What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending

Mark Snyderman†

Good morning, ladies and gentlemen. This is a sad and rather disappointing set of circumstances that will unfold before you in the next several days. This is a case where a bank suddenly withdrew the promised financing when it had plenty of collateral. This is a case where the bank withdrew money it had promised was due even though it had nothing to lose when it did it.¹

So began the plaintiff's attorney in *K.M.C. Co., Inc. v Irving Trust Co.*, a prototypical example of a hard case making bad law. Similar words uttered in courtrooms throughout the United States signal the increasingly litigious nature of the lender-borrower relationship. *K.M.C.* and similar cases have established the liability of lenders to both their borrowers and third parties under a variety of legal theories² including fraud,³ duress,⁴ interference,⁵ intentional

† A.B. 1979, Washington University; M.A. 1981, Harvard University; Ph.D. 1983, Harvard University; J.D. Candidate 1989, The University of Chicago.

¹ Plaintiff's opening statement at trial in *K.M.C. Co., Inc. v Irving Trust Co.*, 757 F2d 752 (6th Cir 1985), quoted in Helen Davis Chaitman, *David, Inc. v Goliath National Bank*, 13 Litigation 32 (Summer 1987).

² See generally 1-4 *Emerging Theories of Lender Liability* (ABA, 1985, 1987); Werner F. Ebke and James R. Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw L J 775 (1986); Lawrence F. Flick, II and Dennis Replansky, *Liability of Banks To Their Borrowers: Pitfalls and Protections*, 103 Bank L J 220 (1986); John O. Tyler, Jr., *Emerging Theories of Lender Liability in Texas*, 24 Houston L Rev 411 (1987).

³ *Sanchez-Corea v Bank of America*, 38 Cal 3d 892, 701 P2d 826 (1985) (affirming jury award of \$1 million in punitive damages against bank for obtaining assignment of debtor's accounts receivable in return for false representation that it would advance additional funds); *Stirling v Chemical Bank*, 382 F Supp 1146 (S D NY 1974), aff'd 516 F2d 1396 (2d Cir 1975) (cause of action for fraud against lenders for allegedly causing plaintiffs to resign their positions as officers and directors of the debtor company by falsely representing that they would make further loans).

⁴ *PECOS Const. Co. v Mortgage Inv. Co.*, 80 NM 680, 459 P2d 842 (1969) (lender liable for additional fee received at closing upon threat not to fund construction project); *State National Bank v Farah Manufacturing Co.*, 678 SW2d 661 (Tex App 1984) (bank's bad faith threat to declare a default and accelerate payment unduly influenced election of company officers and directors). *Farah* demonstrates the expansion of the good faith doctrine

infliction of emotional distress,⁶ various control theories,⁷ breach of fiduciary duty,⁸ and breach of the covenant of good faith and fair dealing. The success of borrower lawsuits, with jury verdicts frequently in the tens of millions of dollars,⁹ has fed upon itself;

through its importation into the duress context.

⁶ *Farah*, 678 SW2d 661 (Texas court expands common law doctrine of tortious interference with contractual relationship to interference with corporate debtor's governance); *Melamed v Lake County National Bank*, 727 F2d 1399 (6th Cir 1984) (cause of action for tortious interference with corporate governance in bankruptcy where lender took actions normally reserved for trustee).

⁷ *Ricci v Key Bancshares of Maine, Inc.*, No 82-0249-P (D Me April 10, 1987). In *Ricci*, the bank terminated line of credit based on a false rumor that the borrower was involved in organized crime, ignored the borrower's denials, and refused to return his phone calls. The \$6 million awarded for emotional distress was part of a \$15 million total damage award. The case settled for \$10 million. 1 Lender Liab L Rep 8 (Oct 1987).

⁸ Lenders who assume a controlling position over borrowers, whether or not pursuant to the loan agreement, may be liable under several theories. One is tortious interference, discussed in note 5. Another is breach of fiduciary duty, discussed in note 8. In addition, a controlling creditor may be liable to noncontrolling creditors of the borrower (*A. Gay Jensen Farms Co. v Cargill, Inc.*, 309 NW2d 285 (Minn 1981)), may be liable for the borrower's torts (*Conner v Great Western Savings & Loan Assn.*, 69 Cal 2d 850, 447 P2d 609, (1968)), and taxes (*Commonwealth National Bank of Dallas v United States*, 665 F2d 743 (5th Cir 1982)), and may have its claim equitably subordinated to other creditors in bankruptcy (*In re American Lumber Co.*, 5 Bankr 470 (D Minn 1980); *Taylor v Standard Gas & Elec. Co.*, 306 US 307 (1939) ("Deep Rock")). See generally K. Thor Lundgren, *Liability of a Creditor in a Control Relationship with Its Debtor*, 67 Marq L Rev 523 (1984).

Loan provisions calling for various forms of lender control over a borrower's business or assets are a form of security. As the law imposes greater duties on lenders in control relationships, the use of control provisions in loan agreements declines. The protection of lender interests therefore requires greater flexibility in other forms of security arrangements, such as demand notes and specific default provisions. The law has moved in the opposite direction, however, increasing restrictions on lender behavior in all loan agreements.

⁹ The lender-borrower relationship does not, as a general rule, create a fiduciary duty. *Center Bank of Kansas City v Distributors, Inc.*, 705 SW2d 42 (Mo App 1985); *Dolton v Capitol Federal Savings & Loan Assn.*, 642 P2d 21 (Colo App 1981). However, several recent cases have found a fiduciary relationship where there has been a long-term course of dealings between the borrower and the lender, and the borrower has placed trust and confidence in the lender's financial advice. *Barrett v Bank of America*, 183 Cal App 3d 1362, 229 Cal Rptr 16 (1986); *Hooper v Barnett Bank of West Florida*, 474 S2d 1253 (Fla App 1985); *Deist v Wachholz*, 678 P2d 188 (Mont 1984). A fiduciary duty may also be imposed on lenders who exert control over a borrower's business or assets. *In re Process-Manz Press, Inc.*, 236 F Supp 333 (N D Ill 1964), rev'd on jurisdictional grounds, 369 F2d 513 (7th Cir 1966); *In re American Lumber Co.*, 7 Bankr 519 (Bankr D Minn 1979).

In lender liability suits, borrowers who establish a fiduciary duty on the part of the lender have an easier case to make in establishing lender misconduct. Among other things, the fiduciary lender must meet a much more stringent standard of good faith than that required in the usual lender-borrower relationship. This comment will consider good faith requirements only in the non-fiduciary setting.

¹⁰ Two recent cases, involving compensatory damages only, have resulted in awards of over \$100 million. *FDIC v Scharenberg*, No 84-2712 (S D Fla 1987) (\$105 million); *Penthouse Int'l v Dominion Fed. Sav. & Loan*, 665 F Supp 301 (S D NY 1987) (\$130 million award handed down by judge sitting without a jury). The *Penthouse* judgment was subse-

"lender liability" has become the buzzword for a new branch of commercial law. There is a climate of uncertainty among lenders, who realistically must believe that any acceleration, foreclosure, or refusal to continue funding a loan is likely to result in a lawsuit. Quite naturally, this increased cost of doing business will be felt by borrowers as well, through greater difficulty in obtaining loans, higher interest rates, and less flexible credit arrangements.

Breach of the covenant of good faith has been a particularly prevalent claim in lender liability suits. No doubt much of this popularity can be traced to the vague and moralistic nature of the concepts "good" and "bad" faith. In recent years, courts have given an expansive interpretation to good faith performance in borrower lawsuits. As a result of apparently inconsistent court decisions and an expanding scope of liability, lenders find themselves uncertain as to the standard of behavior the law requires. In the words of one commentator, good faith has become a "loose canon" that the courts have used "to further their views of justice."¹⁰

Two frequently cited federal cases are especially troublesome. In *Brown v Avemco Investment Corp.*,¹¹ a Ninth Circuit panel held that the UCC imposes a good faith requirement on specific default provisions, such as due-on-sale clauses. The option to foreclose or accelerate following a specific default may be exercised only if the lender also has a good faith belief that the loan is insecure.¹² In *K.M.C. Co., Inc. v Irving Trust Co.*,¹³ a Sixth Circuit panel found that, despite a demand provision in the loan agreement calling for repayment at any time upon demand, Irving had a good faith obligation to notify K.M.C. before Irving discontinued funding a line of credit.¹⁴ The court rejected Irving's argument that a good faith notice requirement was inconsistent with its right to repayment on demand. Citing *Brown*, the court stated that a demand provision, like a general insecurity or specific default clause, is subject to a good faith standard of reasonableness and fairness.¹⁵

The problem with the *Brown* and *K.M.C.* decisions is not their results as much as the unnecessary expansion of legal principles used to reach them. In each case, the lender exhibited egregious

quently reversed by the Court of Appeals. 1988 US App LEXIS 11877 (2d Cir).

¹⁰ William D. Warren, *Good Faith Under the Uniform Commercial Code*, 1 *Emerging Theories of Lender Liability* 58 (ABA, 1985).

¹¹ 603 F2d 1367 (9th Cir 1979).

¹² *Id* at 1375.

¹³ 757 F2d 752 (6th Cir 1985).

¹⁴ *Id* at 759.

¹⁵ *Id* at 760.

behavior, making its case rather unsympathetic.¹⁶ Both courts might have found for plaintiffs under established principles of waiver or estoppel, without expansion of the requirements of good faith performance. Demand notes and specific default provisions are tools by which lenders and borrowers allocate the risks of uncertainty. These provisions allow lenders to reduce their costs of gathering information, shift the risks of price changes, and avoid the costs of litigation. Such reduced costs are passed on in the form of better contract terms for the borrower. By imposing a good faith obligation in this context, courts upset the reasonable expectations of the parties and significantly limit the flexibility available to lenders and borrowers in furtherance of commercial transactions. Rather than using more narrowly defined rules that might allow consumers of the law to order their behavior, the *Brown* and *K.M.C.* courts have applied an increasingly ill-defined standard to overrule the express terms of a contract.

