The Implied Duty of Good Faith & Fair Dealing in Government & Commercial Contracts

An Age-Old Concept in Need of an Update?

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I. Introduction & Background

The implied duty of good faith and fair dealing is a centuries-old concept and yet it still brings about a great deal of frustration and confusion. What does it mean? When does it apply? Does it and should it mean the same thing in the commercial context, when two private parties contract, as it does when the Government enters into a contract? Is it necessary in twenty-first century business relationships? For Government, how does the duty square with other regulatory or statutory requirements that are the responsibility of agencies not directly involved in the contract performance, *e.g.*, auditors and investigators?

A. What Does It Mean?

The Restatement (Second) of Contracts § 205 provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Comment d to § 205 states:

> Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

Similarly, the Uniform Commercial Code defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 1-201(b)(20) (amended 2003). These explanations do not provide a firm definition of good faith and fair dealing. A review of the roots of the doctrine sheds some insight but does not completely answer the question.

B. Early Cases: Establishment of the Implied Duty of Good Faith & Fair Dealing

1. The Origins of the Duty in the Commercial Context

In the commercial context, the duty of good faith and fair dealing began as an unstated provision that made an agreement enforceable. *See Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88 (1917). In *Wood*, the plaintiff and defendant agreed that the plaintiff would have the exclusive right to place the defendant's endorsements on others' fashion designs and sell or license the defendant's designs. In exchange, the defendant would receive half of all of the profits and revenues. The court rejected the defendant's argument that there was no enforceable obligation, stating:

> The defendant insists, however, that it lacks the elements of a contract. She says that the plaintiff does not bind himself to anything. It is true that he does not promise in so many words that he will use reasonable efforts to place the defendant's indorsements and market her designs. We think, however, that such a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view to-day. A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed. If that is so, there is a contract.

Id. at 90-91 (citations omitted). After *Wood*, courts around the country found an implied duty to use best or reasonable efforts in a contract even when it was not expressly stated. As discussed below, the notion of furthering the parties' intent and reasonable expectations continues to drive the application of the implied duty of good faith and fair dealing in the commercial context.

The duty had a different evolutionary path in the government contracts arena. Specifically, public officials were presumed to act in good faith unless proved otherwise, and this presumption extended to public officials' conduct in the execution or performance of government contracts. *See The Schooner Betsey*, 44 Ct. Cl. 506, 514 (1909) (presuming good faith in the sale of an American ship). The Supreme Court implied a duty of reasonableness to the Government in performing contracts in the nineteenth century. *See Clark v. United States*, 73 U.S. 543, 545-46 (1867); *United States v. Behan*, 110 U.S. 338, 346 (1884). In *Behan*, the appellee had a contract to make improvements to the New Orleans harbor. When the Government determined that the plan would not accomplish its goal, which was not the contractor's fault, it told the contractor to cease performance. The Government appealed a decision awarding the appellee damages, arguing that the appellee was not entitled to lost profits. 110 U.S. at 342. The Supreme Court disagreed, stating:

> But, surely, the willful and wrongful putting an end to a contract, and preventing the other party from carrying it out, is itself a breach of the contract for which an action will lie for the recovery of all damage which the injured party has sustained. The distinction between those claims under a contract which result from a performance of it on the part of the claimant, and those claims under it which result from being prevented by the other party from performing it, has not always been attended to.

Id. at 346.

The Court of Claims continued to apply the implied duty to government contract disputes in the mid-twentieth century. For example, in *George A. Fuller Co. v. United States*, 108 Ct. Cl. 70 (1947), the George A. Fuller Company sued for damages stemming from delays caused by the Government in failing to furnish models on time, changing the work, and in approving of the limestone to be used. The court did not hesitate to find the Government liable for the costs caused by its delays. The court stated:

> Under prior decisions of this court and of the Supreme Court, it follows that the defendant is liable for the damages sustained as a result of these delays.
>
> It is true there is no express provision in the contract which renders the Government liable for delays it may cause the contractor in the performance of the work, nor is there any express provision exempting it from liability for such delay; it is, however, an implied provision of every contract, whether it be one between individuals or between an individual and the Government, that neither party to the contract will do anything to prevent performance thereof by the other party or that will hinder or delay him in its performance.

Id. at 411. The court continued: "Indeed, there is generally in a contract subject to either an express or an implied condition an implied promise not to prevent or hinder performance of the condition." *Id.* at 411-12. The court distinguished the case at bar from situations where the Government caused a delay but contractually reserved the right to make changes. *Id.* at 414. The Federal Circuit, the Court of Federal Claims, and the Boards of Contract Appeals have continued to apply the implied duty of good faith and fair dealing, but the doctrine has evolved over time.

