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# OF TEXTUALISM, PARTY AUTONOMY, AND GOOD FAITH

MICHAEL P. VAN ALSTINE\*

## INTRODUCTION

“[I]t is possible to so draw a contract as to leave decisions absolutely to the uncontrolled discretion of one of the parties and in such a case the issue of good faith is irrelevant.” But the trick is to tell when a contract has been so drawn—and surely the mere recitation of an express power is not always the test. Sometimes it may suffice . . . . But to say that every expressly conferred contractual power is of this nature is virtually to read the doctrine of good faith . . . out of existence.<sup>1</sup>

This observation of Justice (then Judge) Antonin Scalia about the force of good faith in contractual relations, though clearly intended to be rhetorical, in recent years has come to be almost prophetic. Paralleling a renewed emphasis on formalism in the interpretation of other legal texts—most notably, statutes<sup>2</sup> and

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1. *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1153-54 (D.C. Cir. 1984) (Scalia, J.) (quoting *MacDougald Constr. Co. v. State Highway Dep't*, 188 S.E.2d 405, 407 (Ga. Ct. App. 1972)). For an analysis of Justice Scalia's own limited view of the duty of good faith as reflected in the *Tymshare* opinion, see discussion *infra* note 193.

2. The subject of statutory interpretation has spawned some of the most spirited debates of modern American legal scholarship. For critical examinations of the return of formalism in this interpretive context, see Daniel A. Farber, *The Inevitability*

treaties<sup>3</sup>—the 1990s have witnessed the rise of a new textualist approach to the contractual duty of good faith as well. In its extreme form, this view holds that every expressly conferred contractual power is presumptively absolute and unrestricted. Because the parties' writing reflects the sole repository of interpretive evidence, the textualist logic runs, every such express power renders altogether irrelevant any "implied" notions of "good faith" and "fair dealing."

Indeed, recent textualist courts have voiced irritation over suggestions to the contrary. "More often than we care to recall," the Seventh Circuit admonished a plaintiff in a recent opinion, "we have reminded litigants that . . . [they] may not seek to litigate issues of 'good faith' in lieu of abiding by explicit provisions of contracts."<sup>4</sup> As Justice Scalia warned only fifteen years ago,<sup>5</sup> this modern celebration of the authority of text threatens to consign the doctrine of good faith to an inconsequential marginal note in the law of contracts.

This renewed assault by the forces of formalism in contract should not come as a surprise. The duty of good faith in the performance and enforcement of contracts is now a familiar

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of *Practical Reason: Statutes, Formalism, and the Rule of Law*, 45 VAND. L. REV. 533 (1992); Richard J. Pierce, Jr., *The Supreme Court's New Hypertextualism: An Invitation to Cacophony and Incoherence in the Administrative State*, 95 COLUM. L. REV. 749 (1995). For an introduction to the broader debate over statutory interpretation, see William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321 (1990); W. David Slawson, *Legislative History and the Need to Bring Statutory Interpretation Under the Rule of Law*, 44 STAN. L. REV. 383 (1992).

3. See David J. Bederman, *Revivalist Canons and Treaty Interpretation*, 41 UCLA L. REV. 953, 963-64 (1994) (analyzing the influence of the new formalism on treaty interpretation); Michael P. Van Alstine, *Dynamic Treaty Interpretation*, 146 U. PA. L. REV. 687, 722-26 (1998) (same).

4. *L.A.P.D., Inc. v. General Elec. Corp.*, 132 F.3d 402, 404 (7th Cir. 1997).

5. There is no small amount of irony here. The principal champion of a textualist approach to the interpretation of statutes and treaties, of course, is Justice Scalia himself. See ANTONIN SCALIA, *A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW* 16-35 (1997) (discussing the propriety of reliance on text in interpretive inquiries); see also Bradley C. Karkkainen, "Plain Meaning": *Justice Scalia's Jurisprudence of Strict Statutory Construction*, 17 HARV. J.L. & PUB. POLY 401, 432-39 (1994) (analyzing Justice Scalia's textualist views on statutory interpretation); Van Alstine, *supra* note 3, at 722-26 (discussing Justice Scalia's views on treaty interpretation).

feature in our legal landscape.<sup>6</sup> Throughout its history, however, the doctrine has served as a focal point for controversy in the law of contracts.<sup>7</sup> This is so because it stands uneasily at the crossroads of two inherent tensions in the law. The first arises from the competing goals of providing determinate rules to ensure certainty in the contracting process, while at the same time preserving sufficient flexibility to accommodate the complexity of human interaction.<sup>8</sup> The second tension involves the closely related, but equally contentious, conflict between party autonomy and party heteronomy. At issue in this dimension is the need to reconcile the power of private parties to define for themselves the scope of their obligations with the role of the state in imposing minimal standards of honesty and fairness in the process.<sup>9</sup>

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6. The duty of good faith has found express acceptance in the *Uniform Commercial Code*, the *Restatement (Second) of Contracts*, and now the common law of nearly all of the states. See U.C.C. § 1-203 (1995) ("Every contract or duty within this Act imposes an obligation of good faith in its performance and enforcement."); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."); see also *infra* notes 74-89 and accompanying text (discussing in detail the broad acceptance of the duty of good faith in the UCC and the common law of contracts). The contractual duty of good faith also has inspired a substantial body of scholarly work, the significance of which for the rise of the new textualism I analyze in detail below. See *infra* notes 103-29 and accompanying text.

7. Professor Robert Braucher, one of the most influential scholars of his time, observed at the close of the drafting of the *Uniform Commercial Code* that the duty of good faith "produced more controversy and comment than most other questions affecting the Code pervasively." Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 814 (1958). For a more recent observation in the same vein, see Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131, 1178 (1995) ("Easily the most interesting and important implied term in modern American contract law is good faith . . .").

8. Compare *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990) (noting that reading good faith as a broad obligation of reasonable conduct "would reduce commercial certainty and breed costly litigation"), and *Shawmut Bank Conn., N.A. v. Chorches*, No. CV95-57587-5, 1995 WL 548716, at \*2 (Conn. Super. Ct. Sept. 8, 1995) (same), with *Hoffman-La Roche, Inc. v. Campbell*, 512 So. 2d 725, 738 (Ala. 1987) (describing the duty of good faith as "the obligation to preserve the spirit of the bargain rather than the form"), and *Fisher v. Toombs County Nursing Home*, 479 S.E.2d 180, 184 (Ga. Ct. App. 1996) ("'Good faith' is a shorthand way of saying substantial compliance with the spirit, and not merely the letter, of a contract.").

9. Compare *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (observing with regard to the duty of

These tensions find their most challenging practical expression when the intangible notion of “good faith” collides with the apparent force of an express contractual term. Unfortunately, the law provides only cryptic guidance on the proper resolution of this conflict. It is now commonly recognized that the duty of good faith is “imposed” in every contract,<sup>10</sup> and cannot be disclaimed, even by express stipulation.<sup>11</sup> The duty thus applies as a matter of law and without the need for any affirmative action by the parties,<sup>12</sup> or, in more fashionable terminology, is an “immutable” rule of contract law.<sup>13</sup>

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good faith that “[c]ontract law does not require parties to behave altruistically toward each other; it does not proceed on the philosophy that I am my brother’s keeper”), and *Market Street Assocs. v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991) (“The contractual duty of good faith is . . . not some newfangled bit of welfare-state paternalism or the sediment of an altruistic strain in contract law . . .”) (citation omitted), with RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (asserting that the duty of good faith forbids conduct that “violate[s] community standards of decency, fairness or reasonableness”), and Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 811 (1982) (arguing that good faith “is of a piece with explicit requirements of ‘contractual morality’ such as the unconscionability doctrine and various general equitable principles”).

10. For the limited exceptions to this rule, see *infra* note 79.

11. See U.C.C. § 1-102(3) (“[T]he obligation[] of good faith . . . prescribed by this Act may not be disclaimed by agreement . . .”); RESTATEMENT (SECOND) OF CONTRACTS § 205 (stipulating that the duty of good faith is “impose[d]” in every contract); see also *Olympus Hills Shopping Ctr., Ltd. v. Smith’s Food & Drug Ctrs., Inc.*, 889 P.2d 445, 450 n.4 (Utah Ct. App. 1994) (“While it is true that courts impose an obligation of good faith in every aspect of the contractual relationship . . . the obligation of good faith is ‘constructive’ rather than ‘implied’ because the obligation is imposed by law and cannot be disclaimed.”).

12. See, e.g., *Maher v. Associated Milk Producers*, No. 94-5035, 1995 WL 34847, at \*2 (10th Cir. Jan. 30, 1995) (“[The] implied covenant [of good faith] is automatically present in every contract, regardless of what the parties may have intended.”); *Koehrer v. Superior Court*, 226 Cal. Rptr. 820, 828 (Ct. App. 1986) (stating that “the obligations stemming from the implied covenant of good faith and fair dealing are imposed by law”); *Amoco Oil Co. v. Ervin*, 908 P.2d 493, 499 (Colo. 1995) (holding that the duty of good faith applied in a contract notwithstanding an express provision that excluded all implied covenants).

13. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989) (describing “immutable” rules as ones that “cannot be contracted around” and noting that “under the Uniform Commercial Code . . . the duty to act in good faith is an immutable part of any contract”); Dennis Patterson, *The Pseudo-Debate over Default Rules in Contract Law*, 3 S. CAL. INTERDISC. L. REV. 235, 237 n.6 (1993) (describing the duty of good

This is a rather awkward immutable rule, however. For in almost the same conceptual breath, the *Uniform Commercial Code* (UCC or "the Code"), for example, makes the "non-disclaimable" obligation of good faith subject to "standards" the parties may define by "agreement."<sup>14</sup> In other words, at some ill-defined level the force of good faith is indeed subject to the power of party autonomy. The precise interaction of the duty of good faith with express contract language thus remains an important jurisprudential mystery.<sup>15</sup>

The new textualist<sup>16</sup> approach offers a deceptively simple answer to this mystery: When the parties to a contractual relationship reduce their agreement to a writing, the office of the law is simply to enforce the express terms as written. In the terse prose of Judge Easterbrook of the Seventh Circuit, transactors are entitled to literal enforcement of their contracts, "even to the great discomfort of their trading partners, without being mulcted for lack of 'good faith.'"<sup>17</sup>

This Article demonstrates that this new textualist trend misapprehends the role of good faith in contractual relationships.

faith as an "immutable rule[]" of contract law).

14. See U.C.C. § 1-102(3) (stating that "the parties may by agreement determine the standards by which the performance of [good faith] is to be measured"). For its part, the *Restatement (Second) of Contracts* fails to provide any explicit guidance on this matter. See *infra* notes 110-17 and accompanying text.

15. Indeed, a recent comprehensive commentary on the duty of good faith issued by the *Uniform Commercial Code's* Permanent Editorial Board astonishingly fails to mention section 1-102(3) at all. See PEB COMMENTARY ON THE UNIFORM COMMERCIAL CODE, PEB COMMENTARY NO. 10, FINAL DRAFT, U.C.C. Rep. Serv. (Callaghan) (Feb. 10, 1994) [hereinafter PEB COMMENTARY NO. 10]. Professor Allan Farnsworth pointed out this core problem in his brief review of the duty of good faith shortly after promulgation of the UCC. See E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 678 (1963) ("[I]f an objective standard is to be read into the general obligation of good faith performance, the limits on variation by agreement of conditions implied under that obligation are far from clear."); see also Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 IOWA L. REV. 503, 513 (1991) ("The relationship between good faith and the concept of agreement is both a central and obscure aspect of Code jurisprudence.").

16. The term "new textualism" derives from William Eskridge's examination of a parallel development in the interpretation of statutes. See William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 624-25 (1990).

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

The duty of good faith performance springs from the simple idea that certain expectations of fair and reasonable conduct are so fundamental that the parties rarely mention them in negotiation, and almost never distill them into express terms.<sup>18</sup> The Article argues that the new textualism in contract goes astray in failing to recognize that this animating tenet of good faith applies even—indeed, in particular—to a discretionary power otherwise left unrestricted on the face of contractual text. In this context as well, the duty of good faith and fair dealing fulfills its essential function by protecting the justified expectations the parties have not reduced to express contractual language.

The argument on this score proceeds in three principal parts. Part I explores briefly the course of contract interpretation from the rigid formalism of classical contract theory through the modern contextualist approach. The goal of this exercise is to set the jurisprudential context for the analysis of the new textualism that follows. To complete this necessary context, Part I concludes with a review of the emergence of the modern duty of good faith as well as with an examination of the most influential scholarly theories on its proper conceptualization.