This comment is specifically concerned with the concept of good faith performance in commercial lending. From a broader perspective, good faith in lender liability will be treated as a case study of good faith contract performance in general. The comment analyzes the various conceptions of good faith embraced by the UCC and several commentators, and then examines how these conceptions might apply in the context of contracts to loan money. Finally, a critical appraisal of *K.M.C.*, *Brown*, and related decisions leads to a series of recommendations about the use of the good faith performance doctrine in commercial lending cases, and more generally in contract disputes.

It is the thesis of this comment that good faith performance, particularly in the context of lender liability, is a dangerous and unnecessary doctrine that unjustifiably restricts freedom of contract and creates a needless presumption that allows judges and juries to substitute their conceptions of reasonableness and fairness for those of parties more knowledgeable about the realities of the market. The inconsistent application of the good faith doctrine to lending practices adds uncertainty and other costs to business transactions in abrogation of the fundamental purposes of commercial law.

¹⁶ See text at notes 59 and 79 for details of these cases.

I. THE NATURE OF GOOD FAITH PERFORMANCE

A. The UCC

The concept of good faith is ubiquitous in contract law. It is important, therefore, to distinguish what Allan Farnsworth describes as the two senses of good faith.¹⁷ The first is generally concerned with good faith purchase:

Here "good faith" is used to describe a state of mind: A party is advantaged only if he acted with innocent ignorance or lack of suspicion. This meaning of "good faith" is very close to that of lack of notice.¹⁸

This sense of good faith is intended, for example, in UCC § 3-302(1)(b),¹⁹ requiring that a holder in due course of an instrument take in good faith, i.e., in the honest belief that the paper is valid.²⁰

The second sense of good faith is good faith performance:

In this sense "good faith" has nothing to do with a state of mind—with innocence, suspicion, or notice. Here the inquiry goes to decency, fairness or reasonableness in performance or enforcement.²¹

Good faith performance is most commonly required where a contract contains an open quantity or price term, or is subject to conditions in the control of one party. Requirements and output contracts are typical examples.²² In the loan context, good faith performance will generally apply to refusals to honor lending com-

¹⁷ E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U Chi L Rev 666 (1963).

¹⁸ Id at 668.

¹⁹ Uniform Commercial Code Official Text With Comments (West, 1978). Subsequent references to the Uniform Commercial Code refer to the Official Text, unless otherwise indicated.

²⁰ Prior to the adoption of the UCC there had been a long-standing dispute as to whether the good faith standard for holders in due course was subjective or objective. The drafters of the UCC, after experimenting with an objective test in the 1952 draft, adopted the present provision in 1957, apparently intending to resolve the dispute in favor of a subjective test. James J. White and Robert S. Summers, *Handbook of the Law Under the Uniform Commercial Code* § 14-6 at 563 (West, 2d ed 1980); Alan Schwartz and Robert E. Scott, *Commercial Transactions: Principles and Policies* 975 (Foundation, 1982). But see Neil O. Littlefield, *Good Faith Purchase of Consumer Paper: The Failure of the Subjective Test*, 39 S Cal L Rev 48 (1966), for an argument that a subjective test is often inappropriate in holder in due course cases, and that courts do not always use it.

²¹ Farnsworth, 30 U Chi L Rev at 668 (cited in note 17).

²² UCC § 2-306(1) states, in relevant part:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith . . .

mitments, refusals to make loans and advances, accelerations, and foreclosures.²³

Farnsworth's definition of good faith performance, including notions of "decency, fairness, and reasonableness," is partially consistent with the UCC's definition of good faith performance. Section 2-103(b) of the Code defines good faith "in the case of a merchant" to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." This definition is applicable to § 2-305 on open price terms and § 2-306 on output and requirements contracts, among others. More generally, § 2-311(1) requires that any provision under a sales contract leaving performance to be specified by one of the parties must be made "in good faith and within the limits set by commercial reasonableness."

The UCC commercial reasonableness definition of good faith applies only to Article 2—Sales, and within Article 2 only to merchants. Section 1-203, in the Code's General Provisions, states: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." Section 1-201(19) defines good faith as "honesty in fact in the conduct or transaction concerned."

The drafters of the Code explicitly rejected application of reasonable commercial standards to good faith in all commercial agreements. Section 1-201(18) of the May 1949 draft of the UCC reads:

"Good faith" means honesty in fact in the conduct or transaction concerned. Good faith includes good faith toward all prior parties and observance by a person of the reasonable commercial standards of any business or trade in which he is engaged.

The ABA Section on Corporation, Banking and Business Law recommended that the objective reasonableness standard be dropped, and good faith limited to the absence of dishonesty, trickery, deceit, or improper purpose.²⁴ It argued that commercial reasonableness was too vague and evolutionary a standard in many contexts

²³ See generally Michael L. Weissman, *Lender Liability: The Obligation to Act in Good Faith and Deal Fairly*, 69 J Comm Bank Lending 2 (December, 1986); Note, *K.M.C. Co. v Irving Trust Co.: Discretionary Financing and the Implied Duty of Good Faith*, 81 Nw U L Rev 539 (1987); Note, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?* 40 Vand L Rev 1197 (1987); Comment, *Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 Emory L J 917 (1987).

²⁴ Walter D. Malcolm, *The Proposed Commercial Code*, 6 Bus Law 113, 128 (1951).

to be of any practical use. Adoption of such a standard might diminish flexibility in commercial transactions:

[T]he phrase "observance of reasonable commercial standards" carries with it the implication of usages, customs or practices. If this is true there immediately arises the very difficult problem of *what* usages, customs or practices are those intended to be included in the standard. Any lawyer who has ever attempted to prove what a usage or custom is will immediately recognize how litigious such a standard could grow to be. More serious still is the possibility that "reasonable commercial standards" could mean usage, customs or practices existing at any particular time. This could have the very bad effect of freezing customs and practices into particular molds and thereby destroy the flexibility absolutely essential to the gradual evolution of commercial practices.²⁵

The Code drafters subsequently dropped the reasonableness standard from their general definition of good faith, leaving only the subjective "honesty in fact" standard.²⁶ Objective reasonableness tests were relegated to specific Code provisions, primarily in Article 2.

The rejection of an objective test in § 1-203 and its addition to other sections of the Code creates a "negative implication that § 1-201(19) deals only with dishonesty."²⁷ The legislative history of the Code reveals that the drafters intended to move away from a moralistic conception of commercial law apparent in the 1949 draft.²⁸ The new general definition of good faith signaled a "clear rejection of 'commercial decencies' as an unnecessarily broad, moralistic imperative."²⁹ It seems, therefore, that the UCC imposes no general obligation of commercial reasonableness outside of Article 2.

Nonetheless, one must also consider UCC § 1-102(3):

The effect of provisions of this Act may be varied by agree-

²⁵ Id.

²⁶ Despite disagreement as to how to interpret the drafters' rejection of the commercial reasonableness standard, there seems little doubt that "honesty in fact" is itself a subjective test. Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 Colum L Rev 798, 812 (1958) ("this 'subjective' test, sometimes known as the rule of 'the pure heart and the empty head'"); Farnsworth, 30 U Chi L Rev at 671 (cited in note 17); *La Sara Grain Co. v First National Bank of Mercedes*, 673 SW2d 558, 563 (Tex 1984).

²⁷ Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va L Rev 195, 214 n 69 (1968).

²⁸ Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 Duke L J 619, 624, citing Grant Gilmore, *The Ages of American Law* 83-86 (Yale, 1977).

²⁹ Gillette, 1981 Duke L J at 624.

ment, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

This provision apparently requires that good faith behavior must, at a minimum, be "not manifestly unreasonable."

There is a distinction, however, between a proscription against "not manifestly unreasonable" behavior, and a requirement that all contract performance behavior meet "reasonable commercial standards." "Manifestly unreasonable" is more akin to "unconscionable," or "the result of overreaching." A broader reading of these terms would be inconsistent with the UCC's general presumption that parties to an informed freely-entered agreement may set their own terms, as long as the interests of innocent third parties are protected. For example, even under the stricter good faith requirements of Article 2, § 2-309(3) creates a presumption that the other party receive "reasonable notification" prior to contract termination, but allows the notification requirement to be dispensed with by agreement if such a dispensation would not be "unconscionable."

B. Communitarians and Abolitionists

Robert Summers criticizes the UCC precisely because its definition of good faith is not "open-ended."³⁰ The drafters of the UCC, he says, were concerned with subjective dishonesty in § 1-203, and attempted to deal with nondishonest forms of bad faith—requiring an objective test—through specific provisions, primarily in Article 2. Summers contends that the drafters thereby overlooked, and the UCC does not cover, many forms of nondishonest bad faith.³¹

Farnsworth also believes that § 1-203 applies only to subjective honesty, and that the good faith requirement of the UCC was thereby "enfeebled."³² Because the drafters of the UCC were primarily concerned with good faith in Farnsworth's first sense (good faith purchase), they allowed good faith performance (the second

³⁰ Summers, 54 Va L Rev at 215 (cited in note 27).

³¹ *Id* at 210-15.

³² Farnsworth, 30 U Chi L Rev at 674 (cited in note 17).

sense) to appear only in specific provisions, thereby undermining the status of good faith performance as an "overriding" or "super-eminent" principle.³³

Summers's and Farnsworth's critical attitude toward the narrow reach of the general good faith obligation under the UCC may be described as communitarian; they believe that the duty to perform in good faith should be a broad obligation derived from objective community standards of fairness and decency. In contrast, abolitionists, such as the ABA Section on Corporation, Banking and Business Law (at least in 1951), would abolish any general reasonableness good faith requirement, and limit its scope to subjective honesty in fact, leaving reasonableness requirements to be imposed only in specific circumstances.

The communitarian position, represented in the works of Summers,³⁴ Farnsworth,³⁵ Stephen Burton,³⁶ and B.J. Reiter,³⁷ is

³³ Id.

