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THE IMPLIED COVENANT OF GOOD FAITH IN CONTRACT INTERPRETATION AND GAP-FILLING: REVILING A REVERED RELIC

HAROLD DUBROFF†

INTRODUCTION

The implied covenant of good faith contract performance has become a fundamental concept of modern contract jurisprudence. Originally applied in late Nineteenth Century common law contracts cases,¹ the covenant gained increased acceptance when it was incorporated into the Uniform Commercial Code (“U.C.C.”)² and later adopted by the American Law Institute as part of the *Restatement (Second) of Contracts* (“*Restatement*

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¹ See *infra* notes 14–20 and accompanying text.

² The U.C.C. was promulgated by the National Conference of Commissioners on Uniform State Laws and the American Law Institute in 1951. U.C.C. xv (2005). The original version of the U.C.C. had three general sections relating to good faith. U.C.C. app. xviii §§ 1-201(19) (defining good faith: “‘Good faith’ means honesty in fact in the conduct or transaction concerned.”); 1-203 (stating an obligation of good faith: “Every contract or duty within this Act imposes an obligation of good faith in its performance and enforcement.”); 2-103(1)(b) (defining good faith for purposes of Article 2: “‘Good faith’ in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade). Article 1 of the U.C.C. was revised in 2001. The revision changed the definition of good faith (except for purposes of Article 5) to “honesty in fact and the observance of reasonable commercial standards of fair dealing.” U.C.C. § 1-201 (2004). The 2001 revision also modified the statement of the obligation of good faith—“Every contract or duty within [the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement.” *Id.* § 1-304. Article 2 of the U.C.C. was amended in 2003 to remove the special definition of good faith for purposes of Article 2, except that for jurisdictions adopting the amended Article 2 that had not adopted the revised Article 1, amended Article 2 contains the same definition of good faith that is incorporated into revised Article 1. *Id.* app. xx § 2-103(j).

Second").³ Since the middle of the Twentieth Century it has attracted the attention of scholars⁴ and has become an

³ RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

⁴ See generally STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT 23 (1995); E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 7.17 (3d ed. 2004); Eric G. Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299 (1988); Hazel Glenn Beh, *Student Versus University: The University's Implied Obligations of Good Faith and Fair Dealing*, 59 MD. L. REV. 183 (2000); Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980) [hereinafter Burton, *Breach of Contract*]; Steven J. Burton, *Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View*, 35 WM. & MARY L. REV. 1533 (1994) [hereinafter Burton, *Good Faith in Articles 1 and 2*]; Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981) [hereinafter Burton, *Good Faith Performance*]; Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984) [hereinafter Burton, *More on Good Faith Performance*]; Frederick W. Claybrook, Jr., *Good Faith in the Termination and Formation of Federal Contracts*, 56 MD. L. REV. 555 (1997); Thomas A. Diamond & Howard Foss, *Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery*, 47 HASTINGS L.J. 585 (1996); Claire Moore Dickerson, *From Behind the Looking Glass: Good Faith, Fiduciary Duty & Permitted Harm*, 22 FLA. ST. U. L. REV. 955 (1995); Robert Dugan, *Good Faith and the Enforceability of Standardized Terms*, 22 WM. & MARY L. REV. 1 (1980); Robert Dugan, *Standardized Forms: Unconscionability and Good Faith*, 14 NEW ENG. L. REV. 711 (1979); Russell A. Eisenberg, *Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem*, 54 MARQ. L. REV. 1 (1971); E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 671 (1963) [hereinafter Farnsworth, *Good Faith Performance*]; Daniel Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131 (1989); Barbara A. Fure, *Contracts as Literature: A Hermeneutic Approach to the Implied Duty of Good Faith and Fair Dealing in Commercial Loan Agreements*, 31 DUQ. L. REV. 729 (1993); Mark P. Gergen, *A Cautionary Tale About Good Faith in Texas*, 72 TEX. L. REV. 1235 (1994); Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619 (1981); Victor P. Goldberg, *Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith*, 35 U.C. DAVIS L. REV. 319 (2002); Eric M. Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381 (1978); Eric M. Holmes, *Is There Life After Gilmore's Death of Contract?—Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330 (1980); Emily M.S. Houh, *Critical Race Realism: Re-claiming the Antidiscrimination Principle Through the Doctrine of Good Faith in Contract Law*, 66 U. PITT. L. REV. 455 (2005); Christina L. Kunz, *Frontispiece on Good Faith: A Functional Approach Within the UCC*, 16 WM. MITCHELL L. REV. 1105 (1990); William H. Lawrence & Robert D. Wilson, *Good Faith in Calling Demand Notes and in Refusing to Extend Additional Financing*, 63 IND. L.J. 825 (1988); Monique C. Lillard, *Fifty Jurisdictions in Search of a Standard: The Covenant of Good Faith and Fair Dealing in the Employment Context*, 57 MO. L. REV. 1233 (1992); Saul Litvinoff, *Good Faith*, 71 TUL. L. REV. 1645 (1997); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An*

increasingly familiar issue in commercial litigation.⁵ The attention lavished on the implied covenant has not, however, resulted in the emergence of a clear consensus on what it is. As Judge Posner put it, “[t]he . . . cases are cryptic as to [the meaning of good faith] though emphatic about its existence.”⁶

One of the important roles perceived for the implied covenant has been the resolution of disputes that arise after contract formation. Such disputes generally arise when the express contract either does not address the nature of the dispute, or the application of the express contract language would seem to give rise to an unfair result, which, the disadvantaged party argues, was not contemplated when the

Assessment of Judicial Strategies in Lender Liability Good Faith Litigation, 61 FORDHAM L. REV. 963 (1993); Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 IOWA L. REV. 503 (1991); Dennis M. Patterson, *Good Faith, Lender Liability and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169 (1989); James J. Stankiewicz, *Good Faith Obligation in the Uniform Commercial Code: Problems in Determining Its Meaning and Evaluating Its Effect*, 7 VAL. U. L. REV. 389 (1973); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982) [hereinafter Summers, *The General Duty of Good Faith*]; Robert S. Summers, “*Good Faith*” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968) [hereinafter Summers, “*Good Faith*” in *General Contract Law*]; Harvey L. Temkin, *Too Much Good Faith in Real Estate Purchase Agreements? Give Me an Option*, 34 U. KAN. L. REV. 43 (1985); Richard Thigpen, *Good Faith Performance Under Percentage Leases*, 51 MISS. L.J. 315 (1981); Michael P. Van Alstine, *Of Textualism, Party Autonomy, and Good Faith*, 40 WM. & MARY L. REV. 1223 (1999); Glenn Weisenberger, *Remedies for Employer’s Wrongful Discharge of an Employee Subject to Employment of an Indefinite Duration*, 21 IND. L. REV. 547 (1988); James J. White, *Good Faith and the Cooperative Antagonist*, 54 SMU L. REV. 679, 683 (2001); Joel Iglesias, Comment, *Applying the Implied Covenant of Good Faith and Fair Dealing to Franchises*, 40 HOUS. L. REV. 1423 (2004); Mark Snyderman, Comment, *What’s So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. CHI. L. REV. 1335 (1988); Susan A. Wegner, Comment, *Section 1-208: “Good Faith” and the Need for a Uniform Standard*, 73 MARQ. L. REV. 639 (1990).

⁵ A LEXIS search for “implied covenant w/1 good faith” from 1945 through 2004 reveals a total of 10,715 cases using the phrase.

Number of Cases from 1945 Through 2004 in Which Phrase
“Implied Covenant of Good Faith” Appeared

Years	# Cases	Years	# Cases	Years	# Cases
1945-1954	11	1965-1974	80	1985-1994	3,656
1955-1964	51	1975-1984	494	1995-2004	6,423

⁶ *Mkt. St. Assocs. v. Frey*, 941 F.2d 588, 593 (7th Cir. 1991).

express contract language was adopted. The assertion is then made that the party seeking to take advantage of the omission or the unanticipated application of express contract terms is not acting in good faith, thereby breaching the implied covenant. In arguing and deciding these disputes based on the implied covenant, the parties and courts frequently ignore the fundamental question of how the meaning of the agreement ought to be determined based on principles of interpretation and gap-filling.

In the early stages of the development of the covenant, it served a salutary role in affording a rationale for courts (primarily in New York) to avoid the sometimes harsh results that would otherwise have occurred under the conservative interpretation and gap-filling rules prevalent in the Nineteenth and early Twentieth Centuries, which were grounded in a formalistic approach to contract interpretation and enforcement. But at the same time that the implied covenant of good faith was gaining prominence in the Twentieth Century, the process of contract interpretation was also evolving by moving away from formalism toward an approach based on dual realities: one, language, because of its inherent ambiguity, cannot always express perfectly the actual agreement of the parties, and two, foreseeing all eventualities that may arise in contract performance is beyond the capacity of humans and gaps in contract provisions inevitably will arise. This newer approach to contract interpretation, exemplified by the U.C.C. and *Restatement Second*, which not only tolerates but encourages the exercise of judicial power in facilitating contract interpretation and enforcement, also emphasizes the context of an agreement—usage, course of dealing, course of performance, and other factors present in the relationship that gave rise to the agreement.

This Article will summarize the development of the implied covenant of good faith and the evolution of contract interpretation. It identifies a factor important to the development of the implied covenant of good faith—mitigation of the harsh results of classic contract interpretation—and suggests that courts receptive to modern techniques of interpretation and gap-filling should relegate the covenant to the status of a revered relic—useful in its day, but an impediment to clear analysis of the meaning to be ascribed to agreements. The Article will summarize the difficulties that have been presented by various

attempts to define good faith for purposes of the implied covenant. These difficulties would be eliminated if cases that are really about contract interpretation were approached that way without regard to the issue of good faith.

It must be emphasized at the outset that the concern in this Article is with the universal implication of a covenant of good faith performance and enforcement as a basis for resolving questions of contract interpretation and gap-filling. Cases involving good faith can arise in a variety of other contexts, however.⁷ For example, in some instances a “bad faith” breach of contract may give rise to tort liability⁸ or may deprive a breaching party of the benefits of the substantial performance doctrine;⁹ in other situations, a preliminary agreement or agreement to agree may bind the parties to attempt in good faith to reach a final agreement.¹⁰ In all these cases, the question of good faith cannot be avoided by resort to contract interpretation. In another category of cases, good faith is mandated by law, either because the contract expressly or impliedly confers discretion on a party in performance or enforcement,¹¹ or as a means to police opportunistic conduct.¹² In some of these instances, such as the obligation to exercise good faith in requirement and output contracts, the same criticisms that are suggested with respect to the general implied covenant of good faith apply with equal force; that is, the good faith requirement is simply a surrogate for the real question at issue, which is the interpretation of the contract. In other situations, such as those

⁷ See Burton, *Good Faith in Articles 1 and 2*, *supra* note 4, at 1537–38; Burton, *Good Faith Performance*, *supra* note 4, at 18–21.

⁸ The tort of bad faith breach is generally restricted to cases of insurance companies that wrongfully deny claims of the insured or unreasonably fail to settle claims against the insured that result in liability of the insured in excess of policy limits. See, e.g., *Silberg v. Cal. Life Ins. Co.*, 521 P.2d 1103 (Cal. 1974).

⁹ See *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 244, 129 N.E. 889, 891 (1921) (“The willful transgressor must accept the penalty of his transgression.”).

¹⁰ See E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 264–69 (1987); Charles L. Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U. L. REV. 673, 677–79 (1969).

¹¹ See, e.g., U.C.C. §§ 2-305 (discussing open price to be set by seller or buyer), 2-306 (discussing requirement and output contracts), 2-311 (discussing terms of performance to be set by one of parties); 2-712(1) (2005) (discussing buyer entitled to cover damages in making good faith substitute purchase).

¹² *Id.* § 2-209 cmt. 2 (providing that agreements modifying a contract need not have consideration but must meet the test of good faith).

in which the U.C.C. requirement of good faith for contract modifications applies, the good faith concept is not a substitute for contract interpretation, and the analysis suggested in this Article is not germane. This Article is not concerned with judging conduct once it is established that good faith is required under the contract, as properly interpreted, or otherwise under the circumstances;¹³ instead, its concern is with a more preliminary issue: whether good faith should be required as a general matter without regard to questions of interpretation.

I. A BRIEF HISTORY OF THE IMPLIED COVENANT OF GOOD FAITH AND FORMALIST CONTRACT INTERPRETATION

Although the notion of a good faith purchaser is traceable to ancient times, the implication of a covenant of good faith in contract performance is a relatively recent development in the law of contracts, arising in the second half of the Nineteenth Century.¹⁴ In its earliest uses, the covenant was applied to a variety of situations in which the express contract language, interpreted strictly, appeared to grant unbridled discretion to one of the parties and could reduce or eliminate the other party's contract benefits. These situations arose when the promisor's duty was conditioned on its satisfaction with the promisee's performance;¹⁵ when the duty to buy or sell goods was measured by the needs of the purchaser or the output of the seller;¹⁶ when the promisor's duty to pay was dependent on when he chose to sell property;¹⁷ when an insurer was granted discretion to dispute or settle claims against the insured;¹⁸ when the promisor reserved the right to interpret the contract;¹⁹ and when the

¹³ *Id.*

¹⁴ See BURTON & ANDERSON, *supra* note 4, at 23-33; Farnsworth, *Good Faith Performance*, *supra* note 4, at 670-71; Van Alstine, *supra* note 4, at 1230.

¹⁵ *Balt. & Ohio R. Co. v. Brydon*, 3 A. 306 (Md. 1886); *Doll v. Noble*, 116 N.Y. 230, 22 N.E. 406 (1889); *Singerly v. Thayer*, 2 A. 230 (Pa. 1886).

¹⁶ *Brawley v. United States*, 96 U.S. 168, 171 (1877); *Loudenback Fertilizer Co. v. Tenn. Phosphate Co.*, 121 F. 298 (6th Cir. 1903); *Wigand v. Bachmann-Bechtel Brewing Co.*, 222 N.Y. 272, 118 N.E. 618 (1918); *N.Y. Cent. Ironworks Co. v. U.S. Radiator Co.*, 174 N.Y. 331, 66 N.E. 967 (1903) (dictum); *Genet v. President of the Del. & Hudson Canal Co.*, 136 N.Y. 593, 32 N.E. 1078 (1893); *Asahel Wheeler Co. v. Mendleson*, 180 A.D. 9, 167 N.Y.S. 435 (3d Dep't 1917).

¹⁷ See *Simon v. Etgen*, 213 N.Y. 589, 592, 107 N.E. 1066, 1066-67 (1915).

¹⁸ See *Brassil v. Md. Cas. Co.*, 210 N.Y. 235, 239-40, 104 N.E. 622, 623-24 (1914).

¹⁹ See *Indus. & Gen. Trust v. Tod*, 180 N.Y. 215, 220, 73 N.E. 7, 7 (1905).

promisor attempted to manipulate its profits so as to defeat the promisee's rights based on the existence of such profits.²⁰ In all of these cases the good faith obligation overrode the unqualified discretion that a strict reading of the contract terms seemed to vest in one of the parties. In such cases, the good faith requirement could be used to change the outcome, so that "if the person [who reserved discretion] decide[d], not on the question submitted, but on some question of interest or advantage not made the basis of rights or obligations by the contract, the decision [was] outside of the contract and [was] given no effect by it."²¹

By the early Twentieth Century, the New York Court of Appeals had announced "a contractual obligation of universal force . . . the obligation of good faith in carrying out what is written,"²² as well as its view that, for purposes of implying contract terms, one would be incorrect to "suppose that one party was to be placed at the mercy of the other."²³ Then, in 1933, the New York Court of Appeals decided *Kirk La Shelle Co. v. Paul Armstrong Co.*,²⁴ often cited as the leading early case on the implied covenant of good faith, in which the court declared that:

[I]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.²⁵

In *Kirk La Shelle*, the defendant settled a lawsuit by agreeing to pay, to the plaintiff, half of all receipts from the revival of a play. The settlement also gave, to the plaintiff,

²⁰ See *Marsh v. Masterson*, 101 N.Y. 401, 404–05, 5 N.E. 59, 59–60 (1886).

²¹ *Devoine Co. v. Int'l Co.*, 136 A. 37, 38 (Md. 1927).

