When—or Should We Say Where—Is Compliance with a Contract also a Breach?

Choice of Law and the Covenant of Good Faith and Fair Dealing

By Leon Silver

Carelessness in drafting contract language can result in your client's company undertaking obligations and becoming exposed to liabilities that the company never anticipated because the law implies duties that you cannot otherwise clearly define.

In my practice, my national and regional retail clients most often opt for the company's headquarters' home state as both the exclusive forum and the source for the controlling law in their master vendor agreements as well as any number of other contracts. While the practical realities of having to manage litigation that could conceivably occur anywhere in the country make the forum choice a seemingly straightforward decision, I have often found that contract drafters do not give the choice of law provision enough critical thought. This is particularly so because the choice of controlling law may have the unintended and completely surprising consequence of making conduct that complies with the terms of a contract still actionable for breach.

This article examines how the covenant of good faith and fair dealing can create liability in some states but not others for the exact same acts by a contracting party. Specifically, we will discuss how the covenant of good faith and fair dealing is viewed in six representative states: Arizona and Texas, reflecting the extremes, and Delaware, New York, California, and Illinois, providing a solid survey of the more moderate view. Since almost every state's law implies the duty of good faith and fair dealing in every contract, and because the states apply the duty differently, if you and your clients have not become aware of the how the controlling jurisdiction treats the covenant of good faith and fair dealing, you can find your client's sober and reasoned business decisions turned on their heads.

Arizona: The Broadest View

Arizona sits at the broadest end of the good faith and fair dealing spectrum. We might almost, surprisingly, call Arizona "liberal" in this regard. Arizona, as most jurisdictions, recognizes that the duty of good faith and fair dealing is implied in every contract. *Rawlings v. Apodaca*, 151 Ariz. 149, 163, 726 P.2d 565, 579 (Ariz. 1986). Ideally, this duty deters parties from acting to impair the right of another party to receive the benefits that flow from the contract. *See id.* at 153–54, 726 P.2d at 569–70.

Arizona's implied duty, however, encompasses nearly every action by a party. Any-

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thing a party does that impairs or seems to impair another party's benefits that flow from a contract can breach the implied duty. *Id.* It does not matter whether the party's action relates to an express term or an area on which the contract is silent—either can breach the duty. *Bike Fashion Crop. v. Kramer*, 202 Ariz. 420, ¶14, 46 P.3d 431, 434 (Ariz. Ct. App. 2002). A party may breach the implied duty without breaching an express term, and it may breach an express term without breaching the implied duty. *Wells Fargo Bank v. Arizona Laborers*, 201 Ariz. 474, ¶60, 38 P.3d 12, 29 (Ariz. 2002).

Arizona law's only consistent limitation on the duty of good faith is to prevent it from "directly contradict[ing] an express contract term."

The terms implied in the contract "are as much a part of the contract as are the express terms." *Id.* at ¶59, 38 P.3d at 28. Although the parties must be in privity, the duty "arises by operation of law." *Id.* Therefore, breach of the duty is a claim distinct from breach of contract: " because a party may be injured when the other party to a contract manipulates bargaining power to its own advantage, a party may nevertheless breach its duty of good faith without actually breaching an express covenant in the contract." *Id.* at ¶64, 38 P.3d at 29. Conversely, "[a] party may breach an express covenant of the contract without breaching the implied covenant of good faith and fair dealing." *Id.*

The breach of the duty may sound in contract or in tort. *Id.* at ¶61, 38 P.3d at 29 ("When the remedy for breach of the covenant sounds in contract, it is not necessary for the complaining party to establish a special relationship.").

In its simplest terms, a party breaches the duty by improperly exercising its discretion either discretion expressly allowed in the contract in a way not reasonably expected or discretion not expressly excluded but still contrary to the other party's reasonably expected benefits of the bargain. *Bike Fashion*, 202 Ariz. at ¶14, 46 P.3d at 434.