³⁴ Summers argues that good faith is a "pervasively relevant [concept] in contracting contexts," that defies a single definition, though it is generally concerned with decency, fairness, and reasonableness. Summers, 54 Va L Rev at 263 (cited in note 27); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 Cornell L Rev 810, 826 (1982). He criticizes the UCC definition because there are many "forms of bad faith that do not involve dishonesty, let alone negligence—for example, openly abusing the power to break off negotiations, openly taking unfair advantage of bargaining power, openly acting capriciously or openly undercutting another's performance." Summers, 54 Va L Rev at 210. Summers praises the Restatement definition, but favors an "excluder" conception of good faith that rules out a wide range of heterogeneous context-dependent forms of bad faith. The obvious vagueness of this conception is circumvented, he argues, by the adoption of more specific rules in particular contexts. The "pervasiveness" of good faith serves to motivate these rules. Summers's conception is useful, however, only to the extent that it does produce a consistent body of rules by which consumers of law can organize their behavior.

³⁵ Farnsworth explains that applications of the general obligation of good faith result "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." Farnsworth, 30 U Chi L Rev at 669 (cited in note 17). In pressing his case for an objective good faith standard, Farnsworth stresses that the good faith standard should be "based on the decency, fairness or reasonableness of the community and not on the individual's own beliefs as to what might be decent, fair or reasonable." Id at 672.

³⁶ Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv L Rev 369 (1980); Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 Iowa L Rev 1 (1981); Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 Iowa L Rev 497 (1984). Like other communitarians, Burton defines good faith in terms of the objectively reasonable expectations of the parties. Bad faith, he says, is the exercise of discretion to recapture opportunities foregone upon entering into the contract. Thus, for example, when parties enter into an agreement leaving the price term open, it is reasonably expected that the price-fixing party has foregone the opportunity to set the price at anything drastically different from that determined by the market. Under Burton's scheme there is an objective reasonableness standard with regard to expectations, but courts

best exemplified by the Restatement (Second) of Contracts. Restatement § 205 counsels that a duty of good faith and fair dealing should be imposed in the performance and enforcement of every contract. Comment a to § 205 recites:

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.³⁸

To communitarians, good faith is a "substantial element of what constitutes reasonable expectations,"³⁹ and these expectations are derived from relevant community standards; they are the background understanding upon which all contracts are formed.

Abolitionists do not deny the role of reasonable expectations in contract interpretation, but rather question the value of a blanket provision imposing community standards on every contract. The ABA Section on Corporation, Banking and Business Law outlined two primary difficulties with such a provision: 1) community standards are often vague, leading to excessive litigation over their application; and 2) commercial standards, or at least those of the contracting parties, may evolve more quickly than those adhered to by the courts, and the rigid application of outmoded standards will stifle such evolution.⁴⁰

Clayton Gillette has also argued that the good faith obligation

will have to inquire into the subjective intent of the discretion-exercising party to determine whether it was indeed attempting to recapture foregone opportunities. Burton, 69 Iowa L Rev at 503. This subjective good faith is much closer to the UCC's "honesty in fact."

Burton's analysis has the distinction of being the most limited in scope of the communitarian conceptions. Because the court must find both a violation of reasonable expectations *and* the subjective intent to violate, there will be fewer cases in which the good faith obligation will be applied to proscribe conduct. Beyond this, "foregone opportunity" analysis seems to add little to the general concept that a contracting party must not act so as to violate the reasonable expectations of the other party. After all, the opportunities foregone by a contracting party are those within the reasonable expectations of the parties. Will it be any easier, or involve any different inquiries, for a court to determine what opportunities were foregone than for a court to determine the other party's reasonable expectations?

³⁷ B.J. Reiter, *Good Faith in Contracts*, 17 Valp U L Rev 705 (1983). Reiter's is perhaps the most extreme communitarian theory of good faith. Reiter views good faith as part of the moral basis of contracts. In this view, contracts are not only an end but also a means of achieving more fundamental social goals. *Id.* at 717. Contracts must therefore be constrained if the goals are to be reached.

³⁸ Restatement (Second) of Contracts, § 205 comment a (1981).

³⁹ Reiter, 17 Valp U L Rev at 714 (cited in note 37).

⁴⁰ See ABA quotation in text at note 25.

should be limited to subjective honesty in fact.⁴¹ In addition to the problems identified by the ABA, Gillette insists that the vagueness of the good faith standard will lead to judicial inconsistency and misapplication that will override the freely-entered agreement of the parties.⁴² Most important, an expansive interpretation of good faith, allowing the judiciary to "'do justice' in particular cases" "introduces an element of uncertainty that is likely to increase risks and raise costs at the contract formation stage."⁴³ Gillette maintains that the benefits from a good faith prohibition on dishonesty are worth the costs in interpretation and administration, but the benefits of a broader, objective reading of good faith are not, since existing equitable and common law doctrine is sufficient to handle those cases where good faith as community standards might be applied.⁴⁴

C. The Reification of Community Standards

The differences between the two positions on good faith may be best understood against a background of commonly held principles of contract interpretation. Absent fraud or other forms of illegality, the parties to an informed, freely-entered agreement should be able to set their own terms, and the explicit terms of the contract should be controlling in any subsequent dispute. When a dispute arises over the meaning of the contract, the court examines the contract, and any other evidence permitted by the parol evidence rule, to determine the intentions of the parties. The court interprets the contract in line with the reasonable expectations of the parties. Reasonable expectations are an objective standard derived from the relevant community in which the parties formed and performed the contract. Reasonable expectations are the background understanding informing the terms of every contract.⁴⁵

⁴¹ Gillette, 1981 Duke L J at 619 (cited in note 28).

⁴² Id at 643-49.

⁴³ Id at 650-51.

⁴⁴ Id at 627, 632.

⁴⁵ "That portion of the field of law that is classified and described as the law of contracts attempts the realization of reasonable expectations that have been induced by the making of a promise." Arthur Linton Corbin, *Corbin on Contracts* § 1 at 2 (West, 1963); "In order to determine the legal meaning of a contract or agreement, a 'standard of interpretation' must first be established, that is, the criterion by which the meaning of the language and other manifestations of intention of the parties is to be ascertained. . . . The standard most applicable to a bilateral transaction would seem to be that of reasonable expectation, that is, the sense in which the party using the words should reasonably have apprehended that they would be understood by the other party." Walter H. E. Jaeger, 4 *Williston on Contracts* § 603 at 334, 344-45 (Baker, Voorhis, 3d ed 1961) (footnotes omitted).

These principles of interpretation are fundamental to contract law irrespective of any conception of good faith; the dispute over the meaning of good faith derives essentially from the indeterminacy of language. Given that it is possible to read a contract so as to permit or proscribe virtually any behavior, the question is when a court should be willing to move away from the contract itself and look to community standards of reasonableness, decency, and fairness. It is a disagreement over the strength of the presumption to be given to the explicit terms of the contract. In the end it is a debate over the relative competence of courts and parties to determine what is reasonable.

This comment takes the position that the communitarian conception of good faith performance is dangerous because it represents a reification of community standards.⁴⁶ By giving the general background understanding a label, and reading it explicitly into every contract, as in Restatement § 205, the communitarians have shifted the presumption decidedly away from the text of the contract.

A communitarian conception of good faith is problematic not in theory, where it is consistent with basic principles of contract interpretation, but in practice. A fundamental consequence of the principles of contract interpretation outlined above⁴⁷ is that good faith, even under a communitarian conception, may never be used to override the express terms of a contract.⁴⁸ The enforcement of the duty to perform in good faith is enforcement of the background understanding that is properly an aid to interpretation of

⁴⁶ An early use of the good faith performance doctrine provides an excellent example of its reifying function. Under Roman law, the magistrate in contract disputes had to request that the court compel the defendant to perform for the plaintiff *ex fide bona*—in accordance with good faith. By reciting these magic words, cases outside the very limited jurisdiction of the Roman civil law could be brought before the court, thereby allowing the judge to apply a number of rules derived from the customary commercial practices of the day. Raphael Powell, *Good Faith in Contracts*, 9 Current Legal Problems 16, 19-21 (1956).

⁴⁷ See note 45 and accompanying text.

⁴⁸ A subsidiary consequence of this conception of good faith is that if community standards change, a court must interpret a contract not in line with the new standards, but consistent with the background understanding that formed the reasonable expectations of the parties at the time the contract was formed (unless the court deems that a modification has occurred). Thus, for example, in imposing a good faith obligation on an employment-at-will contract in *Monge v Beebe Rubber Co.*, 114 NH 130, 316 A2d 549, 551 (1974), the argument of the New Hampshire Supreme Court that “[t]he law governing the relations between employer and employee has . . . evolved over the years to reflect changing legal, social, and economic conditions,” was misplaced if these conditions had changed during the six years of the plaintiff’s employment.

contract terms, not a term in and of itself.⁴⁹ The danger in reifying community standards is that it turns the notion of a freely-entered agreement on its head, creating a presumption to look beyond the express terms of the contract. As a result, good faith doctrine, particularly in lender liability cases, has added uncertainty to the law, making it more likely that courts will override contract terms based on their own conceptions of decency and fairness.

One might argue that "good faith" reification is no more dangerous than the use of "reasonable expectations," which is itself a label for the background understanding. The difference is that "reasonable expectations" properly connotes that it is the expectations of the *parties* that are preeminent in contract interpretation; community standards are relevant to the extent they indicate what the parties to the contract must have meant. "Good faith," on the other hand, turns community standards into a thing, an implied term that appears in every contract. Community standards should aid contract interpretation where meaning is ambiguous; a communitarian conception of good faith makes it too easy for judges and juries to look to community standards in every case, even when the intentions of the parties are clear from the face of the document or from other evidence. Communitarians and abolitionists differ fundamentally in their willingness to give judges and juries another tool with which to police agreements.