C. Modern Applications

There are aspects of the doctrine that apply in both commercial and government contracts. In either setting, the duty is interpreted as an obligation to not hinder performance or prevent the other party from obtaining the fruits of the bargain. *See Precision Pine & Timber, Inc. v. United States*, 596 F.3d 817, 820 n.1 (Fed. Cir. 2010); *Centex Corp. v. United States*, 395 F.3d 1283, 1304 (Fed. Cir. 2005); *Bank of N.Y. Mellon Corp. Forex Transactions Litig.*, 921 F. Supp. 2d 56, 80 (S.D.N.Y. 2013). In both sectors, the duty of good faith and fair dealing is part of every contract unless it is expressly excluded. *See Northwest, Inc. v. Ginsberg*, -- U.S. ----, 134 S. Ct. 1422, 1431-32 (2014); *Metcalf Constr. Co. v. United States*, 742 F.3d 984, 990 (Fed. Cir. 2014). Notably, although the duty can be excluded from commercial contracts in some states, it is rarely if ever excluded from government contracts. In both contexts, the duty cannot expand a contract beyond its express terms or contravene terms of the agreement. *See Metcalf Constr.*, 742 F.3d at 991; *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188, 1195 (10th Cir. 2004). Likewise, when a court applies the duty to either type of contract, the boundaries of a permissible application are defined by parties' intent and their reasonable expectations in entering the contract. *See First Nationwide Bank v. United States*, 431 F.3d 1342, 1350 (Fed. Cir. 2005); *Compass Bank v. Eager Rd. Assocs., LLC*, 922 F. Supp. 2d 818, 825 (E.D. Mo. 2013). Finally, courts deciding both types of cases have held that the duty is limited to contract performance and does not apply during negotiations. *Scott Timber Co. v. United States*, 692 F.3d 1365, 1372 (Fed. Cir. 2012); *Market St. Assocs. L.P. v. Frey*, 941 F.2d 588, 596-97 (7th Cir. 1991); *Land O'Lakes v. Gonsalves*, 281 F.R.D. 444, 453 (E.D. Cal. 2012).

However, differences in how the doctrine is applied in commercial contract and government contract cases remain. Because commercial contract disputes are litigated in state and federal courts under state law, there is no uniform definition of the implied duty of good faith and fair dealing. *See Northwest, Inc.*, 134 S. Ct. at 1431. In some states, the doctrine is used as a tool to interpret a contract; in other states, a breach of the implied duty is an independent cause of action. Notably, in most commercial disputes, the jury is fact finder and usually decides whether a party's conduct breached the duty. The doctrine is invoked in practically every type of commercial contract dispute, including insurance, employment contracts, franchise and dealer contracts, leases, and construction disputes.

The doctrine differs in government contract disputes for three primary reasons. One, the Government – a sovereign – is a party to the contract. The Government's involvement brings with it a complicated regulatory and statutory regime, which imposes significant requirements on contractors. The Government is also in a unique negotiating position, where it is more able to set the contract terms and concurrently act as the enforcement authority. Second, bad faith plays a different role in government contract cases. In the commercial context, bad faith often defines what is not good faith. In government contract case law, there has been confusion when courts have muddled the distinct concept of the implied duty of good faith and fair dealing with the evidentiary presumption of good faith on the part of public officials. Finally, in contrast to the commercial context where juries usually decide issues of fact, in the tribunals that resolve government contract claims, judges act as the fact finder and determine whether a party's conduct violated the duty.

II. The Role of Bad Faith

A. Bad Faith in the Commercial Context

1. Bad Faith Defines What Is Not Good Faith

In the commercial contract realm, bad faith is used to define what does not constitute good faith. Essentially, bad faith acts as an excluder for what constitutes good faith. *See* Robert S. Summers, *The General Duty of Good Faith – Its Recognition and Conceptualization*, 67 Cornell L. Rev. 810 (1982). As discussed above, the Restatement (Second) of Contracts lists instances of bad faith conduct, such as evasion, subterfuge, abuse of power, and willful rendering of imperfect performance, as conduct that violates the duty.

Similarly, courts also use the concept of bad faith when determining whether a party breaches the implied duty of good faith and fair dealing. The U.S. District Court for the District of Columbia used this approach in *Himmelstein v. Comcast of the Dist., L.L.C.*, 908 F. Supp. 2d 49 (D.D.C. 2012). In that case, the plaintiff terminated his cable service agreement, the service was disconnected, and Comcast's equipment was removed. However, Comcast's modem was mistakenly left behind, and the plaintiff was charged $220 for the unreturned equipment. Eventually, the outstanding balance was forwarded to a collection agency and reported to the national credit-reporting agencies. When the plaintiff discovered the mistake, he returned the modem to Comcast, and Comcast assured him that the company would correct his account. The plaintiff's credit report was not corrected, and he claimed he had to pay an additional $26,000 when he refinanced his home because of the error. The plaintiff sued Comcast and the collection agency, asserting breach of the implied covenant of good faith and fair dealing as one of four causes of action. The court dismissed two counts, including the breach of the duty of good faith and fair dealing, finding that the plaintiff failed to allege bad faith. *Id.* at 54. In reaching its decision, the court quoted the Restatement and expanded upon the notion of bad faith, stating:

> "Bad faith is more than bad judgment or negligence: it is a neglect or refusal to fulfill some duty or some contractual obligation, not prompted by an honest mistake as to one's rights or duties, but by some interested or sinister motive and implies the conscious doing of a wrong because of dishonest purpose or moral obliquity."

Id. (quoting *Burnsed Oil Co. v. Grynberg*, 320 F. App'x 222, 230 (5th Cir. 2009)). The court determined that Comcast's actions were "a series of mistakes and were not the result of an interested or corrupt motive." *Id.*

