Drafting Around Good Faith

BY ALLEN B. GRODSKY

In California, every contract contains an implied covenant of good faith and fair dealing, which prevents one party from unfairly frustrating the other party's right to receive contractual benefits. The implied covenant is particularly important in situations where an agreement invests one party with a discretionary power affecting the rights of the other party; under the implied covenant, such power must be exercised in good faith. (See *Carma Developers (California), Inc. v. Marathon Development California, Inc.*, 2 Cal. 4th 342, 372 (1992).)

But what if the parties intend to allow one party to exercise discretionary power *without* any good faith restriction? This is not an unusual situation. For example, record companies often bargain for unlimited discretion as to whether and how to distribute albums that a musician records. Similarly, employers want unlimited discretion to decide whether or not to award a bonus. In each of these cases, competent parties intend to "contract around" the implied covenant. But legally, can they do this? The answer is yes. As the California Supreme Court has explained, the covenant cannot be read "to prohibit a party from doing that which is expressly permitted by an agreement." (*Carma Developers*, 2 Cal. 4th at 374.) However, the courts are very particular about the specificity required for a contract to avoid the implied covenant of good faith and fair dealing.

TWO-PRONGED TEST

In general, California courts will interpret a contract to allow a party to use its sole discretion—unlimited by the covenant of good faith and fair dealing—if two conditions are met.

- The express purpose of the contract is to grant unfettered discretion, and
- The contract is otherwise supported by adequate consideration. (See *Wolf v. Walt Disney Pictures & Television*, 162 Cal. App. 4th 1107, 1121 (2008).)

In such cases, one party's ability to use sole unfettered discretion is, by definition, within the reasonable expectation of the parties, and therefore the exercise of discretion is not limited by the implied covenant.

In this context, how does one determine that the express purpose of a contract is to provide unfettered discretion? Courts have addressed this issue in a number of cases.

CASE LAW

Plaintiffs in three particular disputes tried unsuccessfully to invoke the implied covenant to impose a good faith limitation on conduct specifically described and expressly permitted by the contract. In one instance, an employment contract provided that when a Lockheed employee created an invention during his or her employment, the invention belonged to the company; the employee, however, could request from Lockheed a "special invention award" of up to $20,000. The contract expressly stated that Lockheed "may, *but is not obligated to,* grant" a special invention award and that all decisions "shall be final and conclusive." (*Brandt v. Lockheed Missiles & Space Co.*, 154 Cal. App. 3d 1124, 1128 (1984) (emphasis added).) The employee who brought the suit argued that the implied covenant of good faith and fair dealing required that Lockheed's decision whether to grant a special award be made in good faith. The court of appeal disagreed, finding that the language of the contract "could not be more clear and explicit." (*Brandt*, 154 Cal. App. 3d at 1130.) In other words, because the contract specified that Lockheed was not obligated to grant an award, the implied covenant could not impose a restriction on Lockheed to make such decisions only in good faith.

In another case, a commercial

lease provided that the landlord, within 30 days of receiving notice that the tenant intended to sublet or assign the lease, could terminate the rental agreement, enter into its own lease with the intended sublessee or assignee, and keep all the profits realized on account of the termination and reletting. (*Carma Developers*, 2 Cal. 4th at 351–352.) The landlord did exactly what the lease said it could, terminating the lease after receiving notice of the intent to sublease and then negotiating directly with the intended sublessee. The tenant argued that the implied covenant of good faith and fair dealing prevented the landlord from ending the lease unless its objection to the transfer was in good faith. The court of appeal agreed, concluding that as a matter of law the landlord's termination of the lease "solely to realize a profit" breached the implied covenant. But the California Supreme Court reversed, holding that the landlord's "termination of the lease in order to claim for itself appreciated rental value of the premises *was expressly permitted by the lease* and was clearly within the parties' reasonable expectations." (*Carma Developers*, 2 Cal. 4th at 376 (emphasis added).)

Finally, an agreement with an entertainment production company gave Warner Communications the right to manufacture and distribute musician Tom Waits's recordings—or to refrain from these activities. The production company wanted to release a new compilation of the artist's works, but Warner refused to distribute it because Waits—who had no legal right to object—was opposed to releasing the new compilation. The court sided with Warner because the covenant of good faith and fair dealing would be directly at odds with the express contractual grant of discretionary power. (*Third Story Music, Inc. v. Waits*, 41 Cal. App. 4th 798 (1995).)

VAGUE LANGUAGE

The foregoing cases make clear that the covenant of good faith and fair dealing does not limit a party's right to engage in conduct *specifically permitted* by the contract. But what if the contract is not so precise? What if it provides broad discretion to one party but does not specifically address the conduct that another party claims is restricted by principles of good faith and fair dealing? Courts have split dramatically on this issue.

