State Law & State Taxation Corner

Hanaway: A Truly Bizarre Opinion on the Obligation of Good Faith and Fair Dealing

By Thomas E. Rutledge[*]

Within every contract there exist an obligation of good faith and fair dealing. If you don't believe me, believe the *Restatement (2nd) of Contracts*, which at section 205 provides:

> Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.[1]

Numerous Pennsylvania courts have recognized this to be the case.[2] That said, in a recent and fairly described as truly bizarre decision from the Pennsylvania Supreme Court, it held that no obligation of good faith and fair dealing arose in an agreement of limited partnership.[3]

The Hanaways, plaintiffs in this action, were among the limited partners of Sadsbury Associates, L.P., a Pennsylvania limited partnership of which T. R. White, Inc. ("White") served as the general partner. The Sadsbury limited partnership was a financial success. In light of that history, the same participants organized the Parkesburg limited partnership, largely devoted to the organization of a housing development. There was transferred to Parkesburg an option owned by White for what was referred to as the " Davis Tract," a 43.2 acre parcel, and the "Loue Tract," it being another 17 acres.[4] The subdivision plat as well included an adjacent quarry, owned by the Hanaways and on which Parkesburg held an option. The agreement of limited partnership gave White broad discretion with respect to its management and as well imposed ongoing capital contribution obligations upon the limited partners.[5]

Sometime after Parkesburg began the planning effort with respect to the subdivision, the Hanaways advised Parkesburg that the option to acquire the quarry had expired and would not be renewed, and as well that they refused to contribute additional capital to the project. These actions by the Hanaways led other limited partners to be unwilling to contribute additional capital, and the project stalled.[6] White informed the Hanaways that the Davis Tract would be sold, as well as the option for the Loue Tract, for appraised fair market value to a newly formed limited partnership, Park Mansion Partners ("PMP").[7] White served as the general partner of PMP, and its limited partners were those persons who had been limited partners in Parkesburg, with the exception of

THOMAS E. RUTLEDGE is a member of Stoll Keenon Ogden PLLC resident in the Louisville, Kentucky office.

the Hanaways. That sale price was $1.9 million.[8] The Hanaways would assert a fair market value of the two parcels of $8.5 million.[9] Some two years later,[10] the Hanaways would file suit, alleging the sale of the properties to PMP for less than adequate consideration and below fair market value, all "as part of the scheme to eliminate the Hanaways' ownership interests."[11] In response to a motion for partial summary judgment based upon the failure by the Hanaways to identify a specific term of the Parkesburg limited partnership agreement that had been breached, they contended that White had breached the implied covenant of good faith and fair dealing. The trial court granted partial summary judgment, holding, *inter alia*, that the broad discretion afforded White in the agreement of limited partnership could not be overridden by the implied covenant of good faith and fair dealing. An intermediate court of appeals would reverse, holding that the discharge of the contractually granted rights remained subject to the implied covenant of good faith and fair dealing, and on that basis reversed the trial court.[12] In doing so, that intermediate court of appeals both adopted the *Restatement (2nd) of Contracts* section 205 and, as characterized by the Pennsylvania Supreme Court:

> Perceived no reason to treat limited partnership agreements differently than any other type of contract. The majority also opined that the Hanaway's breach of the covenant of good faith and fair dealing claim was a breach of contract action, not an independent action for breach of a duty of good faith.[13]

The Hanaway decision has deprived the innumerable partners in pre-2017 Pennsylvania limited partnerships of those protections.

There could well be an underlying political aspect of this determination. At the intermediate court of appeals, then Judge Donahue, since transitioned to the Pennsylvania Supreme Court, had in a dissenting opinion stated that the implied covenant of good faith and fair dealing does not apply in limited partnerships because they are "creatures of the legislature," that are "governed, first and foremost" by the Limited Partnership Act.[14] This decision of the Pennsylvania Supreme Court would for all interests and purposes adopt that dissent.

As described by the Pennsylvania Supreme Court:

> We granted *allocatur* to consider whether the implied covenant of good faith and fair dealing applies to all limited partnership agreements formed in Pennsylvania, and, if so, whether the implied duty of good faith and prayer dealing can override the express terms of a limited partnership agreement.[15]

In response thereto, White adopted the reasoning espoused by Donahue at the intermediate appellate level, "emphasizing that limited partnership agreements are unique and ill-suited for application of the implied covenant of good faith and fair dealing because they are governed by statute."[16] He pointed out as well that under the Uniform Limited Partnership Act (2013), adopted in Pennsylvania in 2016, there is an express incorporation into the statute of the contractual obligation of good faith and fair dealing, characterizing this as a "drastic change" and reasoning that the obligation of good faith and fair dealing "did not exist at the time that the parties formed Parkesburg and entered into a limited partnership agreement."[17] In contrast, the Hanaways argued that the implied covenant applies in all contracts, including limited partnership agreements.