²² *Brassil*, 210 N.Y. at 241, 104 N.E. at 624. The decision by the insurer to defend, instead of settle within the policy limits, obligated the insurer to appeal once a verdict over four times the policy limit was had against the insured. The insured's rights "go deeper than the mere surface of the contract written for him by the defendant." *Id.* at 242, 104 N.E. at 624. However, the court was careful to note that "[t]he circumstances of this case are peculiar . . . [and w]e do not go beyond them." *Id.* at 242, 104 N.E. at 624.

²³ *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 91, 118 N.E. 214, 214 (1917) (referencing nowhere an application of the implied covenant of good faith, but demonstrating the willingness of a court to recognize the imposition, upon contracting parties, of principles of fairness in dealing).

²⁴ 263 N.Y. 79, 188 N.E. 163 (1933).

²⁵ *Id.* at 87, 188 N.E. at 167.

approval power over all arrangements affecting the rights to the play, except for "motion picture rights."²⁶ At the time of the settlement, all motion pictures were silent. After the development of talking motion pictures, the defendant sold, to MGM, the talking motion picture rights to the play without providing plaintiff with a right of approval, and without sharing any of the revenues from the sale. The court held that talking motion pictures could not have been within the contemplation of the parties at the time of the settlement, and that production of the talking motion picture reduced the value of the revival right payments to the plaintiff. By selling these rights without the approval of the plaintiff, the defendant breached its obligation "not to render valueless"²⁷ the benefit given the plaintiff by the contract. Accordingly, the defendant was required to hold, for the plaintiff, the revenue received from violation of the right of approval.²⁸

In 1932, one year before the decision in *Kirk La Shelle*, the American Law Institute adopted *Restatement of Contracts* ("*Restatement First*").²⁹ There are provisions in *Restatement First* with regard to bona fide purchasers and assignees,³⁰ and conditions based on the personal satisfaction of the promisor³¹—all of which involve the question of good faith—and there are other specific references to "good faith" in *Restatement First*,³²

²⁶ *Id.* at 82, 188 N.E. at 165.

²⁷ *Id.* at 90, 188 N.E. at 168.

²⁸ *Id.* at 85–86, 188 N.E. at 166.

²⁹ RESTATEMENT OF CONTRACTS viii (1932).

³⁰ *See, e.g., id.* §§ 166, 488.

³¹ *Id.* § 265.

³² *See, e.g., id.* §§ 70 illus. 1 (effect of making or accepting a written offer), 170(2)(c) (by whom an obligor may be discharged), 173(b) (priorities between successive assignments of the same right), 174 (an assignee who purchases a right in good faith is not subject to latent equities), 175 illus. 3 (warranties of an assignor), 177 cmt. a (assignment of supposed rights and delegation of supposed duties), 334 illus. 6 (expense of litigation caused by breach of contract), 337 cmt. d (when interest is recoverable as damages), 339 cmt. f (liquidated damages and penalties), 363 (damages or restitution in lieu of specific enforcement), 367 illus. 7 (effect of unfairness, hardship, mistake, and inequitable conduct), 380 cmt. h (enforcement of negative duties that accompany affirmative promises), 383 (effort to obtain a remedy not in fact available), 422(1) (effect of account stated), 441 cmt. b (when one who executes an altered document is bound), 477(a) (when fraud or misrepresentation of a third person makes a transaction voidable), 478 cmt. a (assignment of rights under a voidable transaction), 493(b) (methods of exercising duress), 497 cmt. b (definition and effect of undue influence), 503 illus. 2 (mistakes by only one party, differing mistakes of both parties), 533 (payment of expenses or for services in addition to

but no provision of *Restatement First* imposes a universal obligation of good faith in contract performance or enforcement. In a sense, the absence of an implied covenant of good faith from *Restatement First*, which embodies a formalistic approach to contract interpretation and gap-filling, undermines a central theme of this Article—that the covenant was inspired by the desire of courts to soften the sometimes harsh results of formalistic jurisprudence. Nevertheless, since only New York and a few other states had recognized the covenant by the time *Restatement First* was adopted, the omission of the covenant is readily explained as consistent with the primary objective of *Restatement First*, to set forth the then extant common law of contracts.³³

The formalistic approach to interpretation placed great weight on the supposed capability of language to perfectly express the intentions of the parties as determined from the perspective of an objective third person.³⁴ As such, its application could result in disregarding the actual intention of the parties if that intention was inconsistent with what a reasonable third person would assume the parties intended in light of their overt actions and words.³⁵ The rationale behind this approach was a belief that strict formalism led to consistency and predictability—a desirable attribute in the administration of contract law that permitted parties to arrange their affairs with clear and certain expectations of legal consequences.³⁶

interest), 584(2) (bargain for separation or maintenance).

³³ See Farnsworth, *Good Faith Performance*, *supra* note 4, at 671 (noting that the duty of good faith performance was applied in only a few jurisdictions, and then generally in cases “in which one party’s compensation was fixed in terms of a percentage of the other’s profits, receipts, sales or production and the obligation of good faith was the basis of implying a condition of cooperation by the party who was to pay”); see also RESTATEMENT OF CONTRACTS vi (“The function of the courts is to decide the controversies brought before them. The function of the Institute is to state clearly and precisely in the light of the decisions the principles and rules of the common law.”).

³⁴ See RESTATEMENT OF CONTRACTS § 230 (discussing the objective third person, or the “reasonably intelligent person,” and its role in interpretation).

³⁵ See *id.* § 231 illus. 2 (depicting an example of a buyer and seller agreeing orally that, when used in their contracts, “buy” means “sell” and “sell” means “buy,” and concluding that, absent reformation, the agreement should be interpreted in accordance with the ordinary meaning of buy and sell).

³⁶ See Van Alstine, *supra* note 4, at 1231–32 (referencing “plain meaning” and “parol evidence” as part of the movement towards certainty and predictability).

At the heart of the formalistic approach to contract interpretation was "the plain meaning" rule, which was based on two presumptions. The first was a presumption that words have a finite number of ordinary or commonly understood meanings, and the second was that parties intend that the words included in their contracts be given those meanings.³⁷ Operating under these presumptions allowed questions of interpretation to be treated as questions of law not requiring factual determination regarding the context in which the contract was formed or the actual intentions of the parties.³⁸ Judge Hand's often-quoted observation regarding the plain meaning rule was particularly candid:

It makes not the least difference whether a promisor actually intends that meaning which the law will impose upon his words. The whole House of Bishops might satisfy us that he had intended something else, and it would make not a particle of difference in his obligation. . . . Hence it follows that no declaration of the promisor as to his meaning when he used the words is of the slightest relevancy, however formally competent it may be as an admission. Indeed, if both parties severally declared that their meaning had been other than the natural meaning, and each declaration was similar, it would be irrelevant . . . [and w]hen the court came to assign the meaning to their words, it would disregard such declarations, because they related only to their state of mind when the contract was made, and that has nothing to do with their obligations.³⁹

The parol evidence rule, which applies when the parties reach a final written agreement on some or all of the terms of the contract, intensified the importance of the plain meaning rule by barring proof of prior, or contemporaneous oral, agreements, whether or not such agreements could be proved to have been

³⁷ See *id.* at 1232-33 (noting that the plain meaning rule stands for the proposition that an unambiguous writing is conclusive evidence of actual intent).

³⁸ See RESTATEMENT (SECOND) OF CONTRACTS § 212(2) (1979) (classifying interpretation as a question of fact only if there is an issue of credibility with respect to extrinsic evidence, or when more than one reasonable inference can be drawn from extrinsic evidence). Since the parol evidence rule, as applied by the formalists, barred extrinsic evidence except where language was ambiguous on its face, interpretation of language that had a plain meaning would be solely a question of law for the court. See FARNSWORTH, *supra* note 4, § 7.14 (reiterating the position of *Restatement Second*).

³⁹ *Eustis Mining Co. v. Beer, Sondheimer & Co.*, 239 F. 976, 984-85 (S.D.N.Y. 1917).

actually made.⁴⁰ As applied by the formalists, the parol evidence rule also barred extrinsic evidence intended to interpret the integration itself, unless a court found the writing to be ambiguous on its face.⁴¹ Thus, extrinsic evidence was often barred, even when introduced to demonstrate an ambiguity in the language of the contract. Courts would apply the plain meaning rule, and if a court concluded that the language employed had a plain meaning then there was no ambiguity. Although courts acknowledged the potential injustice and harshness of the rule, classic contract law and *Restatement First* applied it rigorously as a necessary prophylactic against fraud and faulty memories. As one court noted:

[A]pplication of the [parol evidence] rule can work to create harsh results. However, the policies behind the rule compel its consistent, uniform application. Commercial stability requires that parties to a contract may rely upon its express terms without worrying that the law will allow the other party to change the terms of the agreement at a later date.⁴²

A party relying upon the plain meaning and parol evidence rules could seek to enforce rights that contract language, literally interpreted, conferred upon it despite the fact that the literal interpretation was not an accurate reflection of the actual intent of the parties at the time of contracting. Implication of a covenant of good faith, however, provided a justification for courts to look beyond the plain language of an agreement to inquire into the context of a particular bargain and determine the actual intentions and expectations of the parties, although they may have been expressed imperfectly. Two early New York Court of Appeals cases provide interesting illustrations of how changes in the common law evolve—in this case to limit the plain meaning rule so as to achieve reasonable results without abandoning the principles of formalistic jurisprudence. In one of the earliest of the good faith cases, *New York Central Iron Works Co. v. United States Radiator Co.*,⁴³ the defendant was required to fill the “entire radiator needs” of the plaintiff. When iron

⁴⁰ See RESTATEMENT OF CONTRACTS § 237 (1932).

⁴¹ See *id.* § 231; E. Allan Farnsworth, “Meaning” in the Law of Contracts, 76 YALE L.J. 939, 959 (1967); Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 535 (1998).

⁴² *Baker v. Bailey*, 782 P.2d 1286, 1288 (Mont. 1989).

⁴³ 174 N.Y. 331, 66 N.E. 967 (1903).

prices rose beyond the defendant's expectations, it refused to fill the plaintiff's "needs" above those in prior years. Interpreting the contract language under the plain meaning rule, the court concluded that the plaintiff's "needs" consisted of all radiators that it could sell at a profit. Nevertheless, it stated in dictum that, had the defendant properly raised the issue, it could have defended on the grounds that the plaintiff was not acting in good faith in attempting to exploit market conditions that were beyond the contemplation of the parties when the contract was formed:

[W]e do not mean to assert that the plaintiff had the right, under the contract, to order goods to any amount. Both parties in such a contract are bound to carry it out in a reasonable way. The obligation of good faith and fair dealing towards each other is implied in every contract of this character. The plaintiff could not use the contract for the purpose of speculation in a rising market, since that would be a plain abuse of the rights conferred, and something like a fraud upon the seller.⁴⁴

The court cited no authority for its view that bad faith contract enforcement was "something like a fraud."

In the later case of *Kirk La Shelle Co. v. Paul Armstrong Co.*, the court took a different approach. It did not address the question whether "motion picture rights" had a plain meaning that favored the defendant, but it did not deny such plain meaning. The court was, however, persuaded that when the parties entered into their contract they did not contemplate the development of talking motion pictures. The court was further convinced that to adopt the defendant's position would enable the defendant to deprive the plaintiff of the benefits of its bargain. How then to reach a just result without questioning the underlying validity of the plain meaning rule? The court found its answer in the same source as it did in its earlier famous decision in *Lawrence v. Fox*⁴⁵—the law of trusts: "By entering into the contract and accepting and retaining the consideration therefor, the respondents assumed a fiduciary relationship which had its origin in the contract, and which imposed upon them the duty of utmost good faith."⁴⁶

⁴⁴ *Id.* at 335, 66 N.E. at 968.

⁴⁵ 20 N.Y. 268, 274 (1859).

⁴⁶ *Kirk La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 85, 188 N.E. 163, 166 (1933).

Prior to the adoption of the U.C.C., some two decades after the promulgation of *Restatement First*, the common law of most states had not yet recognized a general implied covenant of good faith.⁴⁷ In fact, at that time, the covenant was still largely the creation of the common law of New York, a jurisdiction not noted for its liberal approach to contract interpretation and the parol evidence rule. For this reason, the U.C.C. represented a watershed in the history of the implied covenant because of its inclusion of a general implied covenant of good faith—"Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."⁴⁸ The implied obligation of good faith ultimately then became part of the statutory commercial law of every state. Equally significant, in the half century following promulgation of the U.C.C., the implied covenant has been accepted as part of the common law of most states.⁴⁹

II. MODERN CONTRACT INTERPRETATION AND ITS APPLICATION TO GOOD FAITH CASES

Contrary to the formalism of classic contract law and *Restatement First*, the approach to contract interpretation and gap-filling prescribed by *Restatement Second* and the U.C.C. is more concerned with arriving at the actual agreement of the parties, or where there is no such agreement, construing the contract in a manner that is fair and reasonable under the circumstances. This approach, championed by Twentieth Century scholars and judges such as Professors Corbin⁵⁰ and Llewellyn,⁵¹ and Judges Clark⁵² and Traynor,⁵³ recognized that the complexities of human relationships and motivations often required factual inquiry into the actual intentions of contracting

⁴⁷ See Farnsworth, *Good Faith Performance*, *supra* note 4, at 671.

⁴⁸ U.C.C. § 1-203 (2005).

⁴⁹ See Burton, *Breach of Contract*, *supra* note 4, at 404 (listing the overwhelming number of jurisdictions that recognize a general duty of good faith in contractual obligations).

⁵⁰ Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 162-64 (1965).

⁵¹ K.N. Llewellyn, *The Rule of Law in Our Case-Law of Contract*, 47 YALE L.J. 1243, 1264 (1938).

⁵² See *Parev Prods. Co. v. I. Rokeach & Sons, Inc.*, 124 F.2d 147, 149-51 (2d Cir. 1941).

⁵³ See *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 644-45 (Cal. 1968).

parties, consideration of the context in which contracts were formed, and a willingness to overtly exercise judicial power to resolve disputes, based on court determinations of reasonableness, where the parties had not considered or reached agreement on situations arising after contract formation.

Restatement Second and the U.C.C. have by no means abandoned objectivity in contract interpretation and gap-filling,⁵⁴ but an objective determination of the meaning of contract terms is made upon an examination of the context of the bargain, permitting exploration into the subjective intent of the parties and the circumstances attendant to the particular contract at issue.⁵⁵ This approach rejects the assumption that the meaning of contract language, not ambiguous on its face, can be determined without regard to consideration of the context in which it is used.⁵⁶ Although they share a common philosophy on contract interpretation and construction, *Restatement Second* specifically incorporates "standards" of interpretation not found in the U.C.C.⁵⁷ Under these standards, the primary focus is on determining what a party knows or should know regarding the intended meaning of the other party. The results of two primary inquiries in the interpretation process determine the meaning to be ascribed to the language of a contract. The first inquiry is whether both parties intended the same meaning for the terms of their contract, whether or not in accordance with the plain meaning of those terms. If the answer to this question is affirmative, then the meaning ascribed to the terms is that intended by the parties.⁵⁸ *Restatement Second* acknowledges that this standard is a rejection of the general approach to contract interpretation of *Restatement First*.⁵⁹

A case that anticipated *Restatement Second's* approach is *Berke Moore Co., Inc. v. Phoenix Bridge Co.*,⁶⁰ in which a contract between a general contractor and a subcontractor provided that the subcontractor would pave a bridge at a set rate per square

⁵⁴ See RESTATEMENT (SECOND) OF CONTRACTS § 201 cmt. a (1979).

⁵⁵ See *id.* § 201 cmt. b.

⁵⁶ See *id.*; see also U.C.C. § 2-202 cmt. 2 (2005).

⁵⁷ Cases controlled by the U.C.C. may be subject to common law standards of interpretation that are not displaced by the particular U.C.C. provisions. U.C.C. § 1-103 (b).

⁵⁸ RESTATEMENT (SECOND) OF CONTRACTS § 201(1).

⁵⁹ *Id.* § 201 reporter's note.

⁶⁰ 98 A.2d 150 (N.H. 1953).

yard measured by the “concrete surface included in the bridge deck.”⁶¹ The subcontractor brought suit for damages, claiming that the surface area by which the square yardage was to be measured included all of the outer surfaces as opposed to just the area on the upper bridge deck, as the general contractor asserted. Although the court acknowledged that a literal interpretation of the contract language favored the subcontractor,⁶² it found that, at the time the contract was entered into, both parties intended that the square yardage be measured by the upper surface of the bridge deck only, and enforced the contract accordingly.

