

IN PRACTICE

BUSINESS ENTITIES

Standards To Measure Good Faith and Fair Dealing Under NJ-RULLCA

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The full title to this article should be “prescribing standards to measure performance of the contractual obligation of good faith and fair dealing under the New Jersey Revised Uniform Limited Liability Company Act.” For obvious reasons, it was shortened.

The New Jersey Revised Uniform Limited Liability Company Act (NJ-RULLCA) includes a contractual obligation of good faith and fair dealing: “A member shall discharge the duties under this act or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.” N.J.S.A. 42:2C39(d). In a manager-managed limited liability company (LLC), this obligation also applies to the managers. N.J.S.A. 42:2C-39(i)(2).

NJ-RULLCA is based on the Revised Uniform Limited Liability Company Act (RULLCA) promulgated in 2006 by the National Conference of Commissioners

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on Uniform State Laws (NCCUSL), with the latest published version dated July 20, 2011. As part of its effort to harmonize the language of its uniform unincorporated entity acts (i.e., Harmonization of Business Entity Acts), NCCUSL has amended RULLCA (now designated as “ULLCA” as part of the harmonization), with the latest published draft dated Jan. 14, 2013. NCCUSL’s comments to both RULLCA and ULLCA should be used by practitioners and the courts to understand NJ-RULLCA, including the language about prescribing standards to measure performance under the contractual obligation of good faith and fair dealing.

Application to Agreements and Statute

As noted, NJ-RULLCA includes a contractual obligation of good faith and fair dealing. The word “contractual” is used “to emphasize that the obligation is not an invitation to re-write agreements among the members.” NCCUSL Comment to RULLCA §409(d) available at www.uniformlaws.org. For clarity, N.J.S.A. 42:2C39(d) was derived from RULLCA §409(d), which is now ULLCA §409(d).

As noted in the statute, the contractual obligation of good faith and fair deal-

ing applies to rights and duties under an operating agreement as well as under the statute. It applies to rights and duties under the statute because the statute serves as a default contract in the absence of an operating agreement:

At first glance, it may seem strange to apply a contractual obligation to statutory duties and rights—i.e., duties and rights “under this [act].” However, for the most part those duties and rights apply to relationships *inter se* the members and the LLC and function only to the extent not displaced by the operating agreement. In the contract-based organization that is an LLC, those statutory default rules are intended to function like a contract. Therefore, applying the contractual notion of good faith [and fair dealing] makes sense.

NCCUSL Comment to RULLCA §409(d). See also NCCUSL Comment to ULLCA §409(d).

What Is Good Faith and Fair Dealing?

The contractual obligation of good faith and fair dealing is the same as the implied covenant of good faith and fair dealing. See NCCUSL comment to ULLCA §409(d) available at www.uniformlaws.org (citing Restatement of Contracts 2d §205).

For a discussion of the implied covenant of good faith and fair dealing existing in every contract in New Jersey,

see, e.g., *Brunswick Hills Racquet Club v. Route 18 Shopping Center Assocs.*, 182 N.J. 210, 225 (2005); *Wilson v. Amerada Hess Corp.*, 168 N.J. 236, 244 (2001). The Appellate Division has summarized the application of the implied covenant as follows:

First, the covenant permits the inclusion of terms and conditions which have not been expressly set forth in the written contract. The covenant acts in such instances to include terms “the parties must have intended...because they are necessary to give business efficacy” to the contract. Second, the covenant has been utilized to allow redress for the bad-faith performance of an agreement even when the defendant has not breached any express term,... And third, the covenant has been held...to permit inquiry into a party’s exercise of discretion expressly granted by a contract’s terms.

Seidenberg v. Summit Bank, 348 N.J. Super. 243, 257 (App. Div. 2002) (citations omitted).

NCCUSL’s Comment to ULLCA §409(d) states that “the contractual obligation of good faith and fair dealing is not a fiduciary duty, does not command altruism or self-abnegation, and does not prevent a member from acting in the member’s own self-interest.” It notes that the Delaware Supreme Court recently concluded that good faith means “faithfulness to the scope, purpose and terms of the parties’ contract,” that fair dealing means “to deal fairly in the sense of consistently with the terms of the parties’ agreement and its purpose,” and that they “necessarily turn on the contract itself and what the parties would have agreed upon had the issue arisen when they were bargaining originally.” NCCUSL Comment to ULLCA §409(d), quoting *Gerber v. Enter. Products Holdings*, 67 A.3d 400, 418419 (Del. 2013).

