

THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

February 12, 2014

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LEGAL PRINCIPLES

Legal Principles

- Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement
- Courts possess a considerable amount of discretion when applying the implied covenant
 - No bright line rule or single definition
 - *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996) (en banc) (“Although the Covenant is a generally acknowledged principle, its precise contours are not fixed.”).
 - *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 440-41 (Del. 2005) (en banc) (noting that despite an existence spanning “at least three centuries of American legal thought . . . the term ‘good faith’ has no set meaning”).
 - *Wade v. Kessler Institute*, 778 A.2d 580 (N.J.Super. A.D. 2001) (stating that a definition of good faith and fair dealing for all cases has not been developed).

Legal Principles

– Fact-intensive inquiry

- *Cincinnati SMSA LP v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998) (noting that the application of the Implied Covenant “should be rare and fact-intensive, turning on issues of compelling fairness.”).
- *Amirsaleh v. Bd. of Trade of the City of N. Y., Inc.* (Amirsaleh II), 2009 WL 3756700, at *4 (Del. Ch. Nov. 9, 2009) (“I recognize that the exact contours of the implied covenant . . . are not always easily discernible in the case law. This is partly driven by the ‘fact-intensive’ nature of the doctrine.”).
- *Baker v. Lafayette College*, 504 A.2d 247 (Pa. Super 1986) (noting that the meaning of good faith varies with the context).

Legal Principles

- Restatement (Second) of Contracts/Uniform Commercial Code
 - Good faith is defined in the Uniform Commercial Code as “honesty in fact in the conduct or transaction concerned.”
 - Fair dealing may require more than honesty (e.g., you cannot act in a way that is contrary to the spirit of the bargain, even if you give the opposing party notice of your actions).
 - Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.

Legal Principles

- **Good faith performance:** Subterfuges and evasions violate the obligation of good faith in performance even if the actor believes his conduct to be justified. **Bad faith may be overt or may consist of inaction.**
 - A complete catalogue of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

Legal Principles

- **Good faith in enforcement:** The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses.
 - The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts.
 - It also extends to dealings that are candid but unfair. Examples include: taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without a legitimate commercial purpose.

Legal Principles

- Common descriptions of the covenant:
 - The covenant requires a party in a contractual relationship to refrain from conduct that prevents the other party from receiving the **fruits of the bargain**. *Nemec v. Shrader*, 2009 WL 1204346, at *5 (Del.Ch. Apr.30, 2009); *Onderdonk v. Presbyterian Homes of New Jersey*, 425 A.2d 1057 (N.J. 1981).
 - A party can be liable for a breach of the covenant when their conduct **frustrates the overarching purpose of the contract**. *Winshall v. Viacom Int'l, Inc.*, 55 A.3d 629, 636 & n.26 (Del. Ch. 2011) (quoting *Dunlap*, 878 A.2d at 442).
 - In Pennsylvania, the doctrine of necessary implication dictates that, absent an express provision, the law will imply a contract between the parties to “perform those things that according to reason and justice they should do in order to carry out the purpose for which the contract was made and to refrain from doing anything that would destroy or injure the other party's right to receive the fruits of the contract.” *Somers v. Somers*, 613 A.2d 1211, 1215 (Pa. Super. 1992).

Legal Principles

- The Implied Covenant is fundamentally a doctrine invoked to protect and fulfill each party’s **reasonable expectations**.
 - *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010) (en banc) (noting that the Implied Covenant is invoked to “imply contract terms when the party asserting the implied covenant proves that the other party has **acted arbitrarily or unreasonably**, thereby **frustrating the fruits of the bargain** that the asserting party **reasonably expected**.”).
 - *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 444 (Del. 2005) (en banc) (“The implied covenant . . . requires that [each party to a contract] act in a way that honors the [other’s] **reasonable expectations**.”).
 - *Wilson v. Amerada Hess Corp.*, 773 A.2d 1121, 1131 (N.J. 2001) (stating the test for determining if implied covenant has been breached as: “a party exercising its right to use discretion in setting price under a contract breaches the duty of good faith and fair dealing if that party exercises its discretionary authority arbitrarily, unreasonably, or capriciously, with the objective of preventing the other party from receiving its reasonably expected fruits under the contract.”).
 - *John B. Conomos, Inc. v. Sun Co., Inc.*, 831 A.2d 696, 707 (Pa.Super. 2003) (stating that “implied covenant of good faith and the doctrine of necessary implication are principles for courts to harmonize the reasonable expectations of the parties with the intent of the contractors and the terms in their contract.”).