Part II turns to a detailed examination of the new textualism in action. This recent trend in interpretation renders irrelevant—or simply disregards—much of the received wisdom on the force of good faith in contractual relations. Although (in principle) the new textualist approach acknowledges a role for the parties' expectations in good faith analysis, the sum of that approach is that the only relevant expectations are those anchored in the express terms of the parties' writing. This view is thus little more than a modern resuscitation of what was thought to be an aging and seriously ailing "plain meaning" rule in contract interpretation.<sup>19</sup> The distilled consequence is that, in the face of an express contractual power, notions of "good faith" and "fair dealing" simply have no role to play at all.

The full impact of this approach comes into sharper focus when one views the substantial practical consequences that flow from its application. If every contractual power is presumptively

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18. See *infra* notes 209-11 and accompanying text.

19. See *infra* notes 30-33 and accompanying text (analyzing the normative force of the "plain meaning rule" in classical contract law).

absolute, the duty of good faith provides no limitation on any decision, for example, to exercise a discretionary right to terminate a contract, to set banking fees, to preclude an assignment or relocation of a dealership, to cease operations under a lease, or even to accelerate another party's performance obligations. In this way, the new restrictive view dispenses with good faith without a review of the parties' actual expectations or of the context in which the discretionary power arose in the first place.

Part III is the heart of this Article, for it examines the essential flaws of this new textualist approach to the duty of good faith. It first explores the centrality of the parties' justified expectations in the flexible interpretive philosophy embraced in the UCC and the *Restatement (Second) of Contracts*. The expectations protected by the duty of good faith amount to more than the "meaning" of a writing pressed from the surface of its words. In this sense, the duty of good faith thus operates as the ultimate repudiation of the textualist view that contractual "interpretation" involves merely uncovering the "answer" put "in" a writing by the parties.

Part III then exposes the poverty of the two fundamental premises of the new textualism. First, it challenges the factual assumption that, in absence of an express limitation, every grant of a discretionary right reflects an agreement of the parties that it is to be absolute. The analysis next turns to the new textualism's subtle but powerful normative foundation. Properly appreciated, the doctrine of good faith reverses the classical presumptions about the burden of expression in the case of discretionary contractual powers. It does so, contrary to the normative premise of textualism, by freeing the other party of any requirement to "protect itself" through negotiation of a corresponding express limitation on such discretion.

The Article concludes with a positive examination of the power of party autonomy to influence the content of the duty of good faith. There is persuasive force in the argument that informed transactors should be able to confer on one, or both, of them a specific discretionary right whose exercise is insulated from external standards of fair and reasonable conduct. As the final section of Part III argues, however, a heightened burden of expression should attend any attempt to achieve that end. This



“burden of bargaining” will include both a requirement of explicitness and a duty to draw attention to any attempt to contract at variance from the strictures imposed by the duty of good faith performance.

The duty of good faith reflects important institutional values in the law of contracts. At its most elemental, it proceeds from the premise that the law ought to protect the fundamental expectations of good faith and reasonable conduct in the performance of contractual relations without requiring a corresponding express agreement of the parties.<sup>20</sup> In recent years, however, the rising tide of textualism has threatened to submerge this essential duty of good faith altogether.<sup>21</sup> Under this view, we are left with a mere snapshot of the surface of contractual relationships, unable to examine the complexity of life below. The sum of the argument advanced here is that this new restrictive trend in interpretation is founded on fundamentally flawed premises about the proper function of good faith and fair dealing in the law of contracts.

#### I. SETTING THE JURISPRUDENTIAL CONTEXT: CONTRACT INTERPRETATION AND THE MODERN DUTY OF GOOD FAITH

In one form or another, an obligation of good faith performance has existed from the earliest formulations of the law governing private obligational relationships.<sup>22</sup> In this country, the doctrine began to find tentative recognition as early as the middle of the nineteenth century.<sup>23</sup> The appearance of such a

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20. See *infra* notes 200-43, 264-81 and accompanying text; see also, e.g., James A. Webster, Comment, *A Pound of Flesh: The Oregon Supreme Court Virtually Eliminates the Duty to Perform and Enforce Contracts in Good Faith*, 75 OR. L. REV. 493, 536-37 & n.182 (1996).

21. See *infra* notes 139-69 and accompanying text.

22. A duty of good faith in the performance of contractual obligations found recognition even in the classical Roman law on private obligational relationships. See Farnsworth, *supra* note 15, at 669-70 (discussing the history of good faith in Roman law); Saul Litvinoff, *Good Faith*, 71 TUL. L. REV. 1645, 1651-54 (1997) (same); see also 2 PATRICK MAC CHOMBAICH DE COLQUHOUN, A SUMMARY OF THE ROMAN CIVIL LAW § 1526, at 452-53 (London, V. & R. Stevens & Sons 1851) (analyzing the essential features of the *bonae fidei* contract under Roman law).

23. For examples of early judicial recognition of a duty of good faith in contract, see *Railroad Co. v. Howard*, 74 U.S. (7 Wall.) 392, 413 (1868); *Murray v. Lardner*,

notion of “good faith” inevitably required, however, a reconciliation with the prevailing interpretations of the force of party autonomy in contractual relations.<sup>24</sup> It should not surprise, then, that throughout its history the doctrine of good faith performance has been swept along by the same jurisprudential currents that have guided contract interpretation in general.

Conventional wisdom holds that contract law has evolved from a “primitive stage of formalism” to a more advanced state that is able to accommodate the full complexity of contractual relationships.<sup>25</sup> This triumph of realism, the received wisdom runs, has achieved its full manifestation in the broad acceptance of the modern duty of good faith performance.<sup>26</sup> We shall see in Part II below, however, that the new textualist approach to the duty of good faith has established its foundation on the very pillars of the interpretive formalism of classical contract law.

### *A. From Formalism to Contextualism: A Short Walk with Contract Interpretation*

#### *1. The Formalist Fixation on Text*

The classical (late nineteenth and early twentieth century) approach to interpretation fastened on contractual text as the sole repository of interpretive evidence. Consonant with that age of conceptualism<sup>27</sup> and an elevated assessment of the value of

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69 U.S. (2 Wall.) 110, 121 (1864); *Goodman v. Simonds*, 61 U.S. (20 How.) 343, 368-69 (1857); *Bush v. Marshall*, 47 U.S. (6 How.) 284, 291 (1848); *Marsh v. Masterson*, 5 N.E. 59, 63 (N.Y. 1886).

24. See, e.g., HUGH COLLINS, *THE LAW OF CONTRACT* 48-49 (1986) (discussing classical emphasis on private autonomy).

25. See *infra* notes 46-65 and accompanying text. The phrase “primitive stage of formalism” emanates from Judge Benjamin Cardozo’s classic exposition of the foundations for the modern doctrine of good faith in *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 214 (N.Y. 1917) (suggesting that “[t]he law has outgrown its primitive stage of formalism”). For an analysis of the impact of this case on the development of the doctrine of good faith performance, see *infra* notes 68-70 and accompanying text.

26. See *infra* notes 74-89 and accompanying text.

27. See Mooney, *supra* note 7, at 1147 (arguing that “classical interpretation decisions seemed often to reflect greater attention to conceptualist abstractions than to the merits of actual disputes”); see also LAWRENCE M. FRIEDMAN, *CONTRACT LAW IN AMERICA* 20-22 (1965) (discussing the significance of abstractions for classical contract

certainty and predictability,<sup>28</sup> that interpretive philosophy took on practical manifestation in a variety of seemingly determinate "rules." The most significant of these were the "plain meaning" and "parol evidence" rules. These familiar dictates operated in tandem to define the meaning and the scope of the parties' agreement without resort to extrinsic evidence to aid the interpretive inquiry.<sup>29</sup>

The plain meaning rule, as its label suggests, posited that if a writing appeared unambiguous on its face, the role of an interpreter was simply to apply that text as written.<sup>30</sup> Indeed, because it began with the premise that an "unambiguous" provision was conclusive evidence of actual intent, classical purists contended that the plain meaning rule relieved the court from the issue of "interpretation" altogether.<sup>31</sup> Classical contract law

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law); Roscoe Pound, *Mechanical Jurisprudence*, 8 COLUM. L. REV. 605 (1908) (discussing the "mechanical" jurisprudence around the turn of the century).

28. See, e.g., *Muncie Natural Gas Co. v. City of Muncie*, 66 N.E. 436, 442 (Ind. 1903) (concluding that when the parties have included a clause in a contract "it ought to be the endeavor of the court, so far as possible, to give to that [clause] the element of certainty, and not to import elements of uncertainty into it that the parties did not see fit to mention"); *Petrie v. Sherman County Community High Sch.*, 7 P.2d 104, 106 (Kan. 1932) (asserting that in the law of contracts "[t]he purpose of a writing is certainty").

29. For a review of the history of these rules of classical contract law, see E. Allan Farnsworth, *Disputes over Omission in Contracts*, 68 COLUM. L. REV. 860, 862-68 (1968) (discussing the historical development of contract law) [hereinafter Farnsworth, *Omission*]; E. Allan Farnsworth, "Meaning" in the Law of Contracts, 76 YALE L.J. 939, 942-65 (1967) (analyzing the classical and modern approaches to the plain meaning and parol evidence rules) [hereinafter Farnsworth, *Meaning*]; Helen Hadjiyannakis, *The Parol Evidence Rule and Implied Terms: The Sounds of Silence*, 54 FORDHAM L. REV. 35, 39-64 (1985) (discussing the history of the parol evidence rule).

30. This classical approach is often associated with the views of Professor Samuel Williston. See 1 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 95, at 349-50 (Walter H.E. Jaeger ed., 3d ed. 1961) ("The court will give [written contract] language its natural and appropriate meaning; and, if the words are unambiguous, will not even admit evidence of what the parties may have thought the meaning to be."); see also 4 *id.* § 610A, at 514 (stating that the express terms of a writing are "the best and most important evidence of intention").

31. See, e.g., *Buffalo Pressed Steel Co. v. Kirwan*, 113 A. 628, 630 (Md. 1921) ("[W]here the language of the contract is clear, free from ambiguity or doubt and complete, there is no need for construction, and it will not be resorted to."); *Meyer Milling Co. v. Baker*, 10 S.W.2d 668, 670 (Mo. Ct. App. 1928) ("Of course, if the language of the contract is clear, and all its terms explicitly stated, then there is no

then bolstered the force of this rule through a battery of "canons of construction,"<sup>32</sup> which permitted the court to give effect to written terms without resort to extrinsic evidence, even in the case of an apparent textual ambiguity.<sup>33</sup>

The "parol evidence rule" closed the formalist circle.<sup>34</sup> If the disputed writing also appeared to be a complete and final expression of the parties' intent, this rule barred introduction of any extrinsic evidence that would contradict or even supplement the written terms.<sup>35</sup> In its classical version, the parol evidence rule also traveled with a powerful escort, the "four corners"

room for construction, and all the court can do is to declare its effect, and enforce it as written.").

32. The canons or "maxims" of construction operated as another formalist surrogate for the actual intent of the parties. Prominent examples included rules holding that the expression of one thing is an implied exclusion of other possibilities within the same subject (the familiar *expressio unius est exclusio alterius*) and that specific terms should prevail over general ones. See generally WILLIAM L. CLARK, JR., *HANDBOOK OF THE LAW OF CONTRACTS* §§ 249-250 (St. Paul, West 1894) (discussing the various "maxims" of construction); 2 WILLIAM F. ELLIOTT, *COMMENTARIES ON THE LAW OF CONTRACTS* §§ 1505-1536 (1913) (same).

33. Not surprisingly, this approach also tracked the rise of an early rigid "objective" theory in the recognition of contractual obligations. Judge Learned Hand delivered perhaps the most famous exposition of this objective theory. See *Hotchkiss v. National City Bank*, 200 F. 287, 293 (S.D.N.Y. 1911) ("A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent."); see also OLIVER WENDELL HOLMES, *THE COMMON LAW* 242 (Mark DeWolfe Howe ed., Belnap Press 1963) (1881) ("The law has nothing to do with the actual state of the parties' minds. In contract, as elsewhere, it must go by externals, and judge parties by their conduct."). The rise of this objective theory of contract is commonly traced to Christopher Columbus Langdell's initial distillation of contract law in the late 1800s. See Thomas C. Grey, *Langdell's Orthodoxy*, 45 U. PITT. L. REV. 1, 4, 11 (1983); Eric M. Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381, 385 (1978) (discussing Langdell's early theories in the context of an analysis of the duty of good faith).

34. Strictly speaking, the plain meaning and parol evidence rules fulfill different, though complementary, functions. The former limits the "evidence" available to interpret express terms in contracts; the latter limits the effect of express or implied agreements not set forth in a writing.

