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What Is a Willful Breach of Contract?

Ambiguity of the term requires clarity when drafting commercial agreements.

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"Willful" can be a problematic word for the commercial litigator. According to Webster's, it simply means "deliberate" (or obstinate, in the case of a disobedient child). In the legal world, it sometimes means something more—"malicious," "wanton," "egregious," "wrongful," "injurious," or a whole host of similar synonyms that mean "with bad intent." Despite this built-in ambiguity, the term "willful" has found its way into a host of significant commercial contracts, including sophisticated merger agreements and other major corporate contracts. In our practice, for example, we have seen numerous contracts that use the word "willful"—usually nestled in provisions that attempt to place limits on liability in the event of a breach of the contract.

In a typical provision using this word, one or both parties will attempt to insulate or cap damages available to the other side to only those damages resulting from a "willful" breach. When such a contract is breached and the dispute lands before a court, the question of what "willful" means can be an outcome-determining issue.

This question will essentially boil down to the two options above. The first is to use the broad, dictionary definition of "willful," which means deliberate, as in by choice, intentional, not by accident. If the defendant breached the contract on purpose, the damage-limiting language will not save him from his conscious decision.

The other option regards "willful" as going beyond mere conscious choice, even beyond choice motivated by pure self-interest. This option regards "willful" as requiring the intent to injure the other party, or some other reckless disregard for the well-being of the other side. Courts have often equated "willful" in this context with conduct rising to the level of an independent tort.

This second option springs from a purist's vision of contract law, which finds questions of intent to be inconsistent with traditional contractual analysis. Contract law, unlike tort law or criminal law, generally does not care about the reasons why a party may choose to transgress, i.e., breach a contract. In fact, the law traditionally protects the choice of a party to make a rational economic decision, so long as the party is willing to compensate the other side through contract damages. According to Holmes, "[t]he 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."[1]

The concept of "efficient breach" sees a societal benefit in allowing a party to breach a less desirable contract in order to pursue a more economically beneficial course so long as the non-breaching party is awarded its full expectation interest in the contract. It is for this same reason that contract law, with very limited exceptions, does not countenance punitive damages for breach of contract. In determining the meaning of "willful" in commercial contracts, this school of thought finds it anathema to fundamental contract principles to punish a party who makes the economically rational "deliberate" decision to breach a contract by depriving that party of the bargained-for limitation on damages.

The 'MetLife' Case

Although there is a dearth of published cases that define "willful" in a contract, the New York Court of Appeals has tackled the issue head on in *Metropolitan Life Insurance Co. v. Noble Lowndes, Int'l, Inc.*, 84 N.Y.2d 430 (1994). There, a jury found that the defendant, a software licensor, breached its contract to develop and install certain insurance claims software. The contract in that case contained a broad limitation of liability clause, limiting plaintiff's recovery of consequential damages—by far the largest category available to plaintiff in that case—to only those damages arising out of defendant's "willful acts or gross negligence." Nonetheless, after trial, the jury awarded plaintiff a large sum of consequential damages, finding that defendant's breach had been "willful." Importantly, the jury also found that the reason for the breach was pure economic self-interest, specifically to escape an "unprofitable business undertaking in order to promote the sale of its computer software division to a competitor company." Id. at 439.

On appeal, the Appellate Division, First Department, reversed the award of consequential damages, finding that defendant's breach did not rise to the level of "willful." In doing so, the Appellate Division adopted the second definition of "willful" outright: "'Willful' is a term of tort, not contract." *Metropolitan Life Ins. Co. v. Noble Lowndes Int'l, Inc.*, 192 A.D.2d 83, 90 (1st Dept. 1993). The court found that, as a matter of law, "willful" means a level of intent that rises to the level of an independent tort, which plaintiff had failed to prove.

On appeal, plaintiff argued that the Appellate Division erred in "refusing to attribute the common, ordinary meaning of willful acts as merely deliberate or intentional conduct." 84 N.Y.2d at 434-35. Instead of accepting the principle of contract construction proposed by the plaintiff (plain and ordinary meaning) and instead of adopting the definition adopted by the Appellate Division, the Court of Appeals opted for another, perhaps more basic, contract axiom: intent of the parties.

> The issue here is not how we and other courts have construed "willful" in other contexts, such as in interpreting statutes using that term or in formulating or applying legal principles in tort or contract law. Rather, the issue is what the parties intended by "willful acts" as an exception to their contractual provision limiting defendant's liability….Id. at 435.