Legal Principles

– Gap Filler – Narrow View

- Delaware, Pennsylvania and New Jersey courts have stated that the covenant cannot be invoked to imply terms that would contradict, override or circumvent the express terms of an agreement.
- One generally cannot claim there was a breach of the implied covenant when the other parties' conduct was authorized by the terms in the agreement. *Nemec*, 991 A.2d at 1125-26.
- Delaware Courts have famously stated: parties “have a right to enter into good and bad contracts, the law enforces both.” *Nemec*, 991 A.2d at 1125-26.
- The implied covenant of good faith and fair dealing cannot properly be applied to give the plaintiffs contractual protections that “**they failed to secure for themselves at the bargaining table.**” *Winshall v. Viacom Intern., Inc.* 76 A.3d 808 at 816 (Del.2013).
- The duty of good faith does not compel a party to surrender rights given by statute or by the terms of its contract. *Creeger Brick & Bldg. Supply Inc. v. Mid-State Bank & Trust Co.*, 560 A.2d 151, 155 (Pa. Super. 1989). Implied duties cannot trump express provisions in a contract. *John B. Conomos, Inc. (R&M)*, 831 A.2d 696 at 706.
- The principles of fair dealing cannot and will not alter the terms of a written agreement. *Rudbart v. N. Jersey Dist. Water Supply Com'n*, 605 A.2d 681, 700 (N.J. 1992).

Legal Principles

- Unwaivable, Overriding Obligation – Expansive View.
 - Delaware, Pennsylvania and New Jersey courts have also described the covenant in broader terms.
 - “Requires more than just literal compliance” with the express terms of the agreement; also requires the parties to “preserve the spirit of the bargain.” *Dunlap*, 878 A.2d at 444.
 - When fairness dictates, the covenant may be invoked, despite the express terms of a contract, to protect a party’s reasonable expectations.
 - The doctrine of necessary implication will be employed to imply an obligation where it is clear that an obligation is within the contemplation of the parties at the time of contracting or is necessary to carry out their intentions, even without an ambiguity in the agreement. *Slater v. Pearle Vision Center, Inc.*, 546 A.2d 676, 680 (Pa. Super. 1988).

Legal Principles

- Delaware, Pennsylvania and New Jersey courts have applied the covenant using both the limited and the expansive view depending on the facts of the dispute.
 - Eg. *Dunlap* (expansive) and *Nemec* (limited).
 - **Summary of Facts from *Nemec v. Shrader*, 991 A.2d 1120 (Del. 2010).**
 - This case involved two retired Booz Allen partners who, throughout their tenure, received annual grants of stock pursuant to an “Officer Rights Stock Plan.” Under that plan, Booz Allen had a right to redeem the retired officers stock at book value; book value was approximately \$120/share. The Company negotiated to sell a part of its business at a price that translated to a total venture value of more than \$700 per share. Despite prior assurance to the retired shareholders that it would not do so, the Company exercised the call prior to the sale. The retired shareholders then sued. The retirees claimed that had the transaction occurred earlier, they would have been able to participate in the \$60 million purchase price.

Legal Principles

- The plaintiffs claimed that, despite the express terms of the stock option plan at issue in the case, the defendant's decision to exercise its call option on the plaintiffs' shares just weeks before a lucrative merger was **arbitrary and unreasonable** because it **advanced no legitimate interest of the defendant**, yet denied the plaintiffs the right to participate in the merger consideration. *Nemec*, 991 A.2d at 1123-25.
- The Court was unmoved by these claims from the two wealthy retired executives and ruled in favor of the Company.