35. For a comprehensive analysis of the various manifestations of the parol evidence rule from classical through modern contract law, see Hadjiyannakis, *supra* note 29, at 39-68; see also John E. Murray, Jr., *The Parol Evidence Process and Standardized Agreements Under the Restatement (Second) of Contracts*, 123 U. PA. L. REV. 1342, 1346-50 (1975) (discussing the origins of the parol evidence rule).

rule,<sup>36</sup> which required the court to resolve the very issue of integration—whether the writing in fact reflected the full and final agreement of the parties—on the face of the document alone.<sup>37</sup>

At the foundation of this fixation on written text lies a faith in both the power of individual autonomy and the certainty of language. In conformance with the liberal notions of the time, the law presumed that transactors were “omniscient,”<sup>38</sup> and thus able to identify and resolve all issues of relevance to their contractual relationship. For its part, the confidence in the determinacy of language led to the conviction that the parties had at their disposal the fine tools necessary to craft their agreement with precision.<sup>39</sup>

In this light, the normative consequences for contract law became clear: Because the process of contracting permitted the distillation of a complete and unambiguous agreement, “interpretation” involved merely a “mechanical” process of deducing the answers already contained in the written text (and, importantly, without the exercise of judicial discretion).<sup>40</sup> From this foundation, classical contract law also was able to proceed directly to the conclusion that every contractual right or obligation was an absolute one,<sup>41</sup> unless the affected party bargained for an

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36. See Hadjiyannakis, *supra* note 29, at 43-45.

37. See *id.*; see also George I. Wallach, *The Declining “Sanctity” of Written Contracts—Impact of the Uniform Commercial Code on the Parol Evidence Rule*, 44 MO. L. REV. 651, 656-58 (1979) (analyzing classical views on the “four corners” rule). The first *Restatement of Contracts*, under the strong influence of Samuel Williston, introduced a limited exception to the “four corners rule” for extrinsic agreements that similarly situated parties “naturally” would not have included within the writing. See RESTATEMENT OF CONTRACTS § 240(1)(b) (1932); 4 WILLISTON, *supra* note 30, § 638, at 1039-42. For a more detailed analysis of the approach of the first *Restatement* to this issue, see Hadjiyannakis, *supra* note 29, at 45-48.

38. See COLLINS, *supra* note 24, at 93 (discussing the “presumption of omniscience” of the classical rules of contract).

39. See, e.g., 2 ELLIOTT, *supra* note 32, §§ 1505-1536 (discussing rules of law based on the assumption that parties could aptly express their intentions).

40. See Pound, *supra* note 27, at 606; see also Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193, 198-99 (1982) (discussing the rigid “plain meaning” and “four corners” rules as reflective of the “old spirit of contract”).

41. This approach had its most potent impact on claims that the performance of a contract had become “impossible.” See, e.g., *Hagar v. Elmslie*, 107 F. 511, 514 (3d Cir. 1901) (“The one who makes . . . an absolute and unqualified stipulation must stand the consequences of his voluntary act, and he will be held by the law of the

express limitation or qualification.<sup>42</sup> All that remained for the office of the law was to provide determinate rules that would preclude attempts to undermine the force of such “unambiguous” contractual text through resort to extrinsic evidence.<sup>43</sup>

This rigidity in interpretive inquiries had significant consequences for the nascent doctrine of contractual good faith. The fixation on “plain meaning” and the primacy of the “four corners” of a writing, fortified by the faith in the capacity of transactors to express their agreement in unambiguous language, left little room for such a flexible notion as an “implied” duty of good faith performance.<sup>44</sup> Whatever potential existed in

contract to a strict observance of its terms, even if it becomes impossible of performance . . . .”); *Stees v. Leonard*, 20 Minn. 448, 451 (1873-74) (stating that even when performance has become impossible, “the hardship is attributable, not to the law, but to the contractor himself, who has improvidently assumed an absolute, when he might have undertaken only a qualified, liability”); *see also* Farnsworth, *Omission*, *supra* note 29, at 862-64 (discussing this premise of classical contract law). For an examination of the evolution of the doctrine of impossibility in this respect, *see* Leon E. Trakman, *Winner Take Some: Loss Sharing and Commercial Impracticability*, 69 MINN. L. REV. 471, 472-75 (1985).

42. This point, in particular, returns to prominence in the rise of the new textualist approach to the duty of good faith performance. *See infra* notes 173-74 and accompanying text. Alternatively, if a party retained unfettered discretion on an essential element of the contract, classical contract law held that her promise was “illusory” and thus that the “contract” failed for lack of “mutuality of obligation.” *Cf.*, *e.g.*, *Wickham & Burton Coal Co. v. Farmers’ Lumber Co.*, 179 N.W. 417, 419-20 (Iowa 1920) (holding that a promise to purchase as much coal as a party would “want to” was unenforceable due to lack of mutuality); *Rudd v. Rudd*, 2 S.W.2d 585, 587 (Mo. 1927) (“A contract which may be terminated at will by one of the parties without liability for damages is, for lack of mutuality, not binding.”).

43. *See* Charles T. McCormick, *The Parol Evidence Rule as a Procedural Device for Control of the Jury*, 41 YALE L.J. 365, 365-68 (1932) (analyzing the role of the parol evidence rule in preventing manipulation of the jury). For an example of such sentiments in the case law, *see* *E.A. Strout W. Realty Agency, Inc. v. Broderick*, 522 P.2d 144, 145-46 (Utah 1974) (arguing that a failure to apply the parol evidence rule would “leave a party to a solemn agreement at the mercy of the uncertainties of oral testimony given by one who in the subsequent light of events discovers that he made a bad bargain”).

44. The little that remained for good faith was a secondary role as part of the doctrine of good faith purchase and a much diluted notion of subjective honesty in fact. *See* Farnsworth, *supra* note 15, at 670-71. As Professor Farnsworth notes, prior to the impact from the adoption of the *Uniform Commercial Code*, only California and New York appeared to infuse the duty of good faith with a limited objective component. *See id.* at 671. *See, e.g.*, *Ratzlaff v. Trainor-Desmond Co.*, 183 P. 269, 271 (Cal. Dist. Ct. App. 1919); *Simon v. Etgen*, 107 N.E. 1066, 1067 (N.Y. 1915);

the doctrine from its early recognition<sup>45</sup> thus evaporated with the rise of formalism and the concurrent elevation of the normative force of certainty and predictability in contractual relations.

## 2. *The Modern Contextual Approach*

The formalist foundations of classical contract law were subject to a withering attack by the forces of realism in the early part of this century. Applying lessons from other areas of the law,<sup>46</sup> Karl Llewellyn and Arthur Corbin, in particular, challenged the idea that language (in whatever form) had a single, determinate meaning, and, derivatively, that the parties were always able (or even desired) to reduce every detail of their agreement to express "contractual" text.<sup>47</sup> At its core, therefore,

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New York Cent. Ironworks Co. v. United States Radiator Co., 66 N.E. 967, 968 (N.Y. 1903).

45. For examples of early judicial recognition of a duty of good faith in contract, see *supra* note 23.

46. Inspired by similar movements in Europe, the early part of this century also witnessed an assault by the powers of realism on formalism in statutory interpretation. See Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed*, 3 VAND. L. REV. 395 (1950); Max Radin, *Statutory Interpretation*, 43 HARV. L. REV. 863 (1930); see also Pound, *supra* note 27, at 606-10 (discussing the problems with "mechanical formalism" in interpretation). For a general commentary on the influence of Karl Llewellyn's realism, see WILLIAM TWINING, *KARL LLEWELLYN AND THE REALIST MOVEMENT* (1973); Eugene F. Mooney, *Old Kontract Principles and Karl's New Kode: An Essay on the Jurisprudence of Our New Commercial Law*, 11 VILL. L. REV. 213 (1966).

47. See Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 161-70 (1965) (observing that written words are inherently ambiguous); K. N. Llewellyn, *The Rule of Law in Our Case-Law of Contract*, 47 YALE L.J. 1243 (1938); K. N. Llewellyn, *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L. REV. 159 (1938); see also GRANT GILMORE, *THE DEATH OF CONTRACT* 57-66 (1974) (examining the decline of formalism in contract). The insights of Llewellyn and Corbin (among others) are now well-accepted truths in the law of contracts. Oliver Wendell Holmes himself long ago observed that "[a] word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." *Towne v. Eisner*, 245 U.S. 418, 425 (1918); see also Farnsworth, *Meaning*, *supra* note 29, at 953 (noting the distinction between ambiguity and vagueness and observing in particular that "[c]ontract language abounds in perturbing examples of vagueness"); Betty Mensch, *Freedom of Contract as Ideology*, 33 STAN. L. REV. 753, 765 (1981) (book review) ("Simply as a matter of language, parties cannot fully communicate to each other; nor can their words completely capture the future. The language they use is as much social as individual, its meaning colored by context and,

realism attacked the classical premise that express terms always represent the best evidence of the parties' agreement, at least without an examination of the context in which the agreement came into being in the first place.<sup>48</sup>

Much of the false edifice of classical formalism, already under substantial pressure in some common law courts, finally crumbled with the adoption of the UCC.<sup>49</sup> Under the principal direction of Karl Llewellyn, the Code rejected the classical fixation on contract text as the definitive evidence of the parties' agreement.<sup>50</sup> In its place now stands a flexible search for the actual agreement of the parties as influenced by the commercial context of its creation. The Code thus defines the core concept of "agreement" as "the bargain of the parties in fact," as found not only in the language they used to describe it but also "by implication from other circumstances."<sup>51</sup> To complete the contextual picture, the Code expressly recognizes that the content of the parties' "bargain in fact" necessarily will include trade usages in the relevant branch of commerce<sup>52</sup> as well as the parties' prior

at the time of enforcement, by judicial hindsight and interpretation."); Murray, *supra* note 35, at 1344 (describing the notion "that the language has only one true and plain meaning" as an "archaic absurdity").

48. For a detailed review of the views of Karl Llewellyn on this score, see Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169, 180-84 (1989).

49. See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 273-74 (1985) (discussing the increasing pressure on the premises of classical contract law early in this century and concluding that "[t]he dam . . . finally burst with the adoption of the Uniform Commercial Code").

50. See Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 YALE L.J. 704, 737 (1931) (arguing that the written contract is merely "a rough indication around which [real working] relations vary"). For a detailed examination of the Code's departure from the formalist interpretive theories of Samuel Williston, see DENNIS M. PATTERSON, *GOOD FAITH AND LENDER LIABILITY: TOWARD A UNIFIED THEORY* 14-19 (1990).

51. U.C.C. § 1-201(3) (1995) ("'Agreement' means the bargain of the parties in fact as found in their language or by implication from other circumstances . . .").

52. See *id.* § 1-205(2) ("A usage of trade is any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question."). For a comprehensive analysis of the role of usages of trade under the Code, see Amy H. Kastely, *Stock Equipment for the Bargain in Fact: Trade Usage, "Express*



course of dealing<sup>53</sup> and subsequent course of performance under their agreement.<sup>54</sup>

This flexible, contextual understanding of the parties' "agreement" thus reflects a repudiation of the rigidity of the classical approach to interpretive inquiries.<sup>55</sup> Indeed, the Code states that it directly "rejects" the notion that an interpreter can divine the meaning of a writing without consideration of the circumstances surrounding its making.<sup>56</sup> Moreover, the Code requires consideration of a relevant usage of trade and its conceptual cousins (course of dealing and performance) even if the parties' writing appears on its face to be a full and final expression of their agreement.<sup>57</sup> Consideration of such circumstances is necessary,

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*Terms," and Consistency Under Section 1-205 of the Uniform Commercial Code*, 64 N.C. L. REV. 777 (1986). For particularly expansive applications of the force of usages of trade under the Code, see, for example, *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772, 780 (9th Cir. 1981) (holding that an express price term was overcome by a usage of trade requiring a supplier to "price protect" a contractor); *Modine Mfg. Co. v. North E. Indep. Sch. Dist.*, 503 S.W.2d 833, 837-38 (Tex. Civ. App. 1973) (permitting introduction of trade usage evidence to show that the term "capacities shall not be less than indicated" should be interpreted to permit "reasonable variations" in capacity).

53. See U.C.C. § 1-205(1) ("A course of dealing is a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct.").

54. See *id.* § 2-208(1). Section 2-208 states:

Where the contract for sale involves repeated occasions for performance by either party with knowledge of the nature of the performance and opportunity for objection to it by the other, any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement.

*Id.* Although this particular definition of "course of performance" is found only in Article 2, which governs sales transactions, its inclusion in section 1-201(3) makes clear that the general concept is part of the definition of all "agreements" governed by the Code.