A Wisconsin District Court used a similar approach in *Tilstra v. Bou-Matic, LLC*, --- F. Supp. 2d ----, 2014 WL 834531 (W.D. Wisc. Mar. 4, 2014). Sid Tilstra and his dairy equipment company sued a dairy equipment manufacturer, alleging breach of contract and interference with economic relations. Mr. Tilstra had been a Bou-Matic dealer since 1981, operating under a dealership agreement that assigned Mr. Tilstra an exclusive sales and service territory and provided Bou-Matic with the right to change, in its sole discretion, the territory. *Id.* at *1. In 2009, Bou-Matic threatened to remove Mr. Tilstra's territory if he did not agree to sell the dealership and its assets to a neighboring dealer. Because of this threat, Mr. Tilstra sold his dealership, but then sued. Bou-Matic moved for summary judgment, arguing that eliminating Mr. Tilstra's territory could not be a breach because the dealership agreement gave Bou-Matic the sole discretion to change his territory. *Id.* at *9. The court rejected this argument, pointing out that a party can be liable for breach of the implied duty of good faith and fair dealing even if all of the contract terms have been fulfilled. The court stated that under Wisconsin law, a plaintiff alleging breach of the implied duty "must allege facts 'that can support a conclusion that the party accused of bad faith has actually denied the benefit of the bargain originally intended by the parties.'" *Id.* (quoting *Zenith Ins. Co. v. Emp'rs Ins.*, 141 F.3d 300, 308 (7th Cir. 1998)). The court concluded that a reasonable jury could find that Bou-Matic evaded the spirit of the termination clause by eliminating Mr. Tilstra's territory without providing notice and showing good cause, as required by the contract, because the defendant's intent and the validity of its reasoning were in dispute.

2. Bad Faith As Motive

Similarly, some courts use bad faith as a proxy for motive. One such case is *TCBY Systems, Inc. v. RSP Co.*, 33 F.3d 925 (8th Cir. 1994), a case arising from a terminated franchise agreement. TCBY's brochure about franchises stated that TCBY was "fully versed in the real estate aspects" of opening a store, and a TCBY real estate director would identify site options and approve an optimal location. *Id.* at 927. TCBY's guidelines provided that a TCBY store needed a population of at least 7,500 within one mile of the store, a median household income of at least $25,000, a median age in the high 20s or low 30s, and a focused market. *Id.* RSP had wanted to own and operate a TCBY franchise in Crystal, Minnesota, a suburb of Minneapolis. However, TCBY would not approve the site or any site near the Twin Cites and instead approved a site in central Minnesota. The division manager that approved the site did not obtain a demographic report for the area and did not verify that it satisfied TCBY's guidelines, which it did not. The population of the area was 3,756, the median household income was approximately $18,000, and the market was scattered. *Id.* RSP opened the store, the gross sales in the first year were less than half of TCBY's $250,000 estimate, and the store never broke even. *Id.* RSP terminated the franchise agreement, TCBY sued, seeking the value of royalties and advertising funds it would have received, and RSP counterclaimed. A jury found that TCBY breached its obligation of good faith and fair dealing in the performance of the franchise agreement, and TCBY appealed. The Court of Appeals for the Eighth Circuit affirmed, holding that there was sufficient evidence for a jury to find that TCBY breached the obligation of good faith and fair dealing. *Id.* at 928. The Eighth Circuit cited TCBY's failure to follow its guidelines for site evaluation and selection, noting that it supported "a finding that TCBY was not honest in fact and acted with a bad motive." *Id.; but see Original Great Am. Chocolate Chip Cookie Co. v River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (stating defendant's motive was irrelevant).

In *Seidenberg v. Summit Bank*, 791 A.2d 1068, 1078 (N.J. Super. Ct. App. Div. 2002), a New Jersey appellate court held that bad faith or ill motive is an essential element to maintain a cause of action based on the implied covenant of good faith and fair dealing. In that case, the plaintiffs were the sole shareholders of insurance brokerage companies and sold their stock to the defendant. The plaintiffs received shares in the defendant's parent corporation, retained executive positions in the companies, and received bonuses based on anticipated growth. The plaintiffs' employment agreements provided that the parties would "work together to formulate joint marketing programs." *Id.* at 1072. The plaintiffs were fired and sued, arguing that the defendant had failed to develop potential customers and relationships with other entities, and these allegations gave rise to an inference of bad faith. *Id*. at 1073. The trial court dismissed the action, finding that the plaintiffs were seeking to prove the existence of and enforce an oral agreement made beyond the four corners of the written agreements. *Id.* The appellate court reversed, noting that the lower court misapprehended the nature of the cause of action and provided an erroneous interpretation of the implied covenant of good faith and fair dealing. The appellate court stated that under the covenant, "'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.'" *Id.* at 1074 (quoting *Sons of Thunder v. Borden, Inc.*, 690 A.2d 575, 587 (N.J. 1997)). The court further explained that the covenant has been used in three types of situations: (1) when the contract does not provide a term necessary to fulfill the parties' expectations, (2) when bad faith served as a pretext for terminating a contract, and (3) when the contract expressly provides for discretion in performance. *Id.* at 1078. The court reasoned that bad faith is relevant in all three situations, particularly when contract performance requires a party to exercise discretion. The court stated:

> Before finding a breach of the implied covenant, care must be taken that the bad faith element is fully realized. . . the covenant is not intended to supplant the prohibition on judicial rewriting of contracts or provide undue protection to contracting parties who can protect themselves, the *Wilson* decision represents an increased emphasis on the importance of this factor: "Contract law does not require parties to behave altruistically

> toward each other; it does not proceed on the philosophy that I am my brother's keeper."
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> [A]n allegation of bad faith or unfair dealing should not be permitted to be advanced in the abstract and absent improper motive.

Id. at 1079 & n.4 (quoting *Wilson v. Amerada Hess Corp.*, 773 A.2d 1121, 1130 (N.J. 2001)) (citations omitted). The court held that the lower court should not have dismissed the plaintiffs' complaint because they alleged that the defendant's actions were "wanton and willful" and that they suffered because of the defendant's "bad faith." *Id.* at 1080.