Wells Fargo Bank, 201 Ariz. 474, ¶60, 38 P.3d 12, 29 (Ariz. 2002), is perhaps Arizona's primary case regarding the implied duty. The case began during Arizona's late 1980s real estate crisis and included allegations against the then-future governor J. Fife Symington III who ultimately resigned during his second term. 201 Ariz. at ¶2, 38 P.3d at 17–18. In 1988, Mr. Symington's partnership secured interim funding from First Interstate Bank to build a commercial development in downtown Phoenix called The Mercado. *Id.* The permanent lenders, who were a collection of pension funds, were to "take-out" the bank's loan by June 1990. *Id.* To that end, the bank, Mr. Symington, and the funds entered a triparty agreement. The triparty agreement did *not* require the bank to provide any information to the funds. *Id.*

In 1989, the real estate market crashed. 201 Ariz. at ¶3, 38 P.3d at 18. Mr. Symington was unable to meet his obligations on a separate loan with the bank. *Id.* The bank, however, granted forbearances on that separate loan until mid-1990 when the funds were to replace the bank on the loan. 201 Ariz. at ¶7, 38 P.3d at 19. Once the funds met their obligation and paid the bank as promised, the bank held Mr. Symington's other loan in default. *Id.*

The funds sued the bank for failing to disclose Mr. Symington's troubled finances. The funds alleged that the implied duty required the bank to disclose Mr. Symington's financial difficulties. The bank disagreed, arguing that it could not be liable because "it did not breach any provision of the Triparty Agreement." 201 Ariz. at ¶63, 38 P.3d at 29.

The Arizona Supreme Court disagreed with the bank:

> The Bank relies too heavily on the literal text. The duty of good faith extends *beyond the written words* of the contract…. [A party] may breach an express covenant of the contract without breaching the implied covenant" and conversely, "a party may nevertheless breach its duty of good faith without actually breaching an express covenant in the contract.

Id. (emphasis added).

The Arizona Supreme Court ruled it a question of fact whether the bank "wrongfully exercised contractual power for 'a reason beyond the risks' that the Funds assumed in the Triparty Agreement, or for a reason inconsistent with the Funds' justified expectations." 201 Ariz. at ¶67, 38 P.3d at 30. *Wells Fargo* exemplifies potential liability for failure to perform a condition not in a contract.

Another Arizona case exemplifies potential liability for "improperly" exercising *express*, unfettered discretion. In *Arizona Towing Profs., Inc. v. State*, an unsuccessful bidder on a contract with the Arizona Department of Public Safety filed a protest. 196 Ariz. 73, ¶5, 993. P.2d 1037, 1038 (Ariz. Ct. App. 1999). Due to the protest, the department cancelled the bid—as it could under an express provision under the contract: "the contracts… are cancelable for convenience on thirty (30) days' notice." *Id.* at ¶7, 993 P.2d at 1039. But the Arizona Court of Appeals disagreed: "[The department] did not act in good faith. It invoked the cancellation for convenience provision in an effort to render moot Shamrock's appeal of its original cancellation over the bid protest." *Id.* at ¶23, 993 P.2d at 1041. Unbridled discretion would permit the department to avoid any appeals. *Id.*

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Under Arizona law, the results can be troubling. In one case handled by your author, the court denied the opposing party's request for leave to amend its complaint to add claims of a widespread and far-reaching alleged fraud. The party then sought to rely on the same facts as part of its claim for breach of the duty of good faith and fair dealing. While the denial of the motion for leave limited the damages that could be claimed to contract damages, reliance on the good faith and fair dealing claim left the door open for discovery and introduction of what would have been, without the good faith and fair dealing claim, inadmissible, inflammatory evidence.

I have also experienced several instances where the trial judge instructed the jury on the implied covenant of good faith and

fair dealing when the plaintiff had not pleaded that claim in the complaint. The courts reasoned that since every contract implied the covenant of good faith and fair dealing, every claim for breach of contract must imply it as well. I find this a dangerous trap for the unwary trial lawyer seeking to defend a case pleaded and defended only as a breach of the contract.

