

Limiting Implied Duties and Terms in Commercial Contracts: Key Cases and Strategies to Minimize Risk

Incorporation, Merger, Choice-of-Law, Sole Discretion, Good Faith and Fair Dealing, and Additional Exclusion Clauses

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Limiting Implied Duties and Terms in Commercial Contracts

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Familiar Canons of Contract Interpretation

1. The court will not look outside the “four corners” of the contract.
2. When interpreting a contract, the intention of the parties should control and the best evidence of intent is the contract itself.
3. The court will not rewrite the contract to fit its notions of fairness and equity.

Implied Contract Duties and Terms

Impose duties and terms that do not appear on the face of the contract:

1. Outside the “four corners” of the contract.
2. Assumes that the parties intended a result that is not evidenced by the contract itself.
3. Allows the court to impose duties that correspond to common law and statutory principles.

Two Most Common Implied Duties and Terms

1. Implied Duty of Good Faith and Fair Dealing.
 - Parties may not frustrate contract purpose or performance.
2. Implied Incorporation Doctrine.
 - Contract incorporates all existing laws.

Good Faith and Fair Dealing: What is It?

1. Allows parties to act in their own self-interests, but prohibits arbitrary, unreasonable, oppressive, underhanded, fraudulent, or deceitful actions.
2. Do not—
 - Prevent the other party from performing its obligations and receiving the benefit of the agreement
 - Frustrate the overarching purpose of the contract
3. Do—
 - Comply with the spirit, and not just the letter, of the contract
 - Provide such cooperation as necessary for the other party's performance

Implied Duty of Good Faith and Fair Dealing: When does it apply?

- Inherent to every contract, but applied as a “gap-filler” when:
 1. Contract language is ambiguous or does not cover the disputed conduct
 2. A party has discretion to act, but the contract does not designate the scope of that discretion
- Does not apply to contradict or override express terms.
- Courts claim to apply it strictly and narrowly.

Good Faith and Fair Dealing: Rationale

- Give effect to the parties' unstated intent
- Hypothetical bargain
 - What the parties would have agreed to had they thought to negotiate the matter.
 - Presumes that:
 1. Parties intend to achieve purpose or goal of contract.
 2. Parties intend to act reasonably and fairly.

Good Faith and Fair Dealing: Application

1. Ambiguous or incomplete language

- Does the party's particular action or inaction, not expressed in the contract, violate the mutual purpose of the contract?
 - Implied duty to seek financing
 - Implied duty to give notice
 - Implied duty to use reasonable or best efforts

Good Faith and Fair Dealing: Application

2. Contract does designate the scope of discretion.

- Did the party exercise its discretion in bad faith, arbitrarily, or capriciously, such that it was an abuse of discretion?
 - Substantively, is there a reasonable basis for the exercise of discretion?
 - Did the party follow an appropriate process in exercising discretion?
 - Review and consider relevant information?
 - Did the party act fraudulently or deceitfully?
 - Was the party motivated by animus?

Implied Incorporation Doctrine: What is It?

- Existing law is part of every contract.
 - Includes valid, settled, and relevant law of all types—constitution, common law, statutes, regulations, ordinances.
 - Dispute over which law is “relevant” or “applicable” to the contract.
 - Excludes laws enacted after the contract is formed, unless the contract states otherwise.
- Conclusive presumption—cannot be rebutted or overcome.
- Applies even if the contract is unambiguous.

Implied Incorporation Doctrine: Rationale

- **Hypothetical bargain**

- What the parties would have agreed to had they thought to negotiate the matter
- Presumes that:
 1. Every person knows the law
 2. Parties intend to adopt all applicable laws in their contract
- “Parties to a contract are presumed to contract mindful of the existing law and that all applicable or relevant laws must be read into the agreement....’ That principle is itself one of commonsense; even a person with little legal knowledge would be loathe to think that a contract is not subject to existing laws unless they are expressly incorporated.”
 - *Wickman v. Kane*, 766 A.2d 241, 258 (Md. Ct. Spec. App. 2011).

- **State’s police power**

- “Contracts must be read ‘as containing an implied condition that they are subject to the exercise of the state’s regulatory police power. Thus, contracts are deemed to implicitly incorporate the existing law and the reserved power of the state to amend the law or enact additional laws for the public welfare.’”
 - *Smith v. Commonwealth*, 743 E.2d 146, 150 (Va. 2013) (internal citations, quotation marks, and brackets omitted).

Implied Incorporation Doctrine: Opt Out?

