

Clients & Friends Memo

Contracting Party Beware: The Implied Covenant Will Not Save You From Your Agreement If You Negotiated Away Your Rights

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On February 1, 2018, the Delaware Court of Chancery granted defendants' motion to dismiss an action brought by minority unitholders of Trumpet Search, LLC ("Trumpet" or the "Company"). The defendants were other unitholders that collectively held a majority of the membership units in Trumpet and, under the governing operating agreement ("OA"), had the power to appoint four of the seven managers on the Trumpet board of directors. Vice Chancellor Glasscock's decision, [*Christopher Miller et al. v. HCP & Co., et al., C.A. No. 2017-0291-SG \(Del. Ch. Feb. 1, 2018\)*](#), is a powerful reminder that the broad freedom of contract that Delaware law accords entities such as LLCs offers both the promise of great latitude to contracting parties and the threat of serious pitfalls for parties that fail to carefully protect their interests in the agreement. The decision also underscores the limits on an implied covenant breach claim under Delaware law.

Background

Trumpet was founded in 2008 to offer clinical services to persons with autism and other developmental disabilities. The plaintiffs, a Trumpet co-founder and related entities, alleged that defendants, a private equity firm (HCP & Co.) and its affiliates (together, "HCP"), breached the implied covenant of good faith and fair dealing in the OA in connection with a sale of the Company. In particular, the OA contained a "waterfall provision" that governed priority of distributions among the unitholders in the event of a sale of Trumpet. "Upon any sale," the OA provided for HCP, which invested around \$14 million to acquire its Class D and E Units, to receive "the bulk of the first \$30 million, before sales proceeds would be available to holders of other classes of membership units." At that point, other classes "would receive millions of dollars in proceeds before [HCP] would again share—pro rata—in the sales price. In other words, the HCP-dominated Board would have an incentive to negotiate any sales price up to about \$30 million, but little incentive to negotiate further." Class D and E Trumpet unitholders were entitled through the OA to receive 200% of their capital contribution in the event of a sale before any payments to other classes, thereby entitling HCP to priority on the first \$30 million in proceeds.

Less than a year after the OA was adopted in May 2016, HCP "championed a sale to an unaffiliated third party, MTS Health Partners, L.P. ("MTS")." MTS initially offered \$31 million and the

“HCP-allied majority of managers elected not to run an open sales process for Trumpet.” In response to minority unitholder complaints, the majority afforded non-affiliated managers five days to find alternative buyers, which permitted an “abbreviated” sales process and pressured MTS to increase its offer to \$41 million and then \$43 million. At this price, Class A and B Unitholders would receive almost nothing while Class C and Common Interest holders would receive no proceeds from the sale. The plaintiffs asserted the defendants breached the implied covenant of good faith and fair dealing by approving the sale at \$43 million without having conducted “an open auction of Trumpet,” which “would have resulted in a substantially higher sales price” and thereby “ensure[d] maximum value for all members.” Importantly, the OA waived all fiduciary duties on the part of Trumpet members and the Board, and permitted the Board to determine, in its sole discretion, the manner in which a sale should occur, subject only to the condition that the sale be to an unaffiliated third party.

The Court granted defendants’ motion to dismiss, finding that there was no gap in the OA for the Court to fill by implying into the OA an “auction sale” requirement in the event of a sale and the defendants did not frustrate the plaintiffs’ reasonable contractual expectations with respect to the Trumpet sale.

Takeaways

The Implied Covenant Of Good Faith And Fair Dealing As Applied in Delaware Does Not Operate To Rewrite Contract Simply Because Regretful Plaintiffs Wished They Had Negotiated A Better Or Different Deal

Plaintiffs insisted that defendants’ failure to engage in an open-market process violated the implied covenant of good faith and fair dealing, even though the OA did not expressly require such a process. In addressing this claim, the Court observed that the “Delaware Limited Liability Company Act permits parties to an LLC agreement to eliminate fiduciary duties that members or managers would otherwise owe to one another,” reflecting the Act’s policy of giving “the maximum effect to the principle of freedom of contract.” While the implied covenant may not be contractually eliminated, applying the implied covenant to a claim is a “cautious enterprise” and it is “rarely invoked successfully.” That is because the term “fair is something of a misnomer . . . [fair] simply means actions consonant with the terms of the parties’ agreement and its purpose.” Likewise, good faith in this context entails “faithfulness to the scope, purpose, and terms of the parties’ agreement,” and not a “free-floating requirement that a party act in some morally commendable sense.” The implied covenant of good faith and fair dealing, according to the Court, “applies only in that narrow band of cases where the contract as a whole speaks sufficiently to suggest an obligation and point to a result, but [where there is a gap such that the contract] does not speak directly enough to provide an explicit answer.”