If it cannot be shown that both parties intended the same meaning of the contract language, then under *Restatement Second's* standards of interpretation it is necessary to move on to the second inquiry, which asks whether either party knew or had reason to know of the meaning intended by the other party. If Party A knew or had reason to know of the meaning intended by Party B, and Party B did not know or have reason to know of the meaning intended by Party A, then Party B's meaning controls the interpretation of the contract.⁶³ Here, although the contract will be interpreted as only one of the parties intended, the other's intention is ignored merely in the sense that the contract will not be applied as it desired. But ignoring such other party's desired intention is justified on the basis that its knowledge (or reason to have knowledge) was superior to that of the first party. Revisit the basic facts of *Berke Moore* for an illustration: had the subcontractor known of the contractor's intention for the term to include the upper bridge deck only, and had the contractor lacked knowledge, or reason to know, of the subcontractor's intention, then the contract would be interpreted to require payment based upon the surface area of the upper bridge deck only.

Restatement Second and the U.C.C also differ from formalism with respect to the relationship of the parol evidence rule to the resolution of ambiguity. Under the formalistic approach, extrinsic evidence offered to interpret an integrated agreement was inadmissible unless the court, as a matter of law, found that the language of the agreement was ambiguous.⁶⁴ In determining whether an ambiguity existed, formalist courts

⁶¹ *Id.* at 151.

⁶² *Id.* at 153.

⁶³ *Id.*

⁶⁴ See *supra* note 41 and accompanying text.

applied the plain meaning rule.⁶⁵ Use of the plain meaning rule could preclude parties' actual intentions from determining the interpretation of their language. *Restatement Second* and the U.C.C. take a more liberal approach in resolving ambiguities, often looking to extrinsic evidence of context in determining whether an ambiguity exists.⁶⁶ *Restatement Second* explicitly acknowledges the inherent uncertainty of linguistic meaning and the capacity of contextual factors to reduce such uncertainty.⁶⁷ Chief Justice Traynor adopted this more liberal approach in the famous case (or infamous in the view of some who still cling to the formalistic approach),⁶⁸ *Pacific Gas & Electric Co., Inc. v. G.W. Thomas Drayage & Rigging Co., Inc.*,⁶⁹ in which he explained the proper approach to resolving contract ambiguity:

The test of admissibility of extrinsic evidence to explain the meaning of a written instrument is not whether it appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible . . . [because] limit[ing] the determination of the meaning of a written instrument to its four corners . . . would either deny the relevance of [party intentions] or presuppose a degree of verbal precision and stability our language has not attained. . . .

. . . .
... [R]ational interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties. . . . If the court decides, after considering this evidence, that the language of a contract, in the light of all the circumstances, "is fairly susceptible of either one

⁶⁵ See *infra* notes 96-103 and accompanying text (discussing *Steuart v. McChesney*, 444 A.2d 659 (Pa. 1982)).

⁶⁶ U.C.C. § 2-202 cmt. 1 (2005); RESTATEMENT (SECOND) OF CONTRACTS § 214(c) cmt. b (1979); see also 3 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 579 (1960).

⁶⁷ RESTATEMENT (SECOND) OF CONTRACTS § 201 cmts. a, b.

⁶⁸ For a particularly strident and unfair criticism of Judge Traynor's approach, see *Trident Center. v. Connecticut General Life Insurance Co.*, 847 F.2d 564, 569 (9th Cir. 1988) (interpreting *Pacific Gas* to leave all contracts, no matter how clearly written, susceptible to being undermined by parol evidence). In writing his opinion in *Trident Center*, Judge Kozinski either overlooked or chose to disregard Justice Traynor's limitation that parol evidence may only be offered to support an interpretation of which the contract language was reasonably susceptible. Judge Kozinski repeated this error in *Wilson Arlington Co. v. Prudential Insurance Co. of America*, 912 F.2d 366, 370 (9th Cir. 1990).

⁶⁹ 442 P.2d 641 (Cal. 1968).

of the two interpretations contended for," extrinsic evidence relevant to prove either of such meanings is admissible.⁷⁰

Although the formalistic approach to contract law recognized that operative usages could vary the plain meaning of contract language or even add to the agreement provisions in accordance with usages that are "not inconsistent with the agreement,"⁷¹ *Restatement Second* and the U.C.C. go further. They permit other contextual factors not recognized by *Restatement First*—course of dealing and course of performance—to be given greater weight than usage in determining a contract's meaning.⁷² Perhaps even more importantly, the U.C.C. has been interpreted by some courts to allow such contextual factors, "unless . . . carefully negated,"⁷³ to be given effect even if they are "seemingly contradictory" to the express terms of the agreement.⁷⁴ *Nanakuli Paving & Rock Co. v. Shell Oil Co., Inc.*⁷⁵ provides a striking example of the power of contextual factors in modern contract interpretation. Nanakuli was a paving contractor that had a long-term requirements contract with Shell Oil for the supply of asphalt. The contract, a fully integrated writing,⁷⁶ provided that the price Nanakuli would pay for asphalt would be "Shell's Posted Price at time of delivery."⁷⁷ No dispute existed as to the determination of Posted Price under the contract. Rather, Nanakuli complained that Shell failed to "price protect": Shell increased its Posted Price after Nanakuli committed itself to fixed-price paving contracts and before Shell delivered the asphalt Nanakuli needed to perform such contracts.⁷⁸ No mention of price protection was made in the written contract, but at trial, Nanakuli was allowed to introduce

⁷⁰ *Id.* at 644–46 (quoting *Balfour v. Fresno Canal & Irrigation Co.*, 41 P. 876, 877 (Cal. 1895)).

⁷¹ RESTATEMENT OF CONTRACTS § 246 (1932).

⁷² U.C.C. § 1-303(e) (2005); RESTATEMENT (SECOND) OF CONTRACTS § 203(b).

⁷³ U.C.C. § 2-202 cmt. 2.

⁷⁴ *Nanakuli Paving & Rock Co., Inc. v. Shell Oil Co.*, 664 F.2d 772, 780 (9th Cir. 1981); *accord* *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3, 9 (4th Cir. 1971); *Michael Schiavone & Sons, Inc. v. Securalloy Co., Inc.*, 312 F. Supp. 801, 803–04 (D. Conn. 1970). *But see* *S. Concrete Servs., Inc. v. Mableton Contractors, Inc.*, 407 F. Supp. 581, 583–84 (N.D. Ga. 1975), *aff'd*, 569 F.2d 1154 (5th Cir. 1978) (unpublished opinion); *Div. of Triple T Serv., Inc. v. Mobil Oil Corp.*, 60 Misc. 2d 720, 731–32, 304 N.Y.S.2d 191, 202–04 (Sup. Ct. Westchester County 1969).

⁷⁵ 664 F.2d 772 (9th Cir. 1981).

⁷⁶ *Id.* at 782 n.14.

⁷⁷ *Id.* at 780.

⁷⁸ *Id.* at 777.

evidence of usage and course of performance to support its position that Shell was required to price protect.⁷⁹ A jury verdict for Nanakuli was set aside by the trial judge, who granted Shell's motion for judgment n.o.v. In the course of vacating the trial judge's decision and reinstating the jury verdict, the Ninth Circuit held: one, the agreement of the parties under the U.C.C. is broader than the express contract and may include contextual factors such as usage and course of performance;⁸⁰ two, such contextual factors may add to the terms of even a fully integrated writing;⁸¹ and three, contextual factors give way to the express terms of the agreement only if such factors would constitute a "complete negation" of the express terms. In *Nanakuli*, the court held that only usage and course of performance evidence tending to prove that the "buyer was to set the price" would completely negate the contract's express terms.⁸²

Analytically distinct from cases that involve the interpretation of express contract language are those in which no express contract provisions address situations or controversies that arise after contract formation. The latter class includes, for example, cases in which an otherwise binding contract omits a term prescribing the time for performance or payment. Such omissions cause conceptual problems for the devout formalist whose philosophy rejects the power of courts to make contracts for the parties. The logic of such a view would seem to require the court to decline to enforce the claimed contract. Nevertheless, courts, whether implicitly or explicitly, and regardless of their jurisprudential philosophy of contract law, acknowledge the impracticality (due to transaction costs) and the impossibility (due to the limits of human imagination in foreseeing the future) of producing an all-encompassing, express agreement. Thus, at least since the Eighteenth Century, contract law has always allowed for filling gaps in contracts.⁸³ The differences between the approach of the formalists, on the one hand, and *Restatement Second* and the U.C.C. on the other, have to do with the theory and technique for gap-filling, and

⁷⁹ See *id.* at 793-94.

⁸⁰ See *id.* at 794-95.

⁸¹ See *id.* at 795.

⁸² *Id.* at 805.

⁸³ See E. Allan Farnsworth, *Disputes Over Omissions in Contracts*, 68 COLUM. L. REV. 860, 862-68 (1968).

more importantly, the types of gaps that may be filled. The traditional approach to gap-filling relied on either strained interpretations of contract language or implication of contract terms based on the presumed intention of the parties.⁸⁴ In this manner, courts could enforce gap-ridden express contracts without acknowledging that they were, in fact, making contracts for the parties.⁸⁵ The technique for gap-filling usually involved no more than stating conclusively what the parties' presumed intention was. Frequently, such presumed intent was by no means self-evident.⁸⁶ With regard to the scope of gap-filling, the traditional approach was to identify particular categories of gaps (performance time, payment time, impossibility, frustration, etc.) that could be filled, and to draw the line at other types of gaps (most importantly, price) that could never be filled regardless of the parties' intention to be bound.⁸⁷ For example, in *Martin Deli v. Schumacher*,⁸⁸ the New York Court of Appeals refused to enforce an option to renew a lease that provided for rent "to be agreed upon" notwithstanding the parties' intent for the provision to be legally binding. The court's rationale was a clear statement of the formalist philosophy:

[A] contract is a private "ordering" in which a party binds himself to do, or not to do, a particular thing. This liberty is no right at all if it is not accompanied by freedom not to contract. The corollary is that, before one may secure redress in our courts because another has failed to honor a promise, it must appear that the promisee assented to the obligation in question.

⁸⁴ See *id.* (providing an extensive history of gap-filling).

⁸⁵ See *id.* at 862 ("It is [a] commonplace that a court should not 'make the contract for the parties.'")

⁸⁶ For example, in the famous case of *Taylor v. Caldwell*, (1863) 122 Eng. Rep. 309 (Q.B.), the court implied a term that the owner of a music hall was discharged from its obligation to make the music hall available to a licensee when the music hall was destroyed by fire. Although acknowledging that the parties had not thought about the possibility of the fire when forming the contract, and that the obligation of the owner was absolute on its face, the court justified its result as carrying out what the intention of the parties would have been had they thought about the possibility of destruction. Of course, it cannot be known how the parties would have addressed the issue had it occurred to them, but it seems just as likely that they would have agreed to some sharing of the licensee's reliance costs, or some other arrangement, where the contract became impossible to perform without the fault of either party, but one or both parties had sustained out-of-pocket losses.

⁸⁷ See Farnsworth, *supra* note 83, at 864-66.

⁸⁸ 52 N.Y.2d 105, 417 N.E.2d 541, 436 N.Y.S.2d 247 (1981).

It also follows that, before the power of law can be invoked to enforce a promise, it must be sufficiently certain and specific so that what was promised can be ascertained. Otherwise, a court, in intervening, would be imposing its own conception of what the parties should or might have undertaken, rather than confining itself to the implementation of a bargain to which they have mutually committed themselves. Thus, definiteness as to material matters is of the very essence in contract law. Impenetrable vagueness and uncertainty will not do.⁸⁹

The approach exemplified by *Martin* is at odds, at least in spirit, with section 204 of *Restatement Second*,⁹⁰ which provides broad power to courts to fill gaps with terms that comport "with community standards of fairness and policy,"⁹¹ and with section 2-204(3) of the U.C.C., which provides that a contract does not fail for indefiniteness if the parties intended to be bound, and that the court will provide "open" terms "if there is a reasonably certain basis for giving an appropriate remedy."⁹² With regard to an open price term, the U.C.C. provides generally that if a contract is concluded with an open price term that is not otherwise fixed, the price will be a reasonable price at the time for delivery.⁹³ *Restatement Second* and the U.C.C. thus dispense with implication of gap-filling terms based on the presumed intent of the parties in favor of an approach that first looks to whether the parties intended to be bound and then fills gaps based on reasonableness. Moreover, no particular types of gaps are off limits, including gaps resulting from invalidating a contract provision.⁹⁴

The modern approach to contract interpretation and gap-filling, then, allows for a larger scope of judicial intervention when language is missing or is susceptible to more than one interpretation. A somewhat different question is presented by cases in which the language of the contract appears to be clear

⁸⁹ *Id.* at 109, 417 N.E.2d at 543, 436 N.Y.S.2d at 249 (citations omitted).

⁹⁰ "When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court." RESTATEMENT (SECOND) OF CONTRACTS § 204 (1979).

⁹¹ *Id.* § 204 cmt. d.

⁹² U.C.C. § 2-204(3) (2005).

⁹³ *Id.* § 2-305.

⁹⁴ See, e.g., *A.N. Deringer, Inc. v. Strough*, 103 F.3d 243, 246 (2d Cir. 1996) (invalidating an overbroad geographical limitation on competition; court will supply "reasonable" limitation).

and complete, yet common sense strongly suggests that the parties did not envision the particular circumstances that actually arose and would have used different language had they done so. Formalism, applying the plain meaning rule and the parol evidence rule, had little difficulty resolving such cases even though the resolution could be absurd.⁹⁵ *Steuart v. McChesney*,⁹⁶ a 1982 decision of the Pennsylvania Supreme Court, provides a fine example of the potential for absurdity. The Steuarts had granted to the McChesneys a right of first refusal on a parcel of land. The right was to be triggered by a bona fide purchaser making an offer to the Steuarts. The price to be paid, however, was not linked to the offer received, but to the property's "market value" according to its assessed value for real estate taxation purposes at the time of the bona fide offer.⁹⁷ When the Steuarts received offers, the McChesneys tendered an amount equal to the assessed value, which was approximately one-fourth the amount of the bona fide offers received by the Steuarts. The tax rolls had not been updated for five years, and the Steuarts brought an action seeking either to cancel the McChesneys' right, or to have the agreement interpreted to make the price of exercising the option equal to either the bona fide offers or fair market value.⁹⁸ The trial court concluded that the formula based on assessed value was intended as "a mutual protective minimum price for the premises rather than to be the controlling price without regard to a market third party offer" and required the McChesneys to pay a price equal to the highest bona fide offer if they wished to exercise their right of first refusal.⁹⁹ The Supreme Court, however, relying on the plain meaning rule and its conclusion that "a more clear and unambiguous expression of the Right of First Refusal's exercise price would be onerous to

⁹⁵ In certain limited, and clearly marked off categories of cases, such as impossibility and frustration, formalism offered relief from the plain and supposedly absolute terms of the contract. Relief was based on the supposed, unstated intent of the parties. *Taylor v. Caldwell*, (1863) 122 Eng. Rep. 309 (Q.B.). However, in cases not falling into these categories, the plain meaning rule was applicable unless, of course, a court felt like providing relief based on the good faith doctrine. See *supra* notes 24–28, 45–46 and accompanying text for a discussion of *Kirk La Shelle Co. v. Paul Armstrong Co.*

⁹⁶ 444 A.2d 659 (Pa. 1982).

⁹⁷ *Id.* at 660.

⁹⁸ *Id.* at 661.