B. Bad Faith in Government Contract Cases

1. The Good Faith Presumption Versus the Implied Duty of Good Faith

Bad faith has played a different role in government contract cases discussing the implied duty of good faith and fair dealing. Namely, some courts have conflated the evidentiary presumption of good faith that applies to an official's conduct with the contractual obligation of good faith and fair dealing. The presumption that public officials act correctly or in good faith is rooted in English law and has been invoked by the Supreme Court since as early as 1816. *See Ross v. Reed*, 14 U.S. (1 Wheat.) 482, 486 (1816). The presumption is prima facie evidence and may be rebutted with evidence showing the contrary. The presumption is not limited to actions related to government contracts. Rather, it applies to all sovereign acts, and is relied on when a plaintiff accuses a government official of fraud or some other sort of wrongdoing; it does not apply when a plaintiff alleges an ordinary breach of contract. *See Tecom, Inc. v. United States*, 66 Fed. Cl. 736, 771 (2005).

However, over the course of time, the concepts became muddled, and courts required a contractor to show bad faith on the part of a government official to succeed on a claim of a breach of the implied duty of good faith and fair dealing. *See L.P. Consulting Grp., Inc. v. United States*, 66 Fed. Cl. 238, 243 (2005) ("To be sure, the government has an implied obligation to carry out its duties under a contract in good faith. In order [to] demonstrate a breach of such duty, plaintiff must demonstrate that the government acted in bad faith. It is well-settled, however, that government officials are presumed to act conscientiously and in good faith in the discharge of their duties.") (citations omitted); *see also White Buffalo Constr., Inc. v United States*, 101 Fed. Cl. 1, 13 (2011), *aff'd in part, vacated in part*, 546 F. App'x 952 (Fed. Cir. 2013).

2. The Federal Circuit Clarifies the Doctrine: *Metcalf Construction Co. v. United States*

The Court of Appeals for the Federal Circuit recently provided some clarity in this area in *Metcalf Construction*, 742 F.3d 984. The case involved a 2002 contract to design and build housing units at a Marine Corps base in Hawaii. The case involved a differing site conditions claim in which Metcalf complained that it was forced to bear higher costs than could have been expected. Metcalf asserted that the solicitation inaccurately described the soil conditions on which the housing needed to be built. When post-award testing was conducted during the performance period (pursuant to the contract), and the problems with the site became known, Metcalf raised them with the contracting officer. The agency would not modify the contract in the allegedly reasonable manner requested by the plaintiff, which provided the basis for the breach of good faith and fair dealing claims.

The Court of Federal Claims held that although the Navy violated a regulation by failing to investigate the soil in a timely manner and failed to issue a notice to proceed until months after it was required to do so, the plaintiff failed to establish liability. Instead, the court awarded liquidated damages against the plaintiff for failing to meet the completion date in the contract. The Court of Federal Claims relied on *Precision Pine*, 596 F.3d 817, and denied the plaintiff's claim because it failed to show that the Navy's actions were "'specifically designed to reappropriate the benefits [that] the other party expected to obtain from the transaction, thereby abrogating the government's obligations under the contract.'" *Metcalf Constr. Co. v. United States*, 102 Fed. Cl. 334, 346 (2011) (quoting *Precision Pine*, 596 F.3d at 829). The Court of Federal Claims further stated that "incompetence and/or the failure to cooperate or accommodate a contractor's request" do not implicate the duty of good faith and fair dealing unless the Government "specifically targeted" the action or undertook the action for the purpose of delaying or hampering contract performance. *Id.* Essentially, the Court of Federal Claims was requiring the contractor to overcome the presumption of good faith that applies to officials' conduct by showing the Government engaged in bad faith during contract performance.

On appeal, the Federal Circuit began by defining the duty of good faith and fair dealing as follows:

> "The covenant of good faith and fair dealing . . . imposes obligations on both contracting parties that include the duty not to interfere with the other party's *performance* and not to act so as to destroy *the reasonable expectations* of the other party regarding the *fruits of the contract*." *Centex Corp. v. United States*, 395 F.3d 1283, 1304 (Fed. Cir. 2005) (emphases added). "Both the duty not to hinder and the duty to cooperate are aspects of the implied duty of good faith and fair dealing." *Precision Pine*, 596 F.3d at 820 n.1. What is promised or disclaimed in a contract helps define what constitutes "lack of diligence and interference with or failure to cooperate in the other party's performance." *Malone*, 849 F.2d at 1445. In short, while the implied duty exists because it is rarely possible to anticipate in contract language every possible action or omission by a party that undermines the bargain, the nature of that bargain is central to keeping the duty focused on "honoring the reasonable expectations created by the autonomous expressions of the contracting parties." *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1152 (D.C. Cir. 1984) (per Scalia, J.).
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> . . .
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> The implied duty of good faith and fair dealing is limited by the original bargain: it prevents a party's acts or omissions that, though not proscribed by the contract expressly, are inconsistent with the contract's purpose and deprive the other party of the contemplated value. *See First Nationwide Bank v. United States*, 431 F.3d 1342, 1350 (Fed. Cir. 2005) (duty was breached by legislation that "changed the balance of contract consideration").

