

CONTRACTS

DEFEATING CLAIMS FOR BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

By: John T. Coyne

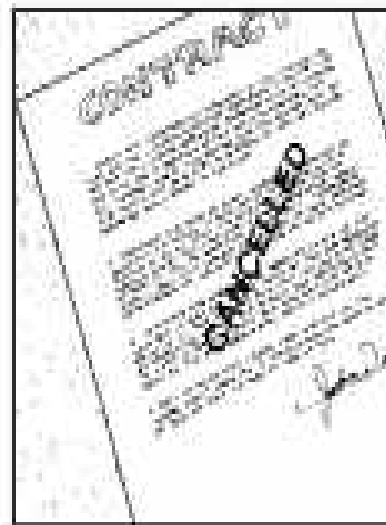
Judge Richard Posner aptly described the implied covenant of good faith and fair dealing as a “chameleon” in *Empire Gas Corp. v. American Bakeries Co.*, 840 F.2d 1333, 1335 (7th Cir. 1988). Indeed, it is capable of manipulation to justify virtually any position. Contracting parties have seized upon the covenant when attempting to salvage losses traceable to their own failure to negotiate sufficient contractual rights and protections. This article discusses means for anticipating and combatting such claims both at the time of contract negotiation and during litigation.

Sons of Thunder, Inc. v. Borden, Inc., 148 N.J. 396 (1997) is something of a high-water mark in a series of cases holding that a contracting party, even in exercising a bargained-for-right to terminate, may be subject to liability for breach of the implied covenant of good faith and fair dealing. Defendant, a manufacturer in the food processing industry, contracted with independent boat owners to harvest clams. Rigging the vessels required expensive equipment to enable shucking of the clams at sea so that defendant would be able to avoid the expense of disposing of the shells on land. In order to fit their boats to defendant’s specifications, the boat owners obtained financing, putting their personal assets at risk. The initial contracts were for one year and contemplated for renewal for a five-year period if not terminated at the end of the first year. Defendant negotiated a right of first refusal on all clams harvested and assured plaintiffs that it would purchase a guaranteed minimum number of clams per month. For a variety of self-serving reasons, defendant decided before the first anniversary of the contract that it was not in its financial interest to continue purchasing

clams for plaintiffs. Indeed, throughout the first year, defendant breached its contractual obligation to purchase the prescribed minimum amount of clams and ultimately terminated the contract.

Relying heavily on *United Roasters, Inc. v. Colgate-Palmolive Co.*, 649 F.2d 985 (4th Cir.) cert. denied 102 S.Ct. 599 (1981), the court held that even though defendant did have the prerogative to terminate the contract, it still was liable for breach of the implied covenant of good faith and fair dealing. The court declined to overturn the jury’s award for breach of the covenant of one year of lost profits beyond the date of termination. The post-termination loss of profit award was in addition to damages arising from defendant’s failure to purchase the minimum amount of clams prior to termination. Defendant did not challenge the latter on appeal.

Perhaps the most remarkable aspect of *Sons of Thunder* is that there was no need to resort to the implied covenant to justify redress to plaintiff. The conduct cited by the court as violating the covenant -- defendant’s failure to purchase the requisite minimum number of clams -- actually constituted a breach of the express contractual terms for which damages were awarded. Moreover, there was no nexus between the post-termination lost profits and the violative conduct inasmuch as plaintiff was powerless to resist a properly-effected termination in any event. There was, for example, no contention that plaintiff’s ability to avoid termination was reduced by the crippling effect of defendant’s sharp practices. The award of pre-termination breach of contract damages made plaintiff whole and the



recovery for breach of the covenant was a windfall. As *Sons of Thunder* illustrates, the manner of styling a claim can become quite significant in the calculation of damages. If characterized solely as a breach of contract, the damages would have been the marginal lost profits on the shortfall between the minimum number of clams defendant agreed to purchase and the amount actually purchased. On the implied covenant claim, however, the court sanctioned an award of damages of lost profits for a full year beyond the date of termination. In defending claims for breach of the covenant, one must be wary of efforts to augment damages through creative labeling of claims.