- **Majority Rule: Yes.** Actual bargain prevails over hypothetical.
 - “*It is well established that ‘unless the contract provides otherwise, all applicable law in force at the time the agreement is made implicitly forms a part of the agreement without any statement to that effect.’*”
 - *Geller v. Kinney*, 980 N.E.2d 390, 397 (Ind. Ct. App. 2012) (emphasis added). *See also Path to Health, LLP v. Long*, 383 P.3d 1220, 1227 (Idaho 2016); *Williams v. Stone*, 109 F.3d 890, 896 (3d Cir. 1997) (Maryland law); *Metro. Sports Facilities Comm’n v. Gen. Mills, Inc.*, 460 N.W.2d 625, 629 (Minn. Ct. App. 1990); *In re Estate of Patterson*, 381 N.W.2d 109, 116 (Neb. 1986); *S&D Serv., Inc. v. 915-925 W. Schubert Condo. Ass’n*, 478 N.W.2d 478, 483 (Ill. Ct. App. 1985). *See generally* 11 Williston on Contracts § 30:19 (4th ed. 1999) (collecting cases).
- **Minority Rule: No.** State’s police power prevails over all.
 - “The statute is as much a part of the contract . . . even though the parties knew nothing of the statute and did not include the provision *or even though they knew of the legislation and expressly agreed upon the exact contrary.*”
 - *Sterling Eng’g & Const. Co. v. Town of Burrville Hous. Auth.*, 279 A.2d 445, 447 (R.I. 1971) (emphasis added).

Implied Incorporation Doctrine: Pushback

- **Limitations on doctrine**

- Statute is not implied term when it is far afield of matters of normal interest to parties
- Statute is implied term only if it is “self-implementing”
- Contract must incorporate particular laws with specificity; general choice of law provision does not suffice

- **Recent Federal Circuit:** No wholesale incorporation of statutes and regulations.

- Ineffective to provide: “This agreement is subject to the present regulations of the [agency] and to its future regulations not inconsistent with the express provisions hereof.”
- Must expressly state intent to incorporate and identify statutes and regulations.
- Unfair to impose new obligations, with attendant risk and potential liability, by mere implication
 - *Precision Pine & Timber, Inc. v. United States*, 695 F.3d 817, 826 (Fed. Cir. 2010); *Northrop Grumman Info. Tech., Inc. v. United States*, 535 F.3d 1339, 1344-45 (Fed. Cir. 2008); *Earman v. United States*, 114 Fed. Cl. 81, 103-04 (2013, aff’d, 589 Fed. Appx. 991 (Fed. Cir. 2015)).
- But Federal Circuit has not overruled or reconciled other cases applying the implied incorporation doctrine

Implied Contract Terms and Duties: U.C.C.

- **Implied Incorporation Doctrine in the U.C.C.**

- “Unless the context otherwise requires, this Article applies to transactions in goods” (§ 2-102)
- “Contract” defined as “the total legal obligation that results from the parties’ agreement as determined by the [U.C.C.] *as supplemented by any other applicable laws.*” (§ 2-201(b)(12))
- “Agreement” defined as “the bargain of the parties in fact, as found in their language or inferred from other circumstances. . . .” (§ 2-201(b)(3))
- “[S]tatutes are a source of implied contractual terms—the Uniform Commercial Code being the most common such source—just like common law doctrines, such as the duty of good faith, which . . . is read into all contracts.” 337 F.3d 951, 955 (7th Cir. 2003).

- **Good and Fair Dealing in the U.C.C.**

- “Reasonable price” if the price is left open (§ 2-305)
- “Best efforts” in exclusive dealing contracts unless otherwise agreed (§ 2-307)
- Implied warranty of merchantability (§ 2-314)
- Fitness for a particular purpose (§ 2-315)

Implied Contract Duties and Terms: What Can You Do?

- **Merger Clause.**
 - Entire Agreement. The parties hereto agree that: (1) all understandings and agreements made between them are merged into this agreement, which fully and completely expresses their agreement; and (2) all prior agreements between the parties are superseded by this agreement, which integrates all promises, agreements, conditions, and understandings between the parties.
- **Limitation of Duties.**
 - The [party] undertakes to perform such duties and only such duties as are specifically set forth in this agreement, and no implied covenants or obligations shall be read into this agreement against the [party].
- **Amendment only in writing executed by all parties.**
- **Choice of law provision.**
- **Mind the gap.**
 - If a contract party has discretion, designate the scope of discretion.
 - If the parties want to opt out of the implied incorporation doctrine (if allowed), state expressly.
 - If the parties wish to incorporate certain statutes, regulation, ordinances, etc., state expressly.

CHOICE OF LAW

- A **choice of law** provision establishes the substantive law that governs disputes to the agreement.
- **Choice of law** provisions are generally enforced if there is a substantial relationship with selected state and no fundamental policy issues.
- In absence of **choice of law** provision, conflicts of law principles will govern.
- By setting **choice of law** in advance, parties to an agreement avoid disputes down the road on governing law.



CHOICE OF LAW

- Purpose:
 - Provide greater certainty as to which law will apply;
 - Reduce the cost in a dispute that would be associated with determining which law will apply; and
 - Take advantage of the law of certain jurisdictions.



CHOICE OF LAW

- Enforceability:

- Most governing law clauses are enforceable if a connection or **reasonable relationship (nexus) between the chosen jurisdiction and the transaction** can be demonstrated:
 1. Examples: principal place of business of the parties; jurisdiction in which the contract was negotiated.
 2. Some states have statutes that do not require such a nexus (but instead are based upon amount in controversy) (e.g., §5-1401 of the New York General Obligations Law). Some courts have nonetheless required a reasonable nexus.
- A court might disregard in cases against public policy; adhesion contracts, or contract induced by fraud.
- Certain subject matter might be governed by law other than that chosen (e.g., corporate governance, UCC rules relating to secured transactions).