As with most scholarly disputes, the disagreement about the proper scope of good faith takes place at the margins. Notwithstanding the indeterminacy of language, most behavior tends either to fall clearly within the language of the contract and thus within the contract terms, or clearly outside the language of the contract, and therefore within the province of community standards. The classic examples of the duty to perform in good faith fall within the latter category. These examples include contracts with open price terms, output and requirements contracts, and contracts in which the specification of certain conditions is under the control of one party. In these cases courts must look to community standards (the reasonable expectations of the parties) rather than allow *any* price or *any* demand or specification to bind

⁴⁹ Some of the more extreme communitarians, such as Reiter and Summers, might not agree with this characterization of the communitarian position. They might argue that the good faith obligation does indeed empower a court to override the terms of a contract where standards of decency, fairness, and reasonableness dictate. The argument that good faith as the reification of community standards is an unnecessary exercise in discretion by judge and jury applies with even greater force to this more expansive conception of good faith.

the other party. At the low end there must be some price, output, or demand if the contract is not to fail for want of consideration. At the high end, some prices and demands may be so great as to be beyond the reasonable expectation of any party. (This is what is meant by opportunistic behavior.) The UCC thus imposes a duty on the parties to such a contract to set the price, or the demand or specification, in good faith. In each case, good faith is qualified in terms of "reasonableness" or "market price."⁵⁰

The good faith "reification" in these cases is merely a shorthand for an interpretational principle over which there is no dispute. The background understanding in open-price, open-output and requirements contracts is clear enough that the law can reduce transaction costs by codifying these expectations. It is cheaper for those rare actors who really intend an open price term to be within one party's complete discretion to specify that intention explicitly than for everyone else to specify the reasonable limitations on their open price terms. However, there seems to be no purpose served by the Code's use of the term "good faith" in these cases, where the term "reasonable" will do just as well.

The drafters of the UCC restricted the use of good faith as reasonableness to specific provisions within the Code rather than

⁵⁰ UCC § 2-305(2) specifies:

A price to be fixed by the seller or by the buyer means a price for him to fix in good faith.

Comment 3 explains:

Good faith includes observance of reasonable commercial standards of fair dealing in the trade if the party is a merchant. (Section 2-103). But in the normal case a "posted price" or a future seller's or buyer's "given price," "price in effect," "market price," or the like satisfies the good faith requirement.

§ 2-306 places the reasonableness requirement directly in the text of the statute:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.

Query whether "good faith" adds anything to the meaning of this section. Comment 2 further explains:

... the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his output or requirements will approximate a reasonably foreseeable figure.

Similarly, § 2-311(1):

An agreement for sale which is otherwise sufficiently definite ... to be a contract is not made invalid by the fact that it leaves particulars of performance to be specified by one of the parties. Any such specification must be made in good faith and within limits set by commercial reasonableness.

Again, what does the expression "good faith" add here?

creating a supereminent principle. Farnsworth, Summers, and other communitarians criticize this "enfeebled" good faith requirement of the UCC because it does not create a sufficient presumption to look to community standards in other cases. The abolitionists counter that the inability of the courts to define reasonableness with sufficient clarity in other circumstances imposes costs of uncertainty that outweigh any moral advantage that might accrue from further intrusion into freedom of contract. Rather than engage in further abstract discussion, it is perhaps best at this point to turn to specific examples of contract performance behavior and assess the effects in each case of the reification of community standards as a duty to perform in good faith. Our examples come from loan contracts.

II. GOOD FAITH PERFORMANCE IN LOAN CONTRACTS

A. The Commercial Lending Market

Perhaps the only generality about the lending of money to businesses that may be made with certainty is that it allows of almost no generalities. An essential characteristic of commercial lending is that each situation is unique, requiring individualized solutions. Among the myriad factors that will vary from loan to loan are the borrower's monetary needs, the period over which the loan will be available, the conditions under which it will be available, and the period and other terms of repayment. There will also be variability in the loanworthiness of the borrower, the creditor's costs of obtaining information about the borrower's loanworthiness, the availability of security (whether real property or chattels), and the existence of other secured and unsecured creditors of the borrower who may have superior property rights. To these normal complexities of the lending relationship must be added the present volatility in the lending market caused by frequent bank failures, rapid fluctuations in prices and interest rates, deregulation of banks, and the growth of interstate banking.⁵¹

Complex problems call for variegated and innovative solutions, for a plethora of lending tools including both secured and unsecured open lines of credit, transaction loans, working capital

⁵¹ FDIC Chairman Predicts Sizeable Increase in Bank Closings in 1987 Over Record Level in 1986, NY Times, § 4 at 17 (Jan 22, 1987); H. Helmut Loring and James M. Brundy, *The Deregulation of Banks*, 42 Wash & Lee L Rev 347 (1985); Nancy Dunnan, *The Wild World of Interstate Banking*, 71 ABA J 54 (Nov 1985); Helen R. Friedli, *Changing Times in Interstate Banking*, 1986 Colum Bus L Rev 97.

loans, revolving credit, and term loans and leases.⁵² The distinctions both within and between these categories stem from differences in the cost to creditors of obtaining information about the borrower, creditors' security, and the consequent allocation of risks between the parties.

The key to the credit decision is information. The relevant information has been characterized as the three C's of credit: Character, Capacity, and Capital.⁵³ "Character is an inner quality and not something worn as a visible garment."⁵⁴ It requires for its assessment not only a personal interview, but an extensive background check. "Capacity is the ability of those who manage a business to manage it successfully."⁵⁵ A background check, albeit of a different sort, is also necessary here. "Capital refers to the finances available for the operation of a business."⁵⁶

This information is relevant both at the time of the initial credit decision and at subsequent decisions to continue funding or accelerate payment, that is, during contract performance. The annals of lending are filled with stories of lenders who, to their eventual chagrin, continued to lend money with insufficient information about the borrower.⁵⁷ That such information is difficult to gather is a fact of commercial life; all credit decisions must be made with less than ideal levels of information.

In a world of zero information costs, a borrower would reasonably expect a lender to call a loan only when the expected loss from default exceeds the expected benefit from repayment. But such an assessment requires information, and in this world gathering information is costly. Because these costs will be passed on to the borrower as less favorable interest or repayment terms, the parties may negotiate to reach another solution. The lender may be allowed greater discretion in the decision to accelerate payment (i.e., it may be allowed to make the decision based on less information) in exchange for more favorable interest or other terms for the borrower. This is at least part of the explanation for demand notes

⁵² See generally Douglas A. Hayes, *Bank Lending Policies: Domestic and International* 105-129 (Michigan, 2d ed 1977); Herbert V. Prochnow, ed, *Bank Credit* 116-137, 189-218, 236-247, 289-300 (Harper & Row, 1981).

⁵³ William H. Bryan, *The Banker and the Credit Decision*, in Prochnow, *Bank Credit* at 2.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.* at 3.

⁵⁷ See, for example, *Spilled Milk: A Special Collection from The Journal of Commercial Bank Lending on Loans that Went Sour* (Robert Morris, 1985).

and specific default provisions such as due-on-sale clauses: the borrower agrees that the lender may call the loan based either on its complete discretion or with only the very limited information that the collateral has been sold, and the lender agrees to interest and repayment terms more favorable to the borrower.

Even when the lender has gathered the best possible information, loans will vary in the degree to which the lender feels secure about repayment. Which is to say that information about future events is never perfect; there will always be uncertainty as to whether the loan will be repaid. When uncertainty is high, lenders will demand high interest rates and quick repayment, or may refuse to fund altogether. Another explanation for demand notes and specific default provisions is that they allow lenders to reduce their uncertainty in exchange for better contract terms for the borrower. This uncertainty includes not only fear of default, but uncertainty about the outcome of future litigation. One of the reasons lenders require demand notes and specific default provisions is to avoid the cost of later trying to justify acceleration decisions in court. Because lenders avoid these costs, borrowers get better loan terms.

The complexities of commercial lending necessitate individualized solutions. Demand notes, due-on-sale clauses, and other provisions that move away from a strict rule of reasonable belief in a loan's insecurity are tools by which lenders and borrowers reach agreement; they represent an agreed-upon allocation of risks in a complicated market. When courts limit the flexibility with which these tools may be used, parties must live with inefficient allocations of risks and benefits. Further, the costs to all contracting parties are likely to become more uniform. To the extent that lenders are unable to distinguish between good and bad risks at the time of contract formation, cross-subsidization will ensue. As all borrowers are offered similar lending terms, lower risk borrowers, who under a more flexible system might achieve more favorable terms, are in effect subsidizing higher risk borrowers, who might be subject to discretionary demand or default provisions in a world without court-imposed terms.

B. Good Faith in Lender Liability

The preceding section presents a brief sketch of the background understanding of loan contracts to which a communitarian conception of good faith should refer. Unfortunately, this has often not been the case in the application of good faith in lender liability. The next two sections examine in detail two principal areas of lender liability law.

1. Demand notes and notice.

In *K.M.C. Co., Inc. v Irving Trust Co.*,⁵⁸ Irving refused, without notice, to continue funding a discretionary line of credit, ultimately leading to the collapse of K.M.C. The jury found that Irving had breached the loan agreement, and a Sixth Circuit panel affirmed. Irving's behavior towards K.M.C. was particularly egregious: the loan was adequately secured at all times; the bank had regularly covered K.M.C.'s overdrafts via the line of credit in the past; the bank failed to live up to its policy of giving notice before acceleration of loans; the bank officer knew that failure to cover the check would be disastrous to K.M.C.'s business; and the bank's decision not to continue funding was apparently motivated by a personality conflict between the bank officer and K.M.C.'s president.⁵⁹ Based on these facts, the court upheld the magistrate's jury instructions regarding the obligation of good faith. Drawing an analogy from Section 2-309 of the UCC's sales provisions, requiring reasonable notification before termination of an ongoing contractual relationship, the court held that Irving had a good faith obligation to notify K.M.C. before discontinuing funding, despite the express provisions of the line of credit agreement.⁶⁰ The court rejected Irving's argument that a good faith notice requirement was inconsistent with its right, under the loan agreement, to repayment on demand. Citing UCC § 1-208, the court stated in dictum that a demand provision, like a general insecurity or specific default clause, is subject to a good faith standard of reasonableness and fairness.⁶¹

UCC § 1-208 provides:

A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

The § 1-208 rule is consistent with the reasonable expectations of parties to an agreement containing an insecurity clause. "When

⁵⁸ 757 F2d 752 (6th Cir 1985).

⁵⁹ Tyler, 24 Houston L Rev at 418 (cited in note 2).

⁶⁰ *K.M.C.*, 757 F2d at 759.

⁶¹ *Id* at 760.

he deems himself insecure" must mean at least when the party has an honest belief in insecurity, and not merely "whenever he feels like it." Section 1-208 thereby gives effect to the words of the contract.