Legal Principles

- **Summary of Facts from *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434 (Del. 2005).**
- Anne Dunlap was a passenger in Mark Cardillo's vehicle and was severely injured upon collision with a Delaware Transit Corp. bus. She sued Cardillo, DART and the bus driver. Cardillo's insurance company paid the policy limit of \$500,000, yet DART offered to settle for \$175,000 of its \$300,000 policy limit. Dunlap sought underinsured motorist (UIM) benefits and was informed by State Farm that she must exhaust all applicable tortfeasor policies before pursuing a UIM claim. The jury ultimately found Cardillo solely liable for the accident. State Farm paid the UIM coverage limit to Dunlap, and then State Farm was sued for bad faith. The trial court granted State Farm's motion to dismiss with prejudice as State Farm had not unreasonably delayed or refused payment of its UIM coverage limits. The Supreme Court of Delaware upheld most of the trial court's judgment; however, it ruled that State Farm's refusal to cooperate with the Dunlaps' request could be considered a breach of the implied covenant of good faith and fair dealing.

Legal Principles

- The plaintiff claimed that, despite the express terms of the insurance policy at issue in the case, the defendant's insistence on the exhaustion requirement of the policy was arbitrary and unreasonable because it advanced no legitimate interest of the defendant, yet resulted in the plaintiff risking and ultimately losing monetary recovery (\$125,000) in a separate lawsuit. *Dunlap*, 878 A.2d at 444-45.
 - Here, the Court sympathized with Dunlap, who was catastrophically injured through no fault of her own. They also noted that insurance companies typically possess very unequal bargaining power with their policyholders.
- The same five Supreme Court justices heard both cases.

Legal Principles

- *Somers v. Somers*, 613 A.2d 1211(Pa. Super. 1992)
- **Facts:** Uncle and nephew entered into an employment agreement for uncle to act as a consultant. The agreement specified no term, but provided for a monthly consulting fee, and 50% of net profits from the Walkkill project, which involved the construction of a correctional facility in New York. During negotiations for the Walkkill project, uncle and nephew disagreed about the handling of the claim and nephew terminated uncle's employment.
- **Arguments:** Uncle brought case alleging nephew and company breached duties implied in the agreement.
- **Rule:** The duty of "good faith" has been defined as "[h]onesty in fact in the conduct or transaction concerned."
- **Holding:** Uncle stated claim for relief for breach of employment contract based on implied duty of good faith and is therefore entitled to a trial to attempt to prove nephew and company breached their duty of good faith.

Legal Principles

- **Analysis:** The court expanded on the duty of good faith by describing it in various ways. In Pennsylvania, the doctrine of necessary implication dictates that, absent an express provision, the law will imply a contract between the parties to “perform those things that according to reason and justice they should do in order to carry out the purpose for which the contract was made and to refrain from doing anything that would destroy or injure the other party's right to receive the fruits of the contract.” Although a complete list of types of bad faith is impossible to define, “it is possible to recognize certain strains of bad faith which include: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.” The court found that this duty applied to at-will employment contracts.
- **Note: No Simultaneous Claims in PA** - Pennsylvania does not allow parties to assert simultaneous claims for breach of contract and breach of the implied duty of good faith and fair dealing based upon the same alleged conduct. *LSI Title Agency, Inc. v. Evaluation Servs., Inc.*, 951 A.2d 384, 391-92 (Pa.Super Ct. 2008). When both claims are brought the implied covenant of good faith and fair dealing is subsumed in a breach of contract claim and the breach of good faith and fair dealing claim must be dismissed. *Id.* at 392. Separate causes of action cannot be maintained, even in the alternative. *Somers v. Somers*, 613 A.2d 1211, 1214 (Pa.Super. Ct. 1992).

Legal Principles

- *Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575 (N.J. 1997).
- **Facts:** Clam supplier sued purchaser after purchaser terminated minimum supply contract. The contract contained an express provision that either party could cancel without reason. However, before termination, the buyer continuously breached other express provisions of the contract by not buying the required amount of clams from the supplier. Further, the buyer knew that the supplier depended on income from the contract to pay loans on his boats.
- **Arguments:** The supplier alleged breach of contract and implied covenant of good faith and fair dealing, while the purchaser argued that the implied covenant of good faith and fair dealing cannot override an express and unambiguous termination clause in a contract.
- **Rule:** Every contract contains an implied covenant of good faith and fair dealing.