Although the Court of Appeals acknowledged that "whether the breaching party deliberately rather than inadvertently failed to perform contractual obligations should not affect the measure of damages," it refused to apply a blanket definition for "willful."

Instead, the Court employed standard tools of contractual analysis to determine the intent of the parties. First, it looked to the manner in which the risks of non-performance were distributed throughout the contract. For instance, under one provision of the contract, if defendant had failed to perform in accordance with certain specifications, plaintiff's sole remedy was to terminate the agreement and receive a full refund. Id. at 436. In another provision, which dealt with one particular service that the Court noted constituted approximately two-thirds of the purchase price, plaintiff's remedy was limited to (i) terminating the contract, completing the work itself and recovering any cost difference from defendant; or (ii) receiving a full refund of payments already paid to defendant. Id. at 437.

The Court noted that these provisions made clear that the intent of the parties was to place the risks on the shoulders of the plaintiff. In

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other words, given the context of the entire agreement, it would make no sense to interpret "willful" to expose the defendant manufacturer to massive consequential damages for intentional non-performance.

Second, but along these same lines, the Court looked at the entire contract and noted that plaintiff could not have been held liable for significant consequential damages if the roles had been reversed and it had been the breaching party. Accordingly, the Court found that it would make no sense to interpret the limitation on liability clause to "eliminate any semblance of reciprocity between plaintiff and defendant as to their exposure to liability for heavy consequential damages." Id. at 437.

Finally, the Court looked at the provision in which the word "willful" appeared and observed that it contained phrases peculiar to tort law, not contract law.

> Under the interpretation tool of ejusdem generis applicable to contracts as well as statutes, the phrase "willful acts" should be interpreted here as referring to conduct similar in nature to the "intentional misrepresentation" and "gross negligence" with which it was joined as exceptions to defendant's general immunity from liability for consequential damages. Id. at 438.

In light of the above, the Court of Appeals held that the term "willful acts"—in that contract—was intended by the parties to include only "truly culpable, harmful conduct" and would not include a mere intentional or deliberate breach. Id. at 438. Critically, the Court limited its interpretation of the term "willful" to the meaning contained within the four corners of that particular contract and expressly overturned the holding of the Appellate Division to the extent it purported to define the term with respect to all contracts as a matter of law. Id. at 435.

After 'MetLife'

Both before and after the *MetLife* decision, there are almost no other published cases on this issue. Although there is little reason to believe a court would depart from the reasoning of New York's highest court, there is scant guidance as to how courts will go about determining whether parties intended to use one or the other definition of "willful" in a commercial contract. The lack of guidance on this issue is further complicated by the fact that the meaning of "willful" in the contract at issue in the *MetLife* case was relatively easy to determine by reviewing other provisions in the contract. It remains to be seen how a court would rule on this issue in a contract that does not include such guidance.

Courts dealing with this question since *MetLife* have approached it as an issue of fact, not to be resolved on pretrial dispositive motions. The most notable examples are two federal district court cases dealing with (potentially very expensive) breaches of merger agreements.

In *Vtech Holdings, Ltd. v. Lucent Technologies, Inc.*, 172 F.Supp.2d 435 (S.D.N.Y. 2001), plaintiff Vtech claimed that it was entitled to hundreds of millions of dollars in consequential damages arising out of Lucent's breach of warranty under a merger contract. On a motion to dismiss, Lucent argued that the claim should be capped at $45 million, as the merger agreement contained a provision that capped liability except for "intentional tort or willful misrepresentation." Id. at 441. The district court refused to enforce the cap, holding that "it is surely unclear at this point whether the parties intended 'willful misrepresentation' to be limited to torts rather than breaches of representations and warranties in the Agreement" and that "[t]he interpretation of the exclusion is not so unambiguous that it can be decided as a matter of law at this time." Id. at 442.

More recently, in the failed merger case of *Consolidated Edison, Inc. v. Northeast Utilities*, 249 F.Supp.2d 387 (S.D.N.Y. 2003), reversed in part by *Consolidated Edison, Inc. v. Northeast Utilities*, 426 F.3d 524 (2d Cir. 2005), the merger agreement contained a provision that substantially limited the damages available to each side in the event of a breach unless the breach was "willful and material." In this case, Consolidated Edison agreed to acquire Northeast Utilities in a cash and stock deal valued at $3.6 billion. Prior to closing, Consolidated Edison sought to renegotiate the terms of the deal and lower the purchase price. Northeast Utilities refused to renegotiate and the merger fell apart. Both parties sued, Northeast Utilities alleging that Consolidated Edison failed to proceed with the merger as it was required to do under the merger agreement because Consolidated Edison simply decided the agreed-upon price in the agreement was too high. See *Consolidated Edison*, 249 F.Supp.2d at 390.