55. The concept of a "contract" is relegated almost to an afterthought in this flexible interpretive scheme. See *id.* § 1-201(11) (defining a "contract" merely as "the total legal obligation which results from the parties' agreement").

56. This point is made forcefully in the comments to section 1-205. See *id.* § 1-205 cmt. 1 ("The meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances.").

57. See *id.* § 2-202(a). Although this particular provision is found in Article 2 governing sales transactions, the Code elsewhere makes clear that such contextual evidence may "supplement or qualify" the express terms of a writing. See *id.* §§ 1-

the Code emphasizes, in order for an interpreter to divine the "true understanding" of the parties.<sup>58</sup>

The *Restatement (Second) of Contracts*, now followed in principle by a number of common-law courts,<sup>59</sup> proceeds on the same fundamental course. Like the Code, it mandates that "[w]ords and other conduct are interpreted in the light of all the circumstances"<sup>60</sup> and rejects any requirement of "ambiguity" in express terms before the surrounding circumstances become relevant.<sup>61</sup> Indeed, even more forcefully than the Code, the *Second Restatement* makes clear that extrinsic evidence of the parties' actual understanding on the meaning of an express term is always

205(3) (regarding usage of trade and course of dealing), 2-208(1) (regarding course of performance); see also *id.* § 1-205 cmt. 1 (stating that evidence derived from commercial context "may explain and supplement *even the language of a formal or final writing*" (emphasis added)). This conclusion applies with particular force for a course of performance. The Code expressly provides that this form of "agreement" between the parties may be "relevant to show a waiver or modification of any term inconsistent with such course of performance." *Id.* § 2-208(3) (referencing section 2-209).

58. See *id.* § 2-202 cmt. 2 (noting that section 2-202 makes evidence of usage of trade, etc. admissible "in order that the true understanding of the parties . . . may be reached"); see also *id.* § 2-202 cmt. 1 (stating that the Code "definitively rejects . . . (c) The requirement that a condition precedent to the admissibility of the type of evidence specified in paragraph (a) [usages of trade, etc.] is an original determination by the court that the language used is ambiguous").

59. Perhaps the most famous rejection of the "four corners" and "plain meaning" rules of classical contract law is found in the California Supreme Court's opinion in *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641 (Cal. 1968). For other common law opinions in the same vein, see, for example, *Keating v. Stadium Management Corp.*, 508 N.E.2d 121 (Mass. App. Ct. 1987); *C.R. Anthony Co. v. Loretto Mall Partners*, 817 P.2d 238 (N.M. 1991); *Abercrombie v. Hayden Corp.*, 883 P.2d 845 (Or. 1994); *Berg v. Hudesman*, 801 P.2d 222 (Wash. 1990).

60. RESTATEMENT (SECOND) OF CONTRACTS § 202(1) (1981); see also Robert B. Braucher, *Interpretation and Legal Effect in the Second Restatement of Contracts*, 81 COLUM. L. REV. 13 (1981) (providing observations by the Reporter of the *Second Restatement* on its interpretive scheme); Speidel, *supra* note 40, at 199-200 (discussing the importance of contextual factors in the *Second Restatement's* flexible interpretive approach).

61. See RESTATEMENT (SECOND) OF CONTRACTS § 202 cmt. a (stating that the rules of interpretation "do not depend upon any determination that there is an ambiguity, but are used in determining what meanings are reasonably possible as well as in choosing among possible meanings"); *id.* § 212 cmt. b (asserting that "meaning can almost never be plain except in context" and concluding that extrinsic evidence is always admissible to show the meaning of a writing); *id.* § 214 cmt. b ("Even though words seem on their face to have only a single possible meaning, other meanings often appear when circumstances are disclosed.").

admissible, even in the face of a fully integrated agreement.<sup>62</sup> Similarly, the *Second Restatement* requires examination of all relevant evidence on the issues of integration and the consistency of extrinsic evidence with the written text, even if the writing appears complete on its face.<sup>63</sup>

The express terms of a contract of course retain significant interpretive force under both the Code and the *Second Restatement*. Both in fact will afford primacy to express terms if an interpretation consistent with contextual evidence would be unreasonable under the circumstances.<sup>64</sup> This apparent hierarchy operates, however, subject to a more powerful, primary directive in interpretive inquiries. This directive requires that an interpreter first exhaust all reasonable means of reconciling the various sources of interpretive evidence before making a reflexive retreat to the apparent meaning of the express terms.<sup>65</sup>

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62. See *id.* § 214(c) (stipulating that extrinsic evidence is admissible to establish "the meaning of the writing, whether or not integrated").

63. See *id.* § 209 cmt. c ("Whether a writing has been adopted as an integrated agreement is a question of fact to be determined in accordance with all relevant evidence."); *id.* § 216 cmt. b ("The determination whether an alleged additional term is consistent or inconsistent with the integrated agreement requires interpretation of the writing in the light of all the circumstances, including the evidence of the additional term."). Under the influence of Arthur Corbin, the *Second Restatement's* version of the parol evidence rule thus disavowed many of the premises of its classical predecessor. For an examination of the influence of Professor Corbin on the *Second Restatement's* parol evidence rule, see Hadjiyannakis, *supra* note 29, at 51-55. Even in the case of a fully integrated writing, the *Second Restatement*, like the Code before it, admits evidence of usage of trade as well as of prior and subsequent conduct to explain, supplement, or even qualify the writing. See RESTATEMENT (SECOND) OF CONTRACTS § 222(3) (stating that usage of trade "gives meaning to or supplements or qualifies" the parties' agreement); *id.* § 223(2) (applying the same analysis to course of dealing); *id.* § 202(4) (stating that course of performance is given "great weight" in interpretation).

64. See U.C.C. § 1-205(4) (providing that express terms control usage of trade and course of dealing if a consistent construction is "unreasonable"); see also *id.* § 2-208(2) (defining the same result but also including a course of performance); RESTATEMENT (SECOND) OF CONTRACTS § 203(b) (stating that express terms are given "greater weight" than usage of trade and courses of dealing and performance).

65. See U.C.C. § 1-205(4) ("The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other . . ."); see also *id.* § 2-208(2) (defining the same result but including a course of performance); RESTATEMENT (SECOND) OF CONTRACTS § 202(5) (stating the same result for all three sources).

This is, of course, but a brief summary of conventional contract interpretation. It nonetheless suffices for present purposes, for the important message at this stage in our analysis is one of principle: Even at the basic level of the interpretation of the obligations constructed through a formal agreement of the parties, both the UCC and the modern approach reflected in the *Second Restatement* have swept away the rigid textualist presumption that the parties' writing represents the definitive source of interpretive evidence. It is in this environment that we turn to the (re)emergence of perhaps the most controversial doctrine in modern contract law, the duty of good faith that is imposed on the parties in the performance of contractual relationships.

### *B. The Emergence and Significance of the Duty of Good Faith*

We have seen above that the rigidity of classical formalism in large measure relegated the duty of good faith performance to a place of insignificance in contract doctrine.<sup>66</sup> At this early stage in its development, the principal function of such a notion was merely a negative one: "Good faith" operated to preclude a party from taking affirmative action to "prevent or hinder" the satisfaction of a contractual condition or actual performance by the other party.<sup>67</sup>

Early indications of a more promising future came in an expanded understanding of the traditional "implied promise" theory. Thus, as Benjamin Cardozo famously observed in *Wood v. Lucy, Lady Duff-Gordon*,<sup>68</sup> an express promise may be lacking "and yet the whole writing may be 'instinct with an obligation,'

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66. See *supra* note 44 and accompanying text.

67. See RESTATEMENT OF CONTRACTS § 295 (1932) (precluding "prevent[ion] or hind[erance]" of the satisfaction of a condition to performance). For an example from this early stage in the good faith doctrine, see *Carns v. Bassick*, 175 N.Y.S. 670, 673 (App. Div. 1919) ("To hold that one may employ another . . . to do a specific thing, and yet may with impunity deliberately prevent the other from doing that thing, is . . . plainly violative of good faith."); see also 1 NEW YORK REVISION COMM'N, REPORT RELATING TO THE UNIFORM COMMERCIAL CODE 310, 312-14 (1955) (containing an examination by Professor Edwin Patterson of New York case law on this subject in connection with the adoption of the UCC in New York).

68. 118 N.E. 214 (1917).

imperfectly expressed.”<sup>69</sup> Such a promise was implied in the exclusive dealing arrangement at issue in that case, Judge Cardozo reasoned, because the law should not “suppose that one party was to be placed at the mercy of the other.”<sup>70</sup>

The function of this “implied promise” thus was a positive one: It provided the external standard necessary to rescue a relationship from the “lack of mutuality” that was fatal to enforceable obligations under the traditional common law.<sup>71</sup> At the same time, a small number of other courts, most notably in New York, began to recognize that the proper justification for such an “implied promise” was to be found in a broader duty of good faith performance.<sup>72</sup> Nonetheless, through the early part of this century, the significance of contractual good faith lay more in its promise than in its practical significance.<sup>73</sup>

The adoption of the UCC breathed new life into the doctrine of good faith.<sup>74</sup> As is now well known, section 1-203 of the UCC

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69. *Id.* at 214 (quoting *McCall Co. v. Wright*, 117 N.Y.S. 775, 779 (App. Div. 1909), *aff'd*, 91 N.E. 516 (N.Y. 1910)); see also Robert A. Hillman, “Instinct with an Obligation” and the “Normative Ambiguity of Rhetorical Power,” 56 OHIO ST. L.J. 775 (1995) (providing an illuminating examination of the “rhetorical power” of this observation as applied by Judge Cardozo).

70. *Wood*, 118 N.E. at 214.

71. See STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH 30-31 (1995); Hillman, *supra* note 69, at 779-94.

72. The most famous exposition of this early notion of good faith came in *Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163 (N.Y. 1933), in which the New York Court of Appeals stated:

In 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.

*Id.* at 167. For a more detailed examination of this early history of the duty of good faith, see BURTON & ANDERSEN, *supra* note 71, at 21-34.

73. The doctrine of good faith similarly operated as an implied limitation on express “satisfaction” clauses in contracts. For an early case to this effect, see *Clausen v. Vonnoh*, 105 N.Y.S. 102 (App. Term. 1907) (regarding satisfaction with a portrait). For a more recent example, see *Locke v. Warner Bros., Inc.*, 66 Cal. Rptr. 2d 921, 925 (Ct. App. 1997) (reversing summary judgment against a claim by Sondra Locke that a movie studio breached the duty of good faith by rejecting her movie proposals).

74. See Farnsworth, *supra* note 15, at 671 (“[B]y the time of the promulgation of the Uniform Commercial Code, good faith performance had, in spite of its ancient

establishes that “[e]very contract or duty within [the Code] imposes an obligation of good faith in its performance or enforcement.”<sup>75</sup> This general obligation is then supplemented by nearly sixty express references to “good faith” in the more specific provisions of the Code.<sup>76</sup> As the comment to section 1-203 makes clear, the duty of good faith is not limited to these particular applications; rather, it represents a comprehensive principle that applies to all obligations within the scope of the Code.<sup>77</sup>

This aspect of the UCC, perhaps more than any other, profoundly influenced the course of contract law in the United States. Following the lead of the UCC, the *Second Restatement* embraced the fundamental precept that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”<sup>78</sup> The promulgation of the *Second Restatement* in turn gave impetus to a nascent trend in the common law of the states. Indeed, by the mid-1980s effectively all of the states had recognized a broadly applicable duty of good faith in the performance and enforcement of contracts.<sup>79</sup>

lineage, become a poor and neglected relation of good faith purchase. The Code revive[d] it . . . .”).

75. U.C.C. § 1-203 (1995). As this provision makes clear, the duty of good faith also imposes a duty of good faith in the “enforcement” of a contract. Although difficult definitional issues may arise, the primary focus in this aspect of good faith is the enforcement of rights after breach, including in particular the assertion of claims for breach and the mitigation of damages. For a comprehensive analysis of good faith in enforcement, see Eric G. Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299 (1988) (arguing that an enforcing party acts in good faith if, under the circumstances existing at the time of enforcement, invocation of an enforcement term would advance primarily the purposes for which it was included in the agreement without imposing unnecessary costs on the other party).

76. See, e.g., U.C.C. §§ 1-203 cmt. (listing sections 1-208, 2-508, 2-603, 2-614, and 2-615 as “[p]articular applications of [the] general principle” of good faith), 2A-109(1), 2A-405(a), 3-416(b), 3-417(a), 4-103(a), 4A-202(b), 5-109(a)(1), 7-203, 7-206(2), 9-206(1), 9-208(2).

