

# LEAP OF FAITH: DETERMINING THE STANDARD OF FAITH NEEDED TO VIOLATE THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING FOR DELAWARE LIMITED LIABILITY COMPANIES

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**Abstract:** Delaware courts have long respected the right to contract in Delaware, and possibly no entity is afforded more privileges to set the boundaries of its corporate form than the Delaware Limited Liability Company. Unlike nearly every other state, Delaware permits LLCs to abolish the duties of care and loyalty in their operating agreements, but forbids companies to eliminate liability for “any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.” The problem with the phrase “bad faith violation” is that, when referencing a breach of the implied covenant of good faith and fair dealing, it implies that there exists a non-bad faith violation of the covenant. In determining whether or not “neutral faith” or “non-bad faith” violations of the implied covenant are permissible under Delaware LLC law, this essay argues that Delaware courts should look to the relatively short history of the covenant, the contractarian spirit of Delaware laws and courts, and section 18-1101 of the Delaware Limited Liability Company Act to hold that the implied covenant can only be violated in bad faith.

## INTRODUCTION

Delaware courts have long respected the right to contract in Delaware, and possibly no entity is afforded more privileges to set the boundaries of its corporate form than the Delaware Limited Liability Company (“LLC”). Unlike nearly every other state, Delaware permits LLCs to not only abolish the duty of care in their operating agreements, but also the duty of loyalty.<sup>1</sup> Thus, if their operating agreement so allows, directors of Delaware LLCs are immune from claims such as self-dealing, clandestine profit engorgement, and nepotism, among others. However, Delaware law expressly forbids eliminating lia-

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<sup>1</sup> DEL. CODE ANN. tit. 6, § 18-1101(e) (2013).

bility for “any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”<sup>2</sup>

The problem with the phrase “bad faith violation” is that, when referencing a breach of the implied covenant of good faith and fair dealing, it implies that there exists a non-bad faith violation of the covenant. For example, what is a “good faith” breach of the implied covenant of good faith and fair dealing? This essay acknowledges that in order to find a violation of the implied covenant, “bad faith,” and not something akin to “neutral faith,” must be found. However, it also recognizes that Delaware courts have not expressed a coherent policy rationale for *why* bad faith must be found. This essay recommends that Delaware courts consider that while Delaware LLCs are permitted to contract around the fiduciary duties of care and loyalty, the fact that the implied covenant is never permitted to be contracted out means the Delaware legislature expects it to be taken incredibly seriously. Thus, the weight of available authority on the subject indicates that the covenant cannot be violated except in bad faith.

## I. THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Although it has a reputation as a generic catchall, the implied covenant isn't a blanket opposition to anything seemingly done in bad faith. “General allegations of bad faith conduct are not sufficient” to state a claim, despite the claim's frequent (and frequently unsuccessful) use as a last resort by parties who are otherwise disappointed with where their contracts have brought them.<sup>3</sup>

In order to assert this claim, one must allege “a specific implied contractual obligation, a breach of that obligation . . . and resulting damage.”<sup>4</sup> Courts will look at what the parties hoped to receive from the contract at the point when they entered it, and determine if the actions under scrutiny were (or should have been) reasonably considered *ex ante*. “When applying the implied covenant of good faith and fair dealing, the temporal focus is critical . . . . The implied covenant looks to the past, and seeks to enforce terms that the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting.”<sup>5</sup> Judges will “not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal.”<sup>6</sup> Rather, the covenant asks whether one party

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<sup>2</sup> *Id.*

<sup>3</sup> *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 888 (Del. Ch. 2009).

<sup>4</sup> *Fitzgerald v. Cantor*, 1998 Del. Ch. LEXIS 212, at \*4 (Del. Ch. Nov. 10, 1998).

<sup>5</sup> *Employees Ret. Sys. of City of St. Louis v. TC Pipelines GP, Inc.*, C.A. No. 11603-VCG, 2016 WL 2859790, at \*7 n.47 (Del. Ch. May 11, 2016) (internal quotations omitted).

