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# The Splintering of the Implied Covenant of Good Faith and Fair Dealing in Illinois Courts

*Honorable Howard L. Fink \**

## I. INTRODUCTION

One of the most fundamental reasons that Illinois courts face problems or failures when attempting to resolve contractual disputes stems from courts underutilizing the implied covenant of good faith and fair dealing. The implied covenant mandates that every party to a contract use “good faith and fair dealing in its performance and its enforcement” of the contract.<sup>1</sup> Specifically, Illinois courts are splintered about not only the correct remedy, but also about whether there should be a remedy at all when a contracting party fails to carry out its promises in good faith.<sup>2</sup> Fortunately, some Illinois courts do recognize the relatively new concept that a remedy exists for a breach

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1. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). It should be noted at the outset that the Restatement does not limit the applicability of the implied covenant to any particular type of contract. Rather, the implied covenant applies to all contracts. While some Illinois courts find an implied covenant of good faith and fair dealing in every contract, others indicate that the covenant can be expressly disavowed. *Cf. Sinclair v. State Bank*, 566 N.E.2d 44, 47 (Ill. App. Ct. 4th Dist. 1991) (citing *Washburn v. Union Nat'l Bank & Trust Co.*, 502 N.E.2d 739, 743 (Ill. App. Ct. 3d Dist. 1986) with *American Fidelity Fire Ins. Co. v. General Ry. Signal Co.*, 540 N.E.2d 557, 561 (Ill. App. Ct. 1st Dist. 1989) (citing *Dayan v. McDonald's Corp.*, 466 N.E.2d 958, 971 (Ill. App. Ct. 1st Dist. 1984)). It appears, however, that no case upholds a party's express disavowal of good faith. Moreover, the implied covenant only covers parties performance and enforcement of a contract. By its very wording, the covenant does not apply to the existing law of contracts relating to contract formation. *See Market St. Assocs. v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991). Illinois has codified the covenant of good faith only in the adoption of the Uniform Commercial Code. The Illinois statute reads: “Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” 810 ILL. COMP. STAT. ANN. 5/1-203 (West 1993).

2. *See infra* Part II.A.2 (discussing the differing applications of the covenant in the insurance context).

of the implied covenant of good faith and fair dealing.<sup>3</sup> That concept, however, struggles upstream against the understandable resistance of courts to the creation of tort remedies for breach of the implied covenant that may undermine other, more established, principles of contract law.<sup>4</sup>

This article discusses Illinois courts' use of the implied covenant of good faith and fair dealing in contracts. It begins by reviewing the initial adoption of the implied covenant in Illinois as a basis for relief in insurance disputes<sup>5</sup> and then traces courts' applications of the covenant in other contexts.<sup>6</sup> This article then discusses how the obligation of good faith and fair dealing in contract enforcement has been overlooked in Illinois.<sup>7</sup> Next, it describes a method of analysis which will help Illinois courts in determining whether a party's action or inaction constitutes a breach of the implied covenant.<sup>8</sup> In doing so, this article suggests that the implied covenant should be extended to all contractual relations.<sup>9</sup> If Illinois courts use a common vocabulary and recognize that the implied covenant supplements, rather than displaces, long accepted principles of contract law, this article maintains that they can develop a cohesive body of law to supply a remedy for bad faith breaches of contracts<sup>10</sup> Finally, this article concludes that the implied covenant of good faith and fair dealing should be an enforceable duty imposed on each contract party to both perform its promises and resolve any disputes, thereby ensuring that the performance of the contract meets each party's original expectations.<sup>11</sup>

## II. A HISTORY OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING IN ILLINOIS

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3. See, e.g., *Sinclair*, 566 N.E.2d at 47 (recognizing that the duty of good faith and fair dealing exists in every contract); *Borys v. Josada Builders*, 441 N.E.2d 1263, 1266 (Ill. App. Ct. 1st Dist. 1982) (noting that contracting parties always have a duty to perform the contract in good faith).

4. See *Foy v. City of Chicago*, 551 N.E.2d 310, 313 (Ill. App. Ct. 1st Dist. 1990) (refusing to apply the implied covenant of good faith and fair dealing to an employment-at-will contract); *Harrison v. Sears, Roebuck & Co.*, 546 N.E.2d 248, 256 (Ill. App. Ct. 4th Dist. 1989) (declining to expand Illinois law to allow punitive damages for an alleged breach of the implied covenant of good faith and fair dealing).

5. See *infra* Part II.A.

6. See *infra* Part II.B.

7. See *infra* Part III.

8. See *infra* Part IV.A.

9. See *infra* Part IV.B.

10. See *infra* Part V.

11. See *infra* Part VI.

Illinois' initial articulation that the implied covenant of good faith and fair dealing exists arose in the insurance context. Beginning from the idea that insurers and insureds have a special relationship mandating a requirement of good faith and fair dealing, Illinois courts have also explored the implied covenant's applications in other relationships. Courts have failed to reach a consensus, however, as to the implied covenant's function.

*A. Insurance Cases – The Initial Application of the Implied Covenant of Good Faith and Fair Dealing*

The context of insurance contracts is significant in triggering the imposition of liability upon insurers using the implied covenant of good faith and fair dealing. The implied covenant is appropriate in the insurance context because of several factors present in most insurance contracts. Generally, (1) the insured enters the contract to obtain peace of mind and security;<sup>12</sup> (2) the insured seeks protection from loss and calamity rather than commercial advantage;<sup>13</sup> (3) the bargaining power of the two parties is "inherently unbalanced" because of the "adhesive nature" of the insurance contract;<sup>14</sup> and (4) insurers are suppliers of a vital service which is quasi-public in nature.<sup>15</sup> Thus, insurers hold themselves out as fiduciaries.<sup>16</sup> In light of this fiduciary relationship between insurers and insureds, courts have determined that insurers are bound by a duty of good faith and fair dealing.

*1. Ledingham v. Blue Cross Plan for Hospital Care of Hospital Service Corporation*

In 1975, Illinois recognized that insurers are bound by a duty of good faith and fair dealing. In the seminal case of *Ledingham v. Blue Cross Plan for Hospital Care of Hospital Service Corporation*,<sup>17</sup> the Illinois Appellate Court held that the implied covenant of good faith and fair dealing is an independent cause of action in both contract and tort for an insurance company's breach of its duty to deal fairly with

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12. See Sandra Chutorian, Note, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 377, 383 n.35 (1986) (citing *Egan v. Mutual of Omaha Ins. Co.*, 620 P.2d 141, 145 (Cal. 1979)).

13. See *id.* (citing *Egan*, 620 P.2d at 145).

14. See *id.* (citing *Egan*, 620 P.2d at 146).

15. See *id.* (citing *Egan*, 620 P.2d at 146).

16. See *id.* (citing *Egan*, 620 P.2d at 146).

17. *Ledingham v. Blue Cross Plan for Hosp. Care of Hosp. Serv. Corp.*, 330 N.E.2d 540 (Ill. App. Ct. 5th Dist. 1975), *rev'd on other grounds*, 356 N.E.2d 75 (Ill. 1976).

the insured.<sup>18</sup>

In its analysis, the *Ledingham* court extensively reviewed and then followed California case law,<sup>19</sup> noting, "[c]learly then it seems there is

18. See *id.* at 548.

19. See *id.* at 546-47 (citing *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. Ct. App. 1967) (recognizing that a health insurer's relationship with a policy holder gives rise to implied duties, the breach of which would trigger tort liability)). Although this article focuses on the status and progress of the implied covenant of good faith and fair dealing in Illinois, the early development of the implied covenant occurred principally in New York and California. See *Comunale v. Traders & General Ins. Co.*, 328 P.2d 198, 200 (Cal. 1958) ("There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything that will injure the right of the other to receive the benefits of the agreement."); *Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E.163, 167 (N.Y. 1933) ("[I]n every contract there is an implied covenant that 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, which means that in every contract there exists an implied covenant of good faith and fair dealing.").

Notably, the New York court's statement in *Kirke La Shelle* contains no limitation restricting application of the covenant to insurance contracts or to instances when any other special or fiduciary relationship exists between contract parties. See *Kirke La Shelle Co.*, 188 N.E.2d at 167. Additionally, California courts initially refused to expand the implied covenant of good faith and fair dealing into the commercial realm. See *Glendale Fed. Sav. & Loan Ass'n v. Marina Heights Dev. Co.*, 135 Cal. Rptr. 802, 822 n.8 (Cal. Ct. App. 1977) ("While a breach of the implied covenant of good faith and fair dealing gives rise to a cause of action sounding in tort in the insurance field, we are not aware of any appellate court case, and none has been cited, extending that principle to other contractual relationships.") (citations omitted). The California Supreme Court also determined that an implied-at-law duty of good faith might interfere with freedom to contract and thus refused to extend the application of bad faith breach to commercial contracts. See *Seaman's Direct Buying Serv., Inc. v. Standard Oil Co.*, 686 P.2d 1158, 1166-67 (Cal. 1984), *overruled by Freeman & Mills, Inc. v. Belcher Oil Co.*, 44 Cal. Rptr.2d 420 (Cal. 1995), and *overruled in part by Della Pena v. Toyota Motor Sales, U.S.A., Inc.*, 902 P.2d 740 (Cal. 1995). For detailed discussions of *Seaman's*, see Eileen A. Scallen, Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161 (1985) and Comment, *Seaman's Direct Buying Service Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case*, 71 IOWA L. REV. 893 (1986).

Thereafter, in *Crisci*, the California Supreme Court permitted an insured to recover in tort for emotional damages caused by the insurer's breach of the implied covenant of good faith and fair dealing. See *Crisci*, 426 P.2d at 179. Since then, California has been a leader in the development of the theory of the covenant of good faith and fair dealing in the insurance field and in the creation and extension of the concept of the "contort." See Matthew J. Barrett, Note, "Contort": *Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts – Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510, 510 (1985). A "contort" allows a plaintiff the opportunity to sue both for contract damages and also for tort damages for alleged tortious breaches of the implied covenant of good faith and fair dealing. See generally Barrett, *supra* (reviewing case law in states other than Illinois and arguing against the extension of the covenant of good faith and fair dealing by the acceptance of the contort); Chutorian, *supra* note 12 (arguing that the cause of action in tort for breach of the implied covenant of good faith and fair dealing is an improper solution to the issues

an implied-in-law duty of good faith and fair dealing in California, and we are persuaded the same duty should and does obtain in Illinois.”<sup>20</sup> Overall, the court established that the implied covenant imposes affirmative duties on contract parties—the violation of which is both a breach of contract and a tort.<sup>21</sup>

## 2. Illinois’ Response to *Ledingham*

Despite the *Ledingham* court’s initial articulation of the implied covenant of good faith and fair dealing as a basis for relief in the insurance context, some Illinois courts have not accepted the implied covenant. Moreover, even within the courts that accept the covenant, opinions still differ as to its implications. For example, some Illinois courts recognize the covenant as a legal ground for relief.<sup>22</sup> Other

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of inadequate compensation and bad faith conduct in the performance and termination of contracts); Michael H. Cohen, Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CAL. L. REV. 1291 (1985) (discussing and examining California’s development of the “contort”); Scallen, *supra* (arguing the denial of contract formation is a variation of the tortious breach of the implied covenant of good faith and fair dealing and does not give rise to separate tort liability).