77. See *id.* § 1-203 cmt. (stating that the concept of good faith “applies generally . . . to the performance or enforcement of every contract or duty within this Act,” and that “[t]his section sets forth a basic principle running throughout this Act”).

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

79. See 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, 585 n.1 (1996) (listing citations of state courts that have expressly recognized a broadly-applicable duty of good

This elevation of the doctrine of good faith to a pervasive contractual duty also brought, however, a broader—and more controversial—potential to influence the content of the parties' obligations in the first instance.<sup>80</sup> In its less contentious form, this modern version has continued its traditional function of forbidding affirmative acts that would prevent or hinder performance by another party, which may also include an obligation of cooperation in the satisfaction of conditions within a party's control.<sup>81</sup> Moreover, and more commonly, recent courts have pressed the doctrine into service as a means to fill gaps in incomplete contracts.<sup>82</sup>

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faith performance). For an earlier list to the same effect, see Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 404 (1980). There are a few notable exceptions. Texas has rejected a broad common-law duty of good faith in absence of a "special relationship" between the parties. See *Smithkline Beecham Corp. v. Doe*, 903 S.W.2d 347, 356 (Tex. 1995); *Natividad v. Alexis, Inc.*, 875 S.W.2d 695, 697 (Tex. 1994). Moreover, a number of states have refused to recognize such a duty in at-will employment relationships. For a comprehensive analysis of this latter issue, see 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) (studying state approaches to the role of good faith in employment relationships).

80. It is worth emphasizing here that the duty of good faith also can have broad-ranging implications in the *enforcement* of contracts. See *supra* note 75 and accompanying text.

81. See *Tagare v. Nynex Network Sys. Co.* 994 F. Supp. 149, 159 (S.D.N.Y. 1997) (stating that the duty of good faith and fair dealing "includes 'an implied undertaking on the part of each party that he will not intentionally and purposely do anything to prevent the other party from carrying out the agreement on his part'" (quoting *Carvel Corp. v. Diversified Management Group, Inc.*, 930 F.2d 228, 230 (2d Cir. 1991))); RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (defining bad faith to include "interference with or failure to cooperate in the other party's performance"); see also *infra* note 349 (citing recent applications of this principle).

82. See, e.g., *Taylor Equip., Inc. v. John Deere Co.*, 98 F.3d 1028, 1032 (8th Cir. 1996) (describing good faith as a "method to fill gaps" in a contract (quoting *Continental Bank, N.A. v. Everett*, 964 F.2d 701, 705 (7th Cir. 1992))), *cert. denied*, 117 S. Ct. 1553 (1997); *Chrysler Credit Corp. v. Marino*, 63 F.3d 574, 579 (7th Cir. 1995) (same); *Bourgeois v. Horizon Healthcare Corp.*, 872 P.2d 852, 856 (N.M. 1994) (same); see also Farnsworth, *supra* note 15, at 672 (noting over 25 years ago that "the chief utility of the concept of good faith performance has always been as a rationale in a process . . . of implying contract terms"). The new textualists in contract acknowledge *only* this role for the duty of good faith, and even then only in a substantially restricted form. See *infra* notes 181-83 and accompanying text.

The final function of the modern doctrine of good faith is the most controversial. The debate at this level revolves around the extent to which good faith can limit, modify, or otherwise give content to the express terms of a contract.<sup>83</sup> In a variety of separate provisions, the Code, for example, imposes a good faith limitation on the exercise of specific discretionary powers.<sup>84</sup> The question that remains, however, is whether this role of good faith performance can apply in a comprehensive manner to place similar limits on contractual behavior in general.

Contributing to the controversy is ambiguity over the very power of the parties to influence the force of the duty of good faith. On the one hand, the Code expressly prohibits contracting parties from disclaiming the application of good faith in its entirety.<sup>85</sup> Although the case law is limited, there is a solid consensus that the same conclusion obtains in the common law as well.<sup>86</sup> The Code then provides, however, that the parties remain free to define by agreement the standards by which good faith is

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83. See *infra* notes 103-29 and accompanying text.

84. See, e.g., U.C.C. § 2-305(2) (1995) (noting that a party's right to specify a price term is subject to good faith); *id.* § 2-306(1) (same regarding unspecified quantities under requirement and output contracts); *id.* § 2-311(1) (same regarding a party's specification of other particulars of performance); see also *id.* § 1-208 (imposing good faith limitations on discretionary acceleration of performance obligations); *id.* § 2A-109 (same in the lease context).

85. See *id.* § 1-102(3) ("[T]he obligation[] of good faith . . . prescribed by this Act may not be disclaimed by agreement . . .").

86. See *BA Mortgage & Int'l Realty Corp. v. American Nat'l Bank & Trust Co.*, 706 F. Supp. 1364, 1376 (N.D. Ill. 1989) (citing *Morris v. Columbia Nat'l Bank*, 79 B.R. 777, 785 (N.D. Ill. 1987)); *Rhode Island Hosp. Trust v. Trust*, No. 700674, 1992 WL 38350 (Conn. Super. Ct. Feb. 18, 1992); *Stark v. Circle K Corp.*, 751 P.2d 162, 166 (Mont. 1988); *PDQ Lube Ctr., Inc. v. Huber*, 949 P.2d 792, 797 n.7 (Utah Ct. App. 1997) (stating that the obligation of good faith "is imposed by law and cannot be disclaimed" (quoting *Olympus Hills Shopping Ctr., Ltd. v. Smith's Food & Drug Ctrs., Inc.*, 889 P.2d 445, 450 n.4 (Utah Ct. App. 1994))). *But cf.* *Cambridgeport Sav. Bank v. Boersner*, 597 N.E.2d 1017, 1024 (Mass. 1992) (concluding without analysis that an express agreement to waive defenses to a guaranty obligation also amounted to a waiver of the protection of good faith). Scholarly commentary is in accord with the proposition that the duty of good faith cannot be waived in its entirety. See BURTON & ANDERSEN, *supra* note 71, at 72-74; 3A CORBIN, CORBIN ON CONTRACTS § 654A(B) (Supp. 1998); Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1, 4 (1981).



to be measured (as long as such standards are not “manifestly unreasonable”).<sup>87</sup> For its part, the *Second Restatement* fails to provide any express guidance on this score.<sup>88</sup>

The recognition of a broadly applicable, abstract duty of good faith performance thus leaves the analysis with the more challenging problem of defining its proper scope and force in practical application. Intense scholarly effort over the years, as we shall see in detail immediately below, has yielded substantial insights into the conceptualization of good faith.<sup>89</sup> Considerable controversy remains, however, and no more so than on the precise interaction between express contractual text and the force of good faith performance.

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87. See U.C.C. § 1-102(3) (stating that although the obligation of good faith may not be disclaimed, “the parties may by agreement determine the standards by which the performance of such obligation[] is to be measured if such standards are not manifestly unreasonable”). With regard to the import of this latter clause, see *infra* note 354 and accompanying text. For an examination of pre-Code law in light of the proposed “nondisclaimability” language of section 1-102(3), see 1 NEW YORK REVISION COMM’N, *supra* note 67, at 310, 312-14 (relating comments by Professor Edwin Patterson). Subsequent law unification efforts have also embraced this scheme of prohibiting broad disclaimers of the duty of good faith, while permitting the parties to define the standards by which good faith is to be measured. See Revised Uniform Partnership Act §§ 103(b)(5), 404(d), 6 U.L.A. 1 (1995); Uniform Limited Liability Company Act §§ 103(b)(4), 409(d), 6A U.L.A. 434 (1995).

88. See *infra* notes 112-15 and accompanying text.

89. For analyses of the general conceptualization of the duty of good faith, see BURTON & ANDERSEN, *supra* note 71; Andersen, *supra* note 75; Burton, *supra* note 79; 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, *Practice View*]; Burton, *supra* note 86; Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984) [hereinafter, Burton, *Reply*]; Diamond & Foss, *supra* note 79; Russell A. Eisenberg, *Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem*, 54 MARQ. L. REV. 1 (1971); Farnsworth, *supra* note 15; Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619; Litvinoff, *supra* note 22; Timothy J. Muris, *Oppportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); Patterson, *supra* note 15; Robert S. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968); Summers, *supra* note 9.

### C. *The Competing Conceptualizations of Good Faith*

#### 1. *The Decreasing Significance of the Subjective-Objective Debate*

Unfortunately, the UCC itself provided much of the initial fuel for the controversy over the conceptualization of the duty of good faith. In its general provisions, the Code defines "good faith" merely as "honesty in fact,"<sup>90</sup> a standard historically understood as a "subjective" one.<sup>91</sup> In language originally limited to "merchants" in sales transactions, however, the Code's Article 2 then added an overlay of "reasonable commercial standards of fair dealing" to this minimalist floor.<sup>92</sup> The resultant ambiguity in interaction led scholars to expend considerable intellectual energy on divining where the subjective standard should end and the force of objective reasonableness should begin.<sup>93</sup>

Close examination reveals that this abstract debate is rapidly becoming more theoretical smoke than practical fire. First, and most important, the continuing overhaul of the various Articles of the Code already has substantially diminished the relevance of the minimalist subjective test. Articles 2A, 3, 4, 4A, and 8 now have expressly joined the objective standard first embraced

90. See U.C.C. § 1-201(19) (defining good faith as "honesty in fact in the conduct or transaction concerned").

91. Robert Braucher once famously termed this the "pure heart and the empty head" test. Braucher, *supra* note 7, at 812; see also Martin J. Aronstein, *Good Faith Performance of Security Agreements: The Liability of Corporate Managers*, 120 U. PA. L. REV. 1, 31 (1971) (stating that good faith as defined in section 1-201(19) of the UCC "[has] been historically construed as applying only to the actor's subjective state of mind"); Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 92 n.64 (1993) (discussing the history of the Code's restriction of good faith "to the subjective duty of honesty in fact").

92. See U.C.C. § 2-103(1)(b) (defining good faith for merchants in sales of goods transactions as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade").

93. See Burton, *supra* note 86, at 16-18 (examining the drafting history of, and the internal inconsistencies in, the Code's original approach to the definition of good faith); Summers, *supra* note 89, at 207-16 (discussing in detail the drafting history of the Code's subjective standard of good faith); see also Farnsworth, *supra* note 15, at 673-74 (criticizing the original subjective standard for "enfeebl[ing]" the notion of good faith and arguing that it should properly include a requirement of commercial reasonableness).

in Article 2.<sup>94</sup> Even the recently completed work on Article 9 governing secured transactions adopted, after much contentious debate, the same approach.<sup>95</sup> Indeed, the drafting work on the revised "General Provisions" in Article 1 is explicitly proceeding on the basis of a generally-applicable definition of good faith that includes "reasonable commercial standards of fair dealing."<sup>96</sup>

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94. See U.C.C. § 2A-103(3) (incorporating by reference the objective standard of UCC section 2-103(1)(b) with regard to lease transactions); *id.* § 3-103(a)(4) (defining good faith with respect to negotiable instruments as "honesty in fact and the observance of reasonable commercial standards of fair dealing"); *id.* § 4-104(c) (incorporating by reference the definition of good faith from section 3-103 for the actions of banks); *id.* § 4A-105(a)(6) (defining good faith with respect to fund transfers by banks as "honesty in fact and the observance of reasonable commercial standards of fair dealing"); *id.* § 8-102(a)(10) (defining good faith with respect to investment securities as "honesty in fact and the observance of reasonable commercial standards of fair dealing").

95. See *id.* § 9-102(43) (Pre-Final Official Draft (as approved) 1998), available in National Conference of Comm'rs on Uniform State Laws, *The National Conference of Commissioners on Uniform State Laws, Drafts of Uniform and Model Acts, Official Site* (visited Oct. 18, 1998) <<http://www.law.upenn.edu/bll/ulc/ulc.htm>> [hereinafter *NCCUSL Official Site*] (defining "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing"). The drafting work on Article 2B governing licenses is proceeding on the same basis. See U.C.C. § 2B-102(22) (August 1 Draft, 1998) (defining "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing"). The one limited exception remains Article 5 governing letters of credit. In that case, the unique three-party relationship, together with the "ministerial" role played by banks in honoring presentations, of their very nature require a limited notion of good faith. See U.C.C. § 5-102(a)(7) (defining good faith with respect to letters of credit merely as "honesty in fact in the conduct or transaction concerned").

96. The draft revisions to UCC Article 1 explicitly expand the definition of "good faith" to include an objective component of reasonable commercial standards. See U.C.C. § 1-201(22) (September 1997 Draft) (defining the general obligation of "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing") (emphasis added), available at *NCCUSL Official Site*, *supra* note 95. The draft revisions to Article 1 also carry forward the existing provisions on the duty of good faith and its interaction with party autonomy. See *id.* § 1-305 ("There is an obligation to act in good faith in the performance and enforcement of every contract and duty within the scope of [the Code]."); see also *id.* § 1-303(b) ("Except as provided elsewhere in [the Code], the obligations of good faith, diligence, reasonableness and care prescribed by [the Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable.").

