

[The Implied Covenant of Good Faith and Fair Dealing](#)

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It is well established that every contract has an implied covenant of good faith and fair dealing with respect to the parties' performance and enforcement of the agreement. The covenant imposes an obligation on parties to act in good faith and deal fairly with other parties to the contract, even though this duty is not specifically stated in the agreement.

Most contracts, especially complex agreements, cannot address every conceivable scenario nor provide detailed terms regarding every aspect of each party's obligations. Performance may entail or necessitate actions that are not expressly set forth in the agreement and/or involve discretion on a party as to how to go about performing its obligations. The implied covenant of good faith and fair dealing prevents parties from exercising discretion and performing their contractual obligations in bad faith and in a manner that denies the other party the benefit of its bargain. The covenant can provide judges with a legal basis to fill gaps that may exist in contracts, as well as to restrict unreasonable or bad faith performance of contractual obligations when warranted by the circumstances.

Despite its broad application to all contracts, the meaning of and requirements imposed by the implied covenant of good faith and fair dealing are often not adequately understood by parties to commercial agreements. Counsel must therefore properly address the issue when preparing or reviewing contracts for their clients, as well as ensure that clients understand what the covenant requires when performing their agreements to avoid any violations.

This practice note will examine how the implied covenant of good faith and fair dealing applies to contracts, the obligations created by the covenant for contracting parties, how the courts have addressed the covenant, and issues that counsel should consider when drafting commercial agreements.

For more information on implied covenants, see [Commercial Agreement Representations, Warranties, Covenants, Rights, and Conditions](#), [Warranty and Disclaimer of Warranty Drafting](#), and [Representations and Warranties Drafting](#).

Recognition of the Duty of Good Faith and Fair Dealing

The implied covenant of good faith and fair dealing has been recognized by the courts for over 80 years, when it was first defined as a covenant "that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." This early definition remains the general standard that is still applied today.

The covenant is closely tied to upholding the reasonable expectations of the parties to a contract, and imposes minimal good faith requirements for performance by the parties. The courts have employed the covenant to prohibit a party from acting arbitrarily or unreasonably in a manner that frustrates the other party's reasonable expectations and benefit of the bargain. Pursuant to the covenant, a party must act in a way that is honest and faithful to the agreed purposes of the contract. A party must not act in bad faith, dishonestly, or with improper motive designed to destroy or injure the other party's right to receive the benefits or reasonable expectations of the contract.

If discretion is exercised in a manner not contemplated by the parties, the party exercising such discretionary power may be deemed to have performed in bad faith. Thus, a party must exercise discretion within the reasonable expectations of the other party or else be at risk of violating the covenant of good faith and fair dealing. An

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insurance carrier may be found to have acted in bad faith in violation of the covenant when denying a claim under an insurance policy when it conducts an inadequate investigation of the claim or fails to seek or consider evidence relevant to the merits of the claim.

The fact that a party may have a contractual right to use its sole discretion when determining whether to proceed with or terminate a contract will not always insulate the terminating party, as its actions may be limited by the covenant of good faith and fair dealing. For example, if a financing agreement permits the lender to terminate the contract in its sole discretion if it finds an environmental study on the property unacceptable, it could breach the covenant if it attempts to terminate the agreement where the study did not find any problems with the property.

In addition to performance, the covenant also applies to a party's enforcement of an agreement. Good faith in enforcement applies to a party's assertion, litigation, and resolution of contract claims and defenses relating to the agreement, and will be violated by dishonest conduct. Accordingly, a party may not conjure up a nonexistent dispute, assert interpretations of an agreement that are contrary to its understanding, or falsify facts. In certain cases, the covenant can apply to actions that, while on the surface appear fair, defeat the intent and spirit of the agreement. It also extends to dealings which, although candid, are unfair, such as taking advantage of the other party's circumstances to force a modification of a contract without any legitimate business reason.

Behavior that has been held to violate the covenant include making harassing demands for assurances of performance, rejecting performance for unstated reasons, abusing discretionary power, intentionally failing to mitigate damages, and acting in an arbitrary or unreasonable fashion when determining the other party's compliance with the contract or terminating the agreement.

In addition to judicial recognition, similar variations of the covenant of good faith and fair dealing have also been recognized and adopted in the Uniform Commercial Code (UCC) and the Restatement (Second) of Contracts.

The Uniform Commercial Code

The UCC provides that "every contract or duty within the UCC imposes an obligation of good faith in its performance and enforcement." [UCC § 1-304](#). The UCC recognizes that the basic principle of good faith runs throughout the UCC, and mandates good faith in the performance and enforcement of all agreements. Such duty generally applies to every contract within the UCC, even though only certain UCC sections expressly refer to an obligation of good faith. While such an obligation does not provide the basis for an independent cause of action under the UCC, a failure to perform or enforce a contract or any contractual duty or obligation in good faith constitutes a breach of contract.