The issue of whether the good faith standard in § 1-208 is subjective or objective is unresolved. The official comment makes reference to the "honesty in fact" standard of § 1-201(19), and several courts have held that the good faith in § 1-208 depends only on the accelerating party's actual mental state.⁶² Other courts seem to favor some form of reasonableness standard,⁶³ and Grant Gilmore believes that § 1-208 means the "creditor has the right to accelerate if, under all the circumstances, a reasonable man, motivated by good faith, would have done so."⁶⁴

The objectivists seem to have the better of the argument here. If "when he deems himself to be insecure" is to mean nothing more than "when he *honestly* deems himself to be insecure," § 1-208 is superfluous; § 1-203 and § 1-201(19) already work to impose an honesty in fact requirement on all contracts. Moreover, without an objective reasonableness standard, § 1-208 imposes the nearly impossible burden of proving the other party's subjective state of mind.

In the end, however, the debate is mostly irrelevant, as an objective and subjective standard will often reach the same result in practice. "[T]he operational effect of the standard applied must be measured by the results reached rather than the incantations of priests."⁶⁵ Regardless of the standard applied, the party with the burden of proof will submit objective evidence tending to demonstrate that there were no reasonable grounds for insecurity. The inquiry will be whether the lender, faced with certain information regarding the security of the loan, could have believed it was insecure; whether the belief is characterized as "honest" or "reasona-

⁶² See, for example, *Karner v Willis*, 238 Kan 246, 710 P2d 21 (1985); *Van Bibber v Norris*, 275 Ind 555, 419 NE2d 115, 122, 124 (1981); *Farmers Coop. Elevator, Inc. v State Bank*, 236 NW2d 674, 678 (Iowa 1975); *Fort Knox National Bank v Gustafson*, 385 SW2d 196, 200 (Ky App 1964).

⁶³ See, for example, *K.M.C.*, 757 F2d at 761; *Brown v Avemco Inv. Corp.*, 603 F2d 1367, 1376 (1979); *Williamson v Wanlass*, 545 P2d 1145, 1149 (Utah 1976); *Universal C.I.T. Credit Corp. v Shepler*, 164 Ind App 516, 329 NE2d 620, 623-24, 626 (1975); *Sheppard Federal Credit Union v Palmer*, 408 F2d 1369, 1371 (5th Cir 1969).

⁶⁴ Grant Gilmore, 2 *Security Interests in Personal Property* § 43.4 at 1197 (Little, Brown, 1965).

⁶⁵ James J. White and Robert S. Summers, *Handbook of the Law Under the Uniform Commercial Code* § 26-3 at 1090 (West, 2d ed 1980) (arguing that the result of most cases would be the same under either standard).

ble" is probably inconsequential.⁶⁶ Indeed, even among the courts purporting to use a subjective test, the evidence cited goes to the question of reasonable grounds for insecurity.⁶⁷

While the application of some form of good faith standard to a general insecurity provision is noncontroversial, the justification for § 1-208's imposition of good faith on "at will" language is unclear. The official comment explains that § 1-208 is intended to give effect to clauses that "seemingly grant[] the power of an acceleration at the whim and caprice of one party." The good faith standard is imposed so that such clauses will not "be held to make the agreement void as against public policy or to make the contract illusory or too indefinite for enforcement" This concern seems more appropriate for "at will" language than for clauses that impose an "insecurity" condition. The official comment continues: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason." If the drafters of the UCC were worried about "at will" acceleration clauses because they might work to void the contract, why did they clearly exempt demand notes, under which repayment surely depends on the "whim and caprice" of one of the parties, from the good faith requirement? One possibility is the ubiquity of demand notes. When parties agree that acceleration may be at the "whim and caprice" of the creditor, general commercial practice requires that they use a separate demand note to effectuate their intentions. Thus, the expectations of the parties are clear, the creditor may call the loan "at will." On the other hand, the reasonable expectation (the background understanding) of parties who merely include an insecurity clause in a larger loan agreement is that the clause imposes some conditions on the lender's ability to call the loan. One must still question why the words "at will" would be used in the context of an insecurity clause.⁶⁸

⁶⁶ Of course, given the vagueness of the good faith concept, it may often be misapplied, regardless of the precise standard used. In *First National Bank in Libby v Twombly*, 689 P2d 1226, 1228-30, 213 Mont 66 (1984), it was established at trial that Twombly approached the bank regarding conversion of a promissory note because he was concerned that he wouldn't be able to make the payment when due. Nonetheless, the court upheld the jury verdict that under § 1-208 the bank did not have a good faith reason to believe that the prospect of payment was impaired so as to justify acceleration of the note.

⁶⁷ See, for example, *Van Bibber*, 419 NE2d at 124-25; *Fort Knox National Bank*, 385 SW2d at 198-200.

⁶⁸ There are obvious parallels between this problem and the controversy over employment at will. See generally William L. Mauk, *Wrongful Discharge: The Erosion of 100 Years of Employer Privilege*, 21 Idaho L Rev 201 (1985). California is at present the only state that imposes on employers a general good faith obligation in exercising their termina-

"At will" language aside, the official comment to § 1-208 clearly dictates that the good faith requirement does not apply to demand notes. The holding of the court in *K.M.C.*, which equates a demand provision to an acceleration clause and implies a good faith obligation, is wrong in this regard. As one court puts it: "The imposition of a good faith defense to the call for payment of a demand note transcends the performance or enforcement of a contract and in fact adds a term to the agreement which the parties had not included."⁶⁹ The court in *K.M.C.* abused good faith doctrine, imposing its own notions of "reasonableness and fairness"⁷⁰ in abrogation of the intention of the parties clear on the face of the instrument.

In its principal holding, the *K.M.C.* court interpreted the good faith obligation to require Irving to give *K.M.C.* reasonable notification before discontinuing funding of a discretionary line of credit, absent valid business reasons precluding Irving from so doing.⁷¹ The court justified this decision through analogy to UCC § 2-309(3), which requires reasonable notification before termination of a contract.⁷² In particular, the court quoted official comment 8 to § 2-309, stating that "the application of principles of good faith

tion rights. *Cleary v American Airlines, Inc.*, 111 Cal App 3d 443, 168 Cal Rptr 722 (1980). However, *Foley v Interactive Data Corp.*, 184 Cal App 3d 241, 219 Cal Rptr 866 (1986), currently under review by the California Supreme Court, may limit this doctrine.

Under the present analysis such an obligation should be imposed only if it is within the reasonable expectations of the parties; it should not be used to override terms of the contract. Given that the good faith obligation in employment at will has been imposed only on the employer, the critical inquiry is whether the labor market is such as to justify expectations that the employer's termination decision should be more constrained than that of the employee. The debate thus centers around such issues as unequal bargaining power and the relative ease with which employees can move from job to job and employers can rehire. See, for example, Note, *Protecting At Will Employees Against Wrongful Discharge: The Duty to Terminate Only in Good Faith*, 93 Harv L Rev 1816 (1980); Lawrence E. Blades, *Employment at Will vs. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 Colum L Rev 1404 (1967); Richard Epstein, *In Defense of the Contract at Will*, 51 U Chi L Rev 947 (1984).

⁶⁹ *Center Bank of Kansas City v Distributors, Inc.*, 705 SW2d 42, 48 (Mo App 1985); *Accord Flagship National Bank v Gray Distribution Systems, Inc.*, 485 S2d 1336, 1340 (Fla App 1986); *Fulton National Bank v Willis Denney Ford, Inc.*, 269 SE2d 916 (Ga App 1980); *Allied Sheet Metal Fabricators, Inc. v Peoples National Bank*, 10 Wash App 530, 518 P2d 734, 738 n 5 (1974); *Simon v New Hampshire Savings Bank*, 112 NH 372, 296 A2d 913, 915 (1972).

⁷⁰ *K.M.C.*, 757 F2d at 760.

⁷¹ *Id* at 759.

⁷² UCC § 2-309(3) provides:

Termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable.

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." The drafters of the UCC thus made a determination of the reasonable expectations of the parties, absent specific contractual provisions to the contrary. But the UCC drafters made this determination only for *sales* contracts; its application to loan contracts in *K.M.C.* is inappropriate.

No doubt the court believed that the need to "give the other party reasonable time to seek a substitute arrangement" is as valid in loans as in sales,⁷³ but that empirical assumption may be incorrect. With a discretionary line of credit, as was involved in *K.M.C.*, the period between notice and actual termination would allow the borrower to continue drawing down funds, thus circumventing the lender's bargained-for discretionary protection against further insecurity.⁷⁴ Moreover, as Irving argued, when the discretionary line of credit is coupled with a demand provision, it would be inconsistent to imply a notice requirement. To force Irving to give *K.M.C.* an opportunity to seek alternative financing would be to endanger the very security interests the demand note gives Irving the right to protect. At any rate, this is the sort of judgment that the UCC leaves to the parties.

The *K.M.C.* court addressed these objections first by erroneously imposing a good faith requirement on demand notes. Second, the court qualified the notice requirement, stating that funding could be terminated without notice if doing so involved a "valid business judgment," defining that expression in terms of reasonableness.⁷⁵ Such a limitation is contrary to the UCC, which imposes a commercial reasonableness standard in only certain circumstances, most notably in sales. "[T]he absence of a . . . burden of observing 'reasonable commercial standards' on a secured party reflects the code drafters' recognition that sales transactions are more amenable to establishment of 'reasonable commercial standards' than are the relations between secured parties and debt-

⁷³ See Note, 81 Nw U L Rev at 551-59 (cited in note 23), for an argument that this analogy is "defensible and logical." Id at 559.

⁷⁴ Flick and Raplansky, 103 Banking L J at 228 (cited in note 2) suggest that "perhaps a court would impose a corresponding 'good faith' duty on the borrower to draw down only those funds actually needed in the ordinary course of its business." This solution only compounds the problem if the imposition of a good faith duty is inappropriate in these situations. Moreover, it does not eliminate the lender's exposure to the excessive extension of credit that discretionary lending is intended to eliminate.