In my humble opinion, the Pennsylvania Supreme Court could have easily resolved this dispute without making any further examination of the obligation of good faith and fair dealing. Specifically, it could have held, as a factual matter, that the actions undertaken by White in reorganizing the then failing Parkesburg limited partnership fell within the general partner's authority and/or that the plaintiffs had failed to adequately plead how White's actions constituted a breach of the limited partnership agreement. In the alternative, the court could have found that the Hanaways did not individually have standing to bring the action in that it was properly a derivative action, and on that basis ordered that it be dismissed.[18] *As but another alternative, the court could have found that any claim for violation of the implied covenant did not survive the passing of the statute of limitations for a breach of contract action.*[19] *Had the court done so, the* Hanaway *opinion would have been entirely uninteresting. Unfortunately, that is not the way it went down.*

The Pennsylvania Supreme Court would hold that, except with respect to limited partnerships organized under the Uniform Limited Partnership Act as adopted in Pennsylvania in 2016, the implied covenant of good faith and fair dealing does not apply with respect to limited partnership agreements. The contrary rule would apply in limited partnership agreements governed by Pennsylvania's new (2016) Limited Partnership Act,[20] it

expressly providing for the obligation of good faith and fair dealing.[21] After stating that "The Hanaways had the opportunity to bargain for specific protections without having to rely upon implicit concepts,"[22] a statement that can be made only if one entirely ignores the gap-filler purpose of the implied covenant,[23] the court went on to hold that "there was no duty of good faith applicable to limited partnership agreements formed pursuant to PRULPA."[24]

A Very Split Decision

This decision was joined in by three members of the six-person court. Justice Donahue, who participated in the decision at the intermediate appellate level, did not participate. There was a dissenting opinion by two of the sitting justices, an opinion which would have found that the contractual obligation of good faith and fair dealing applies to any contract, and that the failure to reference the obligation in the prior limited partnership act in no manner abrogated its existence.[25] From there, the dissent would have suggested a focus upon "whether the implied covenant of good faith and fair dealing may impose duties that are inconsistent with the duties imposed by the express terms of a limited partnership agreement," suggesting that:

> It is illogical to conclude that, had the limited partners considered this issue at the time of forming the limited partnership, the limited partners would have authorized Parkesburg (*sic*—White), as the general partner, to exercise its discretion in bad faith to the detriment of either the Partnership or the limited partners.[26]

No Implied Covenant If Agreement Based on Statute?

This is, at minimum, a disturbing decision. It is axiomatic that the agreement of limited partnership is an enforceable contract. RULPA (1985), at Section 101(9), provides "'Partnership agreement' means any valid agreement, written or oral, of the partners as to the affairs of a limited partnership and the conduct of its business." Numerous courts have held this to be the fact. Of course, it makes sense that the partnership agreement is an enforceable contract; elsewise, how could there ever be suits asserting there to have been, typically by the general partner, a breach of the agreement; if there was no agreement, how could it be violated?

For a state supreme court to suggest that because limited partnership agreements are created pursuant to statute that the obligation of good faith and fair dealing is somehow inapplicable is simply nonsensical. Rather, section 205 of the *Restatement* indicates that its reach extends to "every contract."

Nothing about *Restatement (2nd) of Contracts* section 205 suggests that the implied covenant is somehow conditional upon the degree of statutory influence otherwise applicable to the contract at issue. Were that the case, there would exist the question of what degree of statutory involvement is necessary in order to abrogate the application of section 205 of the *Restatement (2nd) of Contracts* and the implied covenant? Partnership agreements are heavily influenced by statute. LLC operating agreements are heavily influenced by statute. Stockholder buy/sell/restriction agreements are heavily influenced by statute. Security agreements are heavily influenced by statute. The list goes on. Is the implied covenant inapplicable in all of them? If it is applicable there but not in limited partnership agreements, why?

If the reasoning of the Pennsylvania Supreme Court is correct, a new question arises: If a contract to the maximum degree possible should depart from the statutory base, would the implied covenant be applicable?[27] Put another way, if a contract is initially not subject to the implied covenant because of a statutory overlay, does departure from the statutory overlay cause its application as an invasive function?