Under Arizona law, the implied duty creates real, unknown duties and limits express discretion. While this result might seem reasonable when examining how a corporate decision affects a specific right under a particular contract, how could a large company, one with operations throughout the country, dealing with thousands of vendors and vendor contracts, reasonably make even routine business decisions? Is a company required to predict the potential deleterious effect on every single contractual relationship that it has? Arizona law seems to lean in that direction, and a litigant has to be prepared for an opponent to make this argument as late as closings.

Texas: The Narrow View

Texas law is dramatically different from the other states and is at the opposite end of the spectrum from Arizona: "There is no general duty of good faith and fair dealing in ordinary, arms-length commercial transactions." *Formosa Plastics Corp. USA v. Presidio Engineers and Contractors, Inc.*, 960 S.W.2d 41, 52 (Tex. 1998). Instead, a duty of good faith and fair dealing "arises only when a contract creates or governs a special relationship between the parties." *Subaru of America, Inc. v. David McDavid Nissan, Inc.*, 84 S.W.3d 212, 225 (Tex. 2002).

Formosa, 960 S.W.2d 41, 52 (Tex. 1998)., exemplifies a drastic difference based on the choice of law. Formosa requested a bid from Presidio for construction work at its plastics factory. *Id.* at 43. Formosa chose Presidio, which presented the lowest bid. Once engaged in the work, Presidio discovered that Formosa had misrepresented the project to entice an unreasonably low bid. *Id.* Eventually Presidio sued for breach of contract and breach of the duty of good faith and fair dealing as well as fraudulent concealment. *Id.* The court submitted the claim for breach of the duty of good faith to the jury, which returned a verdict for $1.5 million. *Id.* Yet the appellate court reversed the award, holding that the trial court never should have submitted the issue to the jury. *Id.* at 51–52. Arizona law, on the other hand, would have permitted the claim.

Accordingly, it would seem that opting for the law of Texas, at least as far as the covenant is concerned, would limit unanticipated exposure in a routine contract relationship.

Delaware

Because many companies are incorporated in Delaware, and as a result, often choose to contract under Delaware law, it is good practice to know how Delaware law treats most issues. Under Delaware law,

> [t]he implied covenant of good faith and fair dealing inheres in every contract governed by Delaware law and 'requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.'

Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 145–46 (Del. Ch. 2009) (internal citation omitted).

Said another way, "[t]he implied covenant requires that the discretion be used reasonably and in good faith." *Id.* at 146–47 (emphasis added).

The implied covenant, however, "does not apply when 'the subject at issue is expressly covered by the contract.'" *Id.* at 146. Thus, "[t]he doctrine… operates 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 does not speak directly enough to provide an explicit answer." *Id.* To elaborate,

> [t]he test for the implied covenant depends on whether it is 'clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter.'

Id. See also Dunlap v. State Farm Fire & Cas. Co., 878 A.2d 434, 442–43 (Del. 2005) (deciphering an implied term should be "'rare and fact-intensive'") (internal citation omitted).

Under Delaware law a court will look closely at the overall intent of the parties as specifically set forth in the contract to determine whether an action does or does not violate the covenant.

New York

New York law, while similar to Delaware, is a step closer to Arizona. Under New York law,

> Within every contract is an implied covenant of good faith and fair dealing. This covenant is breached when a party to a contract acts in a manner that, although not expressly forbidden by any contractual provision, would deprive the other party of the right to receive the benefits under their agreement.

Aventine Inv. Mgmt., Inc. v. Canadian Imperial Bank of Commerce, 697 N.Y.S.2d 128, 128 (N.Y. App. Div. 1999).

Under Delaware law a court will look closely at the overall intent of the parties as specifically set forth in the contract to determine whether an action does or does not violate the covenant.

