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## Whittling Away at Duty of Good Faith

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Last year, in *Cussler v. Crusader Entertainment, LLC*, B208738, 2010 WL 718007 (Cal. Ct. App. Mar. 3, 2010), the California Court of Appeal rejected Crusader's argument that in failing to approve Crusader's many proposed screenplays for the film "Sahara," the author Clive Cussler had breached the implied duty of good faith that under California law is read into every contract. The California Supreme Court subsequently denied petitions for review filed by Cussler and by Crusader. (This author filed an amicus letter in support of Crusader's petition for review.)

That would seem the end of the story—why revisit it? Because the court of appeal's opinion is flawed—it's based on analysis that doesn't make sense, and it fails to consider the policy issues implicated. This article explains why California courts should adopt a different approach.

### **Background**

In 2001 Cussler and Crusader entered into a contract that contemplated that Crusader would produce films based on Cussler's novels featuring the character Dirk Pitt.

Before the contract was signed, Cussler approved a screenplay for the film "Sahara." The contract provided that Crusader would "not ... change the Approved Screenplay ... without Cussler's written approval exercisable in his sole and absolute discretion." After the contract was signed, Crusader sought to change the approved screenplay, but Cussler rejected the screenplays submitted by Crusader and began writing his own. It was Crusader's refusal to use Cussler's revised screenplay that prompted Cussler to sue Crusader in January 2004.

### **Court of Appeal Opinion**

In considering Crusader's claim of breach of the implied duty of good faith, the court of appeal's opinion cited *Carma Developers (Cal.), Inc. v. Marathon Development California, Inc.*, 2 Cal. 4th 342 (1992), as standing for the proposition that the implied duty cannot vary the express terms of a contract.

But it went on to note that in *Third Story Music, Inc. v. Waits*, 48 Cal.Rptr.2d 747 (Cal. Ct. App. 1995), the court of appeal had pointed out that *Carma* sets up "an apparent inconsistency between the principle

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that the covenant of good faith should be applied to restrict exercise of a discretionary power and the principle that an implied covenant must never vary the express terms of the parties' agreement."

In *Third Story Music*, the court held that "courts are not at liberty to imply a covenant directly at odds with a contract's express grant of discretionary power except in those relatively rare instances when reading the provision literally would, contrary to the parties' clear intention, result in an unenforceable, illusory agreement."

The *Cussler* court cited this rule, holding that because Crusader had received consideration under the contract regardless of how Cussler exercised his discretion, in that Crusader had the right to use the approved screenplay to produce the film, it followed that the contract was not illusory, even if Cussler had acted unreasonably in withholding approval of a different screenplay. And because the contract wasn't illusory, the implied duty of good faith didn't apply.

The court of appeal also noted that the parties clearly understood the difference between "absolute" and "reasonable" discretion because another provision of the contract prohibited Crusader from "unreasonably" withholding approval of Cussler's public statements regarding the film Sahara.

### ***Problems with the Caselaw***

The illogic underlying the California caselaw begins with the two branches of the *Carma* court's analysis: First, it held that "[t]he covenant of good faith finds particular application in situations where one party is invested with a discretionary power affecting the rights of another." But second, it also held that "implied terms should never be read to vary express terms."

As noted in *Third Story Music*, those two elements are inconsistent: The discretion to which the implied duty applies can only have been granted by means of an express term, so it doesn't make sense to say that the implied duty cannot vary express terms. The *Carma* standard doesn't work.

The court in *Third Story Music* attempted to reconcile the inconsistency in the *Carma* standard, but the rule it stated doesn't make sense either. Unfettered discretion can indeed render a contract illusory. But parties are routinely granted discretion with respect to aspects of a contract that have no bearing on the consideration supporting that contract. To say that a party is free of the implied duty of good faith once a contract is supported by consideration is to drastically, and arbitrarily, limit the scope of the implied duty.

To the illogic of *Carma* and *Third Story Music*, the *Cussler* court added its own. That another provision in the contract between Crusader and Cussler prohibited Crusader from "unreasonably" withholding approval serves only to underscore that which is inarguably the case—that the provision at issue is not subject to a reasonableness standard. Use of an explicit reasonableness standard in the other provision has no bearing on application of the implied duty of good faith to the provision at issue—a reasonableness standard is different from, and more exacting than, a good-faith standard.

