

## ARIZONA SUPREME COURT EXPANDS DUTY OF GOOD FAITH IN CONTRACTS

By Keith Hendricks

Arizona courts have long held that every contract contains an implied duty to act in good faith and with fair dealing. In a case arising out of the Mercado project in downtown Phoenix, Arizona, the Arizona Supreme Court recently re-emphasized and expanded this implied duty. Under the expansion of the implied duty of good faith, a party can now allege a breach of contract where the other side takes an action inconsistent with risks allegedly assumed in a contract, or for reasons inconsistent with the other party's justified expectations. Such allegations are controlled by the facts of the transaction, and not necessarily the language of any documents. In addition, a party's reasonable expectations under a contract are important in determining whether there is a breach.

The Supreme Court's decision was announced in the case Wells Fargo Bank v. Arizona Laborers, Teamsters and Cement Masons Local No. 395 Pension Trust, 201 Ariz. 474, 38 P.3d 12 (2002). This case arises out of financing for the Mercado project.

In the late 1980's, a developer approached a bank to seek financing for the project. The bank agreed to provide construction financing as long as there was a permanent loan commitment in place. A permanent loan commitment was obtained from various pension funds. Under the permanent loan commitment, the pension funds could decline to close on the loan if the developer failed to pay its debts as they became due, or defaulted on any other loan obligations. At the bank's request, the developer, the pension funds, and the bank entered into a tri-party agreement. Under the tri-party agreement, the bank was authorized to volunteer information regarding developer's well-being to the pension funds, but the bank was not obligated to provide this financial information.

As the construction on the Mercado was completed, developer's real estate ventures and general financial condition deteriorated. Neither developer nor the bank disclosed this deterioration to the pensions funds. It was alleged in the lawsuit that the bank knew developer was providing false information to the pension funds and that by not disclosing the deteriorating financial condition, the bank actually helped developer defraud the pension funds.

In proceedings before the trial court, the bank argued that under its contract and common law it was not obligated to provide the pension funds with any information regarding developer's finances. The trial court agreed and dismissed the pension funds' claims. The Arizona Court of Appeals also agreed with this position and affirmed the trial court's action. The case was then brought to the Supreme Court. The Arizona Supreme Court disagreed, holding that the allegations in the complaint stated a claim for: (1) aiding and abetting a fraudulent act; (2) breaching the implied covenant of good faith and fair dealing; (3) interfering with contractual relations; and (4) fraudulently concealing material information. The Arizona Supreme Court ruled that the pension funds were entitled to present these claims to a jury. Notably, in ruling on the implied covenant of good faith and fair dealing, the Arizona Supreme Court expanded prior-existing doctrine.

Prior to the Wells Fargo case, the implied covenant of good faith and fair dealing was described by the courts as a doctrine that prohibits “a party from doing anything to prevent other parties to the contract from receiving the benefits and entitlements of the agreement.” See Rawlings v. Apodaca, 151 Ariz. 149, 153-54, 726 P.2d 565, 569-70 (1986). Because the tri-party agreement provided that the bank was not obligated to provide information to the pension funds, the bank argued it could not breach an implied duty of good faith when it failed to provide this information. The Supreme Court held that even if the bank did not breach the literal language of the contract, a jury could find that the bank breached the implied duty of good faith if it acted for a reason outside the risks assumed by the pension funds, or for reasons inconsistent with the pension funds’ justified expectations.

The Wells Fargo case thus states a new test to determine if there is a breach of the implied duty of good faith. The Court held that where one party “wrongfully exercises the contractual power for a reason beyond the risks that the [other party] assumed, or for a reason inconsistent with the [other party’s] justified expectations,” there could be a breach of the implied duty of good faith.

The Wells Fargo case makes it clear that the party’s reasonable expectations under a contract are important in determining whether there is a breach. If a party to a contract acts unfairly, or in a manner inconsistent with the other side’s reasonable expectations, then there may be a claim of a breach of the implied covenant of good faith even if there is no violation of a specific provision of the agreement.

Because the question of whether there has been a violation of the implied duty of good faith is primarily a factual question, it will probably now be more difficult to obtain a ruling from a judge as to whether there has been a breach of contract before the case is set for a jury trial. As such, it is now more important than ever for a party to be able to demonstrate that it has objectively acted in good faith with regard to the other party in a contract and that it has acted in a manner consistent with the other party’s justified expectations. For more information, please contact Keith Hendricks at 602-916-5000.