⁷⁵ *K.M.C.*, 757 F2d at 761.

ors.”⁷⁶ Rather than enforcing a discretionary line of credit agreement as it appeared, the court implied a notice requirement by analogy to an inapplicable UCC sales provision. Perhaps recognizing that the analogy between loans and sales is flawed, the court limited the requirement by mandating inquiry into “valid business judgment” in further disregard of the UCC.⁷⁷

2. *Due-on-sale and specific default provisions.*

As support for its imposition of a good faith requirement on demand notes, the court in *K.M.C.* cited *Brown v. Avemco Investment Corp.*⁷⁸ In *Brown*, a loan agreement between Robert Herriford and Avemco contained a due-on-sale clause stating that payment in full on the loan would be due if Herriford, without the written permission of Avemco, sold or leased the airplane used as security on the loan. Herriford leased the plane to plaintiffs without Avemco's permission in 1973. Plaintiffs made payments on Herriford's loan, without objection from Avemco, until 1975, when plaintiffs exercised their option to buy the plane and offered Avemco what they believed to be a sufficient amount to pay off Herriford's debt in full. Avemco refused the tender, and demanded payment of a larger sum from Herriford within ten days. Without further negotiations with either Herriford or the plaintiffs, Avemco repossessed the plane at the end of the ten days and sold it for an amount substantially larger than that due on the loan. The plaintiffs sued for conversion.⁷⁹

The jury found for Avemco, and a Ninth Circuit panel reversed and remanded for failure to instruct the jury on the application of the UCC and equitable principles to acceleration clauses. On the equitable side, the court believed:

⁷⁶ *Van Bibber*, 419 NE2d at 122.

⁷⁷ A recent First Circuit case, applying the good faith obligation to “impure” demand notes, also deserves mention. In *Reid v Key Bank of Southern Maine, Inc.*, 821 F2d 9 (1st Cir 1987), the loan contract contained a demand note, and in a separate document, specific provisions of default. The court read these provisions as qualifying the demand note; the bank could call the loan only following the occurrence of one of the specified events, or in the good faith belief that it was insecure. *Id.* at 14-15. However, another reading is possible—one that does not nullify the demand note, and is consistent with the expectations of the parties evident on the face of the instruments. Under this reading, the loan would be payable on demand and the list of default provisions would describe events that would certainly lead to a demand for repayment, but are not intended to be exclusive. In *Reid*, the lender provided the borrower with guidelines for borrower performance, and as a result the court eliminated a provision of the contract to which both parties explicitly agreed.

⁷⁸ 603 F2d 1367 (9th Cir 1979).

⁷⁹ *Id.* at 1368-69.

The facts sufficiently suggest the possibility that . . . the creditor accelerated not out of a reasonable fear of security impairment but rather from an inequitable desire to take advantage of a technical default. Indeed acceleration because of a lease executed two years earlier is less clearly defensive and is subject to even more suspicion.⁸⁰

In applying the UCC, the court looked to § 1-208. The court held that the § 1-208 good faith requirement applies to specific default provisions, such as a due-on-sale clause, as well as to general insecurity provisions. The court reasoned that insecurity clauses "are designed to protect the creditor," and "are not to be used offensively, e.g., for the commercial advantage of the creditor," and that the good faith requirement was designed to prevent such abuse.⁸¹

It should be clear by now that the *Brown* rule is neither supported by the UCC nor the reasonable expectations of the parties. The official comment to § 1-208 explains that its good faith obligation is intended to apply to contract provisions that might appear to grant the power of acceleration at the "whim and caprice" of one party. Specific default provisions, such as the due-on-sale clause in *Brown*, do not fall in this category; by definition such provisions establish specific criteria for default and there is no need to imply additional terms in order to protect the contract from invalidation as illusory or indefinite. Nor is there need to look to community standards to establish the reasonable expectations of the parties; they are described on the face of the instrument.

While the weight of judicial authority recognizes that the good faith standard for insecurity clauses does not apply to default clauses,⁸² the *Brown* decision is not unprecedented. The Utah Supreme Court, in applying § 1-208 to a default-type acceleration clause, has found that "this statute [§ 1-208] is in harmony with the principles of equity. . . . It seems to recognize that acceleration is a harsh remedy which should be allowed only if there is some reasonable justification for doing so, such as a good faith belief

⁸⁰ Id at 1379.

⁸¹ Id at 1376, 1379.

⁸² See, for example, *Abrego v United Peoples Federal Sav. & Loan Assn.*, 281 Ark 308, 664 SW2d 858 (1984); *Brummund v First National Bank of Clovis*, 99 NM 221, 656 P2d 884 (1983); *Hersch v Citizens Savings & Loan Assn.*, 146 Cal App 3d 1002, 1011, 194 Cal Rptr 628 (1983); *Layne v Fort Carson Natl. Bank*, 655 P2d 856, 857 (Colo App 1982); *Matter of Sutton Invest., Inc.*, 46 NC App 654, 266 SE2d 686 (1980); *Don Anderson Enterprises v Entertainment Enterprises*, 589 SW2d 70, 73 (Mo App 1979); *Crocket v First Federal Sav. and Loan Assn. of Charlotte*, 289 NC 620, 224 SE2d 580, 588 (1976).

that the prospect of payment is impaired.”⁸³ The court in *Brown* gives a similar rationale: acceleration has “draconian consequences for the debtor,” and should be used by the lender only to protect itself against insecurity, not as an offensive weapon for commercial advantage when the loan is secure.⁸⁴

The idea that a specific default provision may be used only as a shield against insecurity and not as a sword for commercial advantage, such as to capture better interest rates or an increase in the value of collateral, misunderstands the concerns of the parties to a loan contract. Default provisions have the obvious property of protecting the lender's security. But specific default provisions also serve to lower the information costs associated with the acceleration decision; debtors obtain more favorable terms in other areas in exchange for a decrease in the lender's costs in determining and justifying its acceleration decision. For the courts to require a “reasonable” basis for insecurity apart from that agreed to by the parties is to eliminate part of the advantage for which the lender has bargained.

In addition, the good faith sword vs. shield rule assumes that an acceleration provision can only serve as protection against insecurity. It places the risk of rising interest rates on the lender. But changes in the market are as much a potential cost to the lender as is the possibility that the loan will not be repaid. There is no reason to believe that the lender will not take all of these potential costs into account in negotiating the terms of the loan agreement. The mortgagee who has the right to demand repayment when the mortgaged property is sold has greater protection against rising interest rates, and this advantage will be reflected in more favorable terms for the borrower. When the courts prevent lenders from using due-on-sale and other default provisions as protection against changes in the market, they do not eliminate these costs. If not through default provisions, these costs will be passed on to the borrower in other ways, such as higher interest rates, variable interest loans, and shorter times to repayment. By proclaiming that default provisions may only be used for one purpose, the good faith obligation limits the tools available to contracting parties to

⁸³ *Williamson v Wanlass*, 545 P2d 1145, 1149 (Utah 1976), quoted in *Brown*, 603 F2d at 1377. Accord *State Bank of Lehi v Woolsey*, 565 P2d 413, 417 (Utah 1977).

⁸⁴ *Brown*, 603 F2d at 1376. See Note, *Judicial Treatment of the Due-On-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, 27 Stan L Rev 1109 (1975), for a more complete exposition of the sword vs. shield argument.

reach an agreement in their best interests.⁸⁵

III. THE COSTS OF REIFICATION

The argument set out here in opposition to a broad interpretation of good faith performance is essentially one of freedom of contract. The parties to a freely-entered agreement are in the best position to assess the relative costs and benefits associated with the transaction and allocate those costs and benefits in a way that maximizes the joint product of their venture and thus the welfare of both parties. Courts should be reluctant to upset this balance unless ambiguity or incompleteness in the contract clearly requires reference to external terms. By reifying community standards, the communitarian view of good faith compels courts to police agreements more aggressively, imposing contractual requirements not in the contemplation of the parties.

Key to this argument is the assumption of a freely-entered agreement, which presupposes that the parties have an accurate perception of contract terms. Fraud and misrepresentation, proscribed even under an abolitionist, subjective conception of good faith, are therefore sufficient to invalidate a contract. Beyond this, there may be situations in which one of the parties suffers from such a relative lack of sophistication that the parties, taken together, are not in the best position to assess the relative costs and benefits of the contemplated transaction. Whatever the virtues of this argument in other contexts, it seems of little merit in commercial lending. The plaintiffs in these lender liability cases are businesspeople for whom credit is as common as employees and taxes. If freedom of contract has any validity it is in the furtherance of commerce, where we must assume commercial actors enter transactions with their eyes open.

It is not the role of the courts, who are less versed in commerce than the parties, to upset commercial transactions merely because, in hindsight, one of the parties made a bad deal. In a marvel of metaphor, a recent decision by Judge Posner makes a strong case for leaving contracting parties to their own terms:

[The party seeking to get out of the contract] did not seek to negotiate better terms. He put himself over a barrel; the courts will not put him upright. He gambled that at the price he was paying . . . he would be able to pay off [his] debt . . .

⁸⁵ A similar argument is made in Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J L & Econ 293, 311-14 (1975).

and make a profit for himself. He threw a pair of balanced dice, and lost, and that is the end of it so far as Indiana law is concerned. If the courts let him off the hook, it would just make it more difficult for people in his position to strike deals they believe are advantageous—that indeed are advantageous when made, though given the inevitable uncertainties of commercial life (of life, period) a certain percentage go awry. The less protection [the creditor] has, the less willing it will be to extend credit.⁸⁶

A. Unrequited Costs.

Courts that rewrite contracts by reference to an external good faith standard impose costs to society as a whole for which there are insufficient countervailing benefits. When loss is shifted from a borrower to a lender in contradiction of contract terms, the immediate cost to the lender is balanced by the gain to the borrower; the wealth transfer, of itself, presents no loss to society. There are, however, two other costs associated with a communitarian standard of good faith for which there are insufficient offsetting benefits. First, courts make mistakes. Because courts are in an inferior position relative to commercial actors to assess proper commercial standards, courts may adopt rules, such as those in *K.M.C* and *Brown*, that misallocate the burdens and benefits that the parties have already allocated by the express terms of the contract. By forcing parties into a different arrangement than they had agreed to, courts can only make both parties worse off. Borrowers may thus wind up involuntarily paying, through decreased availability of credit and less attractive credit terms, for protection from lenders' arbitrary action. Similar costs would be imposed from mistakes in the other direction if, as seems unlikely, courts were to excessively reduce the restrictions placed on lenders.