<sup>6</sup> *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010). The court further acknowledges the right of parties “to enter into good and bad contracts,” noting that contracts of both types will be enforced by the law. *See id.*

is frustrating the purpose of the contract through some “loophole” not expressly outlined in the contract.

Because Delaware courts show utmost consideration to the four corners of a voluntary agreement, they consider use of the covenant to be a “rare and fact-intensive exercise” saved only for a “narrow band of cases.”<sup>7</sup> Parties alleging a violation of the covenant may not base their claims “on conduct authorized by the terms of the agreement.”<sup>8</sup> The difficulty of stating a claim for violation of the covenant means that parties rarely invoke it successfully.<sup>9</sup>

## II. GOOD FAITH AND BAD FAITH

Bad faith is a very specific term of art in Delaware. In distinguishing the phrase from “fraud,” the Delaware Supreme Court has relied on Black’s Law Dictionary to find that

[The] term “bad faith” is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; it is different from the negative idea of negligence in that it contemplates a state of mind affirmatively operating with furtive design or ill will.<sup>10</sup>

Indeed, a party’s *mens rea* is at the crux of bad faith. The Delaware Court of Chancery (the “Chancery Court”) has similarly held that a plaintiff must show that the defendant’s actions were driven by an “improper purpose” in order to prove bad faith.<sup>11</sup>

“Good faith,” unlike bad faith, is not defined affirmatively by Delaware courts, and is instead almost always defined in reference to bad faith. For example, when confronted with contracts that do not themselves define bad faith, courts have adopted a presumption that actions were taken in good faith “unless [they] went so far beyond the bounds of reasonable judgment that [they seem] essentially inexplicable on any ground other than bad faith.”<sup>12</sup> The Delaware Uniform Commercial Code (“UCC”) does affirmatively define good faith as “honesty in fact and the observance of reasonable commercial stand-

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<sup>7</sup> Lonergan v. EPE Holdings LLC, 5 A.3d 1008, 1018 (Del. Ch. 2010) (first quoting Dunlap v. State Farm & Cas. Co., 878 A.2d 434, 442 (Del. 2005); then quoting Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 146 (Del. Ch. 2009)).

<sup>8</sup> Dunlap, 878 A.2d at 441.

<sup>9</sup> See Kuroda, 971 A.2d at 888.

<sup>10</sup> Desert Equities, Inc. v. Morgan Stanley Leveraged Equity Fund, II, L.P., 624 A.2d 1199, 1208 n.16 (Del. 1993) (quoting *Bad Faith*, BLACK’S LAW DICTIONARY (5th ed. 1983)).

<sup>11</sup> See Amirsaleh v. Bd. of Trade of City of New York, Inc., C.A. No. 2822-CC, 2009 WL 3756700, at \*5 (Del. Ch. Nov. 9, 2009).

<sup>12</sup> CDX Holdings, Inc. v. Fox, 141 A.3d 1037, 1054 (Del. 2016), *reargument denied* (June 13, 2016) (quoting DV Realty Advisors LLC v. Policemen’s Annuity & Benefit Fund of Chicago, Ill., 75 A.3d 101, 110 (Del. 2013)).

ards of fair dealing.”<sup>13</sup> Still, outside of the specific commercial context of the UCC, “good faith” has been given no specific meaning; it has served only to exclude numerous forms of “bad faith” actions.<sup>14</sup>

It is also unclear if “good faith” ought to be interpreted objectively or subjectively. For example, the Chancery Court has recently stated that the “common law definition of good faith, at least in the fiduciary context, was historically subjective, but there has been some suggestion that that may no longer be the case.”<sup>15</sup> Determining whether something is in good faith is extremely fact-specific, making the term even more difficult to define.<sup>16</sup>

### III. NEUTRAL FAITH?

Since good faith is defined only in reference to bad faith, do the two standards present the courts with an exclusive, binary set of options? In other words, is it possible to act “not in bad faith,” but at the same time *not* act “in good faith?”