The Reach of Hanaway

At least one member of the Pennsylvania bar has suggested that this decision is not that important because, with the application of the new Pennsylvania Uniform Limited Partnership Act to existing limited partnerships,[28] they will all become subject to the new law's express incorporation of the implied covenant of good faith and fair dealing. I can't accept that. First, with respect to all of those legacy limited partnerships, the implied covenant of good faith and fair dealing will not apply retroactively to conduct and actions that accrued prior to the drag-in effective date.[29] Second, only a minority of the states have adopted the Uniform Limited Partnership Act (2001).[30] Litigants in other states, seeking to avoid the application of the implied covenant of good faith and fair dealing, are going to cite this decision of the Pennsylvania Supreme Court in support of the notion that the covenant is somehow inapplicable. Hopefully, those foreign courts will undertake an appropriate analysis and an appreciation that the implied covenant exists in every contract, and its reference in the Uniform Limited Partnership Act (2001) is primarily in order to make clear that it cannot be waived in an agreement, but the terms of its application may be explained.

Why Good Faith and Fair Dealing

There are a variety of formulae used to describe the effect of the implied covenant. Under a positive formula, the implied covenant of the good faith and fair dealing obligates a party to a contract to do "everything necessary" to carry out the contract.[31] There is as well a negative burden to not act to "prevent [] the creation of the condition under which payment would be due."[32] The U.S. Supreme Court, in *Northwest, Inc. v. Ginsberg*,[33] noted the different applications of the implied covenant, observing:

> While most States recognize some form of the good faith and fair dealing doctrine, it does not appear that there is any uniform understanding of the doctrine's precise meaning. "[T]he concept of good faith in the performance of contracts 'is a phrase without general meaning (or meanings) of its own.'" Of particular importance here, while some States are said to use the doctrine "to effectuate the intentions of parties or to protect their reasonable expectations," *ibid.,* other States clearly employ the doctrine to ensure that a party does not "violate community standards of decency, fairness, or reasonableness."[34]

The implied covenant informs the application of the agreed-upon terms of the contract; it does not provide extra-contractual terms.[35] The covenant of good faith and fair dealing will not preclude a party from exercising its contractual rights.[36] Another important point is that the implied covenant does not serve to preclude self-dealing conduct, but rather only police it at the margins by protecting the express contractual terms.

> As to allegations that "constitute self-dealing," a party may act in its own interest and not breach the covenant of good faith and fair dealing, as long as its discretion is not used in a way that is contrary to the spirit of the agreement.[37]

This is not to suggest that good faith and fair dealing are inapplicable in a fiduciary relationship; rather, the reverse is the typical rule. The fiduciary must discharge the obligations undertaken by contract consistent with good faith and fair dealing. The *Hanaway* decision has deprived the innumerable partners in pre-2017 Pennsylvania limited partnerships of those protections. If the Pennsylvania Supreme Court wanted to prevent White from having to defend the actions he took in response to the Hanaways after they precipitated the problems in Parkesburg, it could have done so through the statute of limitations defense[38] without doing violence to limited partnership law. Unfortunately, that path was not taken.

All in all, this is just a bizarre decision.

ENDNOTES

* A frequent speaker and writer on business organization law, Thomas E. Rutledge has published in journals including The Business Lawyer, the Delaware Journal of Corporate Law, the American Business Law Journal and the Journal of Taxation, and is an elected member of the American Law Institute. He blogs at *Kentuckybusinessentitylaw.blogspot.com*.

1 *See* Restatement (2nd) of Contracts §205.

2 *See*, *e.g.*, *Donahue v. Federal Express Corporation*, 753 A2d 238, 242 (Pa. Super. Ct. 2000) (in reviewing an at-will employment contract, "Every contract in Pennsylvania imposes on each party a duty of good faith and fair dealing in its performance and its enforcement."); *Somers v. Somers*, 613 A2d 1211, 1214 (Pa. Super. Ct. 1992) ("In the absence of an express provision, the law will imply an agreement by the parties to a contract to do and 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."); *Sylk v. Bernsten*, Nos. 1906, 080528, 080530, 2003 Phil. Ct. Com. Pl. LEXIS 75, at *29 (C.P. Feb. 4, 2003) (The implied duty of good faith and fair dealing arises under the law of contracts); *Kaplan v. Cablevision of PA, Inc.*, 671 A2d 716, 722 (Pa. Super. Ct. 1996) ("[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement" (quoting Restatement (Second) of Contracts, §205) (internal quotation marks omitted)). The law of other states is similar. *See Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc.*, 171 S.W.3d 4, 11 (Ky. 2005) ("Within every contract there is an implied covenant of good faith and fair dealing, and contracts impose on the parties thereto a duty to do everything necessary to carry them out."); *see also* Ky. Rev. Stat. Ann. §275.003(7); *id*. §362.1-404(4); *id*. §362.2-408(4); *id*. §386A.1-060(6). *Accord* Restatement (2nd) of Contracts §205 (1981). *Dick Broadcasting Co., Inc. of Tennessee v. Oak Ridge FM, Inc.*, 395 S.W.3d 653 (Tenn. 2013) ("It is well-established that "[i]n Tennessee, the common law imposes a duty of good faith in the performance of contracts." *Wallace v. Nat'l Bank of Commerce,* 938 S.W.2d 684, 686 (Tenn. 1996). In *Wallace,* this Court observed that "[i]t is true that there is implied *in every contract* a duty of good faith and fair dealing in its performance and enforcement, and a person is presumed to know the law." *Id.* (emphasis added) (quoting *TSC Indus., Inc. v. Tomlin,* 743 S.W.2d 169, 173 (Tenn. Ct. App. 1987) (citing Restatement (2nd) of Contracts §205 (1979))).).