### ***Redundancy Mistaken for Waiver***

If you allow a party to skirt the implied duty of good faith by using a special form of language of discretion, then any party that accepts that language is in effect waiving the benefit of the implied duty. But another problem with the California caselaw on the implied duty is that courts may have been too quick to regard a given provision as effecting such a waiver.

It's commonplace for language of discretion to include the phrase *at its discretion*. But it's tautological—if you're granting discretion to a party, it's redundant to say that the party may exercise that discretion *at its discretion*.

And the word *sole* doesn't add anything—a grant of discretion to a party is necessarily to that party only. And *absolute* too is redundant if nothing in the contract language otherwise suggests that the grant is conditional.

So the phrase at issue in the *Cussler* case—*at its sole and absolute discretion*—looks like just the sort of redundancy that's a hallmark of traditional contract prose. It's likely that many contract parties are unaware that *at its sole and absolute discretion* has been construed to mean, in effect, “even if [the party in question] does so in bad faith.” That sort of surprise can readily lead to a dispute, and may have done in the *Cussler* case.

### ***Making Waivers Unenforceable***

Given that California caselaw fails to offer a principled basis for determining when the implied duty of good faith applies to a given contract provision, and given that the language acknowledged by California courts as effecting a waiver of the implied duty is far from clear, a different approach is required.

This article proposes that California courts (1) hold that waivers of the implied duty of good faith are unenforceable and (2) decide whether to apply the implied duty to a given provision based on the expectations of the parties, as indicated by how specific that provision is.

Regarding the first element, having a party waive the benefit of the implied duty in a given provision would spare the other party the risk of having its exercise of discretion challenged as lacking good faith. But that certainty comes at a steep cost, in that allowing contract parties to exercise discretion in bad faith does nothing to enhance contract relations. A disgruntled party could use the other party's waiver of the implied duty as license to sabotage the transaction—that may well have been Cussler's intention in rejecting Crusader's screenplays. By holding that waivers of the implied duty of good faith are unenforceable, California courts would help ensure basic fairness in contract relations.

### ***Determining Party Expectations***

Determining whether the implied duty of good faith applies to a party's exercise of discretion requires a standard that avoids the contraction inherent in the *Carma* analysis. No black-and-white rule is possible—instead, courts would be required to make a reasoned attempt at ascertaining the expectations of the parties.

When in a contract Party A has discretion to act in a given manner, it might be that exercise of that discretion would be contrary to the interests of Party B. If the action in question is described with specificity, or if the contract specifies circumstances under which Party A may take the action in question, then it would be reasonable to conclude that Party B had made an informed decision to allow Party A to take the action in question and that the consequences of that action had been reasonably foreseeable. It would follow that it wouldn't be reasonable to apply the implied duty of good faith so as to prevent Party A from taking that action.

A good example of such a specific grant of discretion is the contract language at issue in *Carma*—a provision in a commercial lease allowing the lessor to terminate the lease and recapture the leasehold if the lessee notifies the lessor that it wishes to sublet or assign the lease.

But a contract might provide few or no constraints on a party's exercise of discretion. That's particularly likely when the discretion is exercisable with respect to all future occurrences of a given event or circumstance. The more open-ended a given grant of discretion, the less likely it is that the consequences of unfettered exercise of that discretion had been reasonably foreseeable, and the less likely it is that the parties had had in mind that the party exercising discretion would be unconstrained by any notion of good faith. And the more sense it would make for a court to read into the contract the implied duty of good faith with respect to exercise of that discretion.

The discretion granted Cussler with regard to approving changes represents just such an open-ended, generalized grant of discretion, making it a good candidate for application of the implied duty.

This proposed standard may be what the *Carma* court had in mind—that the implied duty of good faith applies to a party's exercise of discretion unless the express terms of a contract (ignoring any waiver of the implied duty of good faith) supply sufficient detail as to make it reasonable to conclude that the parties had contemplated the exercise of discretion at issue.

### ***Not Just California***

So California caselaw on waiver of the implied duty of good faith is flawed. It would make more sense to hold that waivers of the implied duty of good faith are unenforceable, leaving courts to decide whether to apply the implied duty of good faith to a given provision based on the expectations of the parties, as indicated by how specific that provision is. This recommendation would also apply to those jurisdictions with caselaw on waiver of the implied duty of good faith resembles California's.