New York courts reason that "the implied covenant 'ensures that parties to a contract perform the substantive bargained-for terms of their agreement.'" *Geren v. Quantum Chem. Corp.*, 832 F. Supp. 728, 732 (S.D. N.Y. 1993) (internal citation omitted). But "covenant of good faith can be implied only where the implied term is consistent with other mutually agreed upon terms in the contract." *Sabetay v. Sterling Drug, Inc.*, 506 N.E.2d 919, 922 (N.Y. 1987); *Sabetay*, 506 N.E.2d at 922 ("No obligation can be implied, however, which would be inconsistent with other terms of the contractual relationship…."). And "[w]hile the duties of good faith and fair dealing do not imply obligations 'inconsistent with other terms

of the contractual relationship,' they do encompass 'any promises which a reasonable person in the position of the promissee would be justified in understanding were included.'" *511 W. 232nd Owners Corp. v. Jennifer Realty Co.*, 773 N.E.2d 496, 500–01 (N.Y. 2002) (internal citation omitted). Thus, under New York law, a court can look beyond the express intent of the parties as stated in the contract, but it cannot impose an obligation that would be inconsistent with the contract.

State courts generally do not recognize waiver of the duty of good faith and fair dealing.

If a party waives all defenses under a loan agreement, New York courts likely will include a defense of the implied covenant of good faith in the waiver. *See Hotel 71 Mezz Lender, LLC v. Mitchell*, 880 N.Y.S.2d 67, 69 (N.Y. App. Div. 2009) (finding that a guaranty's waiver of all defenses to enforcement would included waiver of a claimed defense of breach of the duty of good faith and fair dealing).

California

California law also implies a covenant of good faith and fair dealing in every contract. *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 200 (Cal. 1958). The parties covenant not to do "anything which will injure the right of the other to receive the benefits of the agreement." *Id.* The duty finds "'particular application in situations where one party is invested with a discretionary power affecting the rights of another. Such power must be exercised in good faith.'" *Carma Devs. (Cal.) Inc. v. Marathon Dev. Cal., Inc.*, 2 Cal. 4th 342, 372, 826 P.2d 710 (Cal. 1992) (internal citation omitted).

Similar to Delaware, California law appears to limit the covenant to the express discretion in the contract: "It is universally recognized the scope of conduct prohibited by the covenant of good faith is circumscribed by the purposes and express terms of the contract." *Id.* at 373. The covenant is "limited to assuring compliance with the express terms of the contract, and cannot be extended to create obligations not contemplated in the contract." *Racine & Laramie, Ltd. v. Dep't of Parks & Recreation*, 11 Cal. App. 4th 1026, 1032 (Cal. Ct. App. 1992).

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> [t]he… covenant… rests upon the existence of some specific contractual obligation. "The covenant of good faith is read into contracts in order to protect the express covenants or promises of the contract, not to protect some general public policy interest not directly tied to the contract's purpose."… "In essence, the covenant is implied as a supplement to the express contractual covenants, to prevent a contracting party from engaging in conduct which (while not technically transgressing the express covenants) frustrates the other party's rights to the benefits of the contract."

Id. at 1031–32 (internal citation omitted); *Guz v. Bechtel Nat'l, Inc.*, 24 Cal. 4th 317, 349–50, 8 P.3d 1089 (Cal. 2000) ("The covenant thus cannot 'be endowed with an existence independent of its contractual underpinnings.' It cannot impose substantive duties or limits on the contracting parties beyond those incorporated in the specific terms of their agreement."). Although the implied covenant rests on express terms, a court applying California law will dismiss it if it "relies on the same acts[] and seeks the same damages[] as" a breach of contract claim. *Bionghi v. Metropolitan Water Distr.*, 70 Cal. App. 4th 1358, 1370 (Cal. Ct. App. 1999). This is dramatically different from Arizona law, which allows a party to seek the same damage for the same acts under either theory. *See*, *e.g.*, *Bike Fashion*, 202 Ariz. ¶¶11 & 17, 46 P.3d at 434–35 (rejecting a jury instruction that stated, "A party to a contract is not liable for breach of an implied contract provision where there is an express written contract provision between the parties relating to the same subject," and holding that "a party may breach the implied covenant of good faith and fair dealing even if the express terms of the contract speak to a related subject").

Illinois

Every contract under Illinois law includes an implied covenant of good faith and fair dealing. *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 971 (Ill. 1984). Consistent with other states, the Illinois duty "requires the party vested with contractual discretion to exercise that discretion reasonably and with proper motive, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties." *Resolution Trust Crop. v. Holtzman*, 618 N.E.2d 418, 424 (Ill. Ct. App. 1993).

Illinois law, similar to California law, appears to limit the duty of good faith and fair dealing to discretion given under the contract. *Northern Trust Co. v. VIII S. Mich. Assocs.*, 657 N.E.2d 1095, 1104 (Ill. Ct. App. 1995). Unlike Arizona, under Illinois law the duty will not permit a party to read into a contract a duty that did not already exist. *Id.* As one court explained, "[w]hile this obligation exists in every contract in Illinois, it is essentially used as a construction aid in determining the intent of the parties where an instrument is susceptible of two conflicting constructions." *Resolution Trust*, 618 N.E.2d at 424.

Unlike the other states discussed here, Illinois law permits express disavowal of the covenant. *See Foster Enters., Inc. v. Germania Fed. Sav. & Loan Ass'n*, 421 N.E.2d 1375, 1380 (Ill. Ct. App. 1981). However, the disavowal must be explicit. For instance, the Illinois Court of Appeals found that a provision for termination with or without cause did not constitute a disavowal and that the implied covenant still applied to the discretion afforded under the contract. *Hentz v. Unverfehrt*, 604 N.E.2d 536, 539 (Ill. Ct. App. 1992). More recently the Illinois Court of Appeals found that a borrower's waiver of all "claims or defenses" was not an *express* waiver of the duty of good faith and fair dealing. *RBS Citizens, Nat'l Ass'n v. RTG-Oak Lawn, LLC*, 943 N.E.2d 198, 204 (Ill. Ct. App. 2011) ("The waiver of defenses here did not specifically address the duty of good faith and fair dealing, and therefore we cannot find there was an express disavowal of the duty.").

Managing Expectations Under the Covenant

As we have seen, the law in different states can lead to significantly disparate results. While a sharp line exists between Texas and the other five states, the outcomes

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under the other states' laws is difficult to predict. Arizona puts the fewest constraints on the duty. Although implied terms may not contradict express terms, they do not necessarily have to relate to them. This permits claim distortion and an opening into which to squeeze would-be fraud.

State courts generally do not recognize waiver of the duty of good faith and fair dealing. For example, stuck with the covenant, the Supreme Court of Utah suggested ways to limit it: "the degree to which a party to a contract may invoke the protections of the covenant turns on the extent to which the contracting parties have defined their expectations and imposed limitations on the exercise of discretion through express contract terms." *See Smith v. Grand Canyon Expeditions Co.*, 84 P.3d 1154, 1159 (Utah 2003). In other words, when relying on Utah law, you can try to limit the covenant by trying, as best you can, to take discretion out of the contract. I suspect that a scrivener would find this a difficult and unwieldy task, and regardless, who can really anticipate every instance in which contracting parties will need to exercise discretion?

In light of these problems, you can consider choosing the law of Texas, under which courts will require a special relationship to find that an implied duty exists. Alternatively, Illinois law is somewhat unique in that it permits "express disavowal" of the duty. *Bass v. SMG, Inc.*, 328 Ill. App. 3d 492, 504 (Ill. Ct. App. 2002) ("'a covenant of good faith and fair dealing' is implied in every contract as a matter of law, absent an express disavowal.").

Even under the Arizona model, it is reasonable to believe that a court will try to enforce the stated intent and expectations of the parties over any implied duty. But, in no case should a party believe that it can avoid the reasonable expectations of the other party unless it has expressly disavowed the covenant under the law of a state for which that disavowal will be effective.

While I am not suggesting that you base your choice of law provision solely on the operation of the covenant, the unforeseen results of the broad view of the covenant dictate caution both in the choice of law and in the drafting of contract language that creates the parameters of the duty. This is particularly so because carelessness can result in your client's company undertaking contractual obligations and becoming exposed to liabilities that the company never anticipated because the law implies duties that you cannot otherwise clearly define. FD