⁹⁹ *Id.*

conceive"¹⁰⁰ permitted the McChesneys to buy the property for twenty-five percent of its value. Apparently, the court was unmoved by the seeming internal contradiction in the contract language¹⁰¹—value according to the “assessment rolls” was far less than “market value.” The court’s approach was, however, consistent with formalist dogma that ambiguities in integrated agreements must be patent in order for parol evidence to be introduced.¹⁰² *Steuart v. McChesney* was decided in 1982. Had it been decided 100 (or more) years earlier it would not be so remarkable. It stands as a caution to those inclined to believe that the common law evolves at a uniform pace in all places.¹⁰³

Courts, influenced by, or influencing, principles of interpretation found in the *Restatement Second* and the U.C.C., take a different view of cases in which the most obvious interpretation of the contract language conflicts with what the parties actually intended or could be supposed to have intended. *Nanakuli* could be cited as an example of such a view. “Posted Price at time of delivery” apparently covered the entire universe of pricing questions. Yet without determining that the contract language was either ambiguous or suffered from an obvious omission, the court used the contextual factors of usage and course of performance to, in effect, recognize a gap that could be

¹⁰⁰ *Id.* at 663.

¹⁰¹ The agreement provided:

During the lifetime of said Steuarts, should said Steuarts obtain a Bona Fide Purchaser for Value, the said McChesneys may exercise their right to purchase said premises at a *value equivalent to the market value of the premises according to the assessment rolls* as maintained by the County of Warren and Commonwealth of Pennsylvania for the levying and assessing of real estate taxes

Id. at 660 (quoting agreement) (emphasis added).

¹⁰² See *supra* notes 40–42 and accompanying text.

¹⁰³ Another relatively modern case following the approach of *Steuart v. McChesney* is *Lewis v. Carnaggio*, 183 S.E.2d 899 (S.C. 1971), in which a landowner had contracted with a builder for the construction of a house. Evidence was introduced that the owner had intended on spending no more than \$34,500, and insisted on such language in the contract. *Id.* at 900. The chosen builder drew up a contract from a form book, and the pertinent language read “the owners shall not be required . . . to pay to the contractor any amount in excess of the sum of [\$34,500] which is the estimated cost of construction, plus the fee provided for herein.” *Id.* (quoting agreement). The clear grammatical import of the comma, held the court, was to separate the payment cap term from the term requiring the payment of the contractor’s fee. *Id.* Although this decision was sensible from a grammatical standpoint, a review of the facts surrounding the case indicated that this was not in fact what the parties intended. *Id.* at 901 (Littlejohn, J., dissenting).

filled. Of course, the result in *Nanakuli* was based on specific provisions of the U.C.C. that permit even fully integrated contracts to be supplemented by usage and course of performance. But even where no statutory authority exists to vary the “plain meaning” of contract language, courts will do so based on common law principles of interpretation and gap-filling where such language is clearly at odds with parties’ expectations. This was the situation in *Spaulding v. Morse*,¹⁰⁴ in which a trust agreement provided that the divorced husband would pay child support for his son until the son completed four years of college. The son, who finished high school in early 1946, was immediately inducted into the Army, and the husband ceased paying support. The trust provided that the trustee would turn over the support payments to the mother “to be applied by her or the trustee upon or toward the maintenance and education of [the son], so long as she shall maintain and educate [the son] to the satisfaction of said trustee.”¹⁰⁵ In construing the legal effect of the trust instrument, the Massachusetts court quoted from an earlier case dealing with contract interpretation:

Every instrument in writing is to be interpreted, with a view to the material circumstances of the parties at the time of the execution, in the light of the pertinent facts within their knowledge and in such manner as to give effect to the main end designed to be accomplished. . . . An omission to express an intention cannot be supplied by conjecture. But if the instrument as a whole produces a conviction that a particular result was fixedly desired although not expressed by formal words, that defect may be supplied by implication and the underlying intention . . . may be effectuated, provided it is sufficiently declared by the entire instrument.¹⁰⁶

Considering the evident purpose of the trust to provide support for the son when he was in the custody of his mother and in college, the court held that the obligation to pay child support would be suspended so long as the son was in the Army. *Restatement Second* supports *Spaulding v. Morse*, providing in section 202(1) that “[w]ords and other conduct are interpreted in the light of all the circumstances, and if the principal purpose of

¹⁰⁴ 76 N.E.2d 137 (Mass. 1947).

¹⁰⁵ *Id.* at 138 (quoting agreement).

¹⁰⁶ *Id.* at 139 (quoting *Dittemore v. Dickey*, 144 N.E. 57, 60 (Mass. 1924)).

the parties is ascertainable it is given great weight.”¹⁰⁷ A comment to this section goes on to provide that “[e]ven language which is otherwise explicit may be read with a modification needed to make it consistent with” a common principal purpose of the parties.¹⁰⁸

Putting aside for the present the issue whether a good faith obligation ought to be implied even though doing so is inconsistent with party intent at the time of formation, it seems clear that most of the cases that have been resolved based on the implied covenant could have been decided based on modern notions of interpretation and gap-filling. These cases largely arise when express terms of the contracts either do not address the subject of the dispute that ultimately arises, or, although literally applying to the question raised by the dispute, were not adopted with the dispute in mind. An example of the latter situation is the leading good faith case of *Kirk La Shelle Co. v. Paul Armstrong Co.*¹⁰⁹ Given his view that language is frequently ambiguous, and even in the case of completely integrated agreements evidence can be introduced to determine the meaning given such language by the parties,¹¹⁰ Justice Traynor might well have allowed the plaintiff to prove that the parties intended the term “motion pictures” to apply only to those movie formats (i.e., silent pictures) that were unlike play productions because of the absence of spoken dialogue. From this it would follow that the royalty exclusion provision should not apply to talking pictures. Alternatively, a court applying modern notions of gap-filling could begin its analysis with a determination that, because the parties did not imagine the invention of talking pictures when they entered into their agreement, a gap existed as to how the agreement should apply to talking pictures. Considering such factors as the purpose of

¹⁰⁷ RESTATEMENT (SECOND) OF CONTRACTS § 202(1) (1979).

¹⁰⁸ *Id.* § 202 cmt. c. The facts of *Spaulding v. Morse* form the basis for illustration 4 to section 202. *Id.* § 202 cmt. 2, illus. 4.

¹⁰⁹ 263 N.Y. 79, 188 N.E. 163 (1933) (holding the parties did not contemplate the development of talking motion pictures when entering into the contract); see also *supra* notes 24–28 and 45–46 and accompanying text.

¹¹⁰ *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., Inc.*, 442 P.2d 641, 644 (Cal. 1968) (noting a rule requiring a court to look only at the words of the contract itself without reference to the party's intention merely because the court deems the document unambiguous “would either deny the relevance of the intention of the parties or presuppose a degree of verbal precision and stability our language has not attained”).

the agreement and whether the talking picture royalties would reduce or be in addition to the anticipated dramatic production royalties when the agreement was entered into, the court could fill the gap based on notions of fairness. The results of these divergent approaches might not be the same, but neither of them would require the court to determine whether good faith should require the payment of the royalty.

Other good faith cases, which do not involve the question of interpretation of express contract language, may arise because one party appears to have discretion to act in a way that affects the rights of the other. Such discretion may be explicitly reserved by the terms of the contract. A partial listing of such contracts include: requirement/output contracts in which one party determines a requirement or output that the other is bound to supply or buy; contracts that condition a promisor's duty on being "satisfied" with the performance of the promisee; contracts, such as employment or franchise arrangements, that give one party a right to terminate the contract "at any time"; contracts that give one party the right to determine its time to perform or to set other contract terms, including price; contracts that relieve the promisor of a duty based on the nonoccurrence of a condition; and loan arrangements that give a lender the apparent unrestricted right (such as with a demand loan) to require immediate repayment or to refuse to make future advances. On the other hand, the reservation of discretion may not be explicit in the contract, but instead may arise because the contract does not address situations in which actions of one of the parties can affect the rights of the other. Cases in which the promisee's compensation is dependent on the efforts or other activities of the promisor but which fail to create a standard for such efforts or activities constitute a prime example of this class of cases. These cases may involve contracts for the sale, lease, or licensing of property in exchange for a share of the revenue generated from such property by the promisor, but the agreement fails to specify a level of effort required of the promisor, nor does it forbid the promisor from diverting its attention to other activities that reduce such revenue.¹¹¹

In all of these cases, instead of seeking guidance in the

¹¹¹ For a comprehensive review of good faith cases described above (as well as others), see BURTON & ANDERSON, *supra* note 4, chs. 3-4, 7.

implied covenant of good faith, courts could inquire into the particular background facts to determine whether the parties shared a common understanding of how the discretion would be exercised, and if not, whether one of the parties had an expectation that the other party knew or should have known about, as revealed by negotiation, trade usage, course of dealing, course of performance, or other factors. If based on this analysis neither party is chargeable with a gap-filler favorable to the other party, the court could resort to gap-filling based on principles of fairness in the particular situation, or alternatively could conclude that no gap deserving of filling exists. Instead the court could apply the express terms of the contract literally.

It may be argued that the approach advocated here is, in substance, no different from the approach taken by courts applying a good faith standard, and all that is at stake is whether to label a case as an "interpretation or gap-filling" case or a "good faith" case. Although such an argument has some validity, two critical differences between these approaches exist. First, as will be seen in the next section of this Article, there are profound differences of opinion with respect to the definition and scope of "good faith." These differences are evident in the writings of scholars as well as in the U.C.C. and *Restatement Second*. Although these differences have not played a major role, at least overtly, in deciding cases,¹¹² they nevertheless create an environment for deciding cases that may be unnecessarily vague and rootless. Principles of interpretation and gap-filling, on the other hand, are more precise and give better guidance to courts and contracting parties. Second, and more importantly, whether a court approaches a case as a question of good faith or as a question of interpretation may affect its outcome. This issue, also, will be explored in the next section, but an illustration here may be useful.

In *Fortune v. National Cash Register, Co.*,¹¹³ a salesman was employed under a written agreement that provided for part of his

¹¹² One of the few cases that have explored the differences between competing conceptualizations of good faith is *Centronics Corp. v. Genicom Corp.*, 562 A.2d 187, 191 (N.H. 1989), in which Justice Souter (then a member of the New Hampshire Supreme Court) discussed the differences between the approach to good faith taken by Professors Burton and Summers. Although he concluded that New Hampshire had adopted Professor Summers' view on good faith, he also said that the result in the case would be the same under Professor Burton's view. *Id.* at 191, 194-96.

¹¹³ 364 N.E.2d 1251 (Mass. 1977).

compensation to be based on sales to customers in his territory. The right to commissions did not automatically vest when the sale was made, but depended on future circumstances, including whether the salesman was employed at the time of delivery. The written agreement specifically reserved to both the employer and the employee the right to terminate the employment without cause upon written notice. A large sale was made to a customer in the employee's territory, and therefore credited to the employee, but he was reassigned within the company and then fired in a way that substantially reduced his commissions under the agreement. Consistent with the cause of action pleaded by the plaintiff, the trial judge asked the jury to determine whether the employment was terminated in bad faith,¹¹⁴ and in this connection instructed the jury that the employer would have acted in bad faith had it terminated the employment for the purpose of avoiding payment of any part of the commission that would otherwise have been due.¹¹⁵ The jury verdict was in favor of the employee. Reserving the question whether the implied covenant of good faith applied to all employment contracts, the Supreme Judicial Court of Massachusetts upheld the jury instruction and verdict on the ground that good faith is required to terminate an at-will employee who is entitled to compensation for work performed.¹¹⁶ Since *Fortune* was pleaded and tried solely as a good faith case, the court did not approach the case on the basis of standards of interpretation and gap-filling. Had it done so, the key question would have been the resolution of the conflicting contractual terms which, on the one hand, provided a right to commissions to the employee, but on the other, provided a right to terminate to the employer. The court then would have turned its attention, as the same court did in *Spaulding v. Morse*, to which of the conflicting provisions should have priority. Its analysis could then have been guided by the standards of interpretation and gap-filling adopted by *Restatement Second*, determining: 1) whether the employee knew or had reason to know that the employer reserved the right to terminate his employment so as to reduce commissions;¹¹⁷ 2) if the employee

¹¹⁴ *Id.* at 1255.

¹¹⁵ *Fortune v. Nat'l Cash Register Co.*, 349 N.E.2d 350, 352 n.4 (Mass. App. Ct. 1976), *rev'd*, 364 N.E.2d 1251 (Mass. 1977).

¹¹⁶ *Fortune*, 364 N.E.2d at 1256.

¹¹⁷ Presumably, this would be a question of fact, and if the employee knew or

did not know or have reason to know, whether the employer knew or had reason to know that its right to terminate was not understood by the employee as being exercisable in order to save commissions;¹¹⁸ and 3) if neither the employer nor the employee knew or had reason to know of the interpretation intended by the other, under what circumstances the employer could fairly and reasonably discharge the employee with the effect of reducing the employee's compensation.¹¹⁹ Employee misconduct, financial exigencies of the employer, decline in Fortune's productivity, payment of the commission to another employee,¹²⁰ and departmental reorganizations are some examples of circumstances that might justify termination even if commissions were thereby reduced or eliminated.

Would *Fortune* have come out differently had the defendant argued that contract interpretation rather than good faith should control? That question cannot be answered, but it is clear, at least, that the assignment of questions of fact and law would be of a different dimension if the case were analyzed as an interpretation case rather than a good faith case. Moreover, it is submitted that the interpretation approach to the case offers a principled basis for determining the agreement of the parties, while the good faith approach to the case invites the court to simply state conclusively a rule that seems proper to the

had reason to know, the employer should win. In *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1154 (D.C. Cir. 1984), Justice Scalia supposed that it "would require a degree of folly . . . we are not inclined to posit" that commission salespersons would agree to a provision giving unlimited discretion to an employer to retroactively reduce their commissions. The conclusion that an employee would never agree to such a term seems flawed. For example, the employee could be aware that despite the fact that the employer reserved unlimited discretion, the employer had never in the past exercised such discretion so as to deprive an employee of commissions, and the employee was willing to risk not being the first victim of such discretion; the employee could believe that the employer would be constrained to exercise the discretion so as not to create low morale among other employees, or the employee might believe that the employer would not exercise the discretion in his or her case because the employee would then quit and the employer would lose a valuable salesperson.

¹¹⁸ This would also be a question of fact, and if this was the case then the employee should win.

¹¹⁹ This inquiry would be employed to determine how to fill the gap, and would be a question for the court, except to the extent that the existence or nonexistence of the circumstances raised questions of fact.

¹²⁰ National Cash Register paid twenty-five percent of the commissions on the order credited to Fortune to another employee, and to that extent was not enriched by the termination. *Fortune*, 364 N.E.2d at 1254.

individual judge.

III. THE VARIOUS FACES OF THE COVENANT OF GOOD FAITH

This section will examine various attempts to determine the role of the implied covenant of good faith as well as its content. Commentators are at odds about these questions, and given the state of the case law and the law as represented by the U.C.C. and *Restatement Second*, it is not surprising that application of the covenant can be a confusing and unsatisfying business.

A. Using the Covenant to Imply Terms

The late Professor E. Allan Farnsworth of Columbia University was an early commentator on the implied covenant of good faith.¹²¹ His most important article on the subject examined the covenant as contained in the U.C.C. He criticized the definition of good faith in Article 1 of the U.C.C. as too restrictive because it provided for judging conduct based solely on the honesty of the actor and did not include a requirement of reasonableness, as was required by Article 2 in the case of merchants.¹²² In the course of his critique he observed that the chief use of the covenant was as a “rationale” for a court to imply contract terms necessary to “secure the expected benefits of the contract”¹²³ to a party or to protect “reasonable expectations.”¹²⁴ Limiting good faith to an inquiry into actual honesty would frustrate this use, since the sole question would then be one of fact for the jury, not the court. Professor Farnsworth was not particularly disturbed by the vagueness of the doctrine of good faith as a device to protect reasonable expectations since “[p]art of the strength of such general concepts as ‘good faith’ and

¹²¹ FARNSWORTH, *supra* note 4, § 7.17; E. Allan Farnsworth, *Duties of Good Faith and Fair Dealing Under the UNIDROIT Principles, Relevant International Conventions, and National Laws*, 3 TUL. J. INT'L & COMP. L. 47 (1995); Farnsworth, *Good Faith Performance*, *supra* note 4; E. Allan Farnsworth, *On Trying to Keep One's Promises: The Duty of Best Efforts in Contract Law*, 46 U. PIT. L. REV. 1, 8 (1984) (distinguishing best efforts from good faith); E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987); E. Allan Farnsworth, *The Concept of Good Faith in American Law* (1993), available at <http://w3.uniroma1.it/idc/centro/publications/10Farnsworth.pdf>.