In addition, even in the transitional period, a subjective standard will involve a consideration of the surrounding circumstances to examine the candor of a party claiming "honesty in fact."<sup>97</sup> Thus, the precise content of even this minimalist duty of "good faith" will be decisively influenced by the facts and circumstances of the specific case,<sup>98</sup> including the expectations that arise in the commercial and relational context.<sup>99</sup>

The more recent *Second Restatement* is sensitive to this intuitive reality. The comments to its section on good faith make clear that the content of the obligation of good faith "varies somewhat with the context."<sup>100</sup> Avoiding the often confusing objective-subjective distinction altogether, the comments then conclude that "bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty" in the performance of contractual obligations.<sup>101</sup>

97. See Farnsworth, *supra* note 15, at 672 ("Under a subjective test of good faith it is always open to the trier of the facts to evaluate the credibility of a claim of 'honesty in fact,' and in doing so to take account of the reasonableness or unreasonableness of the claim."). For an application of this conclusion, see *J.R. Hale Contracting Co. v. United N.M. Bank*, 799 P.2d 581, 591 (N.M. 1990) (restating the essence of Professor Farnsworth's observation and concluding that even under a "subjective" standard of good faith, "the conduct and credibility of the [defendant] may be tested by objective standards subject to proof and conducive to the application of reasonable expectations in commercial affairs").

98. See U.C.C. § 1-203 cmt. (noting that the doctrine of good faith "directs a court towards interpreting contracts within the commercial context in which they are created"); PEB COMMENTARY NO. 10, *supra* note 15 (stating that the "reasonable expectations" approach embraced there "applies with equal force" to both the subjective and objective tests defined in the Code).

99. There is also a compelling argument that the common law's objective standards may be imported into the Code's minimalist subjective definition of good faith by way of its gap-filling regime. See U.C.C. § 1-103 (providing that the "principles of law and equity" apply "[u]nless displaced by the particular revisions of [the Code]"); see also *Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575, 587 (N.J. 1997) (holding that, although in general the Code's subjective standard applied, "the obligation to perform in good faith found in our common law will also influence the result"); ROBERT A. HILLMAN ET AL., *COMMON LAW AND EQUITY UNDER THE UNIFORM COMMERCIAL CODE* ¶ 6.03[4] (1985) (arguing that because of the Code's restrictive definition of good faith "one may assume that the common-law and equitable sources of the good-faith obligation will be heavily employed through the avenue of Section 1-103"); Summers, *supra* note 89, at 197 (advancing a similar argument).

100. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981).

101. *Id.* cmt. d.

The once-contentious issue of the Code's competing subjective and objective standards of good faith thus rapidly is losing its luster.<sup>102</sup> Nonetheless, the general acceptance of a fortified duty of "good faith and fair dealing" only increases the significance of the debate over its conceptualization. To set the context for our subsequent analysis, I turn below to a brief review of the two principal theories that have defined the contours of this debate.

## 2. *Excluder Analysis and the Second Restatement*

In one of the earliest and most influential analyses in the area, Professor Robert Summers argued that the concept of "good faith" lacks a single, unifying meaning.<sup>103</sup> Relying on the philosophical insights of J.L. Austin, Professor Summers argued that a more fruitful means of analysis would be to view "good faith" as the absence of its opposite, "bad faith."<sup>104</sup> Thus, he reasoned, good faith as applied by the courts "is best understood as an 'excluder' . . . a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith."<sup>105</sup>

To aid in the practical application of this "excluder analysis," Professor Summers suggests what is in effect a common-law approach. Although suspicious of "reductionist definitions,"<sup>106</sup> even of bad faith, he first offered a nonexhaustive list of categories of conduct that would qualify as "bad faith."<sup>107</sup> With this

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102. See BURTON & ANDERSEN, *supra* note 71, at 74 (concluding that the case law on the objective-subjective debate "is neither consistent nor enlightening," and arguing in favor of a general objective approach); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 27-3 (3d ed. 1988) (concluding, after reviewing case law on the ambiguous standard defined in Code section 1-208 for the acceleration of payment obligations, that "the objective vs. subjective dispute may not be very important").

103. See Summers, *supra* note 89, at 199-209, 262.

104. See *id.* at 201-02 (quoting and discussing J. L. AUSTIN, SENSE AND SENSIBILLA 70-71 (G. J. Warnock ed., 1962)). For a critical view on the use of Austin's excluder analysis in the context of good faith, see Dennis M. Patterson, *Wittgenstein and the Code: A Theory of Good Faith Performance and Enforcement Under Article 9*, 137 U. PA. L. REV. 335, 349-50 (1998).

105. Summers, *supra* note 89, at 196.

106. *Id.* at 207.

107. Professor Summers suggests six categories in this regard: evasion of the spirit of the deal; lack of diligence and slacking off; willful rendering of only substantial

foundation, the aspiration is that courts will use the descriptive list, and the precedent developed by analogy, as a means to “the accumulation of a viable body of case law on good faith.”<sup>108</sup> A fair number of courts in fact have expressed support for such a general, common-law approach to the duty of good faith.<sup>109</sup>

This conceptualization of good faith also substantially influenced the subsequent drafting of the *Second Restatement*. Consonant with “excluder analysis,” the *Second Restatement* does not attempt a formal, positive definition of “good faith.” Rather, the comments to section 205 of the *Second Restatement* merely state that the notion “excludes a variety of types of conduct characterized as involving ‘bad faith.’”<sup>110</sup> Indeed, those comments expressly embrace the descriptive categories of “bad faith” first identified by Professor Summers as analytical guideposts for a casuistic development of the law by the courts.<sup>111</sup>

Unfortunately, neither pure “excluder analysis” nor the *Second Restatement* offers guidance on the precise interaction of the duty of good faith with the force of party autonomy.<sup>112</sup> At one point, the comments to the *Second Restatement* indicate that the duty of good faith derives its force from expectations awakened as the parties’ contractual relationship takes shape: “Good faith performance emphasizes faithfulness to an agreed common pur-

performance; abuse of power to specify terms; abuse of power to determine compliance; and interference with or failure to cooperate in performance by the other party. *See id.* at 232-43.

108. *Id.* at 206; *see also id.* at 264 (“[O]nce we accumulate a body of holdings on what forms of conduct are in bad faith, we should then have the certainty [one would] want, at least as to those forms of conduct . . .”).

109. *See, e.g.,* *Occusafe, Inc. v. EG&G Rocky Flats, Inc.*, 54 F.3d 618, 624 (10th Cir. 1995); *Fremont v. E.I. DuPont DeNemours & Co.*, 988 F. Supp. 870, 877 (E.D. Pa. 1997); *Larson v. Larson*, 636 N.E.2d 1365, 1367-68 (Mass. App. Ct. 1994); *Bourgeois v. Horizon Healthcare Corp.*, 872 P.2d 852, 856 (N.M. 1994); *see also* *Diamond & Foss, supra* note 79, at 590 n.16 (listing more cases that have expressed support for “excluder analysis”).

110. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981); *see also id.* cmt. d (asserting that “[a] complete catalogue of types of bad faith is impossible”).

111. *See id.* cmt. d (listing Professor Summers’s six categories of bad faith almost verbatim as “among those which have been recognized in judicial decisions”).

112. Consonant with the notion of “excluder analysis,” this ambiguity may be intentional. *See* Summers, *supra* note 89, at 215 (criticizing the approach of the Code to the duty of good faith and asserting that “[i]f an obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition”).

pose and consistency with the justified expectations of the other party."<sup>113</sup> This is a view shared in principle by Professor Summers.<sup>114</sup>

At the same time, however, both the comments to the Restatement and Professor Summers suggest that the duty of good faith imposes limitations on party autonomy that derive from broader normative concerns of "decency, fairness or reasonableness."<sup>115</sup> In the words of Professor Summers, good faith "is of a piece with explicit requirements of 'contractual morality' such as the unconscionability doctrine and various general equitable principles."<sup>116</sup> Under this view, in short, the doctrine of good faith

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

114. See Summers, *supra* note 89, at 263 ("In most cases the party acting in bad faith frustrates the justified expectations of another.")

115. RESTATEMENT (SECOND) OF CONTRACTS, § 205 cmt. a (stating that good faith excludes 'types of conduct involving bad faith "because they violate community standards of decency, fairness or reasonableness"); see also Summers, *supra* note 9, at 826 (agreeing with this rationale for good-faith requirements). For an unusually frank judicial statement of this view, see *Koehrer v. Superior Court*, 226 Cal. Rptr. 820, 828 (Ct. App. 1986), stating that "the obligations stemming from the implied covenant of good faith and fair dealing are imposed by law as normative values of society."

116. Summers, *supra* note 9, at 811 (footnotes omitted). In this respect, substantial similarities exist between excluder analysis and the broader theory of "relational contracts." The relational contract theory posits that some contracts would be better understood as wholly cooperative, evolving relationships in which the values of "discreetness" and "presentation" yield to norms, inter alia, of cooperation, mutual adjustment of obligations, and equitable harmonization of conflicts. See generally IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT* (1980) (developing a broader theory of human relationships from the notion of a "social contract"); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981) (describing the basic aspects of relational contracts); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978) (discussing the conflict in contract law between the need for stability and the need for flexibility, and the ways contractual relations are affected by this conflict) [hereinafter Macneil, *Adjustment*]; Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340 (1983) (discussing the values involved in various types of contracts); Richard E. Speidel, *Article 2 and Relational Sales Contracts*, 26 LOY. L.A. L. REV. 789 (1993) (advocating the inclusion of certain relational norms in the revision of UCC Article 2 in response to the development of the principles of relational contract theory). The doctrine of good faith performance would indeed fit comfortably in the definition of such relationships. See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 984-86 (1990) (arguing with regard to franchise relationships that "[t]he doctrinal tool necessary to bring the resolution of franchise contract disputes

performance can operate, at some undefined level, to displace even an informed, explicit agreement between the parties.<sup>117</sup>

In this respect, excluder analysis overstates the proper force of the doctrine of good faith performance.<sup>118</sup> Nonetheless, at its core this approach offers an insight that will be of significance in our subsequent analysis: namely, that the duty of good faith can derive its content not only from the actual, formal agreements of the parties, but also from broader community expectations of fairness and reasonable conduct.<sup>119</sup> Unfortunately, the potential of the casuistic development suggested by excluder analysis also is particularly susceptible to dilution in the changing jurisprudential tides of contract interpretation. As we shall see below, it is precisely the refusal to consider such broader contextual matters that has permitted the new textualism to avoid an analysis of the duty of good faith performance altogether.<sup>120</sup>

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into line with the realities of the franchise relation is the covenant of good faith and fair dealing"); Speidel, *supra* note 40, at 201-08 (discussing the importance of good faith under the "new spirit" of contract). Unfortunately, relational contract theory has found little acceptance in the courts. See BURTON & ANDERSEN, *supra* note 71, at 414 (concluding that "[p]ractically speaking, relational contract law has received little endorsement from the courts"). The principal reason for this is that the specifics of each relationship have frustrated attempts to generalize about the proper "signals" that would indicate that the parties have entered into such a "relational contract." See Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535 (1990) (arguing that the particulars of each case preclude identification of a broad background norm based on either cooperation or egoism); Goetz & Scott, *supra* note 49, at 320 ("Unfortunately, current rules of interpretation provide few effective mechanisms for distinguishing between apparent inconsistency and deliberate indeterminacy. For relational contractors, therefore, interpretive disputes will essentially be a lottery until the state provides the requisite instruments for more accurate signaling.").

117. See Summers, *supra* note 89, at 197-200 (suggesting that the duty of good faith operates in this sense to promote "justice, and justice according to law").

118. See Burton, *Reply*, *supra* note 89, at 498-99 (criticizing excluder analysis to the extent that it "implies that courts typically use the doctrine to render agreed terms unenforceable or to impose obligations that are incompatible with the agreement reached at formation"); see also Diamond & Foss, *supra* note 79, at 590-92 (criticizing the approach as requiring resolution of good faith on an "intuitive ad hoc basis"); Gillette, *supra* note 89, at 650 (expressing similar criticisms); Patterson, *supra* note 104, at 350 (arguing that the flaw in excluder analysis lies in the belief that it "provides judges with sufficient material from which to fashion analogies between old and new instances of bad faith").