20. *Ledingham*, 330 N.E.2d at 547. Further, in deciding whether an implied duty of good faith and fair dealing exists in Illinois, the *Ledingham* court also looked to *Krutsinger v. Illinois Casualty Co.*, which held that an insurer can be guilty of bad faith by arbitrarily refusing to effect a settlement within policy limits. *See id.* (citing *Krutsinger v. Illinois Cas. Co.*, 141 N.E.2d 16, 21 (Ill. 1957)). Moreover, in a later case, the Illinois Supreme Court stated that when damages are awarded against the insured over the policy limits, the insured can recover the excess amount from the insurer. *See Cramer v. Insurance Exch. Agency*, 675 N.E.2d 897, 903 (Ill. 1996) (analyzing in detail the fate of *Ledingham* in the hands of other Illinois courts). Finally, the First District, in *Dykstra v. Crestwood Bank*, expressed its reluctance to expand the doctrine of good faith and fair dealing into the employment-at-will context. *See Dykstra v. Crestwood Bank*, 454 N.E.2d 51, 55 (Ill. App. Ct. 1st Dist. 1983); *see also* *Disario v. Enesco Imports Corp.*, 520 N.E.2d 766, 767 (Ill. App. Ct. 1st Dist. 1987) (holding that the circumstances involved in the firing of an employee did not rise to the level necessary for a tortious breach of the implied covenant of good faith and fair dealing).

21. *See Ledingham*, 330 N.E.2d. at 548.

22. *See Cummings v. Beaton & Assocs.*, 618 N.E.2d 292, 305 (Ill. App. Ct. 1st Dist. 1992) (citing *Hansen v. Johnston*, 249 N.E.2d 133, 137 (Ill. App. Ct. 2d Dist. 1969)) (noting that the “wrongful prevention doctrine” is a corollary to the implied covenant of good faith and fair dealing; thus, in situations where the performance of an agreement becomes impossible due to the willful acts of a party, the agreement to pay becomes absolute); *Sinclair v. State Bank of Jerseyville*, 566 N.E.2d 44, 47 (Ill. App. Ct. 4th Dist. 1991) (citing *Washburn v. Union Nat’l Bank & Trust Co.*, 502 N.E.2d 739, 743 (Ill. App. Ct. 3d Dist. 1986)) (“It is clear that in Illinois there is an implied covenant of fair dealing and good faith in every contract.”); *American Fidelity Fire Ins. Co. v. General Ry. Signal Co.*, 540 N.E.2d 557, 561 (Ill. App. Ct. 1st Dist. 1989) (explaining that, absent express disavowal, the covenant is implied in every contract and that “[t]his principle is demonstrated in a series of Illinois cases examining the duty of a contracting party to use reasonable efforts to bring about a condition precedent”);

courts, however, have held that the implied covenant cannot serve as an independent and enforceable source of duties for contract parties.<sup>23</sup> These courts maintain that the covenant is only meant to be used as a rule of construction when a contract's terms are ambiguous.<sup>24</sup>

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DeKalb Bank v. Purdy, 520 N.E.2d 957, 966 (Ill. App. Ct. 2d Dist. 1988) (holding that it is not inconsistent to find lack of good faith although no fraud occurred); Borys v. Josada Builders, 441 N.E.2d 1263, 1266 (Ill. App. Ct. 1st Dist. 1982) ("It is well established that every contract contains an implied promise of good faith and fair dealing between the contracting parties.").

23. See *Baxter Healthcare Corp. v. O.R. Concepts, Inc.*, 69 F.3d 785, 792 (7th Cir. 1995) (noting that in Illinois, the covenant of good faith and fair dealing does not impose an independent set of duties on the parties); *Guardino v. Chrysler Corp.*, 691 N.E.2d 787, 793 (Ill. App. Ct. 1st Dist. 1998) (explaining that while every contract contains the implied covenant of good faith, this covenant neither imposes additional duties on the parties nor forms an independent tort as a result of its violation); *Anderson v. Burton Assocs.*, 578 N.E.2d 199, 203 (Ill. App. Ct. 1st Dist. 1991) (holding that the doctrine of the implied covenant of good faith is to be used only for ascertaining the parties' intent and not as a basis for independent tort liability); see also *MacDonald-Smith v. FMC Corp.*, No. 89-2280, 1990 U.S. App. LEXIS 7131, at \*19 n.4 (7th Cir. April 30, 1990) (holding that Illinois law does not recognize a cause of action arising from the implied duty of good faith and fair dealing); *Medina v. Spotnail, Inc.*, 591 F. Supp. 190, 196-97 (N.D. Ill. 1984) (noting that generally a corporate officer cannot be held liable for the tortious interference with one of the contracts entered into by the corporation). Even federal courts are split on application of the implied covenant as an independent basis of recovery. Compare *LaSalle Nat'l Bank v. Metropolitan Life Ins. Co.*, 18 F.3d 1371, 1375 (7th Cir. 1994) (holding that the implied duty of good faith does not modify contractual provisions which define the duties of the parties to a contract and is not an independent source of contractual or legal duties) with *Oil Express Nat'l, Inc. v. Burgstone*, 958 F. Supp. 366, 369 (N.D. Ill. 1997) (explaining that breach of the implied covenant of good faith and fair dealing contained in Illinois contracts may give rise to a cause of action if one party is given broad discretion in performing the contract and abuses such discretion in bad faith). See also *Cutchin v. Wal-Mart Stores*, Nos. 95-2152, 95-2514, 1996 U.S. App. LEXIS 6314, at \*3-4 (7th Cir. March 19, 1996) (noting that under Illinois law, the implied covenant does not impose additional duties on contract parties).

24. See *Guardino*, 691 N.E.2d at 793 (explaining that the implied covenant of good faith is not an independent source of obligation for the contracting parties); *Northern Trust Co. v. VIII South Mich. Assocs.*, 657 N.E.2d 1095, 1104 (Ill. App. Ct. 1st Dist. 1995) (citing *Resolution Trust Corp. v. Holtzman*, 618 N.E.2d 418, 424 (Ill. App. 1st Dist. 1993)) (finding that the obligation of good faith and fair dealing is "essentially used to determine the intent of the parties where a contract is susceptible to two conflicting constructions."); *Abbott v. Amoco Oil Co.*, 619 N.E.2d 789, 795 (Ill. App. Ct. 2d Dist. 1993) (noting that the implied covenant of good faith in a contract can be used as a construction tool in determining the parties' intent); *Continental Mobile Tel. Co. v. Chicago SMSA Ltd. Partnership*, 587 N.E.2d 1169, 1174 (Ill. App. Ct. 1st Dist. 1992) (looking to contract terminology to determine whether the plaintiff asserted a cause of action under the implied duty of good faith and fair dealing); *Anderson*, 578 N.E.2d at 203 (emphasizing that the primary use of the implied covenant of good faith is as a construction tool for deciding the parties' intent); *Martindell v. Lake Shore Nat'l Bank*, 154 N.E.2d 683, 690 (Ill. 1958) (stating that every contract imposes a good faith and fair dealing obligation between parties and "where an instrument is susceptible of two conflicting constructions, one which imputes bad faith to one of the parties and the

Further, the way courts apply the covenant often depends on the context of the case. For example, although the First District agrees that the same conduct may give rise in some cases to both tort and contractual theories of recovery, it does not allow a “tort remedy based on an employer’s ‘bad faith’ breach of an implied contract covenant of fair dealing” in at-will employment cases.<sup>25</sup> In other cases, Illinois courts have recognized that the covenant can serve as the basis for an action but have refused to extend the covenant’s use as a source of legal liability beyond the insurance setting.<sup>26</sup>

### 3. The Illinois Insurance Code’s Potential Preemption of the Implied Covenant

Along with courts, the Illinois legislature has also recently reacted to insurance companies’ potential use of bad faith. In 1986, Illinois amended its Insurance Code<sup>27</sup> to allow limited remedies when an insurance company’s refusal to satisfy an insured’s claim is found unreasonable and vexatious.<sup>28</sup> Since this amendment, Illinois courts

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other does not, the latter construction should be adopted.”). It may be that the *Martindell* decision has caused confusion when applied in post Second Restatement cases. The *Martindell* case treats the implied covenant between the parties as a valid rule of construction and considers it a guide to judicial decision makers and others who are called upon to interpret the parties’ express or implied agreement. See *Martindell*, 154 N.E.2d at 691.

To limit application of the covenant to a rule of interpretation, however, flies in the face of its plain meaning. Indeed, the Second Restatement of Contract’s definition of the implied covenant specifically restricts the covenant of good faith and fair dealing to “performance” and “enforcement.” See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); see also *Market St. Assocs. v. Frey*, 941 F.2d 588, 594 (7th Cir. 1991). In *Market Street Associates*, Judge Posner indicates that a party can make a binding contract to purchase something the party knows the seller undervalues. See *id.* Specifically, Judge Posner stated, “[t]hat of course is a question about formation, not performance, and the particular duty of good faith under examination relates to the latter rather than to the former.” *Id.*

25. *Martin v. Federal Life Ins. Co.*, 440 N.E.2d 998, 1006 (Ill. App. Ct. 1st Dist. 1982) (noting that an employer’s breach of contract may give rise to an independent tort but only in “extreme” cases).

26. See *Koehler v. First Nat’l Bank of Louisville*, 597 N.E.2d 1261, 1264 (Ill. App. Ct. 5th Dist. 1992) (citing *Martin v. Federal Life Ins. Co.*, 440 N.E.2d 998, 1006 (Ill. App. Ct. 1st Dist. 1982)) (“Care must be taken to prevent the transmutation of every breach of contract into an independent tort action through the boot-strapping of the general contract principle of good faith and fair dealing.”); *Harrison v. Sears, Roebuck & Co.*, 546 N.E.2d 248, 255 (Ill. App. Ct. 4th Dist. 1989) (looking to the Second and Fifth Districts of Illinois as well as to federal decisions for guidance on whether the implied covenant of fair dealing is operative in the employee at-will context).

27. 215 ILL. COMP. STAT.. 5/155 (West 1993) (amended 1986).

28. See *id.* Specifically, section 5/155 states:

In any action by or against a company wherein there is in issue the liability of a company on a policy or policies of insurance of the amount of the loss



have come to different conclusions in determining whether the statute can preempt a common law claim of breach of the implied covenant of good faith and fair dealing. In a case against a health maintenance insurance organization, for example, the Fourth District found that the statute does not prevent an insured from maintaining a common law action seeking compensatory damages for an insurer's unreasonable delay in the settlement of an insured's benefits claim.<sup>29</sup> In contrast, the First District has held that the Insurance Code preempts an insured's claim against his insurer for common law breach of the implied covenant.<sup>30</sup> Further, regarding damages, the Fifth District has retreated from its original decision in *Ledingham*<sup>31</sup> that a court may award punitive damages in a "proper case" of breach of the implied covenant.<sup>32</sup> Specifically, in *Kohlmeier v. Shelter Insurance Co.*,<sup>33</sup> the Fifth District explained that, after *Ledingham*, the Illinois Legislature

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payable thereunder, or for an unreasonable delay in settling a claim, and it appears to the court that such action or delay is vexatious or unreasonable, the court may allow as part of the taxable costs in the action reasonable attorneys fees, other costs, plus an amount not to exceed one of the following amounts

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*Id.* § 5/155(1); see also *id.* § 125/5-1 (relating to HMOs). Section 5/155 also applies to HMOs unless the enrollee causes delay by failing to execute a lien. See *id.* § 125/5-1.

29. See *Calcagno v. Personalcare Health Management, Inc.*, 565 N.E.2d 1330, 1339 (Ill. App. Ct. 4th Dist. 1991) (noting that the Illinois Insurance Code provisions do not extend to the recovery of compensatory damages stemming from unreasonable delays in the settlement of insurance claims); *Lynch v. Mid-America Fire & Marine Ins. Co.*, 418 N.E.2d 421, 427-28 (Ill. App. Ct. 4th Dist. 1981).

30. See *Perfection Carpet, Inc. v. State Farm Fire & Cas. Co.*, 630 N.E.2d 1152, 1155 (Ill. App. Ct. 1st Dist. 1994) (relying on legislative intent to decide that a policy holder is limited to remedies provided by the Insurance Code when an insurer withholds policy benefits); see also *Buais v. Safeway Ins. Co.*, 656 N.E.2d 61, 63 (Ill. App. Ct. 1st Dist. 1995) (indicating that the Insurance Code provides the sole remedy for a policy holder bringing a claim of bad faith against its insurance company); *Mazur v. Hunt*, 592 N.E.2d 335, 337 (Ill. App. Ct. 1st Dist. 1992) (noting that the Illinois Insurance Code precludes a claim by the insured against insurer for acting in bad faith); *Hoffman v. Allstate Ins. Co.*, 407 N.E.2d 156, 159 (Ill. App. Ct. 2d Dist. 1980) (explaining that the enactment of the Insurance Code by the legislature preempted any claims against insurers for violations of good faith and fair dealing); *Tobolt v. Allstate Ins. Co.*, 393 N.E.2d 1171, 1180 (Ill. App. Ct. 1st Dist. 1979) (agreeing with the reasoning of other courts that the Illinois Insurance Code is applicable in cases involving a violation of good faith and fair dealing by insurance companies).

31. See *supra* Part II.A.1.

32. The court did not provide any guidance regarding what constitutes a proper case. Rather, it simply held that punitive damages were not proper in that case but might be in another case. See *Ledingham v. Blue Cross Plan for Hosp. Care of Hosp. Serv. Corp.*, 330 N.E.2d 540, 549 (Ill. App. Ct. 5th Dist. 1975), *rev'd on other grounds*, 356 N.E.2d 75 (Ill. 1976). The court reversed the trial court's award of punitive damages because the conduct of the insurer in *Ledingham* did not rise to a level of sufficient gravity to justify a grant of punitive damages. See *id.*

33. *Kohlmeier v. Shelter Ins. Co.*, 525 N.E.2d 94 (Ill. App. Ct. 5th Dist. 1988).

amended section 155 of the Illinois Insurance Code to preempt an award of punitive damages for breach for unfair dealing.<sup>34</sup>

*B. Application of The Implied Covenant of Good Faith And Fair Dealing Outside The Insurance Context*

Several Illinois courts, in a fragmented manner, have extended the use of the implied covenant of good faith and fair dealing beyond the insurance field as an independent basis for relief in contract disputes.<sup>35</sup> By reviewing how the implied covenant has fared in the contractual settings that follow,<sup>36</sup> it is apparent that courts' willingness to accept a breach of the implied covenant of good faith and fair dealing as an independent cause of action depends significantly on the type of relationship between the contracting parties.

1. Real Estate

In the real estate context, Illinois courts are responsible for more than redressing the effects of defective titles to real property or the peaceful eviction of tenants who do not pay their rent. Modern real estate transactions often involve large and complex financing schemes and long-term relationships between not only the contracting parties but also suppliers, brokers, lenders, and customers of the parties. The non-completion of a sale or lease of property may trigger domino-style losses. Thus, contract parties often rely on each other's good faith performance of their promises. The implied covenant of good faith and fair dealing is implicated when a contract or lease gives either or both parties a certain amount of discretion which, if used in bad faith, can result in harm to the other party.

In 1989, the Second District used the implied covenant of good faith and fair dealing to decide a controversy over the right of first refusal clause in a commercial real estate contract.<sup>37</sup> The Second District stated in *Vincent v. Doeber* that, as a matter of law, the implied covenant applies to all contracts unless the parties explicitly state otherwise.<sup>38</sup> Specifically, in *Vincent*, the court resolved the question of whether the plaintiff-tenant, Vincent, had the right to purchase a

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34. See *id.* at 104.

35. See discussion *infra* Parts II.B.1-6.

36. Those contractual settings are: real estate, no-damage-for-delay clauses, non-competition agreements, lender liability, discretionary clauses, and terminable at-will contracts. See *infra* Parts II.B.1-6.

37. See *Vincent v. Doeber*, 539 N.E.2d 856, 862 (Ill. App. Ct. 2d Dist. 1989).

38. See *id.* ("A covenant of good faith and fair dealing is implied in every contract as a matter of law, absent an express disavowal.").

commercial corner he leased in Aurora.<sup>39</sup> Vincent's lease contained a right of first refusal clause in the event the landlord decided to sell the property.<sup>40</sup> The landlord, however, wanted to sell the property to another party and, using his discretion to do so, required that Vincent provide a \$10 million guarantor for a \$225,000 note to exercise the right of first refusal.<sup>41</sup> The court found that the landlord's requirement was not made in good faith and therefore violated the implied covenant.<sup>42</sup> Applying the implied covenant, the court found that "[g]ood faith between contracting parties requires one vested with contractual discretion to exercise it reasonably and not arbitrarily or capriciously, and parties to a contract impliedly promise not to do anything which will destroy or injure the other party's right to receive the fruits of the contract."<sup>43</sup>

In contrast, the First District in *Groshek v. Frainey*<sup>44</sup> held that where a prospective real estate purchaser's contract contained an attorney approval clause, the attorney was not required to either articulate his reasons for rejecting the contract or propose modifications.<sup>45</sup> One explanation for this result is that exercising the

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39. *See id.* at 857.

40. *See id.*

41. *See id.* at 858.

42. *See id.* at 862 (holding "that the owners did not act in good faith when they notified Vincent that he had to provide a \$10 million guarantor to exercise his right of first refusal"); *see also* Case v. Forloine, 639 N.E.2d 576, 581 (Ill. App. Ct. 1st Dist. 1993) (upholding a finding that a prospective purchaser did in fact make a reasonable and good faith effort to obtain financing notwithstanding his failure to submit a written mortgage application but recognizing the applicability of the covenant of good faith); Chemical Bank v. Paul, 614 N.E.2d 436, 442 (Ill. App. Ct. 1st Dist. 1993) (quoting BA Mortgage & Int'l Realty Corp. v. American Nat'l Bank & Trust, 706 F. Supp. 1364, 1376 (N.D. Ill. 1989)) (involving a loan agreement for a large apartment building and stating, "[i]t must be recognized that the implied covenant of good faith reflects a strong public policy judgment."); First Bank & Trust Co. v. Timmons, 567 N.E.2d 778, 781 (Ill. App. Ct. 5th Dist. 1991) (examining how the covenant of good faith fared in a mortgage foreclosure case where the mortgagors filed a counterclaim alleging failure of the mortgagee to procure adequate disability insurance); Likens v. Inland Real Estate Corp., 539 N.E.2d 182, 184 (Ill. App. Ct. 1st Dist. 1989) (noting that "[s]imply because the application did not contain a provision that the lessor will hold a residential space for a prospective lessee does not mean that the lessor is free to act in bad faith by refusing to lease the space should the application be approved. Good faith dealing is implied in every contract.").

43. *Vincent*, 539 N.E.2d at 862 (citing *Foster Enters., Inc. v. Germania Fed. Sav. & Loan*, 421 N.E.2d 1375, 1381 (Ill. App. Ct. 3d Dist. 1981); *Prudential Ins. Co. v. Van Matre*, 511 N.E.2d 740, 746 (Ill. App. Ct. 5th Dist. 1987)).

44. *Groshek v. Frainey*, 654 N.E.2d 467 (Ill. App. Ct. 1st Dist. 1995). In *Groshek*, the plaintiff claimed that the defendants' attorney expressed disapproval of potential zoning problems simply because the defendants had changed their minds. *See id.* at 469.

45. *See id.* at 472.

right to have an attorney legitimately approve a contract does not constitute bad faith. Illinois courts have not determined whether a purchaser could require a seller to evict a current tenant where the purchaser knows that his lawyer will not approve the contract, and is merely trying to obtain a better bargaining position against a weakened seller who is unaware that the contract will not be approved. Such conduct may indeed demonstrate bad faith on the part of the purchaser. In such a case, the use of the implied covenant would provide an otherwise unavailable cause of action for the seller.

## 2. No-damage-for-delay Clauses

In addition to real estate, Illinois courts have applied the covenant of good faith and fair dealing to “no-damage-for-delay” clauses. A no-damage-for-delay clause denies a contractor’s right to recover damages caused by another’s delay.<sup>46</sup> In *J&B Steel Contractors, Inc. v. C. Iber & Sons, Inc.*,<sup>47</sup> the Illinois Supreme Court noted that “[t]he most widely recognized exception to a no-damage-for-delay clause encompasses bad faith, fraud, concealment, or misrepresentation on the part of the party asserting the clause’s operation.”<sup>48</sup> The court declared that “[t]he exception arises from duties of good faith and fair dealing implied in every contract. Its operation is, in that respect, essential to judicial enforcement of the legitimate objects of any agreement. We therefore agree . . . that such an exception should be recognized in Illinois.”<sup>49</sup> Notably, “[o]nly unforeseeable delays and obstructions or those not naturally arising from performance of the work itself or the subject of the contract come within the exception.”<sup>50</sup>

## 3. Defense to the Enforcement of a Non-Competition Clause

The implied covenant of good faith and fair dealing has also been extended to non-competition clauses. Non-competition clauses are included in employment contracts by employers who want to protect their business from competition brought about by departing employees. They generally require that departing employees agree not to compete with the employer after their departure from the business. These provisions, known as covenants not to compete or non-

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46. See Maurice T. Brunner, Annotation, *Validity and Construction of “No Damage” Clause with Respect to Delay in Building or Construction Contract*, 74 A.L.R.3d 187, 196 (1976).

47. *J&B Steel Contractors, Inc. v. C. Iber & Sons, Inc.*, 642 N.E.2d 1215 (Ill. 1994).

48. *Id.* at 1222 (relying on 74 A.L.R.3d at 215-16).

49. *Id.* at 1222 (citation omitted).

50. *Id.*

competition clauses, may be valid if carefully limited in time and geographic scope. The employee is protected against the ex-employer, however, when the employer terminates the employment without cause and then seeks to use the non-competition clause to punish or harm the ex-employee. In Illinois, the implied covenant of good faith and fair dealing is a defense to an ex-employer's attempt to enforce a non-competition agreement. In *Bishop v. Lakeland Animal Hospital*,<sup>51</sup> the Second District held that "the implied promise of good faith inherent in every contract precludes the enforcement of a non-competition clause when the employee is dismissed without cause."<sup>52</sup>

#### 4. Lender Liability

Another area where courts have used the implied covenant is lender situations. Commercial lenders were shocked in 1985 when the United States Court of Appeals for the Sixth Circuit rendered the landmark federal decision, *K.M.C. Co. v. Irving Trust Co.*<sup>53</sup> In *K.M.C.*, the Sixth Circuit held that "there is implied in every contract an obligation of good faith [which may impose upon the lender] a duty to give notice . . . before refusing to advance funds under [a loan] agreement."<sup>54</sup> Lending institutions learned that they must now defend decisions to refuse to continue advancing funds under a loan agreement – decisions in which they formerly had unrestrained discretion.<sup>55</sup> Also, under *K.M.C.*, lenders may have to pay substantial damages if they terminate a commercial loan without giving the other party an adequate opportunity to obtain reasonable alternative financing.<sup>56</sup> The reaction to *K.M.C.* has included widespread

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51. *Bishop v. Lakeland Animal Hosp.*, 644 N.E.2d 33 (Ill. App. Ct. 2d Dist. 1994).

52. *Id.* at 36; *see also* *George S. May Int'l Co. v. Int'l Profit Assocs.*, 628 N.E.2d 647, 655 (Ill. App. Ct. 1st Dist. 1994) (holding that over-broad restrictive covenants cannot be enforced against ex-employees unless the covenants are needed to protect long-standing client relationships).

53. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985).

54. *Id.* at 759. Section 2-309, comment 8 of the Uniform Commercial Code states, "[t]he application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute arrangement." *Id.* (citing U.C.C. § 2-309 cmt. 8 (1989)).

55. *See, e.g.*, Patricia A. Milon, *Recent Development, Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?*, 40 VAND. L. REV. 1197, 1216-17 (1987).

56. *See* Susan D. Gresham, "Bad Faith Breach": A New and Growing Concern for Financial Institutions, 42 VAND. L. REV. 891, 905 (1989) (analyzing the treatment of lender/lendee cases particularly as applicable to the Uniform Commercial Code); *see also* HELEN DAVIS CHAITMAN, THE LAW OF LENDER LIABILITY ¶ 4.01 (1990) (discussing the trend among bank customers to bring suit against lenders and creditors and the emerging

criticism and a search for ways to circumvent or avoid the decision's effects on lenders.<sup>57</sup> The *K.M.C.* decision, however, has also attracted defenders.<sup>58</sup>

In response to *K.M.C.*, Illinois courts have sent a mixed message regarding the existence of an implied covenant of good faith and fair dealing in the lender context.<sup>59</sup> Where the First and Fourth Districts of

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trend among courts to award increasingly high damages); Milon, *supra* note 55, at 1225-26; Chutorian, *supra* note 12, at 378-81 (discussing issues concerning tortious breach of the implied covenant of good faith and fair dealing and offering other possible solutions to commercials acts made in bad faith); Jill Pride Anderson, Comment, *Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 EMORY L.J. 917, 928 (1987) (examining the problems that arise when Uniform Commercial Code notions of good faith are applied to traditional lending contracts).

57. See Werner F. Ebke & James R. Griffin, *Lender Liability to Debtors: Toward A Conceptual Framework*, 40 SW. L.J. 775, 806-16 (1986) (contending that good faith obligations provide no guidelines of legally permissible conduct and are inconsistent with the basic notion of fairness that requires notice be given as to what activities are permissible or prohibited); Loeb H. Granoff, *Emerging Theories of Lender Liability: Flawed Applications of Old Concepts*, 104 BANKING L.J. 492, 513-15 (1987) (asserting that the obligation of good faith has been at times misused by borrowers as "a specious weapon for recovery"); Corey R. Chivers, Note, "Contracting Around" The Good Faith Covenant To Avoid Lender Liability, 1991 COLUM. BUS. L. REV. 359, 382-86 (1991) (discussing the practical problems associated with parties' efforts to contract around court-constructed "default" terms); Mark Snyderman, Comment, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. CHI. L. REV. 1335, 1364-67 (1988) (citing *K.M.C.* as a typical example of a hard case making bad law); see also Christine O. Sloan, *Annual Survey of South Carolina Law (January 1-December 31, 1992): Lender Liability: Express Terms of a Contract Versus the Implied Obligation of Good Faith* (Commercial Law, pt. 3), 45 S.C. L. REV. 28, 36 (1993). Sloan reviews *First Federal Savings & Loan Ass'n v. Dangerfield*, 414 S.E.2d 590 (S.C. App. 1992), which held that a commercial lender did not breach the implied covenant of good faith simply because it did not exercise discretion to lessen the liability of a guarantor in default. See *id.* at 28. Sloan observes that this holding departs from *K.M.C.* but "conforms to the growing national trend not to find a breach of an implied obligation of good faith when the parties follow the express terms of a commercial contract." *Id.*

58. See Kenneth J. Goldberg, *Lender Liability and Good Faith*, 68 B.U. L. REV. 653 (1988). The article reviews *Reid v. Key Bank of Southern Maine*, 821 F.2d 9 (1st Cir. 1987), which "upheld a damage award against a bank that had acted within the letter of its loan agreement with the plaintiff-borrower but had nonetheless . . . acted in bad faith" by abruptly terminating the plaintiff's credit line within three months of entering into the credit agreement without giving adequate notice to the plaintiff or negotiating alternative solutions. See *id.* After a balanced analysis, Goldberg concludes that many cases reveal that lenders, rather than the plaintiff's bar, have been aggressive in their approach to dealing with borrowers. See *id.* at 665-70. Goldberg suggests that the good faith standard is an effective way to police unreasonable lender practices. See *id.* at 672-80. He contends that a good faith standard encompassing both subjective and objective components is the best way to instill fairness in the lender/borrower relationship and still provide certainty for a lender to gauge the acceptability of its practices. See *id.* at 676-78.

59. See, e.g., *Citicorp Savings v. Rucker*, 692 N.E.2d 1319, 1324 (Ill. App. Ct. 1st

the Illinois Appellate Court have followed *K.M.C.* in finding an implied covenant of good faith and fair dealing in lender cases,<sup>60</sup> the Seventh Circuit and the Fifth District have not.<sup>61</sup> For example, in *Chemical Bank v. Paul*, the First District found as a matter of law that a borrower did not waive the defense of bad faith under a waiver clause in a loan agreement and personal guaranty.<sup>62</sup> The court held, “[i]n accordance with the law and the public policy of this State, Chemical Bank was required to act in good faith in enforcing the loan agreements at issue. The exercise of good faith and fair dealing is particularly critical where . . . the bank was granted considerable discretion in the use and application of the funds disbursed.”<sup>63</sup> The court also stated that the strong public policy concerns in this context override any contract provisions.<sup>64</sup>

Even more recently, the First District has shown its commitment to the covenant in lender situations. In March 1998, the First District decided *Citicorp Savings v. Rucker*.<sup>65</sup> In *Citicorp*, Rucker borrowed \$25,000, which he secured by a mortgage on an apartment building

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Dist. 1998), *appeal denied*, 1998 Ill. LEXIS 1178 (Ill. Oct. 6, 1998). In *Citicorp*, the court found that a bank did not breach its implied duty of good faith when a mortgagor failed to insure the mortgaged property, and the bank procured replacement insurance and charged it to the mortgagor's account. When the bank actually charged a monthly premium twelve times greater than the amount represented to the mortgagor, however, the court held the mortgagor stated a cause of action for breach of the implied covenant. *See id.*; *see also* *J & B Steel Contractors Inc. v. C. Iber & Sons Inc.*, 642 N.E.2d 1215, 1222 (Ill. 1994) (recognizing a bad-faith exception to a no-damage-for-delay clause that “arises from duties of good faith and fair dealing implied in every contract”); *Groshek v. Frainey*, 654 N.E.2d 467 (Ill. App. Ct. 1st Dist. 1995) (holding that a party's rejection of a real estate contract containing an attorney-approval clause was proper based on a strict interpretation of the contract's language); *Chemical Bank v. Paul*, 614 N.E.2d 436 (Ill. App. Ct. 1st Dist. 1993) (holding that a guarantor did not waive the implied covenant of good faith in a loan agreement when he signed a waiver of defense agreement); *Sinclair v. State Bank*, 566 N.E.2d 44 (Ill. App. Ct. 4th Dist. 1991) (holding that a debtor's complaint against a bank alleging a breach of the duty of good faith was insufficient because it failed to allege a contractual relationship and specific contractual provisions under which the bank failed to perform in good faith); *Vincent v. Doeber*, 539 N.E.2d 856, 862 (Ill. App. Ct. 2d Dist. 1989) (finding bad faith when the owners of property required the holder of a right of first refusal to provide a monetary guarantee when such a guarantee was not part of the original offer).

60. *Chemical Bank*, 614 N.E.2d at 442; *Sinclair*, 566 N.E.2d at 47.

61. *See* *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1355 (7th Cir. 1990); *Koehler v. First Nat'l Bank*, 597 N.E.2d 1261, 1264 (Ill. App. Ct. 5th Dist. 1992); *see also infra* notes 78-80 and accompanying text (discussing these cases).

62. *See Chemical Bank*, 614 N.E.2d at 442-43.

63. *Id.* at 442.

64. *See id.* (reasoning that the amount of discretion given to the bank by the agreement regarding the use and disbursement of funds required the exercise of good faith and fair dealing).

65. *Citicorp Savings v. Rucker*, 692 N.E.2d 1319 (Ill. App. Ct. 1st Dist. 1998).

that he owned. Rucker allowed the insurance on the building to lapse.<sup>66</sup> In accordance with the previously agreed upon mortgage provisions, Citicorp informed Rucker that it would obtain insurance coverage and charge the premium to Rucker's account.<sup>67</sup> Citicorp obtained the insurance from its own subsidiary, which notified Rucker that the annual premium of \$422 was being charged to Rucker's account.<sup>68</sup> Without notifying Rucker, however, Citicorp actually charged his account \$422 per month, not \$422 per year.<sup>69</sup> Rucker fell behind, attempted to tender the \$422, and only then learned that the overdue sum was \$4,300.<sup>70</sup> Citicorp refused to accept the \$422 tender and treated Rucker as if he was in default.<sup>71</sup> Citicorp filed a foreclosure suit and obtained summary judgment for foreclosure and sale.<sup>72</sup> Rucker then filed a counterclaim alleging Citicorp breached its implied duty of good faith and fair dealing and was therefore liable for negligence and fraud.<sup>73</sup> The circuit court entered an order striking and dismissing the counterclaim.<sup>74</sup>

On appeal, the First District reversed and remanded, stating that the duty of good faith and fair dealing requires a "party vested with contractual discretion to exercise that discretion reasonably and with proper motive, not arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."<sup>75</sup> The court found that Rucker had adequately stated a cause of action for breach of the implied covenant.<sup>76</sup>

The Fourth District has also recognized the implied covenant in the lender context.<sup>77</sup> In contrast, the Fifth District has refused to extend the scope of the duty beyond the insurance and employment fields.<sup>78</sup> Specifically, it has held that a bank customer failed to state a cause of action alleging a breach of the implied covenant of good faith where a

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66. *See id.* at 1321.

67. *See id.* at 1321-22.

68. *See id.* at 1322.

69. *See id.*

70. *See id.*

71. *See id.*

72. *See id.*

73. *See id.*

74. *See id.*

75. *Id.* at 1324.

76. *See id.* at 1325.

77. *See Sinclair v. State Bank*, 566 N.E.2d 44, 47 (Ill. App. Ct. 4th Dist. 1991) (citing *Washburn v. Union Nat'l Bank & Trust Co.*, 502 N.E.2d 739, 743 (Ill. App. Ct. 3d Dist. 1991)).

78. *See Koehler v. First Nat'l Bank*, 597 N.E.2d 1261, 1264 (Ill. App. Ct. 5th Dist. 1992).



bank failed to close a loan at a rate set forth in the commitment memo.<sup>79</sup> Further, the Seventh Circuit Court of Appeals, in an opinion by Judge Frank Easterbrook, also declined to follow *K.M.C.*<sup>80</sup>

### 5. Contracts which Vest a Party with Discretion

Problems involving the obligation of good faith and fair dealing also arise when one party to a contract is given broad discretion in performance.<sup>81</sup> The Second District has held that “good faith between contracting parties requires one vested with contractual discretion to exercise it reasonably and not arbitrarily or capriciously.”<sup>82</sup> Further, the parties “impliedly promise” not to “destroy or injure the other party’s rights to receive the fruits of the contract.”<sup>83</sup>

Although Illinois courts have differed in their application of the covenant of good faith and fair dealing in situations where a party has contractual discretion, they have not rejected it outright.<sup>84</sup> For example, in *American Fidelity Fire Insurance Co. v. General Railway*

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79. *See id.* at 1264. A commitment memo stated the bank’s intention to lend if conditions were met. *See id.* at 1263.

80. *See Kham & Nate’s Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1358 (7th Cir. 1990); *see also* Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 IOWA L. REV. 503 (March 1991) for an example of the emotion that this field has generated. Patterson attacks Judge Easterbrook’s ideology, method of analysis, and decision in *Kham & Nate’s Shoes No. 2 Inc.* *See id.* at 504-05. Patterson is particularly distressed by Judge Easterbrook’s approach to good faith and contract law which Patterson concludes, “forsakes the Code drafters’ efforts to displace nineteenth century classicism by returning to the bygone days of plain meaning and objective assent.” *Id.* at 513.

81. *See Resolution Trust Corp. v. Holtzman*, 618 N.E.2d 418, 424 (Ill. App. Ct. 1st Dist. 1993).

82. *Vincent v. Doeber*, 539 N.E.2d 856, 862 (Ill. App. Ct. 2d Dist. 1989).

83. *Id.* (citing *Prudential Ins. Co. of Am., Inc.*, 511 N.E.2d 740 (Ill. App. Ct. 5th Dist.)); *see also Foster Enter. v. Germania Fed. Sav. & Loan Ass’n*, 421 N.E.2d 1375, 1381 (Ill. App. Ct. 3d Dist. 1981) (holding that an arbitrary rejection of an appraisal, in a contract calling for a mutually acceptable appraisal, would be in bad faith).

84. *See Teachers Ins. & Annuity Ass’n of Am. v. LaSalle Nat’l Bank*, 691 N.E.2d 881, 890 (Ill. App. Ct. 2d Dist. 1998) (refusing to allow the defendant to use the implied covenant of good faith to “bootstrap” an alleged breach stemming from a written agreement into an alleged breach of a purported oral agreement), *appeal denied*, 1998 Ill. LEXIS 1030 (Ill. Oct. 6, 1998); *Northern Trust Co. v. VIII S. Michigan Assocs.*, 657 N.E.2d 1095, 1104 (Ill. App. Ct. 1st Dist. 1995) (“The covenant of good faith and fair dealing does not enable a guarantor to read an obligation into a contract that does not exist”); *Resolution Trust Corp.*, 618 N.E.2d at 424 (finding that parties may “enforce the terms of negotiated contracts without being mulcted for lack of good faith”); *Dasenbrock v. Interstate Restaurant Corp.*, 287 N.E.2d 151, 155 (Ill. App. Ct. 5th Dist. 1972) (finding that defendant could not terminate a lease because he made no application for licenses, did not act in good faith, and, if the lease were to leave time for performance optional to lessee, the contract would be void and meaningless).

*Signal Co.*,<sup>85</sup> the First District noted that the implied covenant of good faith and fair dealing is demonstrated in a series of Illinois cases that examine the duties of a contracting party to use reasonable efforts to bring about events that would satisfy a condition precedent.<sup>86</sup> Significantly, in these cases, “the contractual obligation of one party was contingent upon a condition peculiarly within the power of that party.”<sup>87</sup> Thus, the controlling party could avoid incurring any contractual obligation by refusing to satisfy the condition.<sup>88</sup> The court found in each case that the controlling party’s discretion was curtailed by the implied covenant of good faith.<sup>89</sup> The party was therefore obligated to use reasonable efforts to meet any conditions.<sup>90</sup> The First District held, in accordance with the cases, that the doctrine of good faith performance imposes a limitation on the exercise of discretion vested in one party to a contract.<sup>91</sup>

Similarly, in *Abbott v. Amoco Oil Co.*,<sup>92</sup> the Second District found that dealer-supplier agreements, if clear, negate the need for the implied covenant of good faith as a construction aid.<sup>93</sup> Extending *Vincent v. Doeber*, the court further articulated that the duty of good faith and fair dealing requires that the party vested with discretion exercise it reasonably “and with proper motive, not arbitrarily or capriciously” or “in a manner inconsistent with the reasonable expectations of the parties.”<sup>94</sup>

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85. *American Fidelity Fire Ins. Co. v. General Ry. Signal Co.*, 540 N.E.2d 557 (Ill. App. 1st Dist. 1989).

86. *See id.* at 561 (citing *Dayan v. McDonald’s Corp.*, 466 N.E.2d 945, 958 (Ill. App. Ct. 1st Dist. 1984)).

87. *Id.*

88. *See id.*

89. *See id.*

90. *See id.* at 561-62.

91. *See id.* at 562.

92. *Abbott v. Amoco Oil Co.*, 619 N.E.2d 789 (Ill. App. Ct. 2d Dist. 1993).

93. *See id.* at 795-96. The court also recognized a “duty of good faith and fair dealing included in every contract as a matter of law in Illinois.”; *see also supra* Part II.A.2 and note 24 (explaining that a covenant of good faith is employed as a rule of construction for ambiguous contracts).

94. *Abbott*, 619 N.E.2d at 795-96; *see also* *Chemical Bank v. Paul*, 614 N.E.2d 436, 442 (Ill. App. Ct. 1st Dist. 1993) (holding that the defendant did not waive the defense of bad faith when he signed a waiver of defense clause in a loan contract and personal guaranty); *Continental Mobile Tel. Co. v. Chicago SMSA Ltd. Partnership*, 587 N.E.2d 1169, 1174 (Ill. App. Ct. 1st Dist. 1992) (holding that a party with contractual discretion must use that discretion reasonably); *Hayes v. Preferred Risk Mutual Ins. Co.*, 383 N.E.2d 669 (Ill. App. Ct. 5th Dist. 1978) (allowing a jury’s determination that an insurance company did not appropriate its agent’s property rights to commissions when it terminated his agency contract to stand).

Courts now have the difficult problem of determining how to apply the principle of good faith and fair dealing in situations when a party retains some discretionary ability. Specifically, courts must determine whether to use a subjective or objective standard in judging whether a party has exercised its discretion in good faith. The First District has already dealt with this issue in *Forman v. Benson*.<sup>95</sup> In *Forman*, the plaintiff contracted to purchase a commercial building from the defendant subject to a credit report.<sup>96</sup> Despite the bank's objective report that the plaintiff was not at risk, the defendant refused to proceed with the sale based on his interpretation of the credit report.<sup>97</sup>

The First District initially stated that because the sale involved a ten year debtor/creditor relationship, the seller's subjective state of mind merited consideration.<sup>98</sup> Ultimately, however, the court found that the defendant attempted to use his interpretation of the credit report to renegotiate the sale and extract a higher price from the plaintiff.<sup>99</sup> The majority opinion held that the defendant acted in bad faith and was required to sell the property to the plaintiff.<sup>100</sup> In its analysis, the court examined two views: the subjective test allowing complete, unfettered discretion, and the objective test adopting a reasonableness standard.<sup>101</sup> The court concluded that the objective standard is preferred when the contract concerns matters capable of objective evaluation.<sup>102</sup> When a contract provision is added as a personal concession to assuage the fears of one party, however, a subjective standard should be used.<sup>103</sup> In *Forman*, the court applied the subjective standard because the discretion granted was a concession to the defendant.<sup>104</sup> The court cautioned, however, that the contract did not grant the defendant "unbridled discretion" but rather discretion subject to a good faith requirement.<sup>105</sup>

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95. 446 N.E.2d 535, 540 (Ill. App. 2d Dist. 1983) (citing *Honkomp v. Dixon*, 422 N.E.2d 949 (Ill. App. 1st Dist. 1981)).

96. *See id.* at 537.

97. *See id.* at 538.

98. *See id.* at 540.

99. *See id.*

100. *See id.* at 540-41.

101. *See id.* at 538.

102. *See id.* at 538. For example, matters of financial concern are capable of objective evaluation. *See id.*

103. *See id.* at 539.

104. *See id.* at 540.

105. *See id.*

## 6. Contracts Terminable at Will

The application of the implied covenant of good faith and fair dealing to contracts terminable at will has resulted in a split of opinion in Illinois courts. The First District, reluctant to allow a party to use the implied covenant to "bootstrap" tort liability, has refused to extend a tort concept to an action for breach of an employment contract.<sup>106</sup> The First District has also flatly rejected the contention that an insurance company can be barred from terminating an insured pharmacy pursuant to a mutual at-will termination clause under the doctrine of the implied covenant of good faith.<sup>107</sup> The court stated that "[t]erminable at will contracts, such as most employment agreements, are generally held to permit termination for any reason, good cause or not or no cause at all."<sup>108</sup> Similarly, the Fourth District has concluded that it is incongruous to imply a covenant which restricts a party's right to terminate employment at any time.<sup>109</sup>

In contrast to the First and Fourth Districts, the Fifth District has held that at-will employment contracts still imply an obligation of good faith and fair dealing.<sup>110</sup> In *Hentze v. Unverfehrt*, the defendant argued that because the contract contained a provision that it was terminable by either party upon sixty days notice, it explicitly precluded any obligation of good faith.<sup>111</sup> The court, however, rejected the defendant's argument, holding that though it did not require good cause for termination of employment under an at-will contract, such a contract did not expressly renounce a good faith

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106. See *Martin v. Federal Life Ins. Co.*, 518 N.E.2d 306 (Ill. App. Ct. 1st Dist. 1987).

107. See *Alderman Drugs, Inc. v. Metropolitan Life Ins. Co.*, 515 N.E.2d 689, 694 (Ill. App. Ct. 1st Dist. 1987).

108. *Id.* at 694 ("Thus employees who allege they had been terminated in 'bad faith' cannot base a cause of action on a violation of the good faith and fair dealing covenant."). In 1998, the Illinois Supreme Court seems to have laid the matter to rest by holding that contracts for an indefinite duration are terminable at-will for any reason or no reason at all. See *Jespersion v. Minnesota Mining & Mfg. Co.*, No. 83728, 1998 Ill. LEXIS 915, 9-10 (Ill. June 18, 1998), *aff'g*, 681 N.E.2d 67 (Ill. App. Ct. 1st Dist. 1997). The court noted that this rule has been long followed in Illinois. Illinois has, however, carved out a narrow exception to the employment at-will rule for public policy reasons when an employer discharges an employee in response to the employee having sought workman's compensation. See *Kelsay v. Motorola, Inc.*, 384 N.E.2d 353, 356-57 (Ill. 1978). This exception is considered separately from the implied covenant. See *id.* at 356-59.