Delaware courts have not explicitly decided this issue, though they have used strong language in dicta to warn against the potential concept of “neutral faith.” The implied covenant is a relatively new phenomenon in Delaware, only dating back to the early 1980’s.<sup>17</sup> Since that time, Delaware courts have often found implied covenant claims to be defeated because a party did not act in bad faith; however, in those cases they did not explicitly say that the party had acted in good faith, either.<sup>18</sup> Some have said that in order “to plead an act or omission was not in good faith . . . a plaintiff must demonstrate that the de-

<sup>13</sup> DEL. CODE ANN. tit. 6, § 1-201 (2016).

<sup>14</sup> See *Dunlap*, 878 A.2d at 441.

<sup>15</sup> *Policemen’s Annuity & Benefit Fund of Chicago v. DV Realty Advisors LLC*, C.A. No. 7204–VCN, 2012 WL 3548206, at \*13 (Del. Ch. Aug. 16, 2012) (“The common law definition of good faith as applied to contracts is primarily subjective, but there is likely some conduct which is so unreasonable that this Court will necessarily determine that it could not have been undertaken in good faith. That may be because the common law definition of good faith as applied to contracts contains an objective element or it may be that, regardless of the evidence presented as to subjective intent, the Court will necessarily (almost always) find that certain conduct could not possibly have been undertaken in good faith.”).

<sup>16</sup> See *id.* (“Context matters—what is utterly unreasonable in one setting may be perfectly acceptable in another.”).

<sup>17</sup> The first reference to the implied covenant of good faith and fair dealing in Delaware was in 1982. See *Henry J. Majewski v. Magness Constr. Co.*, C.A. No. 056-10-81, 1982 WL 318020, at \*1 (Del. Com. Pl. July 28, 1982).

<sup>18</sup> See *Cont’l Ins. Co. v. Rutledge & Co.*, 750 A.2d 1219, 1234 (Del. Ch. 2000) (“Continental’s conduct does not strike me as unfair or in bad faith.”); see also *Nemec v. Shrader*, 991 A.2d 1120, 1128 (Del. 2010) (“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. We cannot reform a contract because enforcement of the contract as written would raise ‘moral questions . . . .’ Accordingly, we affirm the Chancellor’s dismissal of [plaintiff’s claim].”).

defendants acted in bad faith.”<sup>19</sup> Unfortunately, while Delaware courts have expressed their disdain for neutral faith, they have not put forth a compelling historical account of or policy rationale behind the implied covenant that would lend itself to such an interpretation.

#### IV. THE DELAWARE LIMITED LIABILITY COMPANY ACT’S TREATMENT OF THE COVENANT

The Delaware Limited Liability Company Act (“LLC Act”), which governs the creation and regulation of LLCs in Delaware, is intended “to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”<sup>20</sup> This is in line not only with longstanding Delaware principles, but also with Delaware courts’ specific treatment of LLCs, which are considered “creatures of contract . . . designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.”<sup>21</sup> When parties voluntarily arrange their affairs via contract, Delaware law exhibits a strong bias toward respecting that agreement.<sup>22</sup> The Delaware LLC has been described as the “most flexible contractual entity presently available in the global marketplace.”<sup>23</sup>

This emphasis on the freedom of contract is complicated by section 18-1101 of the LLC Act, which states, in relevant part, that an LLC operating agreement “may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person,” but cannot “eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual

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<sup>19</sup> See *Liberty Prop. L.P. v. 25 Massachusetts Ave. Prop. LLC*, C.A. No. 3027–VCS, 2009 WL 224904, at \*5 n.21 (Del. Ch. Jan. 22, 2009); see also *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 105 (Del. 2013) (“This conclusion does not alter the reasoning expressed in Court of Chancery decisions holding that there is no difference between ‘bad faith’ and ‘a lack of good faith’ in the context of the implied covenant of good faith and fair dealing.”); *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 240 n.8 (Del. 2009) (concluding that though the court has used the terms “bad faith” and “failure to act in good faith” interchangeably in some contexts and noted that these concepts are not necessarily identical in others, it would not, in this case, draw a distinction between the terms); *Amirsaleh v. Bd. of Trade of City of New York, Inc.*, C.A. No. 2822–CC, 2009 WL 3756700, at \*5 n.23 (Del. Ch. Nov. 9, 2009) (noting that the Chancery Court has firmly rejected the idea that “not in good faith” means anything other than “bad faith”). Though the court in *Liberty Property* was applying District of Columbia law, the Chancery Court has held that the two jurisdictions are uniform in their rejection of a concept of “neutral faith.” See *Amirsaleh*, 2009 WL 3756700 at \*5 n. 23.

<sup>20</sup> DEL. CODE ANN. tit. 6, § 18-1101 (2013).

<sup>21</sup> *R & R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, C.A. No. 3803–CC, 2008 WL 3846318, at \*4 (Del. Ch. Aug. 19, 2008) (quoting *TravelCenters of Am. LLC v. Brog*, C.A. No. 3516–CC, 2008 WL 1746987, at \*1 (Del. Ch. Apr. 3, 2008)).

<sup>22</sup> *W. Willow-Bay Court, LLC v. Robino-Bay Court Plaza, LLC*, C.A. No. 2742–VCN, 2007 WL 3317551, at \*12 (Del. Ch. Nov. 2, 2007).

<sup>23</sup> Ann E. Conway, *The Global Use of the Delaware Limited Liability Company for Socially Driven Purposes*, 38 WILLIAM MITCHELL L. REV. 772, 784 (2012).

covenant of good faith and fair dealing.”<sup>24</sup> Under a plain-meaning construction, this latter provision may be read as imposing a “duty not to *in bad faith* violate the implied contractual covenant of good faith and fair dealing.”<sup>25</sup> This meaning would be consistent with the contractual interpretation canon, recognized by Delaware courts, that “words in a statute should not be construed as surplusage if there is a reasonable construction which will give them meaning.”<sup>26</sup>

The absurdity doctrine, however, takes precedence over the surplusage canon.<sup>27</sup> Under the construction proposed above, Delaware LLCs could, in their operating agreements, contract out the implied covenant in all instances that are not “bad faith” violations, including “neutral faith” violations. For example, under this construction, an operating agreement could contain the following section: “Directors of Hypothetical LLC will not be liable for any and all violations of the implied covenant of good faith and fair dealing that are not the byproduct of bad faith.” While this interpretation of the statute seems textually reasonable, it conflicts with the binary system of good/bad faith that most Delaware courts have applied. What appears far more likely is that the term “bad faith” is not placed where it is in section 18-1101 to specify the subset of violations that are impermissible to contract out, but rather used simply to reemphasize what kind of conduct is generally required for violating the implied covenant. While this language is somewhat sloppy, it makes far more sense than the alternative, which would permit liability sections such as the hypothetical contractual provision above.

Additionally, Delaware is one of the few states in the country that permits an LLC to completely eliminate the duty of loyalty.<sup>28</sup> In fact, some other states

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<sup>24</sup> DEL. CODE ANN. tit. 6, § 18-1101 (2013). (“A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”). This language is borrowed directly from Delaware’s law regarding partnerships, which is older than the LLC Act. *See* DEL. CODE ANN. tit. 6, § 17-1101(f) (2010).

<sup>25</sup> Brent J. Horton, *The Going-Private Freeze-Out: A Unique Danger for Investors in Delaware Non-Corporate Business Associations*, 38 DEL. J. CORP. L. 53, 77 n.145 (2013).