Pursuant to the UCC's general definitions, "good faith" is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing." [UCC § 1-201](#). A similar definition is also used in Article 2 of the UCC for transactions involving the sale of goods by merchants. See [UCC § 2-103](#). When a contract permits a party to exercise discretion in its performance, the covenant requires that such discretion be exercised in good faith, and that parties employ honesty in fact in its conduct related to the transaction.

Notably, the UCC prohibits parties from contractually waiving the duty of good faith (as well as diligence, reasonableness, and care). However, parties may still agree to set forth the applicable standards by which their performance of the agreement will be measured, but such standards will be unenforceable should they be deemed manifestly unreasonable. See [UCC § 1-302](#). Therefore, counsel will not be able to avoid the UCC's requirement of good faith by disclaiming it or including unreasonable standards of conduct in the client's agreement.

For more on implied warranties under the UCC, see [Uniform Commercial Code Article 2 Implied Warranties](#) and [UCC Article 2A Express and Implied Warranties](#).

Restatement (Second) of Contracts

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The Restatement (Second) of Contracts (Restatement) further advanced the application of the duty of good faith and fair dealing to all contracts. Section 205 of the Restatement provides that “every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.”

Good faith is described as “faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.” The Restatement recognizes that the duty may require more than simple “honesty” in performing an agreement; the fact that a party may be candid and forward about its actions will not relieve it of its obligations of good faith and fair dealing. Moreover, bad faith may be overt or consist of inaction, and subterfuges and evasions may also violate the obligation of good faith. The fact that a party may maintain a bona fide belief that its conduct is justified or permitted by the agreement will not be the controlling factor when determining if the covenant has been violated.

The Restatement uses examples of bad faith to assist in defining what constitutes good faith, which examples include:

- Evasion of the spirit of the bargain
- Lacking diligence and lacking off
- Willful rendering of imperfect performance
- Abuse of power to specify terms
- Interference or failure to cooperate in the other party’s performance

Application of the Covenant of Good Faith and Fair Dealing

Case law reveals that no single definition has been established for the covenant of good faith and fair dealing. Despite its prolonged existence, there is no bright line rule or set meaning for the covenant. Rather, adjudication of issues relating to the covenant are usually fact intensive and specific, turning to issues of compelling fairness within the context of the subject agreement. Consequently, courts retain broad discretion when applying the covenant to a commercial dispute, and the application of the doctrine will vary based on the particularities of the parties, the agreement, and the prevailing circumstances. The Restatement also acknowledges that within the context of the covenant, the words and conduct of the parties will be interpreted in the light of all the prevailing circumstances.

Interpretation and application of the covenant by the courts provides further insight as to what is required and how the covenant can be circumvented. Courts have held that the covenant imposes an obligation not to hinder performance of the agreement or destroy the reasonable expectations of the other party and thereby deny it the fruits of the bargain. The covenant requires each party to do everything that the contract presupposes will be done in order to accomplish its purpose. However, this implied obligation must arise from the language used in the agreement or must be indispensable to carry out the intention of the parties.

The courts have noted that bad faith requires more than just mere negligence. It requires a conscious and deliberate act which unfairly frustrates the agreed upon purpose of the subject contract and thwarts the reasonable expectations of the other party, as opposed to conduct that constitutes an honest mistake, poor judgment, or negligence. Bad faith entails some interested or sinister motive and implies conscious wrongdoing. If the conduct at issue was the product of a series of mistakes and were not the result of an interested or corrupt motive, a claim that the covenant was breached will generally fail.

It should be noted that some courts have held that the covenant only applies to the performance and enforcement of an existing contract, but does not impose an obligation upon parties to negotiate in good faith. Consequently, a claim based upon bad faith conduct that took place during contract negotiations or prior to the time of contracting may not, in certain cases, provide the basis for a claim for breach of the covenant. The Restatement also notes that the implied covenant of good faith and fair dealing does not deal with good faith in the formation of a contract, although bad faith negotiations may be subject to other sanctions and remedies.

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The covenant of good faith and fair dealing should not be mistaken for contractual terms that address the standard by which a party must perform the agreement, such as a “best efforts” or “reasonable efforts” provision, which primarily focus on a party’s diligence in performing the agreement as opposed to its good faith. For a discussion on contractual efforts provisions, see [Best Efforts, Commercially Reasonable Efforts, and Reasonable Efforts Provisions in Commercial Contracts](#).

Relevant Factors in the Application of the Covenant

In light of the fact that issues relating to the implied covenant of good faith and fair dealing will be extremely fact sensitive, courts have employed both broad and narrow application of the covenant. Numerous factors will impact whether a court will provide a more limited or expansive scope when determining whether and how to apply the covenant, which factors include:

- The motivation behind the defendant’s actions
- The sophistication of the parties
- The bargaining power of the parties
- The type of claim at issue
- The length and complexity of the agreement

A party’s motivation in taking a course of action will usually be a critical part of the court’s analysis. If there is a finding that a party acted with malice or arbitrarily, there is a greater likelihood the covenant will be applied. If a party has no legitimate interest in engaging in certain conduct other than to deprive the other party the fruits of its bargain, a court will be more inclined to find bad faith. Conversely, if the action represents a valid business decision or was the result of a party exercising sound judgment on a contractual issue, which results in detrimental consequences to the other party, the covenant will not be applied. Bad faith is the lynchpin of the covenant – if a party lacks bad motives, the fact it makes a discretionary business decision that has a negative economic impact on the other party will usually not support a claim that the covenant has been breached.

The sophistication of the contracting parties is also an important factor. Courts are less likely to invoke an implied contractual term of good faith and fair dealing where a party is a sophisticated entity. A sophisticated party will usually be represented by competent counsel when entering into an agreement and often will have significant experience or expertise in the subject matter of their contracts. Additionally, a sophisticated party is likely to engage in more thorough negotiations than unsophisticated parties. However, the covenant has been applied to benefit large, sophisticated corporations under appropriate circumstances, so mere sophistication will not, alone, serve to bar application of the covenant.

Another factor concerns whether the parties had equal or disparate bargaining power when negotiating and entering into the agreement. In cases where one party had little, if any, ability to negotiate the agreement, courts will tend to be more inclined to apply the covenant when warranted by the facts and the interests of fairness. For example, in matters involving employment or insurance contracts, the employer and insurer are typically seen as having far greater bargaining power; courts tend to be more sympathetic to parties that have relatively little bargaining power.

Similarly, where the agreement at issue is a lengthy and complex document that was subject to substantial negotiation, courts are less likely to apply the covenant. Courts have recognized it is not their place to insert implied obligations into detailed contract terms that the parties did not agree to when the document was drafted and negotiated.

The Covenant Does Not Negate Basic Principles of Contract Law Construction

Courts will usually not use the covenant of good faith and fair dealing to circumvent the basic principle of contract construction that the express terms contained in the parties’ agreement be given primary consideration. Courts still

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give utmost credence to the clear and unambiguous language contained in a written agreement. The covenant will therefore not serve to contradict or otherwise bypass express terms of an agreement.

Generally, if a party's action was authorized by the terms of its agreement, the covenant cannot be invoked. Rather, the covenant goes to the original bargain between the parties and prevents a party from engaging in acts or omissions that, although not expressly addressed in the agreement, are inconsistent with the purpose of the agreement and deprive a party of its contemplated value.

Nor will the courts use the covenant to rewrite contracts to provide more favorable or equitable terms to one of the parties. Parties are still free to enter into good and bad contracts and the law will enforce the agreement in either case. The courts have recognized that the covenant cannot be used to provide a party with contractual protections that they failed to secure for themselves when negotiating the agreement, and that it does not provide a license to rewrite an agreement because a party did not include terms that, with hindsight, would have made the contract a better deal. Similarly, the covenant does not negate the parole evidence rule, which prohibits the introduction of extrinsic evidence that would replace or alter the written terms of an integrated agreement.

However, when dictated by compelling interests of fairness, the covenant may be invoked to protect a party's reasonable expectations, despite the express provisions contained in the contract. Courts have ruled that the covenant of good faith and fair dealing may sometimes require more than literal or technical compliance with the terms of a contract. Rather, parties are required to preserve the spirit of the bargain and, when equity dictates such a result, the covenant may be used to protect a party's reasonable expectations.

Claims for Breach of the Covenant of Good Faith and Fair Dealing

Any failure to fulfill the duty of good faith and fair dealing will constitute a breach of contract and subject the offending party to damages caused by the breach. Accordingly, counsel must take appropriate measures to ensure that clients understand and honor this obligation, as failure to do so will have the same consequences as a breach of any other term of the agreement. Common areas where disputes relating to the implied covenant of good faith and fair dealing may arise include contracts that expressly provide a party with discretion in its performance of the agreement, contracts that do not contain terms necessary to fulfill the parties' expectations, and when bad faith serves as a pretext for termination of an agreement.

To state a claim for breach of the implied covenant of good faith and fair dealing, a plaintiff must generally plead: (1) the existence of a contractual relationship between the plaintiff and defendant, (2) plaintiff's performance (or excuse from performance) of its obligations under the contract; (3) that the defendant unfairly prevented the plaintiff from receiving the benefits it was entitled to under the contract; and (4) injury to the plaintiff as result of defendant's conduct.

While every breach of contract will usually result in the other party being denied the benefit of its bargain, a breach of the covenant generally involves deceit or unfair subterfuge. Accordingly, not every breach of contract will constitute a breach of the implied covenant of good faith and fair dealing. For example, terminating an employment contract due to legitimate budgetary and fiscal concerns will not support a claim. The fact there may not be a sufficient legal basis or good cause to terminate a contract does mean that a party exercised bad faith in the termination.

The courts have noted that application of the implied covenant should usually be rare and fact intensive, based upon issues of compelling fairness. Some states, however, do not recognize an independent cause of action for breach of the implied covenant of good faith and fair dealing when the plaintiff also asserts a breach of contract claim.

Because the covenant is, in essence, a contract term (albeit implied) that is designed to give effect to the contractual intention of the parties, recovery in cases where the covenant has been breached are usually limited to contract remedies. Some courts have held, however, that tort damages may be available for breach of the covenant of good faith and fair dealing in limited circumstances where there is a special relationship between the parties,

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such as those arising from elements of public interest, adhesion and fiduciary responsibility, as well as cases involving insurance policies where the carrier acted in bad faith.

Drafting Contract Terms to Address the Covenant

As parties are unable to contractually disclaim the covenant of good faith and fair dealing, and in light of the inherent uncertainty that accompanies it, counsel can take measures to provide greater certainty and reduce the risks presented by the covenant. Counsel can address and include specific performance requirements in a client's agreement that may otherwise trigger application of the covenant. If the agreement adequately addresses a party's performance obligations and sets forth what will be required to meet the duty of good faith and fair dealing, there should be little or no basis to apply an implied covenant as there will be no gaps in the agreement which leave room for judicial intervention.

When drafting an agreement, counsel can include specific standards to measure a party's performance, such as:

- Define "good faith and fair dealing" in the agreement
- Provide a detailed description setting forth how the covenant will be applied to the agreement or to particular terms of the agreement
- Include provisions addressing what specific actions or measures a party must take with respect to its performance
- Link good faith performance with the reasonable commercial standards prevalent in the subject industry
- Utilize the relevant industry or trade association's guidelines or code of ethics

Such measures will provide guidance to the parties and any trier of fact in gauging what efforts should be utilized in performing the contract and how such efforts can be objectively measured.

Letters of Intent and Term Sheets

One area in which counsel should be attentive involves the application of the implied covenant of good faith and fair dealing to transactions involving letters of intent (LOI) and term sheets. A provision that the parties will negotiate in good faith could form the basis of a claim that a party breached the covenant with respect to the LOI or term sheet if it does not proceed with the contemplated contract. Notably, some courts have found violations of the covenant even in instances where the LOI or term sheet did not include a provision requiring the parties to negotiate in good faith. Additionally, the covenant may also be applied in cases where a party attempts to impose terms that are materially inconsistent with the terms set forth in an LOI or term sheet.

Even in instances where an LOI or term sheet expressly states it is nonbinding and that the parties will have no obligations thereunder until a definitive agreement has been reached and executed, a finding of bad faith may result in a party being liable for damages if it does not proceed with the transaction.

When drafting or negotiating an LOI or term sheet, counsel can mitigate the uncertainty created by the covenant by including express language regarding a party's duty to negotiate. For example, the document can include an affirmative obligation to negotiate in good faith or, alternatively, expressly disclaim such obligation. Detailing the obligation of the parties to proceed with the transaction, and what circumstances will permit them to withdraw from therefrom can help avoid application of the covenant. For example, the term sheet or LOI can include language that expressly allows a party to terminate the negotiations and not proceed with the transaction at any time for any reason or no reason.

TIP: When representing a client involved in an LOI or term sheet, counsel should ascertain what obligation is imposed under the law governing the document with regard to the duty to negotiate in good faith, as well as the damages such jurisdiction allows in the event of a breach. Consider including a favorable choice of law provision that will (or will not) broadly invoke the covenant to a party's obligation to negotiate an LOI in good faith.

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Even if there is a contractual or implied obligation to negotiate in good faith, such obligation does not mean that a party must then carry out the contemplated transaction. However, in such instances a party should have a legitimate basis for its decision not to consummate the deal or to materially change its terms. Acquiring additional information that alters the feasibility or desirability of the transaction, for example, would usually be sufficient to avoid a finding that the covenant was breached.

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- [Commercial Agreement Representations, Warranties, Covenants, Rights, and Conditions](#)
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- [Uniform Commercial Code Article 2 Implied Warranties](#)
- [UCC Article 2A Express and Implied Warranties](#)
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- [Commercial Contract Drafting and Review](#)
- [Term Sheets in Commercial Transactions](#)
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- [Disclaimer of Warranty of Merchantability Clauses](#)
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- [Disclaimers of Express Warranties Clause](#)
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Checklists

- [Responding to Claims That Goods Do Not Conform to Warranties Checklist](#)
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