109. See *Harrison v. Sears, Roebuck & Co.*, 546 N.E.2d 248 (Ill. App. Ct. 4th Dist. 1989).

110. See *Hentz v. Unverfehrt*, 604 N.E.2d 536 (Ill. App. Ct. 5th Dist. 1992).

111. See *id.* at 539.

requirement.<sup>112</sup> Alternatively, the court stated that parties who have negotiated contracts are entitled to enforce them to the letter "without being mulcted for lack of 'good faith.'"<sup>113</sup> The court ultimately found that the tactics used and the events that followed the termination, rather than the termination itself, went beyond the intent of any at-will clause and, therefore, violated the implied obligation of good faith.<sup>114</sup>

### III. THE IMPLIED COVENANT'S RELATION TO CONTRACT ENFORCEMENT

The implied covenant of good faith and fair dealing also mandates good faith in the enforcement of a contract.<sup>115</sup> Illinois courts have almost entirely overlooked this aspect of the implied covenant. If the covenant serves as an independent source of duties and liabilities for breach of the duty of good faith and fair dealing, courts must explore its application when a party litigates or defends a contract case in bad faith.

Despite any specific mention of good faith or fair dealing, a Seventh Circuit securities case which upheld sanctions of costs and attorneys fees illustrates the covenant's spirit. The securities industry requires its customers to agree in advance to settle its disputes by arbitration—the purpose of which is to provide an "inexpensive alternative to litigation" for disputes "too small to justify full scale litigation."<sup>116</sup> Accordingly, in *Paine Webber Inc. v. Farnam*, the lower court ordered Paine Webber to arbitrate certain disputes with its customers.<sup>117</sup> In response, Paine Webber requested a stay pending appeal.<sup>118</sup> The Seventh Circuit denied Paine Webber's request finding that Paine Webber had filed the present suit to rid itself of its obligation to arbitrate.<sup>119</sup> In fact, the plaintiff was initially forced to obtain an order compelling Paine Webber to arbitrate.<sup>120</sup> The court observed that

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112. *See id.*

113. *Id.* (citing *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990)).

114. *See id.* at 540.

115. *See* RESTATEMENT (SECOND) OF CONTRACTS, §205 cmt. e (1981) ("The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses . . . . The obligation is violated by dishonest conduct such as conjuring up a pretended dispute. . . .").

116. *Paine Webber Inc. v. Farnam*, 843 F.2d 1050, 1052 (7th Cir. 1988) (citing *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987)).

117. *See id.* at 1051.

118. *See id.*

119. *See id.*

120. *See id.* at 1052-53.

“[a]rbitration is neither quick nor cheap when one party litigates to the gills.”<sup>121</sup> Although recognizing that Paine Webber was entitled to seek judicial resolution of its obligation to arbitrate, the court held that Paine Webber was not entitled to file motions with the sole effect of saddling its customers with extra costs.<sup>122</sup> The court stated, “[l]itigants must think twice before filing papers that put their adversaries to expense; they must think three times before filing in arbitration cases; there is no evidence that Paine Webber thought even once before seeking a stay pending appeal.”<sup>123</sup> The court then ordered Paine Webber to pay the costs and attorneys fees incurred in resisting the stay pending appeal.<sup>124</sup> Illinois courts should take their cue from the Seventh Circuit’s decision in *Paine Webber*. Courts should use the implied covenant of good faith and fair dealing in situations where a party litigates a contract’s enforcement in bad faith.

#### IV. NECESSARY CHANGES FOR THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING AS IT NEARS ITS FIRST QUARTER CENTURY IN ILLINOIS

The implied covenant of good faith and fair dealing is not as robust as its proponents wish but it is more tenacious than its opponents desire. Perhaps the covenant has not found easy acceptance, and indeed outright hostility,<sup>125</sup> because Illinois courts fear it will harm or destroy deeply held beliefs that the law of contracts should be governed by principles of certainty, consistency, and predictability.<sup>126</sup> Judges are comfortable with known rules. They are uncomfortable with introducing well-meaning, but vague, phrases such as “good faith” and “fair dealing” that may produce inconsistent, unforeseen or unjust results. The implied covenant’s terms “good faith” and “fair dealing,” however, need not be vague. The terms are definable if courts place them in real world, practical settings. Specifically, in the best common law tradition, courts should determine whether actions are made in good faith only after they apply the terms of the particular contractual relationship before them.<sup>127</sup> Notably, these terms are not

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121. *Id.* at 1053.

122. *See id.*

123. *Id.*

124. *See id.*

125. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 404 (1980).

126. *See* Mary E. Hiscock, *The Keeper of the Flame: Good Faith and Fair Dealing in International Trade*, 29 LOY. L.A. L. REV. 1059, 1061 (1996).

127. The Illinois Supreme Court has said, “where such ‘means’ prove inadequate to meet the changing needs of society, or where such ‘means’ cause injustice, our common

definable by judicial legislation. Accordingly, if courts wish to make the covenant into a more robust legal concept, they must agree on its vocabulary. When courts agree about the terms, they will be more comfortable with accepting the benefits of the implied covenant of good faith and fair dealing and extending the covenant to all contractual relations.

#### A. *Defining "Good Faith" and "Fair Dealing"*

The terms "good faith" and "fair dealing" in the context of the implied covenant are not adequately defined by Illinois case law. Courts' failure to define these terms may explain why some courts have not accepted the implied covenant of good faith as an independent source of legally enforceable duties. If courts can agree on what is covered by the words "good faith" and "fair dealing," they may be able to agree on what is covered by the implied covenant as a whole.

What does good faith and fair dealing mean? Unfortunately no clear or simple definition exists. Nonetheless, Illinois courts can look to the Uniform Commercial Code ("UCC") and the Restatement (Second) of Contracts for guidance. Both the UCC and the Restatement require the implied covenant of good faith and fair dealing in contracts. Section 1-203 of the UCC states that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."<sup>128</sup> Similarly, Section 205 of The Restatement (Second) of Contracts provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."<sup>129</sup> Ultimately, Illinois should adopt the Restatement approach. The Restatement approach is more appropriate than the UCC approach because it defines the covenant by using an excluder concept rather an inclusive method.

#### 1. The UCC Definition

The UCC defines good faith in a positive, inclusive manner. Generally, it defines good faith to mean "honesty in fact in the conduct

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law tradition demands they be modified." *Smith v. Eli Lilly & Co.*, 560 N.E.2d 324, 346 (Ill. 1990) (citing *Alvis v. Ribar*, 421 N.E.2d 886, 896 (Ill. 1981)); *see also* *Amann v. Faidy*, 107 N.E.2d 868, 874 (Ill. App. Ct. 2d Dist. 1952) ("We act in the finest common-law tradition when we adapt and alter decisional law to produce common-sense justice.").

128. U.C.C. § 1-203 (1989). Illinois has adopted the UCC's statement in slightly different form but with similar substance. *See* 810 ILL. COMP. STAT. 5/1-203 (West 1993). It states: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." *Id.*

129. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

or transaction concerned.”<sup>130</sup> In Article 2, Sales, the UCC states that “unless the context otherwise requires . . . ‘[g]ood faith’ in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”<sup>131</sup> The UCC’s positive approach, however, has been criticized.<sup>132</sup> In the context of a diversity case involving a requirements contract, Judge Richard Posner of the Seventh Circuit Court of Appeals lamented that “[t]he Uniform Commercial Code does not contain a definition of ‘good faith’ that seems applicable to the buyer under a requirements contract.”<sup>133</sup> Judge Posner also complained that the term was a “chameleon” with no settled meaning in the law.<sup>134</sup>

Similarly, Professor Robert S. Summers explains that “the attempt to capture in a set of normally necessary and sufficient conditions some characteristic or characteristics common to all things that are or could be called ‘good faith’ is doomed to failure.”<sup>135</sup> Summers has also questioned the meaning that courts and the UCC draftsmen have

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130. U.C.C. § 1-201(19); 810 ILL. COMP. STAT. ANN. 5/1-201(19).

131. U.C.C. § 2-103(1)(b) (West 1989 & Supp. 1998); 810 ILL. COMP. STAT. 5/2-103(1)(b) (West 1993).

132. See *infra* notes 133-47 and accompanying text.

133. *Empire Gas Corp. v. American Bakeries Co.*, 840 F.2d 1333, 1339 (7th Cir. 1988).

134. See *id.*; see also *Market Street Assoc. v. Frey*, 941 F.2d 588, 593 (7th Cir. 1991) (noting that the meaning of good faith is cryptic and confusing). In considering the meaning of the contractual duty of “good faith,” Judge Posner noted that “Wisconsin cases are cryptic as to its meaning though emphatic about its existence, so we must cast our net wider. We do so mindful of Learned Hand’s warning, that ‘such words as ‘fraud,’ ‘good faith,’ ‘whim,’ ‘caprice,’ ‘arbitrary action,’ and ‘legal fraud,’ . . . obscure the issue.” *Id.* at 593 (quoting *Thompson-Starrett Co. v. La Belle Iron Works*, 17 F.2d 536, 541 (2d Cir. 1927)). Judge Posner points out the term, as used in the implied covenant, is limited to performance and does not apply to the formation of the contract. See *id.* at 594. Judge Posner sees the duty of good faith in contract cases as giving rise to contract remedies and as falling “‘halfway’ between a fiduciary duty (the duty of utmost good faith) and the duty merely to refrain from active fraud.” *Id.* at 595. He sees good faith as forbidding “the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule.” *Id.* To Judge Posner, “[g]ood faith” is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.” *Id.* (quoting *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990)).

135. Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 828 (1982) (paraphrasing J. L. AUSTIN, *SENSE AND SENSIBILIA* 70-71 (1962)); see also Chivers, *supra* note 57, at 364 (“The role the good faith covenant plays in this scheme is not exactly clear. The covenant is amorphous. Nearly all jurisdictions instruct courts to imply it but do not provide a clear formula to inform the courts’ discretion. We have thus imported a doctrine without having first agreed what that doctrine is to do.”).



given to the phrase "good faith,"<sup>136</sup> contending that the phrase "good faith," as used by courts, "is best understood as an 'excluder.'"<sup>137</sup> That is, good faith excludes forms of "bad faith" but fails to maintain its own meaning.<sup>138</sup> Summers criticized the UCC drafters for giving the phrase a "general, invariant meaning: 'honesty in fact in the conduct or transaction concerned.'"<sup>139</sup>

Attempts to use an inclusive definition of good faith fail because courts do not and cannot consistently clarify the positive meaning of the phrase.<sup>140</sup> Summers offers a practical solution: rather than searching for a definition of good faith, a lawyer should determine what the judge wishes to exclude in a given case by using this term.<sup>141</sup> Summers then suggests that "[o]nce the relevant form of *bad faith* is thus identified, the lawyer can . . . assign a specific meaning to *good faith* by formulating an 'opposite' for the species of bad faith being ruled out."<sup>142</sup> Summers illustrates this method by an example. Suppose a judge states: "A public authority must act in good faith in letting bids."<sup>143</sup> One can infer that the judge, in effect, is conveying that "[t]he defendant acted in bad faith because he let bids only as a pretense to conceal his purpose to award the contract to a favored bidder."<sup>144</sup> In this context, "'acting in good faith' means letting bids without a preconceived design to award the contract to a favored bidder."<sup>145</sup> Summers concludes that "[w]hen a judge uses the phrase good faith, one is frequently unable to attach a definite meaning to it without knowing what, in context, the judge means to exclude . . . ."<sup>146</sup> Judges, as a practical matter, are usually "more interested in what they are proscribing than in characterizing what is generally

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136. See Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968) [hereinafter Summers, *Good Faith*].