3 *Hanaway v. Parkersburg Group*, 168 A3d 146 (Pa. 2017).

4 *Hanaway*, 168 A3d at 148.

5 For example, the general partner was afforded "full, exclusive and complete discretion in the management and control of the business of the Partnership." *Hanaway*, 168 A3d at 149.

6 While it would appear that the general partner could make a capital call on the limited partners, they were not obligated to contribute additional capital. *Hanaway*, 132 A3d at 463, note 1.

7 As described by the Pennsylvania Supreme Court:

> Lacking capital and financially restrained from proceeding, Parkesburg's development of the Subdivision stalled. With the option on the Loue Tract approaching its expiration date, T.R. White acted to save the development project and its investment. On September 25, 2007, T.R. White informed the Hanaways that, upon obtaining a third party fair market value appraisal, it intended to sell the Davis Tract and the option for the Loue Tract contemporaneously.

Hanaway, 168 A3d at 149.

8 *Hanaway*, 132 A3d at 463.

[9] *Id.*, n. 2; *see also id.,* at 469 ("the sale of TPG property at a price $6 million below market value.").

[10] The intermediate court of appeals described the period as being two and a half years. *Hanaway*, 132 A3d at 463.

[11] *Hanaway*, 168 A3d at 150. While the Hanaways had invested $316,216.22 in Parkesburg, upon its liquidation they received $196,083.20; they sought the $120,000.00 deficiency. *Hanaway*, 132 A3d at 464. The trial court had dismissed the Hanaways' claims for breach of contract and breach of fiduciary duty on statute of limitations grounds, determinations affirmed by the intermediate court of appeals.

[12] *Hanaway v. Parkesburg Group, L.P.*, 132 A3d 461 (Pa. Super. Ct. 2015).

[13] *Hanaway*, 168 A3d at 151.

[14] *Id.*, at 151, 152, quoting *Hanaway*, 132 A3d at 477.

[15] *Hanaway*, 168 A3d at 152.

[16] *Id.*

[17] *Id.*, at 153.

[18] *See, e.g., Weston v. Northampton Personal Health Care, Inc.*, 63 A3d 947 (Pa. 2013).

[19] *Mercy Health Systems of Southeastern Pennsylvania v. Metropolitan Realty Partners LLC*, 2003 WL 21904583, *2 (Pennsylvania Court of Common Pleas July 10, 2003).

> In Count V, Mercy alleges that the Defendants' breached the duty of good faith and fair dealing that, under Pennsylvania law, is implicit in every contract. The Court agrees with Mercy that every contract imposes the duty of good faith and fair dealing; however, the Court finds that an alleged breach of this implied duty does not provide an independent ground for liability.
>
> JHE, Incorporated v. Southeastern Pennsylvania Transport Authority, contains a thorough review of the law of Pennsylvania on the implied duty of good faith and fair dealing. 2002 WL 1018941, *7 (Pa. Com. Pl. 2002). The JHE court held "that a breach of the covenant of good faith is nothing more than a breach of contract claim and that separate causes of action cannot be maintained for each, even in the alternative." *Id.*, at *7. Accordingly, Mercy's claim based upon the breach of the implied duty of good faith and fair dealing must be dismissed.

[20] Pennsylvania adopted the Harmonized Uniform Limited Partnership Act (2013) in 2016 with effective dates in 2017. *See* P.L. 1328, No. 170, adding ch. 86 to title 15 of the Pennsylvania Code.