119. See *infra* notes 229-35 and accompanying text.

120. See *infra* notes 144-92 and accompanying text. For a positive analysis of the



### 3. *The "Foregone Opportunities" Approach*

The second major contribution to the conceptualization of the duty of good faith seeks to focus the analysis on opportunities foregone in the contracting process. Developed by Professor Steven Burton, this approach equates "bad faith" with an attempt by a party to recapture a "cost" of performance (a "foregone opportunity") allocated to her upon entering the contract.<sup>121</sup> The essential interpretive issue of whether a party has agreed to forego an opportunity in this fashion is determined by the reasonable expectations of the parties at the time of formation.<sup>122</sup>

Under this view, the duty of good faith performance assumes its core function when one party retains an ability to control the content or value of performance after formation. Such a "discretion in performance" arises when the contract reserves to one party a power to set the terms of performance, such as (among others) the quantity, price, or time.<sup>123</sup> Thus, Professor Burton concludes, "[b]ad faith performance occurs precisely when discretion is used to recapture opportunities foregone upon contracting—when the discretion-exercising party refuses to pay the expected cost of performance."<sup>124</sup>

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appropriate burden of expression to displace the limitations imposed by the duty of good faith performance, see *infra* notes 285-347 and accompanying text.

121. See Burton, *supra* note 79, at 387-92; see also BURTON & ANDERSEN, *supra* note 71, at 34-57 (expounding on this approach); Burton, *Reply*, *supra* note 89, at 499-507 (defending the foregone opportunities approach in response to criticisms by Professor Summers).

122. See Burton, *supra* note 79, at 390-91.

123. See *id.* at 373; see also BURTON & ANDERSEN, *supra* note 71, at 45-50 (elaborating on the notion of "discretion in performance"); Burton, *Reply*, *supra* note 89, at 501-03 (discussing the same); *infra* note 292 and accompanying text (discussing the role of the doctrine of good faith in countering arguments that a party's discretion on an essential contractual term amounts to an illusory, and thus unenforceable, promise). For an analysis of the significance of discretionary powers in light of the rise of the new textualism in contract, see *infra* notes 244-63 and accompanying text.

124. Burton, *supra* note 79, at 373. For the ultimate issue of the breach of the duty of good faith, Professor Burton originally distilled the foregone opportunities into two essential questions: first, at formation, what were the reasonably expected costs of performance (foregone opportunities) to the discretion-exercising party?; and second, at performance, did the discretion-exercising party use that discretion to recapture the foregone opportunity? Professor Burton conceives of the first inquiry as an objective standard and the second as a subjective one. See Burton, *Reply*, *supra*

Important insights emerge at the core of this approach as well. Casting the issue in terms of economic costs<sup>125</sup> and “foregone opportunities” may add little to the analysis in itself.<sup>126</sup> Nonetheless, as discussed in more detail below, the clear trend

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note 89, at 506-07.

125. Another possible conceptualization of contractual good faith arises from the now-familiar efforts to divine the appropriate “default rules” of contract law from economic considerations. For an introduction into the voluminous literature on this subject, see Ayres & Gertner, *supra* note 13; Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489 (1989); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990). Some scholars have argued in this vein that the only appropriate role for good faith is in prohibiting “opportunistic” behavior that is made possible by the sequential nature of contract performance. See, e.g., *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (Posner, J.) (arguing with regard to the duty of good faith that “[c]ontract law imposes a duty, not to ‘be reasonable,’ but to avoid taking advantage of gaps in a contract in order to exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous”); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 92-94 (4th ed. 1992); see also Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 140-41 (1989) (noting the importance of good faith in prohibiting opportunistic attempts to extract favorable contract modifications); Muris, *supra* note 89, at 552-72 (constructing a comprehensive model of opportunistic behavior). Under the economic approach, good faith can serve the interests of efficiency by relieving the parties of the cost and inconvenience of extensive negotiation over such behavior. Like the other grand theory of contractual relations, relational contract theory (see *supra* note 116), however, the economic approach to good faith has had little impact in the courts. See BURTON & ANDERSEN, *supra* note 71, at 414-15 (observing that “economic approaches have enjoyed limited endorsement from the courts in contracts cases”); *id.* at 416-18 (analyzing the limitations of opportunism as a controlling consideration in good faith analysis); A. Brooke Overby, *Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation*, 61 FORDHAM L. REV. 963, 990-91 (1993) (same); see also Fischel, *supra*, at 141 (acknowledging that “distinguishing opportunistic from non-opportunistic behavior can be very complicated if not impossible”). But see *infra* notes 144-50, 181-92 and accompanying text (noting arguments by recent textualist courts—most notably, Seventh Circuit Judges Easterbrook and Posner—that the doctrine of good faith only serves as a “gap-filling” tool to discipline opportunistic behavior).

126. Moreover, the duty of good faith will be of significance in other contexts beyond the exercise of contractual discretion, in particular when one party affirmatively interferes with performance by the other, and in resolving issues a contract fails to address at all. See *infra* notes 348-57 and accompanying text. This was the subject of an original objection by Professor Summers to the “foregone opportunities” approach advocated by Professor Burton. See Summers, *supra* note 9, at 834. But see Burton, *Reply*, *supra* note 89, at 501-02 & n.24 (reaffirming that good faith may play a role beyond limiting contractual discretion).

of opinion now properly embraces the view that the duty of good faith serves to protect the "reasonable" or "justified" expectations that arise in the contracting process.<sup>127</sup> Of equal importance for present purposes is emphasis on the role of good faith in the context of discretionary powers. Here, as well, a solid consensus currently exists in the courts that a core function of the duty of good faith lies in imposing limitations on a party's exercise of a discretionary power to control an aspect of a contractual relationship after formation.<sup>128</sup>

A "justified expectations" approach, however, also affords substantial deference to the express terms of the parties' contract.<sup>129</sup> The difficulty here, as Part II will show, is that the new textualism adopts this emphasis on express terms, but fails to acknowledge the significance of the broader expectations protected by the duty of good faith. Building on the insights gained

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127. See *infra* notes 215-19 and accompanying text. In his subsequent work, Professor Burton properly has placed greater emphasis on the inquiry into the "justified expectations" that arise in the formation of a contractual relationship. See BURTON & ANDERSEN, *supra* note 71, at 40 (stating that, notwithstanding certain judicial recognition of "foregone opportunities" terminology, a focus on the parties' "justified expectations . . . is a clearer way to express the same thought").

128. See, e.g., Kaplan v. First Options, Inc. (*In re* Kaplan), 143 F.3d 807, 818 (3d Cir. 1998) (holding that one important purpose of the duty of good faith is to "check the exercise of a party's discretion under a contract" (quoting Bane v. Ferguson, 707 F. Supp. 988, 994 (N.D. Ill. 1989), *aff'd*, 890 F.2d 11 (7th Cir. 1989))); Amoco Oil Co. v. Ervin, 908 P.2d 493, 498 (Colo. 1995) (en banc) (same); Citicorp Sav. v. Rucker, 692 N.E.2d 1319, 1324 (Ill. App. Ct. 1998) (same). Perhaps the best elaboration on this point came from Justice David Souter while he sat on the Supreme Court of New Hampshire:

[U]nder an agreement that appears by word or silence to invest one party with a degree of discretion in performance sufficient to deprive another party of a substantial proportion of the agreement's value, the parties' intent to be bound by an enforceable contract raises an implied obligation of good faith to observe reasonable limits in exercising that discretion, consistent with the parties' purpose or purposes in contracting.

Centronics Corp. v. Genicom Corp., 562 A.2d 187, 193 (N.H. 1989); See also Diamond & Foss, *supra* note 79, at 588 n.8 (citing older cases to the same effect); cf. Summers, *supra* note 89, at 199 (agreeing that one of the functions of the duty of good faith is to "prevent the abuse of powers conferred by contract").

129. See BURTON & ANDERSEN, *supra* note 71, at 63-64 (asserting the "[p]riority of [e]xpress [t]erms"); see also Burton, *supra* note 86, at 24 (urging a reformulation of the official comments for the Code's definition of good faith to state that "[t]he express terms of the contract are of central importance in determining the content of the good faith performance obligation").

above, Part III will demonstrate that this new textualism is fundamentally at odds with the essential role of the duty of good faith performance, even in the face of express discretionary powers.

## II. GOOD FAITH AND THE ASCENDANCE OF NEW TEXTUALISM

Conventional wisdom holds, as we saw in brief outline above,<sup>130</sup> that the “archaic absurdity”<sup>131</sup> of the plain meaning rule and its conceptual cousins has yielded to a flexible, contextual approach in contractual interpretation.<sup>132</sup> In recent years, however, the forces of formalism—never fully subdued in any event—have staged an impressive comeback.<sup>133</sup> Paralleling similar developments in other interpretive contexts,<sup>134</sup> the last fifteen years have witnessed an increasing judicial reliance on the classical premise that the express terms of a written contract reflect the definitive source of interpretive evidence.<sup>135</sup>

Indeed, in language strikingly reminiscent of its classical past, judicial interpretation of contracts now often begins and ends with a review of the text and a simple citation to the force of the “plain meaning” and “parol evidence” rules.<sup>136</sup> This trend has led

130. See *supra* notes 30-45 and accompanying text.

131. Murray, *supra* note 35, at 1344.

132. See *supra* notes 46-65 and accompanying text.

133. Professors Goetz and Scott observed as early as 1985 that “an examination of recent cases challenges the conventional premise that methods of contractual interpretation have evolved over the past half-century from an extreme focus on narrow ‘plain meaning’ to the opposite pole of liberal contextual construction.” Goetz & Scott, *supra* note 49, at 264.

134. See *supra* notes 2-3 and accompanying text (discussing the reemergence of formalism in the interpretation of statutes and treaties).

135. A number of scholars have observed this phenomenon. See Goetz & Scott, *supra* note 49, at 307 (noting the conventional wisdom that the plain meaning and parol evidence rules have been abandoned but concluding that “[i]n numerous cases, courts . . . still invoke the primacy of express, written texts to exclude extrinsic evidence”); Mooney, *supra* note 7, at 1159-69 (observing that there has been a growing reliance on the plain meaning and parol evidence rules in the late 1980s and 1990s); Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1713 (1997) (arguing that “it would be wrong . . . to assume that American contract law has abandoned the hierarchical notion of contract interpretation and supplementation” that gives primacy to express terms over implied meaning).

136. The language of these recent opinions is striking for its similarity with the

one recent commentator to describe the “conventional” approach to contract interpretation as holding that “[i]f the language of the contract is plain and unambiguous, there is no room for interpretation or construction . . . . Its meaning is determined without reference to extrinsic evidence.”<sup>137</sup>

This rising tide of textualism has spread even to the role of the duty of good faith performance. The new strain of textualism, similar to its nineteenth-century ancestor,<sup>138</sup> threatens to (re)consign the notion of good faith performance to the margins of contract doctrine.

### A. *The Return of Textualism in Good Faith Analysis*

For a time following its recognition in the UCC, the doctrine of good faith performance experienced a warm reception in the courts. In this early flowering of the doctrine, courts properly understood that the doctrine retains significance even in the face of an express grant of discretion under the contract.<sup>139</sup> The apo-

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approach of classical formalism. *See, e.g.,* *Church v. General Motors Corp.*, 74 F.3d 795, 799 (7th Cir. 1996) (“If the language unambiguously answers the question at issue, the inquiry is over.”); *Grey v. FDIC*, No. 88 Civ. 7452 (MJLTHK), 1998 WL 483460, at \*5 (S.D.N.Y. Aug. 14, 1998) (“The Court should accord the words and phrases of the contract their plain meaning . . . . [W]here the contractual language unambiguously conveys the parties’ intent, ‘extrinsic evidence may not properly be received, nor may a judicial preference be interjected since these extraneous factors would vary the effect of the contract’s terms’” (citations omitted) (quoting *Seiden Assocs., Inc. v. ANC Holdings, Inc.*, 959 F.2d 425, 428 (2d Cir. 1992))); *Waynesboro Village, L.L.C. v. BMC Properties*, 496 S.E.2d 64, 67 (Va. 1998) (“[W]here an agreement is complete on its face, is plain and unambiguous in its terms, the court is not at liberty to search for its meaning beyond the instrument itself. . . . This is so because the writing is the repository of the final agreement of the parties.” (citations omitted)).

137. *Zamir, supra* note 135, at 1715-16 (concluding that the “conventional hierarchy” of contract interpretation embraces the full force of the plain meaning and parol evidence rules).

138. *See supra* note 44 and accompanying text.