<sup>26</sup> *Oceanport Indus., Inc. v. Wilmington Stevedores, Inc.*, 636 A.2d 892, 900 (Del. 1994).

<sup>27</sup> *See* Bryan A. Garner, *Outtakes from a Treatise: Garner and Scalia Present a Quiz on Textualism: Part 1 of 2*, ABA J. (Oct. 1, 2012 7:20 AM), [http://www.abajournal.com/magazine/article/outtakes\\_from\\_a\\_treatise\\_garner\\_and\\_scalia\\_present\\_a\\_quiz\\_on\\_textualism\\_par/](http://www.abajournal.com/magazine/article/outtakes_from_a_treatise_garner_and_scalia_present_a_quiz_on_textualism_par/) [<https://perma.cc/2MFL-UWDH>].

<sup>28</sup> *See generally* Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need to Protect Minority Investors*, 43 AM. BUS. L.J. 609 (2006) (analyzing the results of a study involving state LLC laws and the ramifications for the negotiation of LLC agreements having minority members).

statutorily forbid entities from contracting away fiduciary duties at all.<sup>29</sup> Because Delaware permits fiduciary duties to be eliminated wholesale, it demonstrates a strong respect for a contractarian spirit more so than any other state in the country. This principle is consistent with both Delaware law generally and LLCs specifically, which were created as vehicles that uphold the freedom of contract.

Still, Delaware courts have recognized that the LLC Act is inconsistent with a “purely contractarian view”:

To my mind, when a sovereign makes available an entity with attributes that contracting parties cannot grant themselves by agreement, the entity is not purely contractual. Because the entity has taken advantage of benefits that the sovereign has provided, the sovereign retains an interest in that entity. That interest in turn calls for preserving the ability of the sovereign’s courts to oversee and, if necessary, dissolve the entity. Put more directly, an LLC agreement is not an exclusively private contract among its members precisely because the LLC has powers that only the State of Delaware can confer. Those powers affect the rights of third parties, who at a minimum must take into account the LLC’s separate legal existence and its members’ limited liability shield.<sup>30</sup>

This language is important because it walks back the radically contractarian view typically associated with Delaware corporate entities. Clear evidence of this idea is section 18-1101(e) of the LLC Act, as a “purely contractarian” entity would logically be permitted to contract away liability for violations of the implied covenant. Thus, this rare instance of a limiting principle in the context of Delaware LLCs should be taken very seriously, as it eschews the traditionally contractarian deference granted by Delaware laws and courts. In fact, the implied covenant is of even more importance in Delaware than almost anywhere else because it serves as a last-ditch effort against inappropriate director behavior absent the duties of care or loyalty. In this light, it only makes sense that the implied covenant may not be violated by anything but actions taken in bad faith. A reading of the statute that would permit neutral faith violations of the covenant fails to appreciate the overall guiding principles reflected in Delaware law, focusing instead on the semantics of the statute and the lack of total clarity from Delaware courts. A reasoned approach that considers the unique historical position of the implied covenant in reference to its relationship with the duties of care and loyalty is a much more rational interpretation.

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<sup>29</sup> See, e.g., FLA. STAT. ANN. § 605.0105 (2015).

<sup>30</sup> *In re Carlisle Etcetera LLC*, C.A. No. 10280–VCL, 2015 WL 1947027, at \*11 (Del. Ch. Apr. 30, 2015).

## CONCLUSION

Alleging a violation of the implied covenant of good faith and fair dealing necessitates a rare, fact-intensive exercise that should not be used to alter the otherwise express language of a contract. In determining whether or not “neutral faith” or “non-bad faith” violations of the implied covenant are permissible under Delaware LLC law, Delaware courts should look to the relatively short history of the covenant, the contractarian spirit of Delaware laws and courts, and section 18-1101 of the Delaware Limited Liability Company Act to hold, despite the statute’s somewhat sloppy language, that the implied covenant can only be violated in bad faith.

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