[21] *See* Pa. Code §8635(a) ("A limited partner shall discharge any duties to the limited partnership and the other partners under the partnership agreement and exercise any rights under this title or the partnership agreement consistently with the contractual obligation of good faith and fair dealing."); *id.* §8649(d) ("A general partner shall discharge the duties and obligations under this title or under the partnership agreement and exercise any rights consistent with the contractual obligation of good faith and fair dealing."). *See also* Unif. Ltd. Part. Act. §305(b), 6A U.L.A. 424 (2008) ("A limited partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing."); *id.* §408(d), 6A U.L.A. 439 ("A general partner shall discharge the duties to the partnership and the other partners under this [Act] or under the partnership agreement and exercise any rights consistently with the obligation of good faith and fair dealing.").

[22] *Hanaway*, 168 A3d, at 157.

[23] *See infra* notes 31 through 37 and accompanying text.

[24] *Hanaway*, 168 A3d at 158.

[25] *Id.*, at 159 (dissent).

[26] *Id.*, at 161.

[27] Recall that while the Uniform Limited Partnership Act (2001) and its progeny the harmonized 2013 Act place certain outer limits on the degree to which the partnership agreement may modify rules inter-se the partners (*see* Section 110), no similar limitation existed under prior limited partnership acts.

[28] *See* Pa. Code §8611(b), (c).

[29] *See, e.g., Snitow v. Snitow*, No. 2165 EDA 2016, 2017 WL 6557479, n. 5 (Superior Court of Pennsylvania Dec. 22, 2017) (considering the application of *Hanaway* to a pending limited partnership dispute).

[30] *See, e.g., Klein v. Weiss*, 395 A2d 126, 141 (Md. 1978); *Nw. Nat'l Life Ins. Co.* DC-IL, 627 FSupp 502, 504 (1986); *In Re: Villa West Associates*, CA-10, 140 F3d 798 (1988) (limited partnership agreement, under Kansas law, constitutes a contract between the parties thereto). *See also* Thomas E. Rutledge, Philip D. Amoa and Christina M. Houston, Limited Partnerships: Legal Aspects of Organization, Operation, and Dissolution (BNA Corporate Practice Series Portfolio 24) at (*forthcoming*).

[31] *See, e.g., In re Toliver*, 466 B.R. 720, 742-43 (Bkrtcy. E.D. Ky. 2012), citing *Harvest Homebuilders LLC v. Commonwealth Bank and Trust Co.*, 310 S.W.2d 218, 220 (Ky. App. 2012); *Ranier v. Mount Sterling Nat'l Bank*, 812 S.W.2d 154, 156 (Ky. 1991); *Ram Eng'g & Constr., Inc. v. Uni. of Louisville*, 127 S.W.3d 579, 585 (Ky. 2003).

[32] *See, e.g., Oden Realty Co. v. Dyer*, 45 S.W.2d 838, 840 (Ky. 1932); *Crestwood Farm Bloodstock v. Everest Stables, Inc.*, CA-6, 751 F3d 434, 445; 2014 WL 1856697, *8; *James T. Scatuorchio Racing Stable, LLC v. Walmac Stud Management, LLC*, 2014 WL 2113096, *8 (E.D. Ky. May 20, 2014).

[33] *Northwest, Inc. v. Ginsberg*, SCt, __ U.S. __, 134 SCt 1422 (2014).

[34] 134 SCt at 1431 (citations omitted).

[35] *See, e.g., Winshall v. Viacom International, Inc.*, 2011 WL 5506084 (Del. Ch. Nov. 10, 2011).

[36] *See, e.g., Scheib v. Commonwealth Anesthesia, P.S.C.*, 2011 WL 5008089, *5 (Ky. App. 2011); *Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc.*, 171 S.W.3d 4, 11 (Ky. 2005). *See also United Propane Gas, Inc. v. Federated Mut. Ins. Co.*, 2007 WL 779443, *3 (Ky. App. Mar. 16, 2007) ("Since Federated had a right to settle under the contract and therefore was merely exercising a contractual right, and UPG has otherwise cited us to no specific policy provision alleged to have been breached, we affirm the circuit court's award of summary judgment on the breach of contract claim."); *Hunt Enters. v. John Deere Indus. Equip. Co.*, 18 FSupp 2d 697, 700 (W.D. Ky. 1997) (the covenant of good faith and fair dealing, "does not preclude a party from enforcing the terms of the contract. ... It is not 'inequitable' or a breach of good faith and fair dealing in a commercial setting for one party to act according to the express terms of a contract for which it bargained.").

[37] *Scaturochio*, 2014 WL 2113096, *9.

[38] *See supra* notes 11 and 19.