NCCUSL’s Comment to ULLCA §409(d) also states that:

[c]ourts should not use the contractual obligation to change *ex post facto* the parties’ or this

act’s allocation of risk and power. To the contrary, the obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made.

The comment concludes by stating that “the purpose of the contractual obligation of good faith and fair dealing is to protect the arrangement the [members] have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.”

Standards To Measure Performance

An LLC operating agreement may not eliminate the contractual obligation of good faith and fair dealing. N.J.S.A. 42:2C-11(c)(5). However, “[i]f not manifestly unreasonable, the operating agreement may...prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing...” N.J.S.A. 42:2C11(d)(5). The term “manifestly unreasonable” will not be addressed in this article, but see N.J.S.A. 42:2C-11(h), NCCUSL Comment to RULLCA §110(h) and NCCUSL Comment to ULLCA §105(e).

Unfortunately, NCCUSL’s Comments to RULLCA §110 do not address the phrase “prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing.” See NCCUSL Comment to RULLCA §110. Research on the phrase has not disclosed any case law explaining it. For clarity, N.J.S.A. 42:2C11 was derived from RULLCA §110, which is now ULLCA §105.

As noted, as part of its Harmonization of Business Entity Acts, NCCUSL has amended RULLCA, now designed as ULLCA, with the latest published draft dated Jan. 14, 2013. Unfortunately, NCCUSL’s Comment to ULLCA §105 also does not address the phrase, which has been revised to read as follows: “prescribe the standards, if not manifestly unreasonable, by which the performance of the obligation is to be measured.” See NCCUSL Comment to ULLCA §105.

Professor Daniel S. Kleinberger, one of the co-reporters of both RUL-

LCA and the Harmonization of Business Entity Acts, was kind enough to provide me with a recent unpublished draft of ULLCA which includes a discussion and examples of standards by which to measure performance of the contractual obligation of good faith and fair dealing. The draft, dated March 3, 2014, is available on the American Bar Association website at www.americanbar.org.

NCCUSL’s draft Comment to ULLCA §105 provides the following example of a standard to measure performance under the contractual obligation:

The operating agreement of a manager-managed LLC gives the manager the discretion to cause the LLC enter into contracts with affiliates of the manager (so-called “Conflict Transactions”). The agreement further provides: “When causing the Company to enter into a Conflict Transaction, the manager complies with Section 409(d) of [this act] if a disinterested person, knowledgeable in the subject matter, states in writing that the terms and conditions of the Transaction are equivalent to the terms and conditions that would be agreed to by persons at arm’s length in comparable circumstances.” This provision “prescribe[s] the standards by which the performance of the [Section 409(d)] obligation is to be measured.”

NCCUSL draft (dated March 3, 2014) Comment to ULLCA §105(c)(6). There are two other examples in NCCUSL’s Comments.

Sample Contract Language

Based on the foregoing example, an LLC operating agreement can contain the following standard to measure performance under the contractual obligation of good faith and fair dealing:

When a Member or a Manager, or an Affiliate of a Member or Manager, enters into a contract or transaction with the Company, the Member or Manager complies with the contractual obliga-

tion of good faith and fair dealing if a disinterested person, knowledgeable in the subject matter of the contract or transaction, states in writing that the terms and conditions of the contract or transaction are equivalent to the terms and conditions that would be agreed to by persons at arm's length in comparable circumstances.

Where appropriate, I have been adding the following language to my operating agreements as the standard to measure performance of the contractual obligation

of good faith and fair dealing:

Members and Managers shall exercise their rights and discharge their duties under this Agreement and the Act in a manner consistent with the contractual obligation of good faith and fair dealing. Any right exercised or duty discharged by a Member or Manager pursuant to the written advice of the Company's attorneys, accountants or other professional advisors shall be deemed to satisfy such contractual obligation.

The language about prescribing standards to measure performance under the contractual obligation of good faith and fair dealing has been in existence since at least 2006, when NCCUSL approved and recommended RULLCA for enactment. NCCUSL has now provided commentary on the meaning of this language. Fortunately, the commentary was released shortly after the effective date of NJ-RULLCA. We should anticipate additional commentary and examples as practitioners, academics and eventually the courts focus on the language. For the time being, we have guidance in NCCUSL's draft comments.■