Virtually all courts agree that the implied covenant may not be used to vary express contract terms. See, e.g., *Infomax Office Systems, Inc. v. MBO Binder & Co. of America*, 976 F.Supp. 1247, 1250-53 (S.D. Iowa 1997); *Telecom International America, Ltd. v.*

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AT&T Corp., 67 F. Supp. 2d. 89 (S.D. N.Y. 1999). This appears to be little more than a restatement of the parol evidence rule. In any event, the principle may be employed to greatest advantage by inserting recitals memorializing deliberate omissions from agreements. Using *Sons of Thunder* as an example, if defendant had negotiated a right of first refusal on all claims captured but refused, despite plaintiffs' requests, to commit to any minimum monthly purchase amount, defendant should have insisted on a term reflecting its unwillingness to so commit. Then plaintiffs would be unable to invoke the covenant to imply a minimum purchase requirement because doing so would contradict *express* contractual terms. Absent such a memorialization, however, plaintiffs would be able to argue, citing the covenant, that some minimum purchase requirement should be implied.

Some commentators have suggested other methods by which contracting parties may avoid liability for breach of the covenant through careful draftsmanship. M. Van Alstine, *Of Textualism, Party Autonomy and Good Faith*, 40 William and Mary Law Review 1223 (1999); Note: "*Contracting Around*" the Good Faith Covenant To Avoid Lender Liability, 1991 Columbia Business Law Review, 359 (1991). The issue, however, is somewhat delicate because, under the Uniform Commercial Code, global disavowals of any obligation to act in good faith are forbidden. Uniform Commercial Code, 1-102(3) (stating that "the obligation of good faith. . . prescribed by this Act may not be disclaimed by agreement" but that "the parties may by agreement determine the standards by which the performance is to be measured"). At common law, the result is likely the same. 3A Corbin, Corbin on Contracts 654A(B) (Supp. 1998). An integration clause also does not serve to preclude liability for breach of the covenant. *Allapattah Services, Inc. v. Exxon Corp.*, 61 F.Supp. 2d 1308, 1317 (S.D. Fla. 1999). With artful language, parties may anticipate and defeat claims for breach of the covenant. For exam-

ple, one commentator has suggested in the lender liability context:

All amounts borrowed are repayable upon the demand of lender, and borrower acknowledges that the lender's obligation of good faith and fair dealing should not be deemed to require any period of notice before repayment may be demanded.

Note, 1991 Columbia Business Law Review at 376.

Though drawn from the lender liability context, the above example easily may be adapted to other situations. The key point to be extracted is the explicit reference to the good faith obligation and the tailoring of the waiver to some specific discretionary

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contractual power.

Sons of Thunder may signal a need for some additional language at least where termination clauses are concerned. There, defendant's liability arose not from some improper motivation or failure to give notice before exercising some contractual rights. Rather, the court found fault with defendant's performance of the contract. The consequence of the conduct in question was to effectively limit the defendant's right to exercise

an otherwise unambiguous right to terminate the contract. The parties may attempt to avoid such liability through something akin to the standard severability clause. A typical severability clause provides:

If any provision of this Agreement is invalidated in any jurisdiction, either by statute or by a court, such provision will be deemed to modify to comply with the law or to have been stricken from this Agreement if necessary to comply with the law. If any such provision is so stricken, however, the remainder of this Agreement will remain in effect.

It may be worthwhile to include in termination clauses provisions indicating that the enforceability of the clause is not contingent on the absence of any breach by the terminating party of other contractual provisions or breaches of the covenant arising from such violations. In some cases, a material breach by one party enables the other party to regard the contract as terminated and decline to continue performance. *Ross Systems v. Linden Dairies Delite*, 35 N. J. 329, 341 (1969). Where, however, the breaching party is seeking to effect termination and cap any potential liability for breach, this point should not be cause for concern.

As with many issues, the key to avoid being bitten by the covenant is to be vigilant about it. It is most commonly employed in circumstances where a contract affords wide discretion to one of the parties on some issue. The party seeking to preserve its latitude should attempt to indicate in plain terms that its exercise of discretion is not to be directly or indirectly circumscribed by the covenant. ■

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