaschetto@ycst.com
302.571.6608

John J. Paschetto, Partner. Mr. Paschetto has contributed to several books on corporate takeovers and the limitation of director liability. He is a 1998 graduate of Harvard Law School.

npowell@ycst.com
302.571.6629

Norman M. Powell writes and speaks regularly at conferences and training programs on topics including alternative entities and secured transactions, and serves on the Commercial Financial Services, Legal Opinions, and Uniform Commercial Code Committees of the Business Law Section of the American Bar Association.



ekostoulas@ycst.com
302.576.3589

Evangelos ("Andy") Kostoulas, Associate. Mr. Kostoulas practices primarily in the commercial transactions area with a focus on mergers and acquisitions, the structure and use of Delaware entities, and the rendering of legal opinions. He is a 2007 graduate of the University of Pennsylvania Law School.