Legal Principles

- **Holding:** Reversed appellate court's finding that trial court erroneously denied motion for judgment notwithstanding the verdict because whether purchaser breached its obligation to perform its contractual duties in good faith was question for jury.
- **Analysis:** The court found that an implied covenant of good faith and fair dealing cannot override express terms of the contract, including the termination clause in contract. However, the court found that an obligation to perform in good faith exists in every contract, including those contracts that contain express and unambiguous provisions permitting either party to terminate the contract without cause. The court emphasized the parties' unequal bargaining power as one factor in its decision.

FACTORS INFLUENCING THE SCOPE OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Factors Influencing the Scope of the Covenant

- Combination of contractual, relational and motivational factors all influence how the court applies the covenant.
 - The type of claim before the court.
 - E.g., dispute about an employment agreement vs. dispute about a merger agreement.

Factors Influencing the Scope of the Covenant

- The “sophistication” of the parties.
 - Probably the most important factor.
 - **General rule:** the more sophisticated the parties, the less likely the court will invoke the implied covenant.
 - Sophisticated parties are typically represented by counsel and have significant experience in the subject matter of their agreements.
 - Sophisticated parties are likely to have negotiated more thoroughly than unsophisticated parties.
 - Equal vs. unequal bargaining power.
 - In employment and insurance contracts, the employer and the insurer are typically seen as having greater bargaining power.
 - Courts tend to be more sympathetic to parties that have relatively little bargaining power (e.g., employees and the insured).
 - Basically, courts tend to find that sophisticated parties “should have known better” and try to enforce the express terms of their agreements.

Factors Influencing the Scope of the Covenant

– The motives of the parties

- **General rule:** if the plaintiff can prove that the defendant's actions were spiteful or malicious, the court is more likely to allow a claim for a breach of the implied covenant.
- Arbitrary actions vs. actions taken with sound business judgment.
 - If one party disadvantages the other and does not benefit or could not potentially benefit from its action, then the court is more likely to find a breach of the implied covenant. *Nemec v. Shrader*, 991 A.2d 1120, 1134 (Del. 2010) (“It is now settled Delaware law that a contracting party's exercise of a power in reliance on an explicit contractual provision may be deemed ‘arbitrary’ or ‘unreasonable’ where the other contracting party is thereby disadvantaged and no legitimate interest of the party exercising the right is furthered by doing so”).
 - Without bad motive or intention, discretionary decisions that happen to result in economic disadvantage to the other party are of no legal significance. *Wilson*, 773 A.2d at 1131.

Factors Influencing the Scope of the Covenant

– The motives of the parties *(continued)*

- Examples of bad faith include: “evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.” *Somers*, 613 A.2d at 1214.
- The covenant does not preclude parties from acting in their own self-interest
 - “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.” *Nemec*, 991 A.2d at 1128.
 - A party has not violated a duty of good faith merely because it has negotiated favorable terms for itself. *Creeger*, 560 A.2d at 155.

Factors Influencing the Scope of the Covenant

- The complexity and length of the agreement
 - **General rule:** the more complex the agreement, the less likely a court is to apply the implied covenant.
 - The Court of Chancery stated: “Delaware courts rightly employ the implied covenant sparingly when parties have crafted detailed, complex agreements, lest parties be stuck by judicial error with duties they never voluntarily accepted.” *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. 3658-VCS, 2009 WL 1124451, at *7 (Del. Ch. Apr. 20, 2009).

Legal Principles

- Term Sheets and Letters of Intent
 - The duty of good faith and fair dealing does not impose a duty to negotiate term sheets and letters of intent in good faith. These are two separate doctrines, although certain courts (i.e., New Jersey) have confused them.