A second unrequited cost of court interference is the wasteful litigation produced when courts demonstrate their willingness to rewrite contracts and create vague and inconsistent rules. The recent explosive growth in borrower-lender litigation is a direct result of the expansion in successful theories of lender liability. Judicial activism in contract interpretation creates uncertainty in the market, with resultant costs to all concerned. When lenders legitimately fear that any attempt to call a loan will result in litigation,

⁸⁶ *Amoco Oil Co. v. Ashcroft*, 791 F2d 519, 524 (7th Cir 1986).

both lenders and borrowers are the losers.⁸⁷

B. The Bad Faith Tort.

Another danger in viewing good faith as a broad moral obligation is that it erodes the line between contract and tort. Community standards are part of the contract in that they inform contract terms. Breach of the duty to perform in good faith is thus breach of contract, and breach of the duty to perform in good faith cannot support an action in tort.

To date, use of the tort cause of action for bad faith performance has been limited primarily to the insurance context,⁸⁸ where concern for the traditional lack of compensation for non-monetary suffering in contract damages has been heightened by the special nature of the insurance contract—that it is a contract entered into specifically to achieve peace of mind.⁸⁹ In effect, the imposition of tort damages in these cases works to deter insurance companies from breaching the contract in situations where the insured would otherwise have insufficient incentive to litigate the issue. Awarding attorney's fees to the winning party in insurance contract litigation seems a more efficient solution to this problem.

In the employment area, some courts have reinforced the abrogation of the contract at will through the use of the good faith obligation,⁹⁰ with the imposition of punitive damages for abuse of discretionary authority.⁹¹ Query whether abuse of discretion in em-

⁸⁷ Thanks to Richard Craswell for the preceding tripartite analysis.

⁸⁸ See generally 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 (1986); *Bank's Liability for Breach of Implied Contract of Good Faith and Fair Dealing*, 55 ALR4th 1026 (1987); Thomas A. Diamond, *The Tort of Bad Faith Breach of Contract: When, If At All, Should It Be Extended Beyond Insurance Transactions?* 64 Marq L Rev 425 (1981); Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 Cal L Rev 1291 (1985).

⁸⁹ There are two categories of bad faith tort in insurance. The first successful use of the tort cause of action arose in third party insurance cases, where insurance companies were held liable in tort for failure to accept a reasonable settlement offer from third party plaintiffs. See, for example, *Comunale v Traders & General Insurance Co.*, 50 Cal 2d 654, 328 P2d 198 (1958); *Crisci v Security Ins. Co.*, 66 Cal 2d 425, 426 P2d 173 (1967); *Lange v Fidelity & Casualty Co. of N.Y.*, 290 Minn 61, 185 NW2d 881 (1971). The second category of bad faith tort is in first party insurance cases, where the insurer fails to pay the insured as per the insurance contract. See, for example, *Gruenberg v Aetna Ins. Co.*, 9 Cal 3d 566, 510 P2d 1032 (1973); *United Services Auto Assn. v Werley*, 526 P2d 28 (Alaska 1974); *United States Fidelity & Guar. Co. v Peterson*, 91 Nev 617, 540 P2d 1070 (1975); *Anderson v Continental Ins. Co.*, 85 Wis 2d 675, 271 NW2d 368 (1978).

⁹⁰ See note 68.

⁹¹ See, for example, *Smithers v Metro-Goldwyn-Mayer Studios, Inc.*, 139 Cal App 3d 643, 189 Cal Rptr 20 (1983); *Cleary v American Airlines, Inc.*, 111 Cal App 3d 443, 168 Cal

ployment differs in any principled way from other breach of contract.

The California Supreme Court's decision in *Seaman's Direct Buying Serv. v. Standard Oil Co.*⁹² represents a potentially disastrous expansion of the bad faith tort into the commercial realm. In *Seaman's Direct*, the court held that an oil company that not only breached the contract, but also denied that a valid contract existed, was liable in tort as well as contract. The court first warned, correctly, that it would be "wise to proceed with caution" in applying tort remedies to commercial contracts because "it may be difficult to distinguish between breach of the covenant and breach of contract, and there is the risk that interjecting tort remedies will intrude upon the expectations of the parties."⁹³ Nonetheless, the court established a rule that "a party may incur tort remedies when, in addition to breaching the contract, it seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists."⁹⁴

The difficulty with this formulation is that "there is no principled distinction between a denial that a contract exists—a denial of any liability on the contract—and a denial that a portion of a contract, or certain terms under the contract, exists."⁹⁵ That is, there is no reason the *Seaman's Direct* tort could not be applied by courts to all contract cases. Such complete subversion of the expectation damages standard would indeed represent the death of contract.

Another area in which the good faith tort has been applied to commercial contracts is the wrongful repossession of collateral. In *Alaska Statebank v. Fairco*,⁹⁶ for example, the Supreme Court of Alaska held that punitive damages could be awarded where Statebank had repossessed Fairco's property without a good faith belief that Fairco was in default. Other courts have reached similar decisions.⁹⁷ These cases are distinguishable from other good faith cases in which tort damages are inappropriate. In the wrongful repossession cases, the defendant took affirmative action against the plaintiff's property, instead of merely failing to perform some obli-

Rptr 722 (1980); *Gates v. Life of Montana Ins. Co.*, 205 Mont 304, 668 P2d 213 (1983).

⁹² 36 Cal 3d 752, 686 P2d 1158 (1984).

⁹³ *Seaman's Direct*, 686 P2d at 1167.

⁹⁴ *Id.*

⁹⁵ Note, 86 Colum L Rev at 401 (cited in note 88).

⁹⁶ 674 P2d 288, 296-97 (Alaska 1983).

⁹⁷ *First National Bank in Libby v. Twombly*, 213 Mont 66, 689 P2d 1226 (1984); *Compton v. Craeger Trucking Co., Inc.*, 282 Or 521, 579 P2d 1297 (1978).

gation or demanding repayment. Absent an honest (i.e., good faith) belief that such action is within one's contractual rights, taking possession of another's property without the owner's consent is tortious. Note, however, that the good faith standard here is subjective.

IV. POLICING EGREGIOUS BEHAVIOR

Having dispossessed courts of the ability to rewrite contracts, it is nonetheless the case that some contract performance behavior is so clearly outside the bounds of decency and fairness that it should be prohibited even if not explicitly disallowed by the contract. How is this goal to be achieved while minimizing the costs associated with a communitarian conception of good faith? The UCC provides explicitly for the application of equitable principles in appropriate cases:

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.⁹⁸

The course of dealing or performance between parties may act as a modification of the contract, allowing courts to apply equitable principles in order to impose new duties or prevent one party from engaging in opportunistic behavior. Such a solution is superior to the imposition of a broad good faith obligation for several reasons. First, there is an established body of equitable doctrine; courts and consumers of the law have some basic understanding of what it normally requires to waive a contractual right. A communitarian conception of good faith, by reference to "community standards of decency and fairness," adds costly uncertainty to transactions. Second, equitable solutions are fact bound. The parties to a specific transaction may, through their own behavior, modify their agreement. Thus, courts need not create inefficient rules contrary to the intention of the parties, as in *K.M.C. and Brown*, in order to police egregious behavior.

Most important, by using equitable principles rather than a broad conception of good faith to decide the egregious cases, courts will show greater deference to contract terms. When community standards are an implied term in every contract, it is too easy for

⁹⁸ UCC § 1-103.

judges and juries to apply their own conceptions of fairness and decency. The principles of equity come into play in a much smaller class of cases. The danger that waiver and estoppel will become as much of a loose cannon as good faith is minimized by the presumption, under an abolitionist conception, that courts generally are to leave contracting parties free to order their own relationships.

The German experience underscores by contrast the proper role of equity in American courts. Article 242 of the German Civil Code, like the UCC, imposes a duty to perform all obligations in good faith.⁹⁹ The two provisions have had very different histories, however. During the period of rampant inflation following World War I, good faith became a tool for the German courts to rewrite contracts in order to avoid injustices in debt repayment.¹⁰⁰ The use of good faith as an "equity reserve" was generalized to other situations in which the courts began playing an active role in implying contractual terms and obligations.¹⁰¹ The success of this enterprise in Germany has been dependent upon the German commitment to a grand design for a legal order, and to a constant and active interchange between German courts and German legal academics and professionals.¹⁰² The utility of such a scheme in the much larger and more heterogeneous American legal system is suspect. In Germany, the broad good faith obligation of Article 242 has produced an extensive and well-understood body of law. In American courts, the behavior proscribed by Article 242 is substantially handled by the UCC and existing principles of common law and equity. For example, the German courts have derived the principle of estoppel from the good faith clause.¹⁰³ Similarly, the difficulties caused by post-War inflation may have been handled by the impracticability and frustration doctrines of the common law and the UCC.¹⁰⁴

The *K.M.C.* and *Brown* decisions were no doubt motivated by the obvious abuses committed by the lender in each case. But lender liability may have been established in both *K.M.C.* and

⁹⁹ John P. Dawson, *Unconscionable Coercion: The German Version*, 89 Harv L Rev 1041, 1044 (1976).

¹⁰⁰ Id at 1044-45.

¹⁰¹ Raphael Powell, *Good Faith in Contracts*, 9 Current Legal Problems 16, 32 (1956); Dawson, 89 Harv L Rev at 1045.

¹⁰² Dawson, 89 Harv L Rev at 1123, 1126.

¹⁰³ Id at 1124.

¹⁰⁴ Powell, 9 Current Legal Problems at 33-35 (cited in note 101); Gillette, 1981 Duke L J at 646-47 (cited in note 28).