Metcalf Constr. Co., 742 F.3d at 991. Then, the Federal Circuit clarified that the absence of specific targeting does not preclude a finding that the Government breached the implied duty of good faith and fair dealing in all cases. Rather, specific targeting was required for a breach in *Precision Pine* because the contract allowed for the suspension in performance that the plaintiff based its claim on. *Id.* at 993. Because "the essential basis of *Precision Pine* was that the challenged conduct was not contrary to the contract bargain," (*id.* at 992) a showing of specific targeting and re-appropriation of any benefit guaranteed by the contract was required to demonstrate that a breach of the duty of good faith and fair dealing had occurred. In *Metcalf*, nothing in the contract authorized the Government's conduct. Indeed, the contract recognized that additional post-award testing would occur and that, depending on what was found, it anticipated Metcalf would negotiate for a contract modification. The Federal Circuit also emphasized that a breach of the implied duty of good faith and fair dealing does not require a violation of a contract provision.

3. Federal Circuit Decisions after *Metcalf Construction Co. v. United States*

The Federal Circuit has issued two decision discussing the duty of good faith and fair dealing since *Metcalf* was issued. In the first, *Century Exploration New Orleans, LLC v. United States*, 745 F.3d 1168 (Fed. Cir. 2014), the plaintiff alleged that new federal requirements applicable to drilling operations on the Outer Continental Shelf repudiated and breached its oil and gas lease. The Court of Federal Claims granted the Government's motion for summary judgment, and the Federal Circuit affirmed. After citing *Metcalf* to explain the duty of good faith and fair dealing, the court concluded that the Government did not breach the implied duty because the lease expressly authorized the Government to change the applicable regulatory requirements. *Id.* at 1179.

In *Lakeshore Engineering Services, Inc. v. United States*, --- F.3d ---- , 2014 WL 1394949 (Fed. Cir. Apr. 11, 2014), the plaintiff had an indefinite delivery-indefinite quantity contract to provide construction services. Under the contract, pricing was determined using coefficients proposed by the contractor and set in the contract and prices in the Universal Unit Price Book. After performing for two years, Lakeshore concluded that it incurred higher costs than expected and sought an equitable adjustment. *Id.* at *2. When the Government denied the request and rejected a claim submitted to the contracting officer, Lakeshore sued. The Court of Federal Claims granted the Government's motion for summary judgment, finding that the contract placed the risk of error in pricing on the contractor, and the implied duty of good faith does not guarantee against loss because of contractor error. *Id.* at *3. The Federal Circuit affirmed.

Notably, the court did not discuss either bad faith or the presumption of good faith that applies to a public official's conduct in *Century Exploration* or *Lakeshore Engineering*. Instead, the court focused on the provisions of the contracts at issue and the allocation of risk. Hopefully, the Federal Circuit's explanation and guidance in *Metcalf Construction*, *Century Exploration*, and *Lakeshore Engineering* will put an end to the confusion with respect to the presumption of good faith afforded to a public official's conduct and the duty of good faith and fair dealing. A contractor is not required to show specific targeting or some other form of bad faith conduct to prevail in a breach of the implied duty claim. Requiring a contractor to establish bad faith is not supported by principles of contract law and places an unreasonable and unfair burden on the contractor. Although bad faith may be relevant in the analysis, it is not an essential element of a breach of the implied duty of good faith and fair dealing claim.[1]

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[1] The Federal Circuit addressed the implied duty of good faith and fair dealing in another 2014 case, *Bell/Heery v. United States*, 739 F.3d 1324 (Fed. Cir. 2014), which was issued in January. Like *Lakeshore Engineering*, Bell/*Heery* involved an equitable adjustment claim for increased costs. Bell/Heery had a contract for the design-build construction of a federal correctional institution in New Hampshire. The project involved a cut-to-fill site, requiring the contractor to excavate material from one area of the site and use that material to fill in lower areas, and the operations were required to be performed in

(cont'd)…

III. The Parties' Bargaining Power

A. Commercial Context – Concern with Unequal Bargaining Power

Commercial contract cases concerning a breach of the implied duty of good faith and fair dealing indicate that some courts are concerned with the parties' relative bargaining power. This issue typically arises in two situations: (1) when one party is more sophisticated than the other or (2) when a contract affords one party discretion with respect to contract performance or the right to terminate a contract. Each of these situations is discussed below.

1. Sophistication of the Parties

The Court of Appeals for the Seventh Circuit explained the basis for considering the parties' bargaining power and sophistication in *Market Street Associates L.P. v. Frey*, 941 F.2d 588 (7th Cir. 1991). The case involved a dispute between the partnership and the General Electric Pension Trust and its trustees about a lease. A provision of the lease entitled the lessee, the partnership, to request that the lessor, the trust, finance the costs of improving the premises if the costs were at least $250,000. The trust was required to give reasonable consideration to provide the financing and negotiate in good faith. If the negotiations failed, the partnership would be entitled to repurchase the property at

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compliance with rules and regulations of the state Department of Environmental Sciences. The contract provided that the contractor was responsible for obtaining any necessary licenses and permits and for complying with any applicable federal, state, and municipal laws and regulations. In its proposal, Bell/Heery assumed that it would be allowed to perform the cut-to-fill operation in a single step, but the state denied its requests, which resulted in increased costs. Bell/Heery asserted three causes of action, including breach of the implied covenant of good faith and fair dealing, and the Government moved to dismiss. The Court of Federal Claims dismissed the complaint, and the Federal Circuit affirmed. With respect to the claim for breach of the implied duty of good faith and fair dealing, the Federal Circuit found that the state's conduct – not the agency's conduct - frustrated the performance of the contract, and the plaintiff did not allege that the Government reappropriated benefits promised to Bell/Heery under the contract. *Id.* at 1335.