Legal Principles

• Term Sheets and Letters of Intent (*continued*)

- A non-binding term sheet or letter of intent may include certain binding provisions, even if a deal is never concluded, including a duty to negotiate in good faith.
- Even if the term sheet does not expressly contain a duty to negotiate in good faith, courts may impose a duty. Courts are split on this issue, and in Pennsylvania, New Jersey and Delaware, there is an absence of clarity.
 - In Pennsylvania, courts have not yet recognized breach of a duty to negotiate a contract in good faith as a cause of action. *Jenkins v. County of Schuylkill*, 658 A.2d 380, 385 (Pa.Super. 1995). *But see, Flight Systems, Inc. v. EDS Corp.*, 112 F.3d 124, 129 (3d Cir.1997) (predicting Pennsylvania would recognize such an action); *Com., Dept. of General Servs. v. On-Point Tech. Sys., Inc.*, 870 A.2d 873, 874 (Pa. 2005) (Saylor, J., dissenting) (disagreeing with the majority's disposition of the case and recognizing “an implied duty to negotiate in good faith arising from the commitment to future negotiations”). Nonetheless, Pennsylvania courts have explored whether a duty of good faith in negotiation would have been breached if such a cause of action were recognized by looking at the terms of the letter of intent. *GMH Assocs., Inc. v. Prudential Realty Group*, 752 A.2d 889 (Pa.Super. 2000) (looking at terms of letter of intent to determine no duty was breached); *Jenkins*, 658 A.2d at 386 (finding no breach where letter of intent was not detailed and parties did not intend to be bound, stating scope of duty to negotiate in good faith can only be established by the framework set by the parties in their letter of intent). The Third Circuit Court in *Channel Home Centers v. Grossman* even defined a standard for when a duty to negotiate in good faith would arise from a letter of intent: “(1) whether both parties manifested an intention to be bound by the agreement; (2) whether the terms of the agreement are sufficiently definite to be enforced; and (3) whether there was consideration.” 795 F.2d 291, 299 (3d Cir. 1986).

Legal Principles

- Term Sheets and Letters of Intent (*continued*)
 - New Jersey has very little case law exploring the duty to negotiate in good faith, however it has several statutes relating to certain areas that require good faith negotiations. NJSA.17B:30-13.1(insurance company statute which requiring an obligation to negotiate in good faith; NJSA 34:13A-5.4(a)(5), (b)(3) (Labor and Workmen’s Comp Relations Act which prohibits refusing to negotiate in good faith).
 - In addition, parties can bind themselves to a concededly incomplete agreement if they commit to negotiate together in good faith in an effort to reach final agreement within the scope that has been settled in the preliminary agreement.
 - These risks can be minimized if care is taken.

Legal Principles

- Term Sheets and Letters of Intent *(continued)*
 - Fact and circumstance-specific analysis
 - Language used in the term sheet; circumstances outside of the document.
 - Express term regarding a “duty to negotiate in good faith” or an express disclaimer of the duty.
 - Express term is binding.
 - Transactions being subject to the negotiation, documentation, execution and delivery of final, definitive agreements.

Legal Principles

- Term Sheets and Letters of Intent *(continued)*
 - A duty to negotiate in good faith does not require you to consummate a transaction, nor does it require you to have exclusive dealings with a party.
 - However, if you are going to back out of a deal, OR insist on specific terms that are directly contradictory to a specific provision in the term sheet, you will want to have some very good reasons for it, such as:
 - new circumstances or facts that you did not know or that you assumed did not exist.

HOW TO CONDUCT BUSINESS DEALINGS AND NEGOTIATIONS WITHOUT RUNNING AFOUL OF THE IMPLIED COVENANT

Issues to Consider in M&A Negotiations

- The most common subject of disputes are earn-outs and other purchase price adjustments
- **Summary of *Winshall v. Viacom Intern., Inc.*** 2013 WL 5526290 (Del. 2013).
 - **Facts:** Former stockholders of Harmonix (represented by Winshall), a company that made music-oriented video games including Rock Band and Guitar Hero, brought action against Viacom, a global media and entertainment company, alleging that Viacom **breached the covenant of good faith and fair dealing implied in their merger agreement** by allegedly renegotiating a video game distribution contract with Electronic Arts so as to reduce earn-out payments payable to the former stockholders of Harmonix.
 - In 2006, Viacom acquired Harmonix. After the merger, Harmonix became a wholly owned subsidiary of Viacom. The critical terms of that transaction were embodied in a merger agreement and in an escrow agreement.
 - Under the merger agreement, Viacom agreed to pay the selling shareholders two forms of consideration: (1) a \$175 million cash payment payable at closing, plus (2) a contingent right to receive incremental uncapped earn-out payments, based on Harmonix's financial performance, during the two years after the merger, i.e., 2007 and 2008.