On one side of this split is a case involving a contract that gave defendant Walt Disney Pictures & Television the discretion to assign or license rights to the plaintiff's Roger Rabbit franchise as Disney "saw fit." The plaintiff argued that Disney breached the implied covenant by entering into licenses with third parties in exchange for promotional considerations, without monetary compensation; this meant the plaintiff received no royalties. The court rejected the claim, holding that "recognizing an implied term that would limit the unfettered discretion given to Disney to license the characters as [Disney] saw fit would be at odds with the express terms of the agreement." (*Wolf*, 162 Cal. App. 4th at 599.) It did not matter that the contract failed to expressly state Disney could license the franchise in exchange for only promotional considerations. The court concluded that broad contractual language—as Disney saw fit, to paraphrase the court—was sufficient to establish the parties' intent to grant Disney unfettered discretion.

Two federal courts applying California law have reached the same conclusion. One case involved a mortgage agreement providing that a lender had "sole and absolute discretion" to extend the maturity date. After agreeing to one extension, the lender balked and refused to further extend the loan's due date without new payments. The plaintiff alleged that the shift in the lender's position was inconsistent with the parties' prior dealings. The mortgage agreement did not expressly state that the lender could absolutely refuse to grant extensions (unlike the language in the *Brandt* or *Third Story Music* cases). Nevertheless, the district court held that the contract's broad language provided unfettered discretion inconsistent with the implied covenant of good faith and fair dealing. (*Symbolic Aviation, Inc. v. PNCEF, LLC*, 2010 WL 3584509 (S.D. Cal).)

Also instructive is a franchise dispute in which the governing contract provided that a franchisee could not change location without the franchisor's written consent. When the franchisor refused to allow the franchisee to move, the franchisee sued, arguing that the implied covenant obligated the franchisor to act only in good faith. Though the contract did not specify that the franchisor could refrain from approving a move, the district court nevertheless held that because the agreement provided unfettered discretion on the issue of relocation, the court could not imply a covenant of good faith and fair dealing. (*Dos Beaches, LLC v. Mail Boxes Etc., Inc.*, 2012 WL 1903905 at *6 (S.D. Cal.).)

> The covenant of good faith and fair dealing does not limit a party's right to engage in conduct *specifically permitted* by a contract.

ALTERNATE VIEW

But there is another side to the story. Two other courts have held that when a broad discretionary clause does not *specifically allow* the challenged conduct, a party's conduct is restricted by the implied covenant of good faith and fear dealing.

The primary case for this proposition involves a classic instance of bad facts making bad law. (*Locke v. Warner Bros., Inc.*, 57 Cal. App. 4th 354 (1997).) The plaintiff, Sondra Locke, entered into a movie-development deal with Warner Bros., by which she was paid $250,000 a year for three years and

agreed to submit all motion picture projects first to the film studio. Warner Bros. then had 30 days to accept or reject a submission. The studio rejected every project Locke brought it. But Locke obtained evidence that Warner Bros. never intended to make any films with Locke; it had entered into the agreement only to accommodate actor Clint Eastwood, who was divorcing Locke at the time and agreed to reimburse the studio for the cost of her contract so long as Locke's projects were never produced.

Locke alleged the obvious cause of action (fraud), but she also asserted a claim for breach of the implied covenant of good faith and fair dealing. Warner Bros. argued that the implied covenant could not be imposed in this case because it was inconsistent with the language of the contract.

Relying on *Third Story Music*, the court held that the agreement "did not give Warner the express right to refrain from working with Locke" but rather only gave "discretion with respect to developing Locke's projects." (57 Cal. App. 4th at 367.) Thus, reasoned the court, the implied covenant obligated Warner Bros. to act in good faith.

There are multiple problems with this analysis. The facts of the case clearly state a fraud claim, and the court held that there was a triable issue of fact on fraudulent concealment. The claim for breach of the implied covenant, then, was the proverbial tail wagging the dog.

Moreover, the court's focus on the absence of contractual language permitting Warner Bros. to "refrain" from making any of Locke's projects is not useful because it is impossible to discern from the opinion itself precisely what the contract says. (The court did not quote the exact language.) For example, readers of the opinion do not know if the contract contains broad language that gave Warner Bros. "absolute and sole discretion" regarding Locke's projects—or whether, as the court seems to suggest, the contract says merely that the studio had 30 days to approve or reject a submission. In the latter case, it would be easier to see how the court could conclude there was no evidence that the parties intended to give Warner Bros. unfettered discretion.

The *Locke* case was followed by a dispute over a nonexclusive distribution agreement between Gap, a retailer, and Gabana, a clothing distributor. (*Gabana Gulf Distribution, Ltd. v. Gap Int'l Sales, Inc.* (2008 WL 111223 (N.D. Cal.).) The agreement provided that Gabana had to obtain Gap's approval before selling clothes to any particular retailer, and that Gap "shall have the right in its sole discretion to approve, disapprove, or cancel at any time any Distribution customer." Gabana argued that Gap had breached the implied covenant by instituting a freeze on all new retail customers, regardless of the merits of the proposal.