the price the trust acquired it, plus six percent per year. *Id*. at 591. In July and August of 1988, the partnership requested $2 million to fund improvements. The trust turned down the request, stating it did not meet the trust's $7 million investment requirement. The partnership then sought to exercise its purchase option. The district court granted summary judgment for the trust, finding that the partnership violated the duty of good faith by failing to mention the purchase right in the lease provision when it requested the loan. *Id.* at 592. The Seventh Circuit engaged in an in-depth analysis of the duty of good faith, beginning with the notion that the duty was not equivalent to a fiduciary relationship, stating:

> [I]t is unlikely that Wisconsin wishes, in the name of good faith, to make every contract signatory his brother's keeper, especially when the brother is the immense and ***sophisticated*** General Electric Pension Trust, whose lofty indifference to small (= < $7 million) transactions is the signifier of its grandeur. In fact the law contemplates that people frequently will take advantage of the ignorance of those with whom they contract, without thereby incurring liability. The duty of honesty, of good faith even expansively conceived, is not a duty of candor. You can make a binding contract to purchase something you know your seller undervalues.

Id. at 593-94 (citation omitted) (emphasis added). However, the court distinguished exploiting one's superior knowledge of the market from taking a "deliberate advantage of an oversight by your contract partner concerning his rights under the contract." *Id.* at 594. The court also distinguished conduct during contract negotiations, where parties are alert and on the defensive, from conduct during contract performance – a "cooperative relationship." *Id.* As such, the purpose of the doctrine of good faith is to "forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule." *Id.* at 595. The Seventh Circuit held that summary judgment was improper because the partnership's state of mind, which determined whether the partnership's conduct was honest or manipulative, was a question of fact. *Id.* at 597-98. The court noted:

> We do not usually excuse contracting parties from failing to read and understand the contents of their contract; and in the end what this case comes down to—or so at least it can be strongly argued—is that an ***immensely sophisticated*** enterprise simply failed to read the contract. On the other hand, such enterprises make mistakes just like the rest of us, and deliberately to take advantage of your contracting partner's mistake during the performance stage (for we are not talking about taking advantage of superior knowledge at the formation stage) is a breach of good faith. To be able to correct your contract partner's mistake at zero cost to yourself, and decide not to do so, is a species of opportunistic behavior that the parties would have expressly forbidden in the contract had they foreseen it.

Id. at 597 (emphasis added).

Seidenberg v. Summit Bank, 791 A.2d 1068, discussed above in the section on bad faith and motive, also provides an analysis of the significance of the parties' relative levels of sophistication when determining whether there has been a breach of the duty. In that case, the trial court dismissed the action, in part because the plaintiffs were sophisticated businessmen and entered the employment agreements at issue with the assistance of counsel. In its opinion reversing the dismissal, the appellate court explained that unequal bargaining power is one factor to consider in finding a breach of the implied covenant of good faith and fair dealing. *Id.* at 1075. The court explained that courts should consider the parties' bargaining power because it is relevant to economic dependency and financial strength, both of which are related to a party's reasonable expectations upon entering a contract. However, the court stressed that the parties' levels of sophistication were not the only factor to consider, stating: "while disparate strength may sometimes be a prominent feature, it is not the *sine qua non* of such a cause of action. It is merely one factor among many to be considered." *Id.* As such, the court held that the lower court should not have dismissed the plaintiffs' claim solely because the plaintiffs were experienced businessmen and represented by counsel during contract negotiations.

2. Discretion Vested in One Party

In *Best v. U.S. National Bank of Oregon*, 739 P.2d 554 (Or. 1987), the Supreme Court of Oregon explained how a court should assess a claim that a party breached the implied duty of good faith and fair dealing when the contract provided that party with discretion in acting under the contract. In *Best*, two depositors brought a class action, arguing that the defendant bank violated its duty to set fees in good faith when it increased the fee it charged depositors for processing nonsufficient fund checks from three to five dollars per check over a six-year period. *Id.* at 555. The lower court granted the defendant's motion for summary judgment, and the plaintiffs appealed. The Oregon Supreme Court found it was unfair to assume that the depositors knew about and agreed to the fee because bank employees did not inform customers about the fee unless the customers asked, and the bank did not notify depositors when it increased the fee. *Id.* at 557. Because the defendant did not establish that the plaintiffs agreed to the fees, the court proceeded with the good faith and fair dealing analysis. The court stated:

> When one party to a contract is given discretion in the performance of some aspect of the contract, the parties ordinarily contemplate that that discretion will be exercised for particular purposes. If the discretion is exercised for purposes not contemplated by the parties, the party exercising discretion has performed in bad faith.

Id. at 558. Thus, although the bank had the contractual discretion to set its fees, it was required to exercise that discretion within the confines of the depositors' reasonable expectations. The court reversed the grant of summary judgment because there was a genuine issue of material fact with respect to whether the bank set the fees in accordance with the parties' reasonable expectations. *Id.* at 559.