139. Prior to the 1990s, a number of courts invoked the duty of good faith as a limit on express contractual rights. *See, e.g.,* *Cambee’s Furniture, Inc. v. Doughboy Recreational, Inc.*, 825 F.2d 167, 174-75 (8th Cir. 1987); *Larese v. Creamland Dairies, Inc.*, 767 F.2d 716, 717 (10th Cir. 1985); *Arnott v. American Oil Co.*, 609 F.2d 873, 880-83 (8th Cir. 1979); *Baker v. Ratzlaff*, 564 P.2d 153, 156-57 (Kan. Ct. App. 1977); *Bak-A-Lum Corp. of Am. v. Alcoa Bldg. Prods., Inc.*, 351 A.2d 349, 351-52 (N.J. 1976).

theosis of this flexible approach came in the now famous case of *K.M.C. Co. v. Irving Trust Co.*<sup>140</sup> There, the Sixth Circuit found a breach of the duty of good faith in a bank's surprise refusal to advance additional funds under a discretionary line of credit, even though the loan documents expressly provided that all amounts were payable on demand by the bank.<sup>141</sup>

Like other social activities, however, the practice of contract interpretation appears to fall under the influence of trends. That is, as one approach begins to establish itself, a countertrend often emerges.<sup>142</sup> In this light, the response to the perceived excessive liberality reflected in *K.M.C.* was perhaps predictable: Recent years have witnessed an increasing judicial hostility to the duty of good faith performance in favor of an increased reliance on the normative force of contractual text.<sup>143</sup>

140. 757 F.2d 752 (6th Cir. 1985).

141. *See id.* at 760-63 (holding that the duty of good faith in that context required either sufficient advance notice or "some objective basis upon which a reasonable loan officer in the exercise of his discretion would have acted in that manner"). For a more detailed examination of *K.M.C.*, see Steve H. Nickles, *The Objectification of Debtor-Creditor Relations*, 74 MINN. L. REV. 371, 385 (1989) (suggesting that the objective approach embraced in *K.M.C.* was appropriate under the circumstances); Patterson, *supra* note 48, at 180-84. Other courts from the same time period produced similar holdings. *See, e.g.*, Reid v. Key Bank, Inc., 821 F.2d 9 (1st Cir. 1987) (following *K.M.C.* with regard to a demand note); Brown v. Avemco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979) (finding a breach of good faith in the use of an acceleration clause as a pretext to advance the due date of a loan).

142. *See* Van Alstine, *supra* note 3, at 717 (observing a similar pattern regarding the interpretation of statutes and treaties).

143. The criticism of the ultimate holding in *K.M.C.* has been particularly severe. In a line of opinions too long to capture in a footnote, subsequent courts have rejected the premise of *K.M.C.* that a demand note could be subject to an implied obligation of good faith. *See, e.g.*, Pavco Indus., Inc. v. First Nat'l Bank, 534 So. 2d 572, 577 (Ala. 1988); Southwest Sav. & Loan Ass'n v. SunAmp Sys., Inc., 838 P.2d 1314, 1322-23 (Ariz. Ct. App. 1992); Flagship Nat'l Bank v. Gray Distrib. Sys., Inc., 485 So. 2d 1336, 1341 (Fla. Dist. Ct. App. 1986); Diversified Foods, Inc. v. First Nat'l Bank, 605 A.2d 609, 613-14 (Me. 1992); Check Reporting Servs., Inc. v. Michigan Nat'l Bank, 478 N.W.2d 893, 899 (Mich. Ct. App. 1991); Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 953 (Mo. Ct. App. 1986); Solar Motors, Inc. v. First Nat'l Bank, 537 N.W.2d 527, 539 (Neb. Ct. App. 1995), *aff'd*, 545 N.W.2d 714 (1996); Gaul v. Olympia Fitness Ctr., Inc., 623 N.E.2d 1281, 1287-88 (Ohio Ct. App. 1993); Creeger Brick & Bldg. Supply, Inc. v. Mid-State Bank & Trust Co., 560 A.2d 151, 154-55 (Pa. Super. Ct. 1989). *See also* National Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 680 (S.D.N.Y. 1991) (concluding that *K.M.C.* is inconsistent with New York law, which the *K.M.C.* court purported to apply), *aff'd*, 962 F.2d 1 (2d Cir.

The paradigm for this new approach is the equally famous case of *Kham & Nate's Shoes No. 2, Inc. v. First Bank*.<sup>144</sup> Although the case involved the subordination of a bank's priority claim in bankruptcy for "inequitable conduct,"<sup>145</sup> Judge Easterbrook of the Seventh Circuit took the occasion to expound on the contractual duty of good faith.<sup>146</sup> The specific issue of contention, familiarly, was a bank's refusal to advance funds under a loan agreement that reserved for the bank an express right to terminate financing at any time.<sup>147</sup>

In Judge Easterbrook's view, this express discretionary power ended the matter of good faith: "Although courts often refer to the obligation of good faith that exists in every contractual relation, this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document."<sup>148</sup> Instead, Judge Easterbrook reasoned, the duty of good faith only serves a residual gap-filling role of forbidding "opportunistic" conduct in a way that "could not have been contemplated at the time of drafting, and . . . therefore was not resolved explicitly by the parties."<sup>149</sup> In language that now has become the shibboleth of the new textualist approach, the *Kham & Nate's* court thus held that principles of good faith "do not block use of terms that actually appear in the contract."<sup>150</sup>

Were this an isolated opinion, there would be little reason for concern. One can fairly conclude, however, that *Kham & Nate's*

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1992).

144. 908 F.2d 1351 (7th Cir. 1990). For a particularly critical analysis of Judge Easterbrook's opinion in *Kham & Nate's*, see Patterson, *supra* note 15, at 513-29.

145. *Kham & Nate's*, 908 F.2d at 1353-54, 1357.

146. *See id.* at 1357-58.

147. *See id.* at 1353.

148. *Id.* at 1357 (citations omitted).

149. *Id.* ("Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties.")

150. *Id.* It is no coincidence that Judge Easterbrook has been at the forefront of the new textualist approach to contract interpretation, for he has been one of the leading champions of a restrictive textualist approach to the interpretation of statutes as well. *See* Frank H. Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533 (1983) (advocating a limited role for judges in interpreting statutes); Frank H. Easterbrook, *Text, History, and Structure in Statutory Interpretation*, 17 HARV. J.L. & PUB. POL'Y 61 (1994) (urging greater reliance on text in statutory interpretation).

marked a significant change in the course of the law. Indeed, after that opinion in 1990, an initial trickle of similar views in the case law<sup>151</sup> began to grow into a torrent, even as a few early commentators voiced their disapproval.<sup>152</sup> In a long and growing list of opinions, courts from a number of jurisdictions<sup>153</sup> have parroted the view that the duty of good faith “cannot supplant express contract terms.”<sup>154</sup> This textualist approach has likewise

151. See, e.g., *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 877-78 (5th Cir. 1989) (holding that the duty of good faith has “no role to play” in the face of an express contractual right); *Murphy v. American Home Prods. Corp.*, 448 N.E.2d 86, 91 (N.Y. 1983) (holding that good faith cannot supplant express contract terms); see also Corey R. Chivers, Note, “Contracting Around” the Good Faith Covenant to Avoid Lender Liability, 1991 COLUM. BUS. L. REV. 359, 377 n.62 (citing earlier cases supporting this proposition).

152. See 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, 758-62 (1993) (criticizing the approach in *Kham & Nate’s* for misunderstanding the importance of reasonable expectations in good faith analysis); Patterson, *supra* note 15 (same). But see Overby, *supra* note 125, at 1023 (arguing that “[i]n the lending context, the ‘effectiveness of express terms’ approach, as set out in *Kham & Nate’s*, is the preferable methodology to use in enforcing the parties’ agreement”).

153. Not surprisingly, the Seventh Circuit has remained at the forefront of this new textualist approach to the duty of good faith. See, e.g., *L.A.P.D., Inc. v. General Elec. Corp.*, 132 F.3d 402, 404 (7th Cir. 1997) (holding that good faith cannot block “explicit provisions of contracts”); *Digital Equip. Corp. v. Uniq Digital Techs., Inc.*, 73 F.3d 756, 758-59 (7th Cir. 1996) (holding that good faith does not require a manufacturer to continue its relationship with a dealer after a valid termination); *Industrial Representatives, Inc. v. CP Clare Corp.*, 74 F.3d 128, 132 (7th Cir. 1996) (rejecting a good faith claim where contract permitted termination without cause); *Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273, 280 (7th Cir. 1992) (holding that, in the face of an express clause, contract law does not impose a duty to be reasonable); *Continental Bank, N.A. v. Everett*, 964 F.2d 701, 705 (7th Cir. 1992) (“As a method to fill gaps, [good faith] has . . . nothing to do with the enforcement of terms actually negotiated.”).

154. *Abbott v. Amoco Oil Co.*, 619 N.E.2d 789, 796-97 (Ill. App. Ct. 1993) (quoting *Foster Enters., Inc. v. Germania Fed. Sav. & Loan Ass’n*, 421 N.E.2d 1375, 1382 (Ill. App. Ct. 1981)). A list of cases in this textualist vein limited even to the last few years scarcely can be contained in a single footnote. See, e.g., *Taylor Equip., Inc. v. John Deere Co.*, 98 F.3d 1028, 1032 (8th Cir. 1996) (finding the implied duty not applicable to an express contractual requirement of approval for the assignment of a dealership), *cert. denied*, 117 S. Ct. 1553 (1997); *Riggs Nat’l Bank v. Linch*, 36 F.3d 370, 373-74 (4th Cir. 1994) (finding implied covenant of good faith should not override express terms); *Hall v. Resolution Trust Corp.*, 958 F.2d 75, 79 (5th Cir. 1992) (“[A]n ‘agreement made by the parties and embodied in the contract itself cannot be varied by an implicit covenant of good faith and fair dealing.’” (quoting *Exxon Corp. v.*



been invoked in a wide variety of contexts. Thus, courts have concluded that the duty of good faith becomes irrelevant in the face of any discretionary power, for example, to terminate a contract,<sup>155</sup> to preclude assignment of a contract,<sup>156</sup> to refuse consent to the relocation of a dealership<sup>157</sup> (or to establish a competing one in the same market<sup>158</sup>), to cease operation under a lease,<sup>159</sup> or to set banking fees or loan interest rates.<sup>160</sup>

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Atlantic Richfield Co., 678 S.W.2d 944, 947 (Tex. 1984)); *Allen v. Cornish & Carey*, No. 96-20254 SW, 1997 WL 195433, at \*5 (N.D. Cal. Apr. 11, 1997) (holding that the duty of good faith cannot "obliterate a right expressly provided by a written contract"); *Barnes v. Burger King Corp.*, 932 F. Supp. 1420, 1438 (S.D. Fla. 1996) ("The implied covenant of good faith should not be invoked to override the express terms of the agreement between the parties."); *Cenex, Inc. v. Arrow Gas Serv.*, 896 F. Supp. 1574, 1580-81 (D. Wyo. 1995) (same); *James v. Whirlpool Corp.*, 806 F. Supp. 835, 843-44 (E.D. Mo. 1992) (holding that the implied duty did not "override the express terms of the agreement" which "unmistakably" granted a defendant the right to take the disputed action); *Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc.*, 826 P.2d 710, 728 (Cal. 1992) (holding that the implied duty of good faith "is plainly subject to the exception that the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise have been forbidden by an implied covenant of good faith and fair dealing" (quoting *VTR, Inc. v. Goodyear Tire & Rubber Co.*, 303 F. Supp. 773, 777-78 (S.D.N.Y. 1969))); *Third Story Music, Inc. v. Waits*, 48 Cal. Rptr. 2d 747, 752-53 (Ct. App. 1995) (finding implied covenant of good faith should not override express terms); *Farris v. Hutchinson*, 838 P.2d 374, 376-77 (Mont. 1992) (same); see also *Diamond & Foss*, *supra* note 79, at 587 n.5 (listing additional cases in the same vein).

155. See, e.g., *Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672, 679 (2d Cir. 1985); *Friedman & Son, Inc. v. Safeway Stores, Inc.*, 712 P.2d 1128, 1131 (Colo. Ct. App. 1985).

156. See, e.g., *Taylor Equip.*, 98 F.3d at 1031-32; *James*, 806 F. Supp. at 839, 843; *First Fed. Sav. Bank v. Key Markets, Inc.*, 559 N.E.2d 600, 603-04 (Ind. 1990).

157. See, e.g., *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 876-79 (5th Cir. 1989); *Thoroughbred Ford, Inc. v. Ford Motor Co.*, 908 S.W.2d 719, 733-34 (Mo. Ct. App. 1995).

158. See, e.g., *Barnes*, 932 F. Supp. at 1437-40; *Burger King Corp. v. Holder*, 844 F. Supp. 1528, 1530 (S.D. Fