Beware the Contract You Never Signed

The Implied Covenant of Good Faith and Fair Dealing

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No matter what your written contract says, your business could still be liable for doing—or not doing—things you never even discussed before signing the contract. This is due to the "implied covenant of good faith and fair dealing," an obligation Utah courts can insert into any contract you sign. The implied covenant has taken some companies by surprise, costing them millions of dollars. Fortunately, the Utah Supreme Court recently narrowed and focused what the implied covenant means to you and your business.

The formal definition of the implied covenant is that parties cannot "intentionally or purposely do anything which will destroy or injure the other party's right to receive the fruits of the contract." Courts have also said "a party's actions must be consistent with the agreed common purpose and the justified expectations of the other party." In plain English, this means if you do (or fail to do) something that stops the other side from getting what it was expecting under your contract, you may be liable for the resulting harm.

How does it work in real life? If your contract requires you to remove underground storage tanks when selling a property, even if the contract doesn't state a deadline, you may be liable if you wait until the buyer's financing fails. In another example, if you change the business you put in a leased space to a less successful one, and the landlord proves you intended to reduce the business there in favor of another business you own, you may be liable—even if you had the contractual right to put any business in the leased space that you wanted.

Now, courts say this doesn't mean you have to do something inconsistent with your contract's written terms. In addition, this shouldn't force you to exercise a contract right to your detriment just to benefit the other side. Also, the implied covenant is not supposed to "establish new, independent rights or duties not agreed upon by the parties."

But how do you know when you're harming "the justified expectations of the other party?" Can't courts just say you weren't "playing fair"? How do you know when the other side has gone too far, giving you the right to demand payment and perhaps file a lawsuit if they don't fix the problem?

The Utah Supreme Court just made answering these questions easier. In *Young Living Essential Oils, LC v. Marin*, the court admitted that having judges insert new terms into contracts is "fraught with peril, as its misuse threatens commercial certainty and breeds costly litigation." The court decided it wanted to "foreclose the imposition of a code of commercial morality rooted merely in judicial sensibilities."

To resolve this problem, the court set what it called a "high bar" for inserting a new covenant into a contract: "the court may recognize a covenant of good faith and fair dealing where it is clear from the parties' course of dealings or a settled custom or usage of trade that the parties undoubtedly would have agreed to the covenant if they had considered and addressed it."

This rule is considerably clearer. In addition, it narrows the range of possible "bad faith" actions that can make you liable for violating the implied covenant.

However, businesses are faced with new challenges. You still may be required to do (or not do) something not in your current contract, but is part of your "course of dealings" with the other party. You will need to ask: "What have I done in the past with the particular company or person on the other side? What have I done in prior deals with them?" If you omit a term in your new contract you have used in other contracts with that person before, and then fail to follow it, you may be liable for resulting harm.

In addition, you will need to review the "settled custom or usage of trade" in your industry. A "usage of trade" is any practice or method of dealing in a certain industry done so regularly that people expect it. A "custom" occurs when a "usage" has happened long enough that it becomes the law—or at least a general rule. You now need to ask: "What are the standard ways people in this industry do this type of deal?" Depending on the types of contracts you sign, you may need to decide this with regard to multiple industries.

The court's new ruling is a warning to businesses deciding whether to file suits claiming a breach of the implied covenant. To succeed on such claims, it must be clear the parties to the contract "undoubtedly would have agreed" to the new term.

Businesses should be vigilant in selecting the contract language they use and accept. You should know your industry and its standard contractual customs and provisions. You should use competent and thoughtful legal counsel. Above all, you should never be lulled into thinking the written terms of your agreements include all of the things you should—and shouldn't—do in fulfilling your contracts. UB