Against that backdrop, the Court found no basis to apply the implied covenant in this case because to do so as plaintiffs suggested would impermissibly be to “rewrite a contract simply because a party now wishes it had gotten a better deal.” Here, “the incentive complained of” by plaintiffs – namely, for defendants to negotiate up to but not beyond a \$30 million sale – “is obvious on the face of the OA.” The Court wrote:

It thus appears that the parties to the OA did consider the conditions under which a contractually permissible sale could take place. They avoided the possibility of a self-dealing transaction but otherwise left to the HCP Entities the ability to structure a deal favorable to their interests. Viewed in this way, there is no gap in the parties’ agreement to which the implied covenant may apply.

The Negotiated, Mutual Waiver Of Fiduciary Duties Narrows The Already Slim Chance A Delaware Court Will Apply The Implied Covenant Of Good Faith And Fair Dealing

The Court emphasized that the OA’s elimination of fiduciary duties “as part of a detailed contractual governance scheme,” in the context of an alternative entity agreement, “implies an agreement that losses should remain where they fall” rather than being shifted after the fact. Parties and their counsel should not be lulled into a false sense of security that the implied covenant will effectively substitute for fiduciary duties. To the contrary, the implied covenant is very much a contractual concept that seeks in limited circumstances to effectuate the intent of the parties to the contract “had they considered the issue in their original bargaining positions at the time of contracting.” The Court observed, for instance, that if the parties “had chosen to employ the corporate form here, with its common-law fiduciary duties, this matter would be subject to entire fairness review” given the existence of a controlling stockholder. In that event, the Court would have assessed whether the sale transaction resulted from a fair process and yielded a fair price. Here, as noted, the HPC-dominated Board had virtually complete discretion regarding the sales process.

Waiver Of Fiduciary Duties, Conditioned On A Sale To An Unaffiliated Third Party, Granted The Board Unfettered Discretion To Determine The Marketing And Structure Of Trumpet’s Sale To MTS

The OA provided that “the Board shall determine in its sole discretion the manner in which . . . an Approved Sale[, defined as a sale of all of Tumpet’s membership interests to any independent third party,] shall occur.” In light of this provision, the Court agreed with defendants that there was no gap to fill because the OA permitted them to pursue a sale without an auction so long as the Company ultimately was sold to an unaffiliated third party, such as MTS. The Court rejected plaintiffs’ arguments that the OA addressed only the “form” of the sale, as opposed to the sales process, as “unreasonable” in light of the fact that the “OA explicitly vested the Board with sole

discretion as to the manner in which a sale is conducted.” The Court observed that the OA could have been, but was not, drafted to grant the Board sole discretion only as to the form of a sale transaction, i.e., merger, asset sale, or other structure, or to require a sale to achieve the highest possible value for all Trumpet members, a minimum sales price, a majority-of-the-minority approval condition, or a period during which sales were prohibited. Instead, the plaintiffs chose an “investor-friendly bargain with which they are now dissatisfied” and Delaware Courts do not “give the [p]laintiffs what they failed to get at the bargaining table.” The only limitation in the OA, that the Company be sold to an unaffiliated third party, indicated that “the members considered the implications of vesting discretion in a conflicted board” by prohibiting “the potential for self-dealing” in favor of a sale to an unaffiliated buyer.

Plaintiffs Offered No Reason To Believe Defendants’ Conduct Frustrated Their Reasonable Expectations

In this case, the parties contemplated that Trumpet might be sold through private negotiation rather than an open-market process in light of OA provisions requiring the Board to notify the members of the terms and details in writing with respect to a sale to a third party. The Court observed that “there would have been no need to include a provision in the OA requiring the Board to notify Trumpet’s members when it approves a sale of the company” if only an open-market process was contemplated. Importantly, a detailed account of an ongoing sales process was not included among the many categories of information the OA entitles Trumpet members to request from the Board. Further, the Court highlighted that the OA “was drafted to attract capital investment, by allowing an exit on terms favorable to the investors” in enabling them “to structure and time an exit at a very substantial premium to their investment” at the expense of fiduciary protections for earlier equity holders. In other words, the parties contemplated precisely the factual scenario at issue here but plaintiffs agreed to it in order to attract investment in the first place. Thus, defendants’ pursuit of a quick payout was not arbitrary, unreasonable or unanticipated due to the distribution scheme of the waterfall, which incentivized a sale in order for HCP to achieve the 200% payout contemplated by the OA’s waterfall without the constraint of fiduciary duties to other Trumpet members.

The Court Highlighted Certain Conduct That May Be Sufficiently Egregious To Implicate The Implied Covenant in Similar Situations

The Court found that “Defendants’ conduct during the sales process was not arbitrary, unreasonable, or unanticipated in light of the deal just described; thus there is nothing in the Complaint that might justify the use of the ‘limited and extraordinary legal remedy’ of the implied covenant.” Certain conduct by the Defendants, had it been pled, might have led to a different result. According to the Court:

There are no allegations of fraud or a kickback from the buyer. There is no indication that the Defendants acted from any perverse or cryptic incentive, other than their own self-interest manifest from the waterfall provision of the OA—there is, for example, no indication that they acted with the purpose of harming the non-affiliated members. Such actions plausibly would be of the type addressed by the implied covenant.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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