The court repeated the *Locke* court's distinction between a contract that provides a party with the power to *exercise* discretion, and one that provides the power to *refrain* from exercising discretion. Thus, "because Gap merely bargained for the right to exercise 'discretion' over proposals made by Gabana, Gap did not bargain for the right to refrain from approving all proposals altogether." (*Gabana*, 2008 WL 111223 at *8.) Note that the courts that decided *Symbolic Aviation* and *Dos Beaches* simply ignored the earlier *Gabana* ruling.

CONSIDERATION

When dealing with these issues, it is important to bear in mind the second element of the two-pronged analytical framework. Even if a contract provides unfettered discretion, a promise to use good faith will be implied unless there is other consideration. (*Third Story Music*, 41 Cal. App. 4th at 808.) Very few cases address this specific requirement because most contracts, especially those in writing, are supported by other consideration.

The legal code provides some help here. California's statutes declare that "[a] written instrument is presumptive evidence of consideration." (Cal Civ. Code § 1614.) Furthermore, "all the law requires for sufficient consideration is the proverbial 'peppercorn.' " (*San Diego City Firefighters, Local 145, AFL-CIO v. Bd. of Admin. of San Diego City Emps.' Ret. Sys.*, 206 Cal. App. 4th 594, 619 (2012).) Indeed, "[a]ny valid though slight consideration will support the most onerous obligation." (*Taylor v. Taylor*, 66 Cal. App. 2d 390, 398 (1944).)

The *Third Story Music* case cited above is instructive. The court found that the recording contracts at issue gave unfettered discretion to Warner Communications to decide whether to release a Tom Waits album. However, the contracts required Warner to make various annual and per-album payments to Third Story; and although the money paled in comparison to what could have been earned by a successful recording artist, the court found the consideration adequate, and it commented that judges "cannot make better agreements for the parties than they themselves have been satisfied to enter into, or rewrite contracts because they operate harshly or inequitably." (*Third Story*, 41 Cal. App. 4th at 809.)

With this split in authority, what is the best approach for a drafter who intends to provide unfettered discretion? Here are some suggestions.

- Use broad language in the agreement that makes it as clear as possible that the parties intended for the discretion conferred to be unfettered. Phrases like "sole and exclusive discretion," or "as the party sees fit" are essential.
- Always specify that the party entitled to exercise the discretion may refrain from doing so.
- If possible, give examples of ways in which the party may exercise discretion.

Parties can indeed contract for the right to exercise unfettered discretion; the key is to include the right language. Using the verbal incantations that have influenced the case law will help assure that the drafter's intent prevails in the event a dispute arises.

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Drafting Around Good Faith

1 In California, not every contract contains an implied covenant of good faith and fair dealing.
❑ True ❑ False

2 The implied covenant of good faith and fair dealing prevents one party from unfairly frustrating the other party's right to receive contractual benefits.
❑ True ❑ False

3 When an agreement invests one party with a discretionary power affecting the rights of the other party, there is never an obligation to act in good faith.
❑ True ❑ False

4 Rarely do contracting parties intend for one party to exercise unfettered discretion.
❑ True ❑ False

5 In California, parties cannot write a contract so as to avoid the implied covenant of good faith and fair dealing.
❑ True ❑ False

6 The implied covenant does not prohibit a party from taking action that is expressly permitted by an agreement.
❑ True ❑ False

7 Even if conduct is specifically permitted by a contract, a party can engage in that conduct only in good faith.
❑ True ❑ False

8 For a contractual grant of unfettered discretion to be effective, it must be clearly expressed in the agreement.
❑ True ❑ False

9 Consideration is not required for a clause granting unfettered discretion.
❑ True ❑ False

10 If the contract is clear and supported by adequate consideration, a grant of unfettered discretion is considered to be within the reasonable expectation of the parties.
❑ True ❑ False

11 When granting or denying an employee bonus, the employer is always bound by an implied covenant of good faith and fair dealing.
❑ True ❑ False

12 If a contract gives one party the right to refrain from certain activities, the decision to do so must still be made in good faith.
❑ True ❑ False

13 A contract stating that one party may exercise its rights "as it sees fit" gives that party unfettered discretion.
❑ True ❑ False

14 It is impossible to draft a contract granting unfettered discretion to a record producer or film studio.
❑ True ❑ False

15 Even if a contract provides unfettered discretion, a promise to use good faith will be implied unless there is other consideration.
❑ True ❑ False

16 A written contract is presumptive evidence of adequate consideration.
❑ True ❑ False

17 Token consideration is not sufficient to support an onerous obligation.
❑ True ❑ False

18 Valid consideration requires more than a "peppercorn."
❑ True ❑ False

19 When consideration is so small that a contract operates harshly or unjustly, courts generally will rewrite the agreement to make it fair.
❑ True ❑ False

20 In drafting a contract intended to provide unfettered discretion, it is wise to include examples of the type of decisions over which a party will have such discretion.
❑ True ❑ False

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