¹²² Farnsworth, *Good Faith Performance*, *supra* note 4, at 671–72.

¹²³ *Id.* at 672.

¹²⁴ *Id.* at 669.

'commercial reasonableness' lies in an elasticity and lack of precision that permits them to be, in the language of the Code's own comments, 'developed by the courts in the light of unforeseen and new circumstances and practices.'"¹²⁵

Contract law (at least as expressed in the U.C.C. and *Restatement Second*) has moved away from the rigid formalism of the plain meaning rule and a restrictive parol evidence rule and toward recognition of a more expansive role for the courts in interpreting contracts and filling gaps. In light of this evolution, Professor Farnsworth's observation that "the chief utility" of good faith performance has been to imply contract terms, leads one to question whether such a rationale remains valid. The case of *Market Street Associates v. Frey*¹²⁶ is instructive in answering this question. There, the owner of real estate entered into a sale-leaseback transaction with the General Electric Pension Trust. Paragraph thirty-four of the lease provided that: the lessee could "request" the lessor pension trust to provide financing for leasehold improvements, the lessor would give "reasonable consideration" to such request, the parties would "negotiate in good faith concerning" the request, and that should negotiations fail, the lessee could repurchase the property at its original sales price adjusted by a factor specified in the lease.¹²⁷ Some twenty years after the original transaction the lessee sought financing from a third party for improvements to the real estate. The third party turned down the request because the lessee could not provide a mortgage on the real estate. The lessee then sought to repurchase the real estate. The pension trust demanded a price of \$3 million, which the lessee thought was excessive. The lessee then twice wrote to the pension trust requesting financing for improvements. The lessee's letters did not mention either paragraph thirty-four or the purchase option that would result to the lessee should financing negotiations fail, but one of the letters referred to "financing pursuant to the lease."¹²⁸ The pension trust refused to provide financing, and the lessee exercised the purchase option set forth in paragraph thirty-four, the terms of which yielded an adjusted purchase price of \$1 million. When the pension trust declined to sell, the lessee

¹²⁵ *Id.* at 676 (quoting U.C.C. § 1-102 cmt. 1 (1958)).

¹²⁶ 941 F.2d 588, 593 (7th Cir. 1991).

¹²⁷ *Id.* at 591.

¹²⁸ *Id.*

brought suit to enforce the option. The district court granted summary judgment to the pension trust on the ground that the lessee did not really want financing, wanted only the opportunity to exercise its purchase option, and breached its obligation of good faith by omitting mention of paragraph thirty-four in its request, thereby failing to alert the lessor to the consequences of refusing to provide financing. The Seventh Circuit reversed the grant of summary judgment and remanded to the district court for a determination of what it viewed as the dispositive question in the case—whether the lessee tried to “trick” the pension trust into triggering the paragraph 34 option.¹²⁹ In the course of his opinion for the Seventh Circuit, Judge Posner dealt with the relationship of the implied covenant of good faith to contract interpretation, and suggested that implying contract terms so as to effectuate party intent would produce the same result as imposing an implied covenant of good faith.

We could of course do without the term “good faith,” and maybe even without the doctrine. We could . . . speak instead of implied conditions necessitated by the unpredictability of the future at the time the contract was made.

. . . .

But whether we say that a contract shall be deemed to contain such implied conditions as are necessary to make sense of the contract, or that a contract obligates the parties to cooperate in its performance in “good faith” to the extent necessary to carry out the purposes of the contract, comes to much the same thing. They are different ways of formulating the overriding purpose of contract law, which is to give the parties what they would have stipulated for expressly if at the time of making the contract they had had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero.¹³⁰

Despite Judge Posner’s assertion that implication of contract terms and good faith are interchangeable, the holding in *Market Street* suggests otherwise. In fact, the case illustrates the way in which the implied covenant of good faith may actually divert inquiry from appropriate contract interpretation and implication. In its remand, the Seventh Circuit directed the district court to determine whether the lessee attempted to trick the pension

¹²⁹ *Id.* at 596.

¹³⁰ *Id.*

trust, in which case the lessee would have acted in bad faith and could not enforce the option. On the other hand, if the lessee did not attempt to trick the lessor, but "acted honestly, reasonably, without ulterior motive, in the face of circumstances as they actually and reasonably appeared to it" there would be no bad faith and the option should be enforced.¹³¹ Of course, if bad faith is construed as embracing conduct intended to trick, but not embracing innocent nondisclosure, this would be the appropriate question on which to hinge the result. But it can certainly be argued that a different standard of conduct might have resulted from an inquiry into what the parties, in Judge Posner's own words, "would have stipulated for expressly if at the time of making the contract they had had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero."¹³² If, at the time of negotiating the terms of the lease, the pension trust had envisioned a situation in which the request for financing would not prompt the pension trust official reviewing the request to consider paragraph thirty-four, would the pension trust have proposed language that would protect it only if the lessee acted with a purpose to trick the pension trust? Or would it instead have proposed language that would condition the purchase option on a request for financing that directly referenced paragraph thirty-four regardless of the lessee's motive in requesting the financing? If the pension trust would have proposed the more protective provision,¹³³ would the lessee have agreed to such a proposal? If the answers to the last two questions are yes, then should not the pension trust win the case, regardless of whether the lessee acted in bad faith, as such concept was conceived by Judge Posner? Resolution of these questions would involve considering whether the lease had a gap that should be filled by an implied term and, if so, what that term ought to be.

As Judge Posner suggested, the General Electric Pension Trust is not a particularly sympathetic party to relieve of a duty to read. Moreover, in considering whether a gap worthy of filling

¹³¹ *Id.* at 597.

¹³² *Id.* at 596.

¹³³ The pension trust likely would have proposed the more protective provision, not just because it would be more favorable to the pension trust, but because it would be less apt, given the absence of any requirement to inquire into the motives of a party, to provoke litigation.

exists it would seem relevant whether the express contract consists of a single sentence written on the back of matchbook, or a 100-page printed contract negotiated by legions of lawyers. On the other hand, if an essential purpose of the purchase option was to provide an additional incentive to the pension trust to approve financing for the lessee, should it not be made aware of the purchase option when the time to negotiate the financing arrived? These are interesting and important issues that might have been illuminated by the attention of Judge Posner, but were not addressed.¹³⁴

B. The Covenant as an Excluder of Bad Faith

Another distinguished academic who has made important contributions to the literature on good faith is Professor Robert Summers of Cornell University.¹³⁵ Professor Summers, an early commentator on good faith, believes that good faith should be conceptualized as an “excluder,” having no “general

¹³⁴ Actually, *Market Street* was not a case requiring an implication of any term for its decision. At least two other bases for decision can be suggested, both of which depend on the interpretation of express language in the lease. First, paragraph 34 called for a “request” by the lessee for financing in order to trigger the purchase option. A reasonable definition (interpretation) of the word “request” is an “expression of one’s desire.” XIII THE OXFORD ENGLISH DICTIONARY 679 (2d ed. 1989). If, in fact, the lessee had no desire for financing, but simply wanted to trick the lessor into triggering the purchase option, then its request could be a fraudulent representation of a fact (i.e., its desire for a loan). Judge Posner declined to rule on the issue of fraud, but only with respect to whether the nondisclosure of information readily available to both parties (i.e., the existence of paragraph 34) could be fraud. The question of affirmative fraud was not addressed. Had the issue been addressed, an interesting question would be raised as to whether the pension trust relied on the misrepresentation. Although one might argue that the pension trust was indifferent to the desires of the lessee and therefore the fraud requirement of reliance was not met, it could also be argued that the pension trust did rely in the sense that had it known the lessee’s true desire in requesting financing it would have investigated more carefully the consequences under the lease of turning down the request. A second ground for decision on the facts in *Market Street* not requiring implication is based on the provision of the lease explicitly requiring the parties to “negotiate in good faith” with regard to the requested financing. If, as seems reasonable, the lessee’s initial request for the financing (or its failure to respond to the lessor’s denial of financing) is seen as part of the negotiations, then no implied covenant of good faith would be necessary to determine the outcome of the case. The question would then be the interpretation of “negotiate in good faith” and whether that should require a higher standard from the lessee than simply forbearing from tricking the lessor—a question that Judge Posner also did not address.

¹³⁵ See generally Summers, *The General Duty of Good Faith*, *supra* note 4; Summers, “*Good Faith*” in *General Contract Law*, *supra* note 4.

meaning . . . of its own, and [serving] to exclude a wide range of heterogeneous forms of bad faith."¹³⁶ He argues that the pre-U.C.C. development of good faith was consistent with his conceptualization of the term as an excluder,¹³⁷ and believes that the original U.C.C., because it contained positive definitions of good faith, was seriously flawed. He attributes this flaw to the failure of the draftsman, Karl Llewellyn (Chief Reporter for the U.C.C.), to be "sufficiently faithful"¹³⁸ to the excluder conceptualization.¹³⁹ According to Professor Summers, good faith cannot be defined in the abstract because "any but the most vacuous general definition of good faith will . . . fail to cover all the many and varied specific meanings that it is possible to assign to the phrase in light of the many and varied forms of bad faith recognized in the cases."¹⁴⁰ He believes that bad faith also is not susceptible to statutory definition, but can only be identified as illuminated in judicial decisions.

Courts should determine the scope of the good faith requirement, partly because it is an unusually "circumstance-bound" doctrine and excludes highly varied forms of bad faith, many of which become identifiable only in the context of circumstantial detail of a kind that defies comprehensive statutory formulation.¹⁴¹

Professor Summers agrees with Professor Farnsworth that the flexibility inherent in the doctrine's application is a strength, but Professor Summers views the scope of the doctrine as

¹³⁶ Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 201. Professor Summers notes that Aristotle may have originated the concept of an excluder. Summers, *The General Duty of Good Faith*, *supra* note 4, at 818.

¹³⁷ Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 204.

¹³⁸ Summers, *The General Duty of Good Faith*, *supra* note 4, at 817.

¹³⁹ *See id.* at 824 (explaining that judges are free to define the meaning of "good faith" as they see fit); Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 210-12 (discussing why "with the objective half of the . . . definition of good faith lopped off, the remaining 'honesty in fact' half took on more significance"). Professor Summers says that the U.C.C. Article 1 formulation will not prevent parties from "openly abusing the power to break off negotiations, openly taking unfair advantage of bargaining power, openly acting capriciously or openly undercutting another's performance." *Id.* at 210. Professor Summers also argues that the excluder conceptualization is broader than the subjective/objective standard of Article 2 since the Article 2 definition only applies in the case of a merchant and only "insofar as there are commercial standards of fair dealing in a given trade which are reasonable." *Id.* at 213.

¹⁴⁰ Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 206.

¹⁴¹ *Id.* at 215.

broader, extending its application beyond the performance stage to the formation stage as well.¹⁴² Additionally, he takes issue with Professor Farnsworth's view that the significance of good faith lies in its role of implying contract terms.¹⁴³ Professor Summers views good faith as an independent duty rooted in morality.¹⁴⁴ He identifies four broad categories of bad faith. The first is bad faith in contract negotiation and formation,¹⁴⁵ which is not recognized by either *Restatement Second* or the U.C.C. good faith provisions. The other three, bad faith in performance,¹⁴⁶ bad faith in raising and resolving contract disputes,¹⁴⁷ and bad faith in taking remedial action,¹⁴⁸ generally coincide with *Restatement Second* and the U.C.C. requirements of good faith in performance and enforcement. Professor Summers then further identifies several subcategories of each of his four categories of bad faith. Subcategories of bad faith in performance include evasion of the spirit of the deal, lack of diligence and slacking off, willful rendering of only substantial performance, abuse of the power to specify terms, abuse of the power to determine compliance, and interference with or failure to cooperate in the other party's performance. Bad faith in raising and resolving contract disputes may consist of conjuring up a dispute, adopting overreaching or "weaseling" contract interpretations, and taking advantage to obtain a contract modification or dispute settlement. Bad faith remedial actions include abuse of the right to adequate assurances, wrongful refusal to accept performance from the other party, willful failure to mitigate damages, and abuse of the power to terminate.¹⁴⁹

Professor Summers' excluder analysis clearly influenced the approach of *Restatement Second* to the implied covenant of good faith.¹⁵⁰ Although the language of *Restatement Second* section

¹⁴² *Id.* at 220-32.

¹⁴³ *Id.* at 233.

¹⁴⁴ *See id.* at 198 (recognizing that where "a party is legally as well as morally obligated to act in good faith, he will be significantly less likely to break faith"); *see also id.* at 195 ("[T]here is a growing interest in devising legal standards of contractual morality.").

¹⁴⁵ *Id.* at 220-32.

¹⁴⁶ *Id.* at 232-43.

¹⁴⁷ *Id.* at 243-48.

¹⁴⁸ *Id.* at 248-52.

¹⁴⁹ *Id.* at 232-52.

¹⁵⁰ *See generally* Summers, *The General Duty of Good Faith*, *supra* note 4, at 810-24 (highlighting the substantial influence that Summers' 1968 article had on

205 is not materially different from its counterpart in the U.C.C.,¹⁵¹ reflecting Professor Summers' view, *Restatement Second* does not attempt any definition of good faith (or bad faith for that matter). Instead, in comments, *Restatement Second* refers to types of conduct that Professor Summers identifies as bad faith in performance and enforcement.¹⁵²

Professor Summers' formulation is subject to three objections. The first derives from his assertion that "good faith" cannot be defined because it has no substantive content—it functions instead to exclude bad faith. Yet he also tells us that bad faith cannot (and should not) be defined, but should be recognized as it arises in specific instances. Unquestioningly, there is room for imprecision in the law (think "I know it when I see it"). But something seems amiss about a concept that has no meaning on its own, yet serves as the negative of another concept that also cannot be defined. If bad faith can be identified when it is revealed in specific circumstances, why is it that good faith cannot be similarly recognized?

A second objection to the excluder analysis is its assumption that good faith must be present when bad faith is not found. This assumption is evident in the examples Professor Summers offers to illustrate "excluders"—"voluntary" as the excluder of "involuntary" and "real" as the excluder of "not real."¹⁵³ These excluders are terms that, by definition, completely negate each other (all voluntary acts are not involuntary and vice versa). On the other hand, the term "good faith" is not, at least by definition, a complete negation of "bad faith," and Professor Summers' application of the excluder analysis does not recognize the possibility that the faith of an action can be normatively neutral—neither good nor bad. Certainly, a deed that is not a good deed is not necessarily a bad deed. On a beautiful summer

the "recognition and conceptualization of good faith in section 205" of the *Restatement Second*). In this connection, it is worth noting that of the two Reporters for the *Restatement Second*, Professor Robert Braucher and Professor E. Allan Farnsworth, it was Professor Braucher who was responsible for section 205. *Id.* at 810. Professor Braucher was Reporter until 1971, Professor Farnsworth was Reporter from then on. RESTATEMENT (SECOND) OF CONTRACTS v (1979).

¹⁵¹ Compare U.C.C. § 1-304 (2005) (stating that every contract within the U.C.C. "imposes an obligation of good faith in its performance and enforcement"), with RESTATEMENT (SECOND) OF CONTRACTS § 205 (imposing on each party to a contract "a duty of good faith and fair dealing in its performance and its enforcement").

¹⁵² See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmts. a, d.

¹⁵³ Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 201–02.

morning I may either play golf or volunteer at the local halfway house for homicidal maniacs. Volunteering at the halfway house would be a good deed, but am I doing a bad deed by playing golf instead? I hope not.

The distinction suggested is a matter of some semantic consequence (at least) because both the U.C.C. and *Restatement Second* formulate the duty of good faith as a positive rather than a negative duty. Thus, a performance or enforcement that is not in bad faith could still violate *Restatement Second* section 205 if it is also not in good faith. Nor is this objection trivial; the failure of the excluder analysis to attend to this problem may have real consequences. For example, Professor Summers could rightly count *Market Street Associates v. Frey* as a case that adopts his approach.¹⁵⁴ Judge Posner identified the dispositive issue in the case as whether the lessee intended to trick the lessor into triggering the purchase option. In that case, his focus was on the negative or bad faith question raised by the lessee's conduct. Yet one may wonder whether the lessee, acting in good faith, ought to have called attention to paragraph thirty-four even if it was not trying to trick the lessor. Requiring the lessee to cite lease paragraph thirty-four in any financing request would be a plausible gap-filler if a principal purpose of paragraph thirty-four was to provide an incentive to the lessor to make a loan so as not to trigger the right of repurchase. If the lessor overlooked the right of repurchase and refused the request on ordinary underwriting considerations, an important object of such right's inclusion in the lease would be negated. Professor Summers could, of course, point to his good faith articles (along with other authority) supporting the proposition that bad faith conduct is broader than dishonesty,¹⁵⁵ and Judge Posner, though citing Professor Summers' 1968 article in *Market Street*, may simply have failed to be guided by it. Nevertheless, it seems a stretch to say that the lessee (assuming it did not suspect the lessor's misapprehension) acted in bad faith; on the other hand it seems not nearly as great a strain to say that "good faith" should

¹⁵⁴ See *supra* notes 126–33 and accompanying text.