In the face of Northeast Utilities' claims for both expectation and consequential damages, Consolidated Edison brought a motion for summary judgment and pointed to the limitation on liability provision, arguing that the only way Northeast Utilities could recover these damages was if Consolidated Edison willfully breached the contract. *Consolidated Edison*, 249 F.Supp.2d at 413.

Consolidated Edison cited to the *MetLife* case for the proposition that a willful breach must be undertaken with malice and in bad faith, which Northeast Utilities had failed to establish. Id. at 414. Northeast Utilities disagreed, arguing that the holding in *MetLife* was limited to the specific terms of that contract and that "the definition of willful acts in *MetLife* is of little use in determining what constitutes a 'willful and material breach' under [] the Merger Agreement." Id. at 414.

The district court agreed with Northeast Utilities, denying Consolidated Edison's motion for summary judgment on this issue on the ground that the "terms of the Merger Agreement are not so unambiguous that the Court can determine that Consolidated Edison's interpretation is correct as a matter of law or that Consolidated Edison's actions do not rise to the level of willfulness required to recover consequential damages." Id. at 415.

Breach as Independent Tort

Although cases dealing with contractual definitions of "willful" are scarce, there are a number of cases that address the broader issue of when a breach of contract can rise to the level of an independent tort. These cases rear their heads most often in two related contexts. First, in many jurisdictions, a limitation on liability provision will not even apply to conduct that rises to the malicious/tortious level. Under New York law, for example, an exculpatory agreement will not apply to the "exemption of a willful or grossly negligent act" or when "the misconduct for which it would grant immunity smacks of intentional wrongdoing." *Kalisch-Jarcho, Inc. v. City of New York*, 58 N.Y.2d 377 (1983).[2]

The second area where this issue arises is where a party seeks punitive damages for breach of contract. In Delaware, for example, while punitive damages are not generally available for breach of contract, they can be available if the conduct is willful or malicious. "For a party's breach of contract to be considered willful or wanton, such conduct must be 'malicious[] and without probable cause, for the purpose of injuring [the other party] by depriving him of the benefits of the [contract].'" *The American Original Corp. v. Legend, Inc.*, 689 F.Supp. 372, 380 (D. Del. 1988).

While these cases and their progeny may not convince a judge that "willful" means "tortious" as a matter of law—at least not in a New York court—they give guidance regarding the types of conduct that courts have held to meet (or not meet) the higher level of culpability. The *MetLife* decision in the Appellate Division provides a useful overview of that concept:

> [T]he necessary theory of the complaint is that breach of contract may be so intended and planned; so purposely fitted to time, and circumstances and conditions; so interwoven into a scheme of oppression and fraud; so made to set in motion innocent causes which otherwise would not operate, as to cease to be a mere breach of contract, and become, in its association with the attendant circumstances, a tortious and wrongful act or omission. *MetLife*, 192 A.D.2d at 90 (quoting *Rich v. New York Cent. & Hudson Riv. R. R. Co.*, 87 N.Y. 382, 396-97 (1882)).

Conclusion

The broader lesson, of course, is that parties should recognize the inherent ambiguity of the term "willful" and draft their commercial agreements accordingly. Instead of leaving it in the hands of judges, parties can—and should—make the definition clear on the face of the contract. They should be advised either to use a different word (e.g., "malicious" or "deliberate") or simply to define "willful" (e.g., "For purposes of this provision, the term "willful" requires [or 'does not require'] malicious or tortious intent." Unfortunately, as many litigators are discovering, there are a host of contracts in the world that use the term "willful" but do not offer clear guidance as to its meaning, and significant damages questions may rest on the ability of litigators to "prove" what the parties intended.

1. Holmes, "The Path of the Law," 10 HARV. L. REV. 457, 462 (1897) (quoted in FARNSWORTH ON CONTRACTS §12.17a (3d. Ed.)).

2. This line of cases, of course, raises the question of why parties would even need to carve out a willful/malicious breach exception from a damage limiting provision when courts have already done so by operation of law.