Chodos v. West Publishing Co., 292 F.3d 992 (9th Cir. 2002), also involved a contract that vested discretion in one party. In that case, Rafael Chodos, an attorney specializing in the law of fiduciary duty, and Bancroft-Whitney Corporation[2] entered into an Author Agreement to write a scholarly book on the law of fiduciary duty in 1995. *Id.* at 995. The contract gave the publisher the right, in its discretion, to terminate the publishing relationship after receipt of the manuscript if it determined that the manuscript was unacceptable in form or content. The agreement also afforded the writer 30 days to fix any unacceptable aspects of the manuscript. Mr. Chodos worked on the text for four years with the guidance of Bancroft staff. In 1999, Mr. Chodos was informed that West had decided not to publish the book because it did not fit within the company's product mix and because of concerns with respect to market potential. When Mr. Chodos sued, West relied on the contract provision that gave it the discretion to terminate the

[2] West Publishing Company acquired Bancroft-Whitney Corporation in 1996, and the same editors continued to work with Mr. Chodos. 292 F.3d at 995.

relationship if the manuscript was unacceptable. The district court granted West's motion for summary judgment, and the Court of Appeals for the Ninth Circuit reversed. The Ninth Circuit first held that the contract was not illusory because the implied duty of good faith and fair dealing can be read to impose an obligation on each party. *Id.* at 997. Further, West's ability to terminate the contract was limited by the duty of good faith and fair dealing, and West breached the agreement because its ability to terminate the agreement was limited to circumstances in which the submitted manuscript was unacceptable in content or form and the author did not cure the failure in performance. *Id.* at 997-98. West's change in marketing strategy did not fit within the clause. In reaching its decision, the *Chodos* Court emphasized that it would be inequitable – and possibly unconscionable – for an author to spend years producing a text that met the highest professional standards and allow the publisher's poor planning, inadequate financial analysis, or change in management to allow it to escape its contractual obligations.

The U.S. District Court in Minnesota reached a similar conclusion in *White Stone Partners, L.P. v. Piper Jaffray Cos.*, 978 F. Supp. 878 (D. Minn. 1997). In that case, a commitment letter allowed the lenders to terminate a financing agreement if they found the environmental survey unacceptable. When the parties entered into the commitment letter, the defendants were aware that the property was less that a mile away from a landfill, and that an environmental assessment had not identified any problems. *Id.* at 880. Three days before the closing, one of the defendants terminated the commitment letter, stating "it was not satisfied with the findings of the environmental survey." *Id.*

The court reviewed case law from Minnesota and other federal courts and determined that "sole discretion" provisions can be limited by the duty of good faith and fair dealing. In the case at bar, because the plaintiff would not have agreed to a contract in which the defendants could terminate the agreement for any or no reason simply by expressing displeasure with the environmental survey, the plaintiff alleged sufficient facts that would support an inference of bad faith if proven. *Id.* at 884-85. Accordingly, the court denied the motion to dismiss.

B. Government Contracts – Unequal Bargaining Power Is the Norm

The tribunals that hear government contract cases involving alleged breaches of the implied duty of good faith and fair dealing have not expressed similar concerns about the parties' unequal bargaining power. Perhaps this lack of concern is due to the inevitable power imbalance. In the government contracts context, one party is the U.S. Government – a sovereign country – able to pass laws, levy taxes, and wage war. Although the Government sometimes contracts with extremely large and sophisticated companies, none can possibly match the power of the Government. The Government's unique position is directly related to its role as a sovereign and its roles as a policymaker, regulator, and enforcer.

1. Contracting Partner As a Sovereign

The courts and Boards have long acknowledged that the Government's sovereign conduct can affect the contracts it has and will enter. The unmistakability doctrine addresses this fact. The doctrine applies when enforcement of a contractual obligation would obstruct the exercise of the Government's sovereign power. Under the unmistakability doctrine, "a contract with a sovereign government will not be read to include an unstated term exempting the other contracting party from the application of a subsequent sovereign act (including an Act of Congress), nor will an ambiguous term of a grant or contract be construed as a conveyance or surrender of sovereign power." *United States v. Winstar Corp.*, 518 U.S. 839, 878 (1996). As such, unless there is a clear statement otherwise, a government contract will not be exempt from the operation of a subsequent sovereign act. *Centex Corp.*, 395 F.3d at 1307. In *Winstar*, the Supreme Court distinguished between general legislation and Government acts that are aimed at relieving the Government of its contractual obligations. *Winstar*, 518 U.S. at 898. The *Winstar* plurality stated:

> The greater the Government's self-interest, however, the more suspect becomes the claim that its private contracting partners ought to bear the financial burden of the Government's own improvidence, and where a substantial part of the impact of the Government's action rendering performance impossible falls on its own contractual obligations, the defense will be unavailable.

Id.

The unmistakability doctrine was implicated in *Centex Corp.*, 395 F.3d 1283. There, the plaintiffs argued that tax legislation passed in 1993, five years after the plaintiffs entered a contract with the Government, resulted in a breach of the implied duty of good faith and fair dealing because the legislation deprived the plaintiffs of a bargained-for benefit. The contract at issue in *Centex* arose out of the savings and loan crisis. Because many savings and loan associations ("thrifts") were failing or otherwise in distress, the Government induced healthy financial institutions to take over the thrifts. One of the incentives that the Government offered was the ability to use the failing thrifts' net liabilities as tax deductions. The relevant tax provisions were explained in the request for proposals, and the tax benefits were specifically identified in the plaintiffs' Assistance Agreement with the Government. In 1993, because of opposition to the perceived favorable tax treatment banks were receiving, Congress disallowed the deductions that the plaintiffs had been claiming. The plaintiffs brought an action at the Court of Federal Claims, which entered summary judgment for the plaintiffs. The court determined that the plaintiffs were entitled to deduct the losses at the time of the acquisition, the favorable tax treatment was an important part of the consideration under the agreement, and it was reasonable for the plaintiffs to expect that the Government would not eliminate an element of contract consideration using legislation aimed at ending the benefit.