137. *Id.*; see also *infra* notes 148-63 and accompanying text.

138. See Summers, *Good Faith*, *supra* note 136, at 196.

139. *Id.* (quoting U.C.C. § 1-201(1989)).

140. See Burton, *supra* note 125, at 369. A party who exercises discretion for any purpose within the contemplation of the parties acts in good faith; a party who uses discretion to recapture foregone opportunities acts in bad faith. See *id.* at 373; E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 669 (1963) (good faith results "in an implied term of the contract requiring cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations.").

141. See Summers, *Good Faith*, *supra* note 136, at 200.

142. *Id.* (emphasis added).

143. *Id.*

144. *Id.*

145. *Id.* at 200-01.

146. *Id.* at 201 n.32.

allowed.”<sup>147</sup>

## 2. The Restatement (Second) of Contracts Definition

Summers's analysis and definition is more than academic. In fact, Summers influenced the late Robert Braucher, the Reporter for the Restatement (Second) of Contracts.<sup>148</sup> Thus, the Restatement effectuated the excluder concept. The comments to Section 205 of the Restatement provide “meanings” for the term “good faith.”<sup>149</sup> After describing the UCC's definition as “‘honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade,’”<sup>150</sup> the Restatement (Second) of Contracts departs from both the UCC and the 1931 Restatement of Contracts, stating that “the phrase ‘good faith’ is used in a variety of contexts,” and its meaning fluctuates accordingly.<sup>151</sup> The Second Restatement explains:

Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness. The appropriate remedy . . . also varies with the circumstances.<sup>152</sup>

The Restatement (Second) of Contracts encompasses three bold developments in contract law since 1931. First, the Restatement imposes the implied covenant of good faith and fair dealing in every contract.<sup>153</sup> Second, it requires a commitment to “contractual morality” and, more fundamentally, a commitment to justice according to the law.<sup>154</sup> This commitment is neither narrow nor technical; it enables judges to avoid results which reward and thereby encourage breach of contract.<sup>155</sup> Third, by applying the excluder approach to its definition of “good faith,” the Restatement gives the term broad opportunity to develop.<sup>156</sup> The definition is not completely open-ended, however,

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147. *Id.* at 206.

148. See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmts. a-e and reporter's note (1981) (citing Summers, *Good Faith*, *supra* note 136).

149. See *id.* cmt. a.

150. *Id.*

151. *Id.*

152. *Id.*

153. See *id.* § 205.

154. See Summers, *supra* note 135, at 811.

155. See *id.* The covenant of good faith and fair dealing is a distinct departure from the concept of Holmes and the late nineteenth and first half of the twentieth centuries.

156. See *id.*; *supra* note 135, at 811-12.

because the Restatement clearly limits its application to contract performance and enforcement.<sup>157</sup> Moreover, it is not to be used in the events leading up to the creation of the contract. Rather, the definition comes to life only after the contract is entered.<sup>158</sup>

Applying the excluder approach, the Restatement indicates that:

[s]ubterfuges 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.<sup>159</sup>

The Restatement (Second) comment also instructs that "[t]he obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses."<sup>160</sup> Under the Restatement's excluder approach, good faith in enforcement means an obligation may be violated by dishonest conduct including the following: "conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, [and] falsification of facts."<sup>161</sup> A good faith duty also "extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances

157. See RESTATEMENT (SECOND) OF CONTRACTS § 205.

158. See *id.* cmt. c; see also *Market St. Assoc. v. Frey*, 941 F.2d 588, 594 (7th Cir. 1991) (noting that after contract formation, "[t]he parties are now in a cooperative relationship the costs of which will be considerably reduced by a measure of trust," triggering the good faith duty); Burton, *supra* note 125, at 373-74 (suggesting that only bad faith contract performance should be actionable).

159. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d.

160. *Id.* cmt. e; see also *id.* §§ 73, 89. Section 73 provides, "[p]erformance of a legal duty owed to a promisor which is neither doubtful nor the subject of honest dispute is not consideration; but a similar performance is consideration if it differs from what was required by the duty in a way which reflects more than a pretense of bargain." *Id.* § 73. Section 89 provides:

A promise modifying a duty under a contract not fully performed on either side is binding

(a) if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made; or

(b) to the extent provided by statute; or

(c) to the extent that justice requires enforcement in view of material change of position in reliance on the promise.

*Id.* § 89.

161. *Id.* § 205 cmt. e.

of the other party to extort a modification of a contract . . . without legitimate commercial reason.”<sup>162</sup> Other judicially recognized good faith violations include “harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of power to determine compliance or to terminate the contract.”<sup>163</sup>

### 3. The Excluder Method Offers Needed Flexibility in Defining Good Faith and Fair Dealing

If courts can agree to accept the need for a long term process of defining the implied covenant’s terms using an excluder methodology, courts will be ready to take the next step. That is, courts will be able to determine whether application of the implied covenant as an independent source of legal duties and liability will assist them in resolving controversies in a just manner without destroying the values of consistency, predictability, and liberty of contract.

Some courts will balk, complaining that the excluder approach does not supply them with a clear, positive set of rules. These courts will insist that the law must consist of detailed rules. Such particularized rules, they will claim, allow people to accurately predict the consequences of a decision to disregard those rules. Predictability is particularly important in contract disputes because it is a fundamental principle of contract law.<sup>164</sup> Many people simply want to know what the rules are and are not concerned with the policy behind them. Others, however, are concerned with policy and believe that if a rule and its policy conflict, some “sub-rule” should then fulfill or satisfy the reason or principle for the rule.<sup>165</sup> The excluder approach offers

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162. *Id.* (citing U.C.C. § 2-209 cmt. 2).

163. *Id.*

164. The principles of the common law have included a deeply ingrained belief that the law of contracts must allow the parties to predict accurately and precisely what a court’s reaction will be if a party does not fulfill its promise. Oliver Wendell Holmes’ hypothetical “bad man” wanted to know the “material consequences” if he did not keep his promise. See OLIVER WENDELL HOLMES, *The Path of the Law*, in COLLECTED LEGAL PAPERS 167, 171 (1920). Holmes’ answer was that one need not keep a promise if the consequences of breaking one’s word in a particular case would be profitable to the promise breaker. See *id.* at 175. The law was merely an oracle which would allow the bad man to predict the consequences of his action or inaction. See *id.* at 173. To Holmes, the law was simply “prophesies of what the courts will do in fact, and nothing more pretentious. . . . The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else.” *Id.* at 173-75.

165. See SAMUEL C. COVAL & JOSEPH C. SMITH, *LAW AND ITS PRESUPPOSITIONS* 76 (1986) (suggesting that legal rules should be interpreted in light of the policies, or goals, of the society that created the rule, and that such an interpretation can be made without destroying predictability).

the benefit of assigning a specific meaning to good faith while allowing needed flexibility on a case-by-case basis.

*B. Illinois Should Extend the Implied Covenant to All Contractual Relations*

The genius of science is its ability to face a present day reality and realize that an established principle no longer solves a given problem. This ability should also be present in our application of the law. In some circumstances, our existing rules work well. In others, our existing rules do not comport with present day standards of fairness and decency. Similarly, rules devised in the days of expanding frontiers, emerging capitalism, new theories of evolution, and social survival of the fittest may produce consistent and predictable results. These rules, however, may also produce injustice and actually invoke a court's power to actively aid a person who comes to court in bad faith. To obtain just results in all instances, courts need flexible rules and sub-rules.

The Second Restatement's definitions give parties and courts the tools to work out solutions within the law's rules. Illinois courts, however, have been reluctant to extend the implied covenant of good faith beyond fields that clearly require it.<sup>166</sup> The covenant of good faith should apply to all contractual relations. Accordingly, courts should seek sub-rules in the factual settings that will fit similarly situated parties' needs and expectations when entering into contracts under the same circumstances. For example, HMO's, PPO's and other managed care entities have drastically altered relations among physicians, hospitals, and patients.<sup>167</sup> These new relationships have spawned a national debate about perceived bad faith performance by managed care companies that have allegedly coerced doctors, hospitals, and pharmacists to deny treatment or even to fail to inform insured patients of available tests or procedures.<sup>168</sup> The relationships

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166. See *supra* Part II. Illinois has employed the implied covenant of good faith in the insurance and real estate contexts; in no-damage-for-delay clauses and in non-competition clauses; in the context of lender liability; in contracts that vest one party with discretion; and in contracts terminable at-will.

167. See *Herdrich v. Pegram*, 154 F.3d 362, 373 (7th Cir. 1998) (holding in an ERISA case that "incentives can rise to the level of a breach where, as pleaded here, the fiduciary trust between plan participants and plan fiduciaries no longer exists (i.e., where physicians delay providing necessary treatment to, or withholding administering proper care to, plan beneficiaries for the sole purpose of increasing their bonuses").

168. See Brendan Stephens, *7th Circuit Ruling Sends Suit Against HMO to Trial*, CHI. DAILY L. BULL., August 19, 1998 at 1 (reporting on the decision in *Hedrrich v. Pegram* that the plaintiff had a cause of action based on her health plan's bad faith). The plaintiff alleged that bonuses paid to physician-administrators were based upon the

in this field alone require intensive inquiry by attorneys and courts about how Illinois law can use the implied covenant of good faith and fair dealing to adapt to changing times. The law must be able to accommodate changes in science, technology, and economics.

Similarly, although the employment at-will arrangement gave employers and employees an absolute right to terminate their relationship<sup>169</sup> and sometimes caused harsh results, its use still met the necessities of the first half of the twentieth century. For example, IBM or United States Steel Corporation employees in the early 1950s could expect to remain with their companies for life. Could they or their companies have foreseen the microchip, the closing of steel mills, or the downsizing of the 1990s? Could the courts of the 1950s have been any more clairvoyant? Indeed, can late twentieth century or twenty-first century courts provide any clearer oracles?

Perhaps we can only hope for principles that enable us to solve problems in changing times. In addition to the current rules, therefore, courts must also concern themselves with the underlying principles and reasons for the rules. Courts should always be ready to adjust the rule to fit its reasoning. Following this paradigm, courts need not fear and resist the implied covenant of good faith and fair dealing but should use it to satisfy a fundamental principle of contract law. To wit, the law can fashion a full remedy when a contract party refuses to perform its promises in good faith.