Brown without recourse to the good faith obligation, and without limiting the ability of future borrowers and lenders to reach agreements in their best interest. In *K.M.C.*, the course of dealing between the parties (in which Irving had on several occasions continued funding under similar circumstances), Irving's well-known practice of providing notice to other borrowers, and *K.M.C.*'s reliance on its good relations with Irving, might have acted as a waiver of Irving's right to change its criteria without notifying *K.M.C.*

In *Brown*, the plaintiffs had leased the airplane and made payments on Herriford's loan for two years without objection from *Avemco*. *Avemco* then repossessed the plane without notice and without negotiating with plaintiffs concerning an amount of money the plaintiffs believed sufficient to pay off the loan. The court used the good faith obligation to establish the general rule that secured creditors may not repossess collateral following default in order to make a profit. A less dangerous holding would have been that *Avemco*, through its course of dealings with the plaintiffs, waived its right to repossess without notifying the plaintiffs and allowing them to negotiate over repayment of the loan.¹⁰⁵

Such a use of equitable principles to create a duty to notify is well established in repossession cases. For example, in *Nevada National Bank v Huff*,¹⁰⁶ the Supreme Court of Nevada held that a lender who regularly accepts late payments is estopped from suddenly declaring a default and repossessing collateral without first notifying the borrower that strict compliance with the terms of the agreement will henceforth be demanded.¹⁰⁷

In *Skeels v Universal C.I.T. Credit Corp.*,¹⁰⁸ a Third Circuit panel seemed to equate the good faith obligation with the principles of equity. Citing both UCC § 1-203 and § 1-103, the court held that a lender who had knowledge that the borrower had defaulted on loan payments, but who continued to make assurances that further advances of operating capital were forthcoming, could not re-

¹⁰⁵ Similarly, in employment-at-will cases the California courts may be applying good faith where the same result could be reached under equitable principles without imposing a term that may be beyond the expectations of the parties. In *Cleary*, for example, the court held that "the longevity of the employee's service, together with the expressed policy of the employer, operate[d] as a form of estoppel . . ." 111 Cal App 3d at 456. It was thus unnecessary for the court to impose a good faith obligation when the parties, by their own conduct, had already created certain extra-contractual obligations.

¹⁰⁶ 94 Nev 506, 582 P2d 364, 369 (1978).

¹⁰⁷ Id at 369; Accord *Pierce v Leasing Intern., Inc.*, 142 Ga App 371, 235 SE2d 752, 754 (1977); *Westinghouse Credit Corp. v Shelton*, 645 F2d 869, 873 (10th Cir 1981); *Alaska Statebank v Fairco*, 674 P2d 288, 292 (Alaska 1983).

¹⁰⁸ 335 F2d 846, 851 (3rd Cir 1964).

possess collateral without notifying the borrower. The lender's behavior here acted as a modification of the contract and a waiver of its right to repossess without notice. Given that the case could be decided on narrow equity grounds, the court's reference to a general good faith obligation is superfluous.

V. THE PROPER USE OF THE GOOD FAITH OBLIGATION

When a lender accelerates repayment of a loan or proceeds against a borrower's collateral, it does so under the authority of one of three general types of contractual provisions: a specific condition of default, a general insecurity clause, or a demand provision. Demand provisions and specific conditions of default both declare on their face the reasonable expectations of the parties. There is no need to appeal to notions of fairness or decency, or to look to a background understanding, when the parties to such agreements have negotiated their own solution to a complex problem.¹⁰⁹

Insecurity clauses are similar to open-price or output and requirement contracts in sales; it is necessary to supply some additional meaning to the terms of contracts that clearly do not contemplate unbound discretion. A court must look beyond the explicit terms in order to enforce the contract according to the reasonable expectations of the parties. The UCC imposes an objective good faith obligation on the party with discretion in each of these cases.¹¹⁰ The UCC does *not* impose a good faith obligation—aside from subjective “honesty in fact”—on a party calling a demand note or accelerating upon a specific condition of default.

This comment has been an extended argument that the UCC rules are substantially correct and that courts should follow them. That so many courts have rewritten contracts rather than enforced the reasonable expectations of the parties is largely a result of an overbroad conception of the good faith obligation. Therefore, the following propositions regarding the proper use of good faith are offered.

¹⁰⁹ “[Courts] might resort to considerations of fairness or justice to interpret or supply terms when the intentions of the parties or their reasonable expectations cannot be reasonably ascertained. But it is hard to see what justifies a court in discarding the agreement of parties on grounds of ‘contractual morality’ when the intentions of the parties or their reasonable expectations can be reasonably ascertained . . .” Burton, 69 Iowa L Rev at 499-500 (cited in note 36).

¹¹⁰ See UCC §§ 2-305, 2-306, 2-311(1), 1-208 (quoted in note 50). It is an open question whether the good faith obligation in § 1-208 is objective or subjective, but it should work as an objective standard in practice. See notes 62-67 and accompanying text.

1. *Show great deference to the express terms of the contract, as read in ordinary English; do not appeal to principles of fairness or decency to interpret a contract when the contract is clear on its face or the intention of the parties is clear from the evidence.*

This is merely another version of the rule recited earlier that good faith should never be used to overturn the express terms of a contract. It is a principle consistent with the philosophy of the UCC¹¹¹ and the general tenets of contract law.¹¹² The fundamental danger in the reification of community standards is its presumption that in all cases there are external standards to which courts must look.

2. *Protect the externally determined, objectively reasonable expectations of the parties when the terms of the contract and the evidence of the parties' intentions are ambiguous.*

Again, this is a fundamental principle of contract interpretation.¹¹³ The obligation to perform in good faith is unnecessary to its application. In those cases in which courts must impose external standards, it is important that they do so in line with the realities of the environment in which the transaction has taken place. In commercial lending, the reasonable expectations of the parties include the ability to trade off the costs of information and uncertainty.

3. *Use appropriate legal and equitable theories to impose liability on parties exhibiting egregious behavior; do not rewrite*

¹¹¹ At least one commentator takes this view of the UCC general good faith provision: "[Section 1-203] in effect states that *what is not regulated by the contract* should be done in such a way as to show good faith in the carrying out of what is expressed." 1 Ronald A. Anderson, *Uniform Commercial Code* § 1-203:3 at 165 (Lawyers Co-op, 2d ed 1970) (emphasis added), cited in *Flagship National Bank v Gray Distribution Systems, Inc.*, 485 S2d 1336, 1340 (Fla App 1986), and *Fulton National Bank v Willis Denney Ford, Inc.*, 154 Ga App 846, 269 SE2d 916, 918 (1980).

Moreover, UCC § 1-205(4) provides:

The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other; but when such construction is unreasonable express terms control both course of dealing and usage of trade and course of dealing controls usage of trade.

¹¹² "[T]he courts reiterate the well-established principle that it is not the function of the judiciary to change the obligations of a contract which the parties have seen fit to make. . . . [A]fter interpretation has called to its aid all those facts which make up the environment and setting in which the words are used, the words themselves remain the best and most important evidence of intention." Walter H. E. Jaeger, 4 *Williston on Contracts* § 610A at 513-14 (Baker, Voorhis, 3d ed 1961) (footnotes omitted); "Most of what usually we think of as 'contract law' consists of a legal framework within which parties may create their own rights and duties by agreement." E. Allan Farnsworth, *Contracts* § 7.1 at 445 (Little, Brown, 1982).

¹¹³ See note 45 and accompanying text.

contracts via a vague conception of good faith.

If courts adhere to proposition 1 there will be less call for any external standards, including principles of equity. Nonetheless, fair is fair; and some contract performance behavior is unfair even under existing doctrine. The danger with using good faith to police this behavior is the uncertainty it adds to transactions. It is one thing for a lender to live by the rule that repeated assurances that a loan will not be called may act as a waiver of the ability to demand repayment absent any change in material circumstances, it is quite another for the law to declare that a demand note does not require payment on demand, or that due on sale does not mean due on sale.

Communitarians object to a narrow conception of good faith because they believe that courts must look to community standards of fairness and decency in order to control overreaching and opportunistic contract performance. But fairness is the sine qua non of equity, and equity has the advantage of well-established principles and fact-bound solutions.

4. *Eliminate the term good faith when an objective reasonableness standard is meant.*

In those cases where a court will have to impose an objective standard in order to enforce a contract, it may do so without invoking the good faith obligation. The intentions of the framers of the UCC would be more faithfully executed were every reference to an objective good faith standard replaced with some variant of the word "reasonable."

5. *Abolish the duty to perform in good faith generally.*

When the ABA Section on Corporation, Banking, and Business Law recommended that the UCC restrict good faith to subjective honesty in fact, they recognized such a move might make a general obligation to perform in good faith unnecessary.¹¹⁴ They were correct. The law of fraud already imposes on every party to a contract the duty to perform honestly. Putting another label on this doctrine gives the courts a weapon, not intended by the UCC but very real in its effects, with which to override the intentions of the parties and create uncertainty among the consumers of the law.

VI. CONCLUSION

The preceding may appear to be a protracted example of the

¹¹⁴ Malcolm, 6 Bus Law at 128 (cited in note 24).

naturalistic fallacy. By calling for the elimination of the presumption to look to community standards that is imbedded in the good faith obligation and allowing the terms of a contract to control, even when they violate standards of decency and fairness, it might seem this comment has argued that duties and obligations should be entirely within the discretion of contracting parties. Putting aside that there is much of this fallacy in the very nature of contract law, this comment may be viewed not as under the grip of a fallacy, but as embracing a conscious belief that the market is a better place to work out commercial standards than are the courts or the legislature.¹¹⁵ The market is complex, and contracts form an essential part of its operation. Until the courts know more than the parties about the market and the factors that influence contracts, they should leave the market alone, rather than impose their own conceptions of decency and fairness.

This is not to say that the market will eliminate all contract performance behavior that might be deemed indecent or unfair. We have principles of law and equity designed to curb specific forms of unfairness, and they should be enforced. The obligation to perform in good faith is a "super-eminent principle" that allows courts to attack indecent, unfair, and immoral behavior generally. To communitarians, such a principle is needed to curb numerous forms of bad faith behavior that are not proscribed by existing doctrine. This comment has argued that the benefits of such an attempt to equate the law with morality are outweighed by the costs.

¹¹⁵ See the quotation from the ABA Section on Corporation, Banking and Business Law, in text at note 25.