Issues to Consider in M&A Negotiations

- **Arguments:** Winshall argued that the selling shareholders had a reasonable expectation and the merger agreement imposed an implied obligation that Viacom would not manipulate Harmonix's cost structure so as to reduce the 2008 earn-out payment to the selling shareholders. Further, Winshall argued that Viacom refused to use its bargaining power to decrease the distribution fee payable to Electronic Arts, Inc. (EA), a video game development and distribution company that would distribute the games developed by Harmonix. Instead, Viacom negotiated an amended distribution agreement to decrease the fees payable to EA in later years (after the earn-out period). Winshall claimed this was an act of bad faith that reduced potential profit and decreased the earn-out payments due to Harmonix's former shareholders.
- **Legal Standard:** “[T]he implied covenant is not a license to rewrite contractual language just because the plaintiff failed to negotiate for protections that, in hindsight, would have made the contract a better deal. Rather, a party may only invoke the protections of the covenant when it is clear from the underlying contract that “the contracting parties would have agreed to proscribe the act later complained of ... had they thought to negotiate with respect to that matter.”
Id. at 816.

Issues to Consider in M&A Negotiations

- **Analysis:** The Court said it was not clear that the parties would have agreed to prohibit Viacom and Harmonix from agreeing to the amended EA distribution fee structure had they thought to negotiate with respect to that issue. “The Amended EA Agreement did not diminish or in any way affect the amount of the earn-out payment for 2008. ***For Winshall's implied covenant claim to succeed, it must be clear from the Merger Agreement that Viacom and Harmonix would have agreed to take whatever steps were available and required to maximize the amount of the earn-out. The parties could have created such an obligation in their contract, but they did not.***” Nothing in the 79-page Merger Agreement expressly stated, or could be read to imply, that either party must conduct their businesses, post-merger, so as to maximize the amount of the selling shareholders' earn-out payments. “***It is true that when a contract confers discretion on one party, the implied covenant of good faith and fair dealing requires that the discretion, such as Viacom's discretion in controlling Harmonix after the Merger and during the earn-out period, be used reasonably and in good faith.*** Thus, if Viacom and Harmonix had agreed to pay double EA's ask in distribution fees in 2008 in return for paying no distribution fees in 2009 (when no earn-out payment was due), such an agreement would arguably be a breach of the implied covenant.” *Id.* at 816-817.

Issues to Consider in M&A Negotiations

- **Holding:** The Supreme Court of Delaware upheld the Court of Chancery's decision holding that Viacom's actions did not amount to a breach of the implied covenant of good faith and fair dealing. "Winshall's claim rests upon a fundamental misconception of the limited scope and function of the implied covenant of good faith and fair dealing in Delaware contract jurisprudence."

Issues to Consider in M&A Negotiations

- Takeaways

- Carefully negotiate earn-out and other purchase price adjustment provisions.
- Clearly specify the price and the method(s)/factor(s) involved in calculating any additional payments.
- Consider which party will control the implementation of the agreement and draft the terms accordingly to give more or less discretion to the controlling party.
 - The agreement can give the controlling party absolute discretion or decide to limit discretionary power with a reasonableness or similar qualifier.

Issues to Consider in M&A Negotiations

- **Takeaways** *(continued)*

- Clearly define your expectations under the agreement.
 - E.g., if you want the controlling party to do everything they reasonably can to maximize the earn-out, this must be expressly stated in the agreement.
- Draft comprehensive covenants.
 - Do not rely on suing under the implied covenant of good faith and fair dealing.
 - The scope of the covenant is very limited, especially when the transaction is between sophisticated commercial parties.