¹⁵⁵ See, e.g., BURTON & ANDERSON, *supra* note 4, at 123 (doubting that any court would define "good faith" as "honesty in fact alone"); Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 204–06 (claiming that because forms of bad faith are so broad, it is unlikely for judges to be able to use one definition for the term extensively).

require calling attention to paragraph thirty-four if there is a recognized possibility of the lessor's misapprehension.

A third objection to Professor Summers' approach has to do with how he views the role of the implied covenant of good faith. This Article makes the argument that the implied covenant of good faith has operated as a kind of "safety valve,"¹⁵⁶ useful in curing unreasonable and unjust results the formalists might otherwise reach because of the plain meaning and parol evidence rules. Given the more enlightened attitudes to interpretation and gap-filling recognized today, the good faith covenant is no longer needed. Professor Summer takes just the opposite view.

[I]n addition to the more familiar sources of standards of performance—for example, the contract language itself, case law on how contract gaps are to be filled, and custom and usage—judges turn to specific concepts of good faith in deciding whether a party has or has not performed his agreement. Admittedly, judges frequently introduce these concepts as implied terms in contracts, and not as duties of good faith. But it is almost always better to recognize something for what it is rather than to fictionalize it. And surely, how a doctrine is conceptualized can affect the outcome of cases. For example, it seems likely that a judge who thinks in terms of implied provisions will be less willing to enforce duties of good faith than the judge who thinks explicitly in terms of such duties; one who views himself as "implying terms" is more likely to think he is remaking a contract to some extent—something which judges are reluctant to do.¹⁵⁷

What Professor Summers says—"it is almost always better to recognize something for what it is rather than to fictionalize it . . . [a]nd surely, how a doctrine is conceptualized can affect the outcome of cases"¹⁵⁸—is true. But in a case where the meaning of a contract is disputed, it is preferable to approach the dispute as a matter of contract interpretation and gap-filling, rather than an occasion for enforcing a duty of good faith. Of the fourteen examples of bad faith in performance and enforcement identified

¹⁵⁶ Professor Summers uses the term "safety valve" in a more general sense. "[T]he requirement of good faith often functions as a kind of 'safety valve' which may be turned to fill gaps and qualify or limit rights and duties arising under contracts or rules of law." Summers, *"Good Faith" in General Contract Law*, *supra* note 4, at 215-16.

¹⁵⁷ *Id.* at 233.

¹⁵⁸ *Id.*

by Professor Summers,¹⁵⁹ three would appear not to involve questions of contract meaning and therefore would not be resolvable based on interpretation and gap-filling.¹⁶⁰ The other examples of bad faith offered by Professor Summers are all susceptible to the interpretation and gap-filling techniques described in *Restatement Second* and the U.C.C. A clear illustration of this point is Professor Summers' identification of evading the spirit of the deal as bad faith. Whether the spirit of the deal has been evaded cannot be answered until the "deal" and its "spirit" have been identified. This must be done through interpretation and gap-filling. After that it should be evident whether a party has breached its obligations under the contract.

As examples of evasions of the spirit of the deal, Professor Summers offers cases in which a buyer who is a party to a requirements contract either attempts to avoid ordering what it really needs (say, in the case of a falling market), or attempts to expand its requirements beyond its normal business needs (say, in the case of a rising market). Approaching these cases as matters of interpretation would involve inquiring into the negotiations and other contextual factors of the transaction (e.g., historical requirements of buyer, course of dealing), and filling any gaps with court-determined fair and reasonable terms. At best, deciding these cases on whether the spirit of the deal has been evaded is a less accurate description of what the court should be doing—identifying the contract and enforcing it. At worst, such a method of deciding these cases is unprincipled and may lead to erroneous results in determining rights under the contract.¹⁶¹

Another, but perhaps less obvious, illustration that Professor Summers' bad faith cases should be decided as matters of interpretation and gap-filling, appears in his category of bad

¹⁵⁹ See *supra* notes 144–49 and accompanying text.

¹⁶⁰ The three are willful rendering of only substantial performance, willful failure to mitigate damages, and taking advantage to obtain a contract modification or dispute settlement. The first and second are rules of law limiting the right to damages, and the third is a policing mechanism to prevent duress-type behavior by a party seeking to obtain an advantage in contract modification or settlement. See Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 237, 246, 250.

¹⁶¹ *Mkt. St. Assocs. v. Frey*, 941 F.2d 588 (7th Cir. 1991), discussed in the text accompanying notes 126–34, may be an example of a court reaching a result inconsistent with modern principles of interpretation and gap-filling because of its focus on the good faith doctrine.

faith in abuse of power to terminate. Professor Summers uses cases involving contracts that permit franchise terminations "at will" as examples.¹⁶² Parties asserting bad faith in these situations have occasionally prevailed, but most often courts seem to apply a plain meaning rule to a right to terminate.¹⁶³ However, even the staunch textualist Justice Scalia (then Circuit Judge Scalia) observed that a contract term providing a power to terminate "within [a party's] sole discretion" may not be the equivalent of a term providing a power to terminate "for any reason whatsoever, no matter how arbitrary or unreasonable."¹⁶⁴ Based on this nonequivalency, a legitimate issue of interpretation and gap-filling is raised. The inquiry should focus on the question of whether the parties shared an interpretation that would or would not limit the power to terminate, and if they did not share such an interpretation, whether only one of the parties knew or had reason to know of the other's interpretation. Arguably, without the distraction of a claimed breach of good faith a court might attend more closely to these questions.

Professor Summers' approach to the role of the duty of good faith is largely determined by his belief that the duty is rooted in morality rather than in individual autonomy, and therefore may be used to support results contrary to the party intentions. Professor Robert A. Hillman, of Cornell Law School, an admirer of Professor Summers' approach to good faith,¹⁶⁵ discusses such a situation based on the facts of *Tymshare, Inc. v. Covell*.¹⁶⁶ In *Tymshare*, Justice Scalia, then a D.C. Circuit judge, held that there is an implied duty to act in good faith when retroactively changing the sales quota determining the amount of commission earned by a salesman. Covell, a salesman for Tymshare, was paid salary and commission based on sales credited to Covell in excess of a quota set by Tymshare. Tymshare won a contract from the United States Postal Service, allegedly based on Covell's efforts. Substantial revenues were expected from the contract, and Tymshare set Covell's sales quota so that he would earn

¹⁶² Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 251-52.

¹⁶³ See BURTON & ANDERSEN, *supra* note 4, at 141-46; Van Alstine, *supra* note 4, at 1258-65 (reviewing cases arising in varying contexts rejecting good faith claims in favor of literal enforcement of contract terms).

¹⁶⁴ *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1154 (D.C. Cir. 1984). For a discussion of *Tymshare*, see *infra* text accompanying notes 166-77.

¹⁶⁵ See ROBERT A. HILLMAN, *THE RICHNESS OF CONTRACT LAW* 143-46 (1998).

¹⁶⁶ 727 F.2d 1145 (D.C. Cir. 1984).

\$31,000 in commission if the Postal Service contract produced the expected revenues.¹⁶⁷ When the Postal Service revenues initially proved to be lower than projected, Tymshare reduced Covell's quota so that he would still receive the \$31,000 commission. Postal Service revenues subsequently picked up, eventually exceeding even the original projection. Shortly after adjusting Covell's quotas back to the original level, Tymshare fired him. The question presented to the court was whether Tymshare had acted in bad faith in increasing the quotas. The court held that although the employment contract permitted retroactive quota increases within the "sole discretion" of the employer, Tymshare was not entitled to "reduce the quota for any reason whatever."¹⁶⁸ Justice Scalia interpreted the sole discretion language of the contract as giving Tymshare only "discretion to determine the existence or nonexistence of the various factors that would reasonably justify alteration of the sales quota,"¹⁶⁹ factors primarily based on the performance of Covell. This conclusion was not drawn using a good faith analysis, but was grounded in Justice Scalia's belief that the parties did not intend Tymshare's discretion to be absolute. Rather, Tymshare's discretion depended on whether the reasons for the quota increase were consistent with the factors that would justify it. In effect, Justice Scalia saw a gap and filled it as he believed the parties would have. Justice Scalia did not, apparently, discern any significant difference between adjudicating a case based on an independent duty of good faith or using good faith to imply terms into a contract, since he explicitly approved of both Professor Summers' excluder analysis as well as Professor Farnsworth's view that the significance of the good faith doctrine is to imply terms into contracts.¹⁷⁰ In comparing implication of terms into contracts based on parties' expectations with the duty of good faith, Justice Scalia said:

[T]he authorities that invoke, with increasing frequency, an all-purpose doctrine of "good faith" are usually if not invariably performing the same function executed (with more elegance and precision) by Judge Cardozo . . . when he found that an agreement which did not recite a particular duty was

¹⁶⁷ *Id.* at 1149.

¹⁶⁸ *Id.* at 1154.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 1152.

nonetheless "‘instinct with . . . an obligation’ imperfectly expressed" The new formulation may have more appeal to modern taste since it purports to rely directly upon considerations of morality and public policy, rather than achieving those objectives obliquely, by honoring the reasonable expectations created by the autonomous expressions of the contracting parties. But it seems to us that the result is, or should be, the same.¹⁷¹

Justice Scalia's view of the relationship of good faith to contract interpretation and gap-filling is thus similar to that expressed by Judge Posner in *Market Street Associates*.

In discussing *Tymshare*, Professor Hillman reaches a conclusion that Justice Scalia probably would not share. Professor Hillman's analysis proceeds by suggesting some hypothetical variations on the *Tymshare* facts. First, he supposes that the agreement "had expressly permitted management to change the sales quotas at any time 'for the sole purpose of reducing or eliminating the employee's earned commissions'"¹⁷² rather than providing that quotas could be increased within the sole discretion of the employer. Next, he hypothesizes that Covell agreed to the hypothetical term with full understanding of its implications, and then sued *Tymshare* based on breach of good faith when it increased his quotas solely for the purpose of reducing or eliminating commissions.¹⁷³ Finally, Professor Hillman suggests that the contract is not unconscionable, so that Covell's only chance of prevailing would be on the ground of lack of good faith. Conceding that the change in the quota would be within the reasonable expectations of Covell, Professor Hillman nevertheless concludes that "[m]any courts faced with such harsh facts would probably find bad faith."¹⁷⁴

In *Tymshare*, Justice Scalia stated that the term in the contract was not the same as one that permitted the employer to change quotas "for any reason whatsoever, no matter how

¹⁷¹ *Id.* at 1152-53 (quoting *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 68, 91, 118 N.E. 214, 214 (1917) (quoting *McCall Co. v. Wright*, 133 A.D. 62, 68, 117 N.Y.S. 775, 779 (1st Dep't 1909), *aff'd*, 198 N.Y. 143, 91 N.E. 516 (1910))).

¹⁷² HILLMAN, *supra* note 165, at 150.

¹⁷³ *Id.* at 150-51.

¹⁷⁴ *Id.* at 151. For an argument that there might be valid reasons for Covell to agree to the hypothetical term, see *supra* note 117.

arbitrary or unreasonable.”¹⁷⁵ Although Professor Hillman’s hypothetical language is not as strong as the hypothetical language of Justice Scalia, it seems likely that the Hillman language was intended to convey the same meaning as the Scalia language. Had the alternative language (either version) been used, Justice Scalia would have held that the increase in quota was not in bad faith. In his opinion he carefully separates good faith from other contract rules that are applicable without regard to party intent.

Of course it may be that even when the contract does not contain any implicit restriction upon a contractual power, the law itself will impose one—just as it will eliminate certain contractual powers in their entirety as unlawful, for example, a penalty clause. This pertains, however, not to good faith in performance but to the legality of the performance that has been agreed to. The nonbreaching party who applies by its explicit terms a self-help provision that amounts to a penalty . . . is performing the contract in the utmost good faith, but under a provision that is unlawful. It is not conducive to sound analysis to confuse the two concepts, as sometimes occurs, particularly where illegality on the basis of unconscionability is at issue.¹⁷⁶

Although one can understand why Professor Hillman reaches the conclusion that he does—it supports Professor Summers’ notion that bad faith is an independent duty not controlled by standard notions of interpretation and gap-filling—his conclusion is defensible only if two unstated propositions are correct. The first proposition is that the doctrine of unconscionability, as presently formulated, is inadequate to regulate unfair bargains not voidable by fraud, duress, mistake, etc. This proposition may or may not be true. The second proposition is that if the unconscionability doctrine is inadequate to regulate unfair bargains, the good faith doctrine should be used to make up for the inadequacies of the unconscionability doctrine. This second proposition is hard to defend. The Hillman hypothetical amounts to no more or less than invalidating a fully consensual agreement based on its unfairness—an action precisely within the domain of the unconscionability doctrine. If the unconscionability doctrine is deficient, the appropriate

¹⁷⁵ *Tymshare*, 727 F.2d at 1154.

¹⁷⁶ *Id.* at 1152 n.5 (citation omitted).

remedy is to cure its deficiencies, not to mask them by announcing a parallel doctrine. This is especially true when the "plain meaning" of the parallel doctrine's name (i.e., good faith in performance and enforcement) so poorly describes the use to which it is sought to be put (i.e., unfair in formation). How can a party be said to be performing or enforcing in bad faith when it does no more or less than what was expressly agreed to and understood by the parties?¹⁷⁷

The attempt to accommodate Professor Summers' morality-based good faith analysis with the view that the object of the good faith covenant is to effectuate party expectations, and the confusion this attempt can engender, can be seen in a comment to *Restatement Second* section 205: "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."¹⁷⁸

Applying the first clause of the comment to Professor Hillman's hypothetical based on the *Tymshare* facts would seem to require upholding the employer's right, based on the express agreement reflecting a common purpose and the expectations of the parties that a change in quotas for the sole purpose of reducing or eliminating commissions would be acceptable. On the other hand, the second clause of the comment, although apparently intended to be consistent with the first clause, would support, in Professor Hillman's view, invalidating the employer's

¹⁷⁷ A response to this criticism could be based on the fact that Professor Summers' excluder analysis suggests that bad faith in contract negotiation or formation, as well as in contract performance, may provoke judicial disapproval. See Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 220-32. Of the five types of bad faith in negotiation or formation identified by Professor Summers in his 1968 article, one, taking advantage of another in driving a hard bargain, would seem to cover Professor Hillman's hypothetical. Nevertheless, the excluder analysis has failed to gain traction in contract formation situations; instead these situations have been evaluated under other contract formation rules. See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1979). Moreover, even if the good faith doctrine is considered applicable to negotiation and formation, as well as performance, if *Tymshare* and *Covell* voluntarily agreed to the quota provision as posited by Professor Hillman, it is difficult to see how *Tymshare* could be said to have negotiated in bad faith.

¹⁷⁸ RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a.

right to change quotas, regardless of the agreement, since such action violated standards of fairness.

C. *The Covenant and Recapturing Foregone Opportunities*

Professor Steven Burton of the University of Iowa is yet another of the distinguished scholars who have been influential writers about good faith.¹⁷⁹ Professor Burton agrees with Professor Farnsworth that the implied covenant of good faith performance is used to carry out the intention of the parties or to protect their reasonable expectations by interpreting agreements and implying terms.¹⁸⁰ Unlike Professor Summers, he does not believe that the doctrine has been used (except in aberrational cases)¹⁸¹ to effectuate results inconsistent with party intent for purposes of achieving results based on “fairness, policy, or morality;”¹⁸² nor does he think it should be so used.¹⁸³ Professor Burton’s position on good faith is distinguishable from that of Professor Farnsworth mainly by the fact that he believes that the good faith doctrine would be superfluous if it did no more than justify implication of terms so as to effectuate party intent.¹⁸⁴ In such a case there would be no meaningful difference between the two statements: “Contracts ought to be performed according to their terms in good faith,” and “Contracts ought to be performed according to their terms.”¹⁸⁵ In discussing the U.C.C. good faith requirement, he writes:

When employed as a principle underlying standards of interpretation and rules of performance, good faith as *pacta sunt servanda* would add little to the analysis of a particular problem of contract performance. It would mean what the relevant contract terms, standard of interpretation, and rules of

¹⁷⁹ See generally BURTON & ANDERSEN, *supra* note 4; Burton, *Breach of Contract*, *supra* note 4; Burton, *Good Faith in Articles 1 and 2*, *supra* note 4; Burton, *Good Faith Performance*, *supra* note 4; Burton, *More on Good Faith Performance*, *supra* note 4.

¹⁸⁰ Burton, *More on Good Faith Performance*, *supra* note 4, at 499.

¹⁸¹ See Burton, *Good Faith in Articles 1 and 2*, *supra* note 4, at 1535.

¹⁸² *Id.* at 1534; Burton, *Good Faith Performance*, *supra* note 4, at 3.

¹⁸³ See Burton, *Good Faith in Articles 1 and 2*, *supra* note 4, at 1535–36, 1552–57.

¹⁸⁴ Professor Farnsworth had written that “the chief utility of the concept of good faith performance has always been as a rationale in a process which is not intrusted to the trier of the facts—that of implying contract terms.” Farnsworth, *Good Faith Performance*, *supra* note 4, at 672.

¹⁸⁵ See Burton, *Good Faith Performance*, *supra* note 4, at 4–5.

performance provide. To say that good faith underlies standards of interpretation and rules of performance would be to say that the content of a contract is determined with reference to the agreement of the parties, including adherence to courses of dealing and usages of the trade not negated by express terms, and to the applicable rules of law, construed in light of the underlying purposes and policies of the U.C.C. Awareness of the underlying good faith principle would not affect the determination of the relevant facts in a dispute, or their import.¹⁸⁶

He finds meaning in the good faith doctrine only insofar as it directs attention to facts relevant to the costs undertaken in contract formation (as opposed to facts relevant to the expected benefits of the contract).¹⁸⁷ As Professor Burton sees it, these costs can be affected when a party exercises discretion in contract performance. Such discretion can arise because the contract explicitly grants discretion to one party or because the express contract terms have gaps or ambiguities that, in effect, confer discretion on a party.¹⁸⁸ The core of his analysis is that a party in these circumstances who exercises discretion so as to recapture opportunities forgone in the contract is performing in bad faith; on the other hand a party who exercises discretion to capture opportunities preserved (or not forgone) in the contract is acting in good faith.¹⁸⁹ Initially, Professor Burton believed that the subjective purpose (i.e., actual motive) of the party exercising discretion would determine whether the disputed action was an attempt to recapture forgone opportunities. Subsequently, he changed his view and now supports judging actions on objective grounds (i.e., whether an action was justified on any reasonably expectable ground).¹⁹⁰ The dependent party's reasonable expectations at the time of contract formation with respect to forgone opportunities of the discretion-exercising party, and the reasons for the discretion-exercising party's actions at the time for performance, determine whether a recaptured opportunity is characterized as preserved or forgone by the contract and thus whether the good faith requirement was observed or breached.¹⁹¹

¹⁸⁶ *Id.* (footnote omitted).

¹⁸⁷ *See id.* at 5.

¹⁸⁸ *See* Burton, *More on Good Faith Performance*, *supra* note 4, at 501.

¹⁸⁹ *See* Burton, *Good Faith Performance*, *supra* note 4, at 5-6.

¹⁹⁰ *See* Burton, *Good Faith in Articles 1 and 2*, *supra* note 4, at 1561-62.

¹⁹¹ Burton, *Good Faith Performance*, *supra* note 4, at 6. Professor Burton deals

Professor Burton believes that refining the concept of good faith encourages plaintiffs to sue "only when they stand a reasonable chance of succeeding and of succeeding for good reasons."¹⁹²

It is hard to argue with Professor Burton's view that the good faith doctrine is superfluous if it serves only as a justification for requiring contract performance that is within the justifiable expectations of the parties. But it is also hard to argue that his forgone opportunity analysis is necessary, or even helpful, in analyzing whether a party has exercised discretion in a manner permitted by the contract. Clearly, parties who enter into contracts forgo their opportunities to act in specified and unspecified ways. The very nature of a bilateral contract is to create obligations in exchange for rights. Thus, if I promise to cut my neighbor's lawn in exchange for her promise to pay me \$10, I have forgone the opportunities that might have been available to me by not cutting her lawn. But forgone opportunities will be revealed in the same way reasonably expected benefits will be revealed—by determining the agreement of the parties based on principles of interpretation and gap-filling. Until the agreement is so determined it is not possible to identify opportunities that were forgone by entering the contract. After the agreement is so determined the forgone opportunities will be known but will be of no consequence in determining the rights and obligations of the parties—these have already been determined by the process of interpretation and gap-filling.

An examination of *Mutual Life Insurance Co. of New York v. Tailored Woman, Inc.*,¹⁹³ one of a series of percentage rent cases that Professor Burton has referred to in three of his writings,¹⁹⁴ illustrates this point. In *Tailored Woman*, the defendant lessee, which operated a women's clothing department store, contracted in 1939 to lease the first three floors of an eight-story Manhattan

with good faith contract enforcement as a separate but related issue to good faith performance. He sees good faith enforcement as invoking remedial rights when necessary to protect a party's interest in receiving performance from the other party. See generally BURTON & ANDERSEN, *supra* note 4, at 163-95.

¹⁹² Burton, *Good Faith in Articles 1 and 2*, *supra* note 4, at 1535.

¹⁹³ 309 N.Y. 248, 128 N.E.2d 401 (1955), *affg* 283 A.D. 173, 126 N.Y.S.2d 573 (1st Dep't 1953).

¹⁹⁴ BURTON & ANDERSEN, *supra* note 4, at 55-57; Burton, *Breach of Contract*, *supra* note 4, at 384-85; Burton, *More on Good Faith Performance*, *supra* note 4, at 502-03.

building located at the corner of Fifth Avenue and West Fifty-Seventh Street. Included as rent was four percent of all sales made "on, in, and from" the leased premises.¹⁹⁵ The lease described the premises as having an address of 742 Fifth Avenue. The lessee was given exclusive use of a Fifth Avenue entrance, a Fifty-Seventh Street entrance, and two passenger elevators that were capped at the third floor. The 1939 lease further provided that the lessee's business would "be conducted and maintained in a manner substantially similar to" the business it had conducted at its prior location, where it operated a fur department.¹⁹⁶

Initially, the lessee conducted a substantial fur business in the leased premises. Subsequently, in 1945, the lessee acquired the custom-made dress business of a fifth-floor tenant in the same building. After acquiring this business, the lessee entered into a new lease of the fifth-floor premises of the acquired business with the original lessor. The new lease provided for a flat rental payment only. The 1945 lease described the leased premises as having an address of 1 West 57th Street. It provided that the fifth-floor space was to be used for the sale of all types of women's clothing and accessories, that the 1945 lease would have no effect on the 1939 lease, that the lessee could not make any alteration in the leased premises without the lessor's consent, and that the landlord would maintain the elevators that serviced the fifth floor.¹⁹⁷

Shortly after taking possession of the fifth-floor premises, the lessee altered the two elevators that serviced the first three floors so that they could carry passengers to and from its fifth-floor premises. Initially, the lessee continued the custom-made dress business it had acquired, but when that business was not successful, the lessee integrated the fifth floor into its department store and moved its fur department to that floor.¹⁹⁸

¹⁹⁵ See *Tailored Woman*, 309 N.Y. at 252, 128 N.E.2d at 402.

¹⁹⁶ *Id.* at 252, 128 N.E.2d at 402.

¹⁹⁷ *Id.* at 255, 128 N.E.2d at 405 (Burke, J., dissenting).

¹⁹⁸ The Court of Appeals affirmed the holding of the Appellate Division, but the majority opinions of the two courts differed on the question of when the lessee altered the elevators and integrated the fifth floor into the department store. The Court of Appeals stated that the elevator alteration occurred, and the first three floors were integrated with the fifth floor, after the custom-made dress business was discontinued. *Id.* at 253, 128 N.E.2d at 402-03 (majority opinion). On the other hand, the Appellate Division stated that the elevators were altered, and the operations integrated, by the lessee immediately after it took possession of the fifth floor, the custom-made dress business being discontinued at some later time. 283

The lessor sued for percentage rent on fur sales made on the fifth floor, arguing, first, that the fur sales were made “on, in, or from” the 1939 premises and, second, that the lessee breached express and implied covenants in the lease, including the implied covenant of good faith.¹⁹⁹

The New York Court of Appeals acknowledged that the lessor, when it entered into the 1945 lease, “did not contemplate” that the lessee would remove business from the first three floors to the fifth floor.²⁰⁰ Nevertheless, the court held that since neither the 1939 nor 1945 leases contained provisions that precluded moving the fur department, percentage rent was not due on fur sales that originated on the fifth floor. The lessor’s lack of “foresight” in failing to appropriately restrict the 1945 lease could not, in the view of the court, “create rights or obligations” apart from the written terms of the leases.²⁰¹ Referring to the implied covenant of good faith, the court said: “In deciding this case as we do, we are not moving away from the good old rule that there is in every contract an implied covenant of fair dealing. Defendant, as we see it, was merely exercising its rights.”²⁰²

Professor Burton’s analysis of *Tailored Woman* is that the court concluded that the lessee did not act in bad faith because exercising its discretion to shift business from one floor to another was “an expectable [or ‘normal’] business practice”²⁰³ based on “the justified expectations of the parties arising from their agreement,”²⁰⁴ and accordingly the lessee had not attempted to recapture any forgone opportunities. But whether forgone opportunities were recaptured can be determined only by interpreting the contract. The forgone opportunities assessment is no more or less than a conclusion that follows a judgment that the contract has been breached or not been breached. It provides no assistance in determining whether the contract has been breached; and since, in Professor Burton’s view, a bad faith breach is like any other breach in that it results in harm to the

A.D. at 176, 126 N.Y.S. 2d at 575, *aff’d*, 309 N.Y. 252, 128 N.E.2d 401 (1955).

¹⁹⁹ 309 N.Y. at 255, 128 N.E.2d at 404.

²⁰⁰ *Id.* at 253, 128 N.E.2d at 403.

²⁰¹ *Id.* at 253, 128 N.E.2d at 403.

²⁰² *Id.* at 254, 128 N.E.2d at 403 (citations omitted).

²⁰³ BURTON & ANDERSEN, *supra* note 4, at 56; Burton, *Breach of Contract*, *supra* note 4, at 386 n.79.

²⁰⁴ BURTON & ANDERSEN, *supra* note 4, at 57.

expectation interest of a party, it is difficult to see the "distinctive mission"²⁰⁵ for the good faith performance doctrine that saves it from being "redundant to other contract obligations."²⁰⁶

In their book, Professors Burton and Anderson claim that "[m]ost cases invoking the obligation to perform in good faith can be synthesized using the following principle: a party performs in bad faith by using discretion in performance for reasons outside the justified expectations of the parties arising from their agreement."²⁰⁷ As they apply this analysis to *Tailored Woman*, Professors Burton and Anderson observe that the court concluded, based on the justified expectations of the parties, that the exercise of discretion in moving the fur department was an expectable business practice.²⁰⁸ But such an observation does not address the real question of the case—how did the court determine what the justified expectations of the parties were? Once such a determination is made, the forgone opportunities will inevitably be revealed. It is apparent from reading *Tailored Woman* that the New York Court of Appeals, although not expressly relying on the plain meaning rule, reached its conclusion on the basis that the lease provisions, by their terms, did not preclude moving the fur department to the fifth floor.²⁰⁹ Although the court recited facts relating to the context of the transaction, such as the history of the fur department's operation, the lessee's alteration of the elevators, and the lessor's not contemplating that the 1945 lease would enable the lessee to move the fur department, these facts were treated as essentially irrelevant in the face of a general provision in the 1945 lease allowing sales of women's clothing without restrictions. Another

²⁰⁵ *Id.* at 41.

²⁰⁶ *Id.*

²⁰⁷ *Id.* at 57.

²⁰⁸ *Id.* at 56.

²⁰⁹ The court said:

There is nothing in the main lease to forbid the moving of the fur department and when plaintiff made [the 1945] lease, it again failed to include any restrictions as to the particular kinds of merchandise to be sold in one or the other part of the building . . . True, the [1945] lease said that it would "not have any effect" on the earlier lease but the effect of the two leases, read together and enforcing both, was that defendant had the right to sell all kinds of women's apparel, etc., in any part of [the leased premises], so long as not other use was made of the premises. As we see it, defendant merely exercised that right when it moved the fur department.

309 N.Y. at 253-54, 128 N.E.2d at 403.

court, adopting principles of interpretation embraced by the *Restatement Second*, would proceed in a wholly different manner, however. After weighing the contextual factors and applying standards of interpretation based on knowledge or reason to know of the lessor and the lessee, and judging whether a gap existed given the purpose of the leases, such a court might conclude that the 1945 lease ought to be interpreted to limit fifth-floor sales to types of merchandise not sold on the first three floors at the time of the 1945 lease. Or, on the other hand, such a court might conclude that neither party had reason to know of the understanding of the other and that no gaps in need of filling existed, so that the lessee would be allowed to move the fur department to the fifth floor. Whichever way such a court decided the case, it is difficult to see how a consideration of either good faith or forgone opportunities would be either necessary or helpful.

*D. The Nondisclaimable, Nonbreachable, "Nonexcludable"
Implied Covenant of Good Faith*

The U.C.C., originally promulgated in 1951 under the joint sponsorship of the American Law Institute and the National Conference of Commissioners on Uniform State Laws, was the most significant development in the history of the implied covenant of good faith. Until then, as Professor Farnsworth observed, the covenant had been recognized in only a handful of jurisdictions.²¹⁰ Ultimately, every state adopted all of the articles of the U.C.C., except for Louisiana, which did not adopt Article 2. The original U.C.C. contained several provisions and comments referring to good faith in specific applications, as well as a general provision in Article 1 requiring good faith in the performance and enforcement of all contracts.²¹¹ Article 1 defined good faith as honesty in fact, but a special definition for purposes of Article 2 defined good faith in the case of merchants as honesty in fact and observance of reasonable commercial standards.

The Article 1 limitation of good faith to honesty in fact was probably the most controversial aspect of the original U.C.C.'s good faith provisions. The limitation was roundly criticized by

²¹⁰ Farnsworth, *Good Faith Performance*, *supra* note 4, at 671.

²¹¹ See BURTON & ANDERSEN, *supra* note 4, at 115.

commentators, and revised Article 1, adopted in 2001, expanded the general definition of good faith to require objective good faith (i.e., observance of reasonable commercial standards of fair dealing) as well as subjective good faith. In other words, the general Article 1 definition of good faith now follows the original special definition adopted for purposes of Article 2, except that the requirement of objective good faith is no longer limited to merchants.

The debate over the absence of a general objective standard of good faith overshadowed three other questions raised by the good faith provisions of the U.C.C. These other three questions, which are more relevant to the hypothesis of this Article, will be explored here. The first was raised by Professor Summers, who believes that the concept of good faith has no meaning other than as an excluder of bad faith, which itself should not be defined. His seminal article in *Virginia Law Review* strongly criticized the original U.C.C. in treating good faith as an affirmative duty capable of definition.²¹² As was discussed above, Professor Summers' view clearly influenced the content of *Restatement Second*.²¹³ Given that the American Law Institute was one of the two joint sponsors of the U.C.C. as well as the promulgator of *Restatement Second*, it is odd that the 2001 revision of U.C.C. Article 1 retains the good faith covenant as an affirmative concept, not an excluder, and, perhaps more significantly, retains virtually the same definition of good faith as appeared in Article 2 of the original version.²¹⁴ Moreover, the official comment to the revised Article 1, although relatively lengthy, gives no hint of the excluder analysis contained in the comments to *Restatement Second* section 205 and no legislative history of the Article 1 revision seems to address the question. One is left to wonder at the utility of a concept so unsettled that even the question of

²¹² Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 215.