## V. REMEDIES

Justice Felix Frankfurter<sup>170</sup> once asked, “[d]oes anybody know . . . where we can go to find light on what the practical consequences of [our] decisions have been?”<sup>171</sup> Justice Frankfurter’s question reflected his belief in the wisdom of judicial restraint. Following Justice Frankfurter’s tradition, Illinois courts have exercised judicial restraint by refusing to slide down the proverbial “slippery slope” and create a new cause of action based on the tortious breach of the covenant of good faith and fair dealing. This judicial restraint is appropriate. Illinois does not need, nor should courts create, such a tort. The

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difference between total plan costs and revenues so that an incentive existed for physician-administrators to limit treatment to ensure larger bonuses. *See id.*

169. *See supra* notes 106-14 and accompanying text (discussing the split in the Illinois courts over the applicability of good faith in employment at-will contracts).

170. Justice Frankfurter was an Associate Justice of the Supreme Court of the United States from 1932-1962.

171. THE IMPACT OF SUPREME COURT DECISIONS iv (Theodore L. Becker & Malcolm M. Feeley, eds., 2d ed. 1973).

covenant of good faith and fair dealing simply does not need tort remedies to fulfill its purpose. Indeed, a variety of acceptable remedies for breach of the implied covenant already exist in Illinois.<sup>172</sup> These remedies satisfy the expectations of innocent contract parties when the other party breaches the implied covenant of good faith and fair dealing.

Creating a new cause of action sounding in tort is unnecessary and counterproductive. Specifically, such a creation would require courts to use tort law concepts that define legally enforceable duties and to resolve problems relating to the physical and economic security of people and property. Those concepts are different from those used to define duties and resolve problems in the field of consensual contractual relations. Generally, contract parties simply want certainty and predictability.<sup>173</sup> They oppose giving factfinders the opportunity to subject them to damages beyond those voluntarily assumed if the factfinders decide that failing to fulfill a promise was tortious. Fortunately, courts need not risk this unforeseen or unwanted result. The law of contracts already provides a suitable range of remedies for breach, including the right to receive the benefit of the bargain, known as reliance recovery. It should also provide the right to receive satisfaction of contractual expectation – the loss of a party's bargain plus consequential damages within the contemplation of the parties.<sup>174</sup>

In Illinois, courts today risk a failure to satisfy the expectations of parties who voluntarily act in ways they believe are governed by enforceable rules of law. Illinois has so failed because it has not used already available concepts and remedies in a cohesive and creative manner. Such a cohesive set of rules would satisfy the contract goals of certainty and predictability.<sup>175</sup> Furthermore, the covenant of good faith and fair dealing can provide a remedy that will satisfy parties' contractual expectations. In some instances, a contract party may benefit economically by choosing to breach its obligation under a contract and merely pay the non-defaulting party damages based upon the difference between the contract price and the sold price. Indeed, under Justice Holmes's "bad man" theory, a party may be actually

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172. See *infra* notes 179-87 and accompanying text.

173. See Chutorian, *supra* note 12, at 391 n.2 (citing L.L. Fuller & William R. Purdue, *The Reliance Interest in Contract Damages*: 2, 46 YALE L.J. 373, 375 (1937)); LAWRENCE M. FRIEDMAN, *CONTRACT LAW IN AMERICA* 126 (1965).

174. See *Hentze v. Unverfehrt*, 604 N.E.2d 536, 541 (Ill. App. Ct. 5th Dist. 1992); see also Chutorian, *supra* note 12, at 392 n.85 (citing RICHARD POSNER, *ECONOMIC ANALYSIS OF THE LAW* 90 (2d ed. 1977) for the proposition that in order for a breach to be "efficient" (and thus socially useful), it is crucial that expectation damages be awarded).

175. See *infra* notes 179-87 and accompanying text.

*encouraged* to do so.<sup>176</sup> This sort of breach flies in the face of the party's implied covenant of good faith and fair dealing. It certainly defeats and frustrates the expectation of the other party who has kept his promises in good faith. When a party engages in bad faith performance or a bad faith defense, failure to award contract and procedural remedies in a cohesive manner also results in unjust frustration of the non-defaulting party's expectations.<sup>177</sup> Further, failure to award damages including attorneys' fees to persons defending a bad faith claim unjustly frustrates the expectation of a defendant.<sup>178</sup> The covenant of good faith should not be permitted to become a weapon of bad faith.

Courts can obtain a satisfactory result by providing for fee shifting and compensatory damages upon a finding that a party performed or enforced a contract in bad faith, and the bad faith acts caused the non-breaching party's loss.<sup>179</sup> The amount awarded would simply place the non-breaching party in the same position as if there had been no breach of the implied covenant of good faith. The non-breaching party would receive full expectation but would not gain a windfall of punitive or mental distress damages available in tort law. Moreover, the party who uses the court system in bad faith to defeat or delay an innocent party's expectations or to harass an innocent party will know

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176. *See supra* note 164 (discussing how contract law allows promise-breakers to foresee the consequences of breaking a promise).

177. *See* Summers, *Good Faith*, *supra* note 136, at 253.

178. *See, e.g.*, ILL. SUP. CT. R. 137. Rule 137 requires attorneys and unrepresented parties to sign pleadings motions, and other documents in good faith. *See id.* If the court finds that the documents were not signed in good faith, i.e., not warranted by existing law or intended for an improper purpose, it will impose appropriate sanctions. *See id.* The defendant in a breach of contract action should be able to expect that if the court finds he did not break his promise and was wrongfully accused, the court should put him back in the position he would have been had the plaintiff not brought the suit in bad faith.

179. *See, e.g.*, *Falcon Assoc. v. Cox*, 699 N.E.2d 203, 208-09 (Ill. App. Ct. 5th Dist. 1998) ("When a party is required to retain an attorney to enforce its contractual rights, that party does not receive full compensation, even when it receives the contract price, because that party is required to pay its attorney and the costs of litigation."); *Donnelly v. Washington Nat'l Ins. Co.*, 482 N.E.2d 424, 432 (Ill. App. Ct. 1st Dist. 1985) (allowing recovery for foreseeable consequential damages where an insurance company breached the implied covenant of good faith by failing to inform and also giving incorrect information on the procedure and rates for conversion of life and health insurance policies to a decedent who lost coverage under a group policy); *Clark v. Standard Life & Accident Ins. Co.*, 386 N.E.2d 890, 897-98 (Ill. App. Ct. 1st Dist. 1979) (permitting plaintiff to state a claim for consequential damages based on the loss of his home because defendant refused to pay benefits under the disability insurance policy issued in connection with the mortgage); *see also* *Calcagno v. Personalcare Health Management, Inc.*, 565 N.E.2d 1330, 1339 (Ill. App. Ct. 4th Dist. 1991) (allowing recovery of compensatory damages for prelitigation attorney's fees).



that the longer he engages in such behavior, the more he will pay in sanctions.<sup>180</sup> Indeed, by using Illinois Supreme Court Rules 137,<sup>181</sup> 201(c),<sup>182</sup> 206(e),<sup>183</sup> 218<sup>184</sup> and 219,<sup>185</sup> which contain sanctions for bad faith in other situations,<sup>186</sup> and by enforcing the existing rules which require monetary bonds for frivolous appeals,<sup>187</sup> courts need not create new rules to prevent a party from profiting through its breach of the implied covenant.

## VI. CONCLUSION

Illinois courts have generally accepted that the implied covenant of good faith and fair dealing exists. Yet, they have not developed a cohesive method for using the implied covenant in situations where a

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180. *See Paine Webber Inc. v. Farnam*, 843 F.2d 1050, 1053 (7th Cir. 1988); Douglas R. Richmond, *The Two-Way Street of Insurance Good Faith: Under Construction, But Not Yet Open*, 28 LOY. U. CHI. L. J. 95, 95 (1996) (noting that sanction for breach of duty of good faith may apply to insureds as well as insurers).

181. ILL. SUP. CT. R. 137 (providing for sanctions if a document filed with the court is not "well grounded in fact and . . . warranted by existing law or a good faith argument" for a change in the law).

182. *Id.* at R. 201(c) (preventing abuse in discovery by allowing the court to issue protective orders to prevent "unreasonable annoyance, expense, embarrassment, disadvantage, or oppression" and to supervise discovery).

183. *Id.* at R. 206(e) (allowing a court to terminate a deposition if the opponent conducts an examination in bad faith).

184. *Id.* at R. 218 (requiring parties to participate in pretrial procedures and conferences).

185. *Id.* at R. 219 (providing for a range of consequences for refusal or failure to comply with discovery rules). In addition to, or in lieu of, the seven specific "remedies" listed in subsection (c), the court, upon motion or upon its own initiative, may impose an appropriate sanction such as an order to pay the other party for reasonable expenses incurred as a result of the misconduct including reasonable attorneys' fees and fines for willful conduct. *See* R. 219. The committee comments cite *North Park Bus Service, Inc. v. Pastor*, 349 N.E.2d 664 (Ill. App. Ct. 1st Dist. 1976) and *Safeway Ins. Co. v. Graham*, 544 N.E.2d 1117 (Ill. App. Ct. 1st Dist. 1989) (holding that penalties may be imposed in the trial court's discretion). The language of the Rule is intended to affirm a trial court's authority to impose a monetary penalty against a party or its attorney. *See* R. 219 cmt. c (citing *Transamerica Ins. Group v. Lee*, 518 N.E.2d 413 (Ill. App. Ct. 1st Dist. 1988) (McMorrow, J., dissenting)). *See generally* *Shimanovsky v. General Motors Corp.*, 692 N.E.2d 286, 289 (Ill. 1998) (instructing trial courts on limiting principles relating to Rule 219(c)).

186. *See, e.g.*, R. 91 (requiring "good-faith participation" in arbitration hearings); *see also* *Bachmann v. Kent*, 689 N.E.2d 171, 173 (Ill. App. Ct. 1st Dist. 1997) (upholding the trial court's sanction striking defendant's rejection of an arbitration award for failure to comply with Illinois Supreme Court Rule 137). *Bachman* cited *Hernandez v. Williams*, 632 N.E.2d 49 (Ill. App. Ct. 3d Dist. 1994), for the proposition that the "purpose of Supreme Court Rule 137 is to punish litigants who plead frivolous or false matters or bring suit without any basis in law." *Id.*

187. *See* R. 305 (providing for enforcement of judgments pending appeal); R. 375 (permitting a court to impose sanctions for "appeal[s] not taken in good faith").

contract party fails to perform his undertaking in good faith or attempts to enforce his rights unfairly. The lack of such a cohesive method has led to underutilization of the implied covenant.

An agreement on the meaning of good faith and fair dealing is a necessary first step. Illinois courts should utilize the excluder method which provides a uniform approach while still allowing for flexibility in individual cases. Illinois must then accept the implied covenant of good faith and fair dealing as part of every contract and determine whether the party's performance or enforcement of rights was in good faith in the particular factual situation before the court. Judges can then decide whether the party's performance of a contract or exercise of defense is in bad faith. If the court finds no bad faith, the duty of good faith performance and enforcement mandated by the implied covenant was not breached. Alternatively, if the court finds that the party exercised bad faith, the duty was breached.

When a court finds that a party has breached its duty to perform or resolve disputes in good faith, it need not create a new tort to supply a remedy. Rather, it should fashion and implement a remedy using existing rules of procedure and contract law that will justly satisfy the contractual expectations of the injured party. In doing so, the court will make contract law into a cohesive and more effective social device without impinging on the equally valid and necessary goals of certainty, predictability, and freedom of contract.