The Federal Circuit affirmed. *Centex*, 395 F.3d at 1314. The Federal Circuit found that the legislation ending the tax benefit "was specifically addressed to a small number of transactions" and was not part of a generally applicable, broader change to the Tax Code. *Id.* at 1305-06. The Federal Circuit rejected the Government's argument that applying the implied duty to the contract would expand the parties' contractual obligations, stating:

> [T]he plaintiffs are not arguing for an expansion of the government's duties under the contract or for a duty that is inconsistent with some provision of the contract. Instead, they are arguing that the government should be prohibited from interfering with the plaintiffs' enjoyment of the benefits contemplated by the contract, which is among the core functions served by the implied covenant of good faith and fair dealing . . . Indeed, it would be inconsistent with the recognition of an implied covenant if we

> were to hold that the implied covenant of good faith and fair dealing could not be enforced in the absence of an express promise to pay damages in the event of conduct that would be contrary to the duty of good faith and fair dealing.

Id. at 1306. The *Centex* Court rejected the argument that finding liability was contrary to the unmistakability doctrine because the legislation "was simply an effort by the government through legislation to adjust the costs of a discrete set of contracts into which a government agency had entered," and "[a]n act that is specifically targeted at the fruits of contracts enjoyed by the government's contracting partners is not a sovereign act." *Id*. at 1308. The court noted that the Government was not prevented from changing the tax law. Rather, the Government would be liable for damages if the exercise of its tax power breached a particular contractual obligation. *Id.* at 1309.

Centex does not stand for the proposition that the Government will always be liable for a breach of the implied duty of good faith and fair dealing if a subsequent sovereign act deprives a contracting partner of a contracted-for benefit. Importantly, the court determined that the legislation at issue in *Centex* was aimed at eliminating the plaintiffs' specifically contracted-for benefit. A government contractor is unlikely to succeed on a breach of duty claim when the sovereign act that eliminated the benefit was a generalized act, as shown in *AECOM Government Services., Inc.*, ASBCA No. 56861, Oct. 13, 2010, 10-2 BCA ¶ 34577. AECOM sought an equitable adjustment for Federal Insurance Contributions Act ("FICA") taxes imposed on its wholly-owned offshore subsidiary under a law passed six months after AECOM was awarded an Army contract. AECOM argued that the law breached the implied duty of good faith and fair dealing because it had not contemplated a change in FICA taxes when it entered the contract. The Board granted the Government's motion for summary judgment. The Board distinguished the case from *Centex*, finding that AECOM's contract did not contain a bargained-for benefit because the contract was silent on the issue of the FICA tax status of offshore subsidiaries.

2. Contracting Partner As the Policymaker, Regulator, and Enforcer

Government contract tribunals rarely, if ever, discuss the Government's superior bargaining position as the policymaker and regulator when a contractor alleges a breach of the duty of good faith or fair dealing. The Government is in the unique position of being the regulator and a party to the contract, as well as with enforcement of the contract. A party to a commercial contract has no reason to believe that a contract dispute could lead to a prolonged audit, an IG investigation, a civil fraud claim, or even a criminal proceeding. However, when the Government is on the other side of the bargaining table, a claim submitted to a contracting officer or brought in court under the Contract Disputes Act can easily lead to a fraud counterclaim, or the Government may claim a compliance failure in connection with an audit or investigation. Should the Government's position as a contracting partner and an enforcement authority affect the good faith and fair dealing analysis?

Judges rarely acknowledge that contractors have little ability to negotiate terms. Government contracts could be viewed as essentially adhesion contracts in many respects; if a contractor opposes a regulatory provision, it is unlikely to be changed or removed, absent unusual circumstances. A striking example of this ability is the

Government's right to terminate a contract for convenience, a notion that would be summarily rejected in almost all commercial contract negotiations. Other examples include, the requirement that the contractor submit cost or pricing data, the DoD Business Systems Rule, and the mandatory disclosure rule which similarly have no commercial analog. Part of the good faith and fair dealing analysis involves asking what the parties expected when they entered the agreement. Should the fact that the Government is more able to set the terms affect this analysis? Does a party entering a contract with the Government necessarily have different expectations than a party entering a contract with a commercial entity? Are terms such as those above also subject to the requirement for good faith and fair dealing; for example does that standard apply to the IG when a disclosure is made under the mandatory disclosure rule?

IV. Conclusion

The implied duty of good faith and fair dealing is a centuries-old concept. It is aimed at ensuring that the parties to a contract do not interfere with the other party's performance or destroy the other party's reasonable expectations with respect to the benefits of the contract. Given that the duty has been in place for hundreds of years and is firmly rooted in the common law, it is unlikely that it will fall by the wayside in the near future. However, that does not mean that the concept of the implied duty of good faith and fair dealing would not benefit from greater clarity.

The brief survey of cases discussed here suggests that the duty affords more protections to parties entering commercial contracts than a party contracting with the Government. Courts have often required government contractor plaintiffs to establish bad faith to succeed on a breach of the implied duty claim, a requirement rarely imposed in the commercial contract realm. Similarly, state and federal courts often consider whether the parties in a commercial contract dispute have disparate levels of sophistication, discretion, or bargaining power. Government contract tribunals rarely, if ever, address the fact that the Government is in a unique position as a sovereign, a policymaker, regulator, and an enforcement authority. Which approach is better? Do the parties to a government contract need the implied duty to provide protection for the performance of key contractual obligations? The answer, in brief, is yes.

The implied duty of good faith and fair dealing protects the ability of the parties to rely on their contract, the promises and risks undertaken, and the parties' reasonable expectations.