²¹³ See *supra* notes 150–52 and accompanying text.

²¹⁴ Professor Summers' most severe criticisms of the U.C.C. good faith provisions were aimed at the subjective definition of good faith in Article 1. See Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 207–16. To the extent that the revised Article 1 now incorporates both a subjective and an objective requirement of good faith, the revision can be said to have responded positively to Professor Summers' view. Nevertheless, his influence here is diluted by virtue of the fact that the other two leading commentators on the U.C.C. good faith provisions had also condemned Article 1's limitation of good faith to honesty in fact. See Burton, *Good Faith in Articles 1 and 2*, *supra* note 4, at 1560–63; Farnsworth, *Good Faith Performance*, *supra* note 4, at 666, 673–74.

whether it is capable of definition arouses contradictory answers from the most prominent nongovernmental legal authority in the land.

The second question raised by the U.C.C. good faith provisions came into focus when the Permanent Editorial Board for the Uniform Commercial Code adopted PEB Commentary No. 10 in 1994,²¹⁵ which concluded that a failure to perform or enforce a contract in good faith is not actionable in the absence of other grounds for determining that the contract has been breached. The commentary and its accompanying amendment of the official comment to the good faith obligation provision of the U.C.C. represented the rejection of another aspect of Professor Summers' excluder analysis, which advocated for an independent duty of good faith, not tied to agreement of the parties, but rooted in notions of morality and fairness.²¹⁶ The commentary, on the other hand, adopted the view that the sole purpose of the good faith obligation is to protect the reasonable expectations of the parties. The commentary relates the "conceptual content" of the good faith obligation to the term "agreement" as it is broadly used in the U.C.C. to refer to the bargain of the parties as determined from the express agreement as well as from contextual factors such as trade usage, course of dealing, and course of performance. The commentary rejects the view that a party can act, or fail to act, in good faith except in relation to the agreement, and added the following language to the official comment to U.C.C. section 1-203:

This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a

²¹⁵ The Permanent Editorial Board ("PEB") for the Uniform Commercial Code is a body under the joint control of the American Law Institute and the National Conference of Commissioners on Uniform State Laws. The PEB, from time to time, issues commentary on the U.C.C. which "seek to further the underlying policies of the UCC by affording guidance in interpreting and resolving issues raised by the UCC and/or the Official Comments." U.C.C. app. I, at 1310 cmt. 10 (2005). The members of the PEB at the time of the issuance of Commentary No. 10 were: Geoffrey C. Hazard, Jr. (Chair), Boris Auerbach, Marion W. Benfield, Jr., Gerald L. Bepko, Amelia H. Boss, Lawrence J. Bugge, William M. Burke, Ronald DeKoven, Frederick H. Miller, Donald J. Rapson, Curtis R. Reitz, Carlyle C. Ring, Jr., Robert Haydock, Jr. (emeritus), William E. Hogan (emeritus), Homer Kripke (emeritus), and William J. Pierce. *Id.* app. I, at 1309.

²¹⁶ Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 195, 197-98, 233.

specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.²¹⁷

This language is now part of the official comments to revised Article 1 section 1-304.²¹⁸

Here, as with the comment to *Restatement Second* section 205 discussed above,²¹⁹ it is possible to see the ability of the implied obligation of good faith to confound and confuse contract law. On the one hand, the text of the U.C.C. asserts that there is an "obligation" of good faith. Commentary No. 10, on the other hand, says that the obligation is not capable of being breached, apart from a breach of the contract, so as to give rise to a cause of action. What is one to make of an unenforceable obligation? The commentary tells us that the obligation is relevant only in the process of interpreting the agreement so as to effectuate the reasonable expectations of the parties. But how does the good faith obligation aid contract interpretation? Two passages from the revised official comment suggest the peril in so approaching the good faith obligation. The first passage asserts that "a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power."²²⁰ Reading the foregoing sentence, but omitting the clause "in good faith," does not seem to change its meaning in any way with respect to performance. A failure to perform a specific duty or obligation under a contract is a breach of that contract. The absence of good faith makes the breach no less or more a breach. If anything, the sentence seems to suggest the clearly erroneous conclusion that there can be no breach of the contract if the actor has acted in good faith. The other aspect of the sentence—that a failure to enforce a duty or obligation in good faith makes a remedy unavailable—is no less troublesome,

²¹⁷ U.C.C. app. I, at 1315; see also *id.* § 1-304 cmt. 1.

²¹⁸ *Id.* § 1-304 cmt. 1.

²¹⁹ See *supra* note 178 and accompanying text.

²²⁰ U.C.C. § 1-304 cmt. 1.

but in a different way. By positing that the actor is attempting to enforce a duty or obligation under the contract, it seems reasonable to presume that such duty or obligation has been breached.²²¹ If that is the case, then the comment seems to suggest that even if the contract has been breached, a remedy will not be available if the breach is not asserted in good faith. Interpreted this way, the comment is far from trivially true (the case with the provision with respect to good faith performance). Here the suggestion is that the breaching party can defend on the ground that the victim of the breach is not acting in good faith in claiming a remedy. Providing that failure to enforce in good faith is an independent ground for excusing performance seems inconsistent with the main thrust of the comment that no independent cause of action exists for bad faith performance.²²² It is hard to imagine why the PEB would bury such a significant principle of law in an amendment to the official comments having to do with whether the breach of the duty of good faith is actionable. But what else could the language of the comment mean?

The second troublesome passage from the amended official comment is that “the doctrine of good faith [as opposed to creating a separate duty of good faith] merely directs a court towards interpreting contracts within the commercial context in which they are created, performed and enforced.”²²³ Much of Commentary No. 10 is devoted to reviewing various U.C.C.

²²¹ If the obligation or duty is not breached, no remedy should be available regardless of the good faith or bad faith of the actor.

²²² One group of cases that involve this issue has to do with the perfect tender rule of the U.C.C., which permits a buyer, unless otherwise agreed, to reject goods that “fail in any respect to conform to the contract.” U.C.C. § 2-601(a). A variety of specific statutory exceptions apply to the rule. But if no explicit exception exists, a question can arise whether a buyer can only reject in good faith. Some courts have suggested that failure of a perfect tender gives the buyer an absolute right to reject regardless of its motives, others have suggested that if the rejection is motivated by a desire to avoid the deal rather than with dissatisfaction with the nonconformity, the implied covenant of good faith is violated. *See* JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 8-3(b) (4th ed. 1995). The preferable method of deciding these cases is to focus on the “otherwise agreed” exception to the perfect tender rule, rather than on the question of good faith. Based on familiar principles of interpretation and gap-filling, it should be determinable whether the agreement precluded a pretextual rejection. Dissatisfaction with the draconian policy behind the perfect tender rule is a separate issue, and should not be a basis, under the guise of good faith, for stripping a buyer of a statutorily-granted right of rejection.

²²³ U.C.C. § 1-304 cmt. 1.

provisions relating to how an agreement is interpreted and enforced, including the provisions with respect to trade usage, course of dealing, course of performance, and the weight accorded these factors relative to each other and to the express language of the agreement. In view of these elaborate provisions determining commercial context that are part of the statutory law, why is it necessary to have another provision that "merely directs a court towards interpreting contracts" in accordance with the statute? What Commentary No. 10 brings most clearly to mind is Professor Burton's suggestion that if the purpose of the doctrine of good faith is simply to justify contract interpretation so as to effectuate the reasonable expectations of the parties, the doctrine has no "mission" that justifies its existence.

The third question raised by the U.C.C. good faith provision concerns the parties' ability to eliminate or modify the duty by agreement. Section 1-302(b) provides that the duty of good faith cannot be disclaimed, but the agreement of the parties "may determine the standards by which the performance of [the good faith obligation] . . . is to be measured if those standards are not manifestly unreasonable."²²⁴ Professors Burton and Farnsworth have both criticized this provision's ambiguity and limitation on individual autonomy,²²⁵ but still another question arises from the interaction of this provision with Commentary No. 10. Based on the commentary and the revised official comment to the provision imposing the good faith obligation, we now know that it is not possible to independently breach the obligation of good faith. Rather, the obligation simply directs a court's attention to the principles of interpretation embraced by the U.C.C., the most important of which are the language of the agreement, trade usage, course of dealing, and course of performance.²²⁶ Of course, at the outset it is hard to imagine parties providing in their agreement that it can be performed or enforced in bad faith. But they might provide that "a court interpreting this agreement shall disregard the question whether a party has performed or enforced in good faith." Since such a provision would negate the interpretation of good faith set forth in Commentary No. 10, it

²²⁴ *Id.* § 1-302(b).

²²⁵ Burton, *Good Faith Performance*, *supra* note 4, at 25 (proposing revision of nondisclaimability provision); Farnsworth, *Good Faith Performance*, *supra* note 4, at 676-78.

²²⁶ *See* U.C.C. § 1-303.

would seem that such a provision would be invalidated by section 1-302(b). The official comments to the U.C.C. parol evidence rule, however, provide that the parties to an agreement may negate a court's ability to interpret the agreement in light of trade usage, course of dealing, or course of performance.²²⁷ If the parties can negate these contextual factors of interpretation, why cannot they also negate a rule that directs a court's attention to such factors? If so, there is little or nothing left to the domain of the nondisclaimability of good faith. Of course, it may be argued that the nondisclaimability provision nevertheless has meaning since it prevents the parties from negating the express terms of their agreement, and no provision or comment of the U.C.C. provides that the parties may negate the language of their agreement. Perhaps, then, this is the role of the nondisclaimability provision—to invalidate a contract term providing that “no court shall interpret this agreement in accordance with its terms.”

CONCLUSION

The implied covenant of good faith and fair dealing originated in the late Nineteenth and early Twentieth Centuries, primarily in the common law of New York. It has been suggested in this Article that its origination was a reaction to the rigid interpretation and parol evidence rule of formalist jurisprudence. The implied covenant gave the New York courts a way to achieve a reasonable result without rejecting well-embedded precedent. Despite the receptivity of New York courts (and a few others) to the covenant, for the first fifty years or so of its existence it was not widely recognized and was not included in *Restatement First*. Then, embraced by Karl Llewellyn, the principal draftsman of the U.C.C. and a great believer in fairness and reasonableness in commercial transactions, the implied covenant found its way into the major commercial statute of the Twentieth Century and subsequently into *Restatement Second*. The implied covenant quickly gained prominence in the law of contracts—it became part of the common law of most states and is frequently raised in commercial litigation in a variety of contexts; it also became the subject of a small avalanche of law review articles seeking to define its meaning, role, and scope.

²²⁷ *Id.* § 2-202 cmt. 2.

This Article has sought to establish that the addition of the covenant to the law of contracts has not, by and large, been helpful. One reason for this is that imposing an unbargained for covenant of good faith and fair dealing on contracting does not necessarily mesh with the principle of individual autonomy. This problem can be seen clearly in the contrasting positions of Professors Burton and Summers discussed above. Another reason why the covenant has not been as helpful is its potential to confuse and sometimes misdirect contract disputes that should be resolved by familiar principles of interpretation and gap-filling. At least in jurisdictions that have abandoned the plain meaning rule and a restrictive parol evidence rule, the covenant is no longer necessary to reach the sensible results it helped to achieve in the early common law of New York.

Professor Glanville Williams observed that there are three categories of implied contract terms.²²⁸ The first category is terms that the parties actually intended to be part of their contract, but for some reason or other did not expressly state. The second is terms that the parties overlooked but probably would have included had they considered the issue addressed by such implied terms. The third is terms imposed by the court for reasons of policy or fairness, or in obedience to rules of law. Professor Williams believed that the three categories of implied terms merge into each other "because the distinguishing factor, that of probable intent, is a matter of degree."²²⁹ This latter observation may be valid as a generalization, but it is arguable that the implied covenant of good faith may fit within his third category only, and that the justification for including it there is precarious.

Imagine an empirical study that asks three questions of parties to written contracts. The first question would be: "Would a contract provision stating that 'The parties to this contract will perform their respective obligations and enforce their respective rights in good faith' accord with your actual intent?" The second question would be: "In what way does the promise to perform and enforce in good faith differ from the promise to perform and enforce in accordance with the terms of the contract?" The third question would be: "Why did your contract omit an explicit

²²⁸ Glanville L. Williams, *Language and the Law-IV*, 61 L.Q. REV. 384, 401 (1945).

²²⁹ *Id.*

promise to perform and enforce in good faith?" Although a majority of the answers to the first question might be "yes," a majority of the answers to the second and third questions likely would be "I don't know."

Experienced lawyers would probably agree that they recall few, if any, contracts that expressly include a general covenant of good faith. What can explain such an omission if implication of a general covenant of good faith is to be based on the actual intent of contracting parties? Could it be that parties never include such a covenant because they rely on the law to imply it? This seems highly doubtful. Contracts, especially those drawn by lawyers, frequently contain explicit provisions that the law would otherwise imply. This is true even of the good faith covenant, but only with respect to specific promises, not as a universal contract requirement. For example, standard real estate contracts frequently include a provision permitting the buyer to cancel the contract in the event that he or she is unable to obtain a mortgage. Often, these mortgage contingency provisions are coupled with an express requirement that the buyer will make good faith efforts to apply for and obtain a mortgage. Such an express good faith requirement is unnecessary since it would be implied, but is nevertheless included. Yet such contracts do not include a general provision requiring good faith performance and enforcement of all contract obligations and rights.

It seems probable that a general covenant of good faith is omitted from contract terms for two reasons. The first reason is that parties to a contract do not really care about the faith of the other party—good or bad. All they care about is that the other party will perform as intended. If it is intended that a particular performance be made in good faith (as in the mortgage contingency provision) a specific provision is included, but as a general requirement applying to all contract obligations and rights there is no such intent. The second, and more important, reason that a general covenant of good faith is omitted from contract terms is because such a provision is affirmatively undesirable. Ambiguity in contract provisions is, unfortunately, inevitable, but it is usually not desirable or desired. Clearly, good faith is ambiguous. If I am obligated to render a performance under a contract should I be liable for a breach if I perform, but not in good faith? Or if I have a right under a contract, should I be precluded from exercising such a right if I

do not do so in good faith? The reduction of the clarity of contract provisions and the enhancement of the possibility of contract disputes has probably led parties to reject including general good faith covenants in contracts, and therefore there is no basis for implying such a covenant based on supposed actual or presumed intent.

What then of good faith as an implied term required by fairness, policy, or established law? Established law, of course, it is, but should it be? Broadly speaking, two justifications are offered for the implied covenant of good faith. The first, based on the writings of Professors Farnsworth, Burton and others, and reflected in the official comments to the U.C.C., is that implied good faith is a useful justification or tool for protecting the justified or reasonable expectations of contracting parties by the implication of terms to fill gaps or resolve ambiguities. It has been argued here that modern interpretation and gap-filling techniques, as embodied in *Restatement Second* and the U.C.C., provide a more rational and principled basis for resolving interpretative issues that inevitably arise in express agreements, shackled as they are to the inherent imprecision in language and the fallibility of human drafting. Moreover, the implied covenant of good faith, the meaning of which is widely disputed, is far from a harmless duplication of interpretative principles and actually may subvert appropriate interpretation and gap-filling techniques. The second justification for an implied obligation of good faith, based on the writings of Professors Summers and Hillman, and to a lesser extent on the comments to *Restatement Second*, is that the implied covenant is justified only in part by its protecting the reasonable expectations of the parties. It is also based on notions of morality that may apply to defeat party expectations. Professor Summers also argues that implied good faith should apply to contract negotiation and formation as well as to performance and enforcement.²³⁰

No view is expressed here as to whether good faith should be required in contract negotiation and formation other than to observe that Professor Summers' view generally does not apply in this country although it may in others.²³¹ On the other hand, there seems to be scant justification for an implied covenant in

²³⁰ Summers, "Good Faith" in *General Contract Law*, *supra* note 4, at 220-34.

²³¹ *See id.* at 198.

policing behavior once a contract is formed. If the contract is a fair one, the principle of individual autonomy should require that it be enforced without the uncertainties that would be created by enabling a party disadvantaged by enforcement of the deal to claim bad faith as a defense. If the contract is unfair, the unconscionability doctrine is the existing and appropriate tool for relieving the disadvantaged party.