Issues to Consider in Letters of Intent

- Things to consider when drafting letters of intent (LOI)
 - A “non-binding” term sheet or LOI can sometimes be binding.
 - **Summary of *SIGA Technologies v. PharmAthene, Inc.*, 2013 WL 2303303 (Del. 2013).**
 - **Facts:** Siga was developing a treatment for small pox, but had very limited financial resources. It entered into preliminary discussions with PharmAthene, a pharmaceutical company specializing in biodefense, to help them finance the drug’s development. PharmAthene wanted to merge the two companies, but Siga preferred a licensing deal. The parties compromised by negotiating and agreeing to a definitive merger agreement, but also drafted a detailed term sheet for a license agreement in case the merger fell through. The licensing agreement term sheet was not signed, and a footer on both pages stated, “Non-Binding Terms.” On the condition that they would receive at least a licensing agreement for the drug, PharmAthene provided Siga with a bridge loan while these negotiations were taking place. Both the bridge loan documents and the merger agreement included language confirming that if the merger fell through, the parties would “*negotiate in good faith with the intention of executing a definitive License in accordance with the terms set forth in the License Agreement Term Sheet attached*”... *Id.* at 336. Before the companies completed the merger, Siga received a grant from the National Institute of Health and its stock price rose considerably. Siga let the “drop dead” date on the merger agreement pass. PharmAthene then sent SIGA a proposed license agreement consistent with the license agreement term sheet; however, SIGA decided to reject this agreement and attempted to renegotiate more favorable terms.

Issues to Consider in Letters of Intent

- Things to consider when drafting letters of intent (LOI)
(continued)
 - Some of the economic changes in Siga's new proposal included: the upfront payment increased from \$6 million to \$100 million; the milestone payments increased from \$10 million to \$235 million; the royalty percentages owed to SIGA increased from 8%, 10% and 12% depending on the amount of sales to 18%, 22%, 25% and 28%; and SIGA would receive 50% of any remaining profit whereas the term sheet provided for profit sharing only from U.S. government sales having a margin of 20% or more. *Id.* at 339-340.

Issues to Consider in Letters of Intent

- **Arguments:** SIGA argued it was inconsistent to hold that the licensing agreement term sheet is not a binding license agreement and at the same time conclude that SIGA's obligation to negotiate in good faith requires that SIGA only propose terms substantially similar to the licensing term sheet.

Issues to Consider in Letters of Intent

- **Legal Standard:** Under Delaware law, “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.” *Id.* at 346.

Issues to Consider in Letters of Intent

- **Analysis:** Evidence that “SIGA began experiencing ‘seller's remorse’ during the merger negotiations for having given up control of what was looking more and more like a multibillion dollar drug” bolsters the Court of Chancery’s finding that SIGA failed to negotiate in good faith for a definitive license agreement in accordance with the terms of the licensing agreement term sheet. *Id.* at 347.
 - Although the license agreement term sheet itself is not signed and contains a footer on each page stating “Non-Binding Terms,” the record supports the Vice Chancellor's factual conclusion that “incorporation of the term sheet into the Bridge Loan and Merger Agreements reflects an intent on the part of both parties to negotiate toward a license agreement with economic terms substantially similar to the terms of the License Agreement Term Sheet if the merger was not consummated.” *Id.* at 351.

Issues to Consider in Letters of Intent

- The court held that expectation or “benefit of the bargain” damages would be an appropriate remedy where: (1) the parties memorialized the basic terms of a transaction in a term sheet; (2) the parties expressly agreed to negotiate in good faith a final transaction in accordance with those terms; and (3) but for the breaching party’s bad faith negotiations, the parties would have consummated a definitive agreement having the terms set forth in the term sheet. *Id.* at 351.
- **Conclusion:** The Court held that PharmAthene could recover “benefit of the bargain damages,” i.e., the value of the licensing agreement that “would have been entered into” but for the bad faith. It said that “[w]here the parties have a . . . preliminary agreement to negotiate in good faith and the trial judge makes a factual finding, supported by the record, that the parties would have reached an agreement but for the defendant’s bad faith negotiations, the plaintiff is entitled to recover contract expectation damages.” *Id.* at 351.

Issues to Consider in Letters of Intent

- To mitigate the risk of a court finding a non-binding LOI or term sheet binding, parties should consider including language expressly disclaiming a duty to negotiate in good faith and stating the parties' intend that neither subsequent communications nor any course of conduct will give rise to binding obligations before a definitive agreement is signed.
- Parties should exercise caution in their communications and actions to avoid inadvertently obligating themselves to the terms of a letter of intent or a duty to negotiate in good faith.
- Parties should proceed with caution in demanding economic terms more favorable than those expressly set forth in the term sheet.
 - This is commonly construed by courts as an act of bad faith, especially when the terms vary significantly.