CHOICE OF LAW

- Law selection consideration:
 - Litigation environment of selected state
 - Predictability of state law
 - Enforceability

See *Brown & Brown, Inc. v. Johnson*, 25 N.Y.3d 364 (NY 2015) (New York courts will not enforce otherwise enforceable **choice-of-law** clause if the chosen jurisdiction's law is '**truly obnoxious**' or if the application of the chosen jurisdiction's law violates 'some fundamental principle of justice, some prevalent conception of good morals, some deep-rooted tradition of the common wealth of New York').



CHOICE OF LAW

- Drafting considerations:

- Consider whether the provision should apply only to contractual disputes or if it should also apply to extra-contractual matters such as tort, fraud and statutory claims arising from or related to the agreement.
- If **choice of law** provision should apply to such claims, say so.
- Consider whether there is a need to override **choice of law** rules in provision, due to implied contract terms and/or matters.



CHOICE OF LAW

- What does this look like in practice:

- **Section 8.1: Governing Law**

- The laws of New York govern matters arising under this Agreement.



CHOICE OF LAW

- Potentially improved choice of law provision:
 - **Section 8.1: Governing Law**
 - The laws of New York [(without giving effect to its conflict of laws principles)] govern matters arising out of and relating to this Agreement, including torts.



CHOICE OF LAW

- Additional Practical Points:

- Make clear that the chosen state's **choice-of-law** provisions do not apply.
- Consider whether the selection of law applies to contract claims, as well as extra-contractual claims (e.g., tort).
- Consider whether multiple jurisdictions should be designated, depending upon the subject matter.
- Consider referencing or tracking the language of a **choice-of-law** statute, if applicable.
- Consider addressing conflicts of laws, implied matters, and/or statute of limitations.



CHOICE OF LAW

- **Section 8.1: Governing Law and Forum Selection:** This Agreement is governed by, and is to be interpreted and enforced in accordance with, the internal Laws of the State of [New York] applicable to contracts entered into and performed entirely within the State of [New York] [(pursuant to Section 5-1401 of the New York General Obligations Law)], without giving effect to any **choice of law** or **conflict of laws** rules or provisions (whether of the State of [New York] or any other jurisdiction) that would cause the application of the Laws of any jurisdiction other than the state of [New York]. [The Parties acknowledge that (a) this Agreement was negotiated by or on behalf of the Parties, in whole or in part, in the State of New York, (b) the Parties are delivering this Agreement in the State of New York, and (c) the State of New York has a substantial relationship to Parties and to the Transactions.]



LESSON OF IMPLIED CONTRACT CASES

- Lesson One: Doctrine is inescapable; drafters must assume that it will apply to their contracts.

This is especially true when the contract is in the area of a highly regulated industry or profession.



LESSONS OF IMPLIED CONTRACT CASES

- Lesson Two: Generally, statutes enacted **after** contract formation have no bearing on the rights of parties to contracts because parties are not expected to foresee changes in legislation.
- Drafting Tip: Consequently, if you want to incorporate subsequently enacted legislation into an agreement, you must explicitly provide for such incorporation (opt-in).



LESSONS OF IMPLIED CONTRACT CASES

- Exception: The state's police power is an inherent element of every contract. Therefore, the state's authority – and its law effectuating that authority – are NOT governed by the after-enacted limiting principle.



LESSONS OF IMPLIED CONTRACT CASES

- Lesson Three: Courts find the incorporation of “all applicable laws” or “all applicable regulations” nearly useless – and it leaves your contract open to an allegation of vagueness and/or ambiguity.
- Court of Federal Claims noted such a formulation “would seem to necessarily produce considerable indefiniteness as to the parties’ respective obligations under the contract”.
- Drafting Tip: Choose relevant laws or regs to incorporate, then opt-out of others.



LESSONS OF IMPLIED CONTRACT CASES

- Lesson Four: The UCC, especially Article 2, integrates the implied incorporation doctrine. As such, a contract governed by the UCC is the total legal obligation that results from the parties' agreement as determined by the UCC **as supplemented by other applicable law**.
- Drafting Tip: Thus, you must always assume that the UCC's implied terms and other statutorily supplied terms will apply to a contract governed by the UCC. If you want to exclude them, you must opt-out.



LESSON OF IMPLIED CONTRACT CASES

- Lesson Five: Courts engage in implied incorporation creep outside of the UCC. Vigilance is required to prevent a court from one day to say that the contract has a gap – and that it knows just the implied term to fill that gap. Generally, such gap fillers are driven by concerns of “fairness” and an unwillingness by courts to impose performance on a party which was not bargained for.
- Drafting Tip: Contracts need to be read with any eye to whether there are any gaps that need to be explained – especially when a contract calls for performance which is usual or unexpected. Courts will be skeptical.



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