Issues to Consider in Letters of Intent

- To avoid the possibility of paying large expectancy or “benefit of the bargain damages,” parties might want to consider choosing a choice of law other than Delaware to govern the LOI (e.g., New York).
 - Numerous courts have recognized a cause of action for breach of a duty to negotiate in good faith and at least one California court has gone so far as to recognize a **cause of action for breach of the implied covenant of good faith and fair dealing in a case where the parties’ term sheet did not expressly impose an obligation to negotiate in good faith**. *Copeland v. Baskin Robbins U.S.A.*, 96 Cal. App. 4th 1251 (2002). However, these courts have typically favored reliance, not expectation damages.
 - Include a term in the LOI that excludes expectancy damages.

Intellectual Property Licensing Agreements

- *Microsoft Corp. v. Motorola, Inc.*, No. 10–1823, 2013 WL 4053225 (W.D. Wash. 2013); *Microsoft Corp. v. Motorola, Inc.*, 696 F.3d 872 at 875 (9th Cir. 2013).

Microsoft v. Motorola Summary

- **Facts:** Motorola owns patents that are essential to the 802.11 and H.264 standards and has committed to license them on RAND terms with SSO's. Motorola sent Microsoft two letters offering to license Motorola's SEPs.
- **Arguments:** Microsoft asserted that Motorola's offer was commercially unreasonable and that it breached its RAND commitment, as well as the duty of good faith and fair dealing. Motorola claimed the offer was intended merely as an opening for negotiations and was a common tactic in the industry.
- **Holding:** The court held that: (1) Motorola entered into binding contractual commitments with the IEEE and the ITU, committing to license its declared-essential patents on RAND terms and conditions; and (2) that Microsoft was a third-party beneficiary of Motorola's commitments to the IEEE and the ITU. The court did not decide on whether the duty of good faith and fair dealing required an "offer" to be on RAND terms. The court indicated in dicta however that one of the SSO policies required members to "negotiate licenses on RAND terms" in which case Microsoft could make the argument that Motorola was under obligation to make an offer on RAND terms.

Microsoft v. Motorola Summary

- **Jury Instruction:** In determining whether Motorola’s Oct. 21 offer letter and/or Motorola’s Oct. 29 offer letter complied with Motorola’s duty of good faith and fair dealing, you may compare Motorola’s offers against the RAND royalty rate and range determined by the court and set forth in instruction # 20. However, the size of an offer alone is not exclusively dispositive of whether Motorola has breached its duty of good faith and fair dealing. To determine whether Motorola’s offer breached its duty of good faith and fair dealing, you must use the standard set forth in instruction #16.
- **Take-Aways:** Patents that are classified as “Standard Essential Patents” require careful negotiation. The implied covenant of good faith and fair dealing can become intertwined with the FRAND and RAND standards and commitments.

General Tips for Compliance with the Implied Covenant of Good Faith and Fair Dealing

- Exercise caution when dealing with less sophisticated parties.
 - E.g., employment agreements.
- Be extremely clear when drafting complicated and/or heavily negotiated provisions of an agreement (e.g., earn-outs).
 - Provide context and details whenever possible.
 - Draft comprehensive recitals and covenants.
 - When one party will have control of implementing the agreement (e.g., an earn-out provision), specify the expectations for how much discretion the controlling party will have.
- Never act with malice or out of spite when dealing with the opposing party.
 - Document the business reasons for decisions made pursuant to the agreement.
 - Refrain from actions that are arbitrary or could be seen as unreasonable or for no legitimate business purpose.

General Tips for Compliance with the Implied Covenant of Good Faith and Fair Dealing

- Patents that are classified as “Standard Essential Patents” are subject to increased scrutiny; exercise caution when negotiating these agreements.
- Carefully draft non-binding term sheets and letters of intent with express language that there is no duty to negotiate in good faith in the future; state that negotiations can be broken off for any reason or for no reason.
 - Clearly state that the LOI is not binding and no subsequent actions or communications will make it binding until a definitive agreement is signed by both parties.
- Avoid tactics or behaviors that have triggered successful claims for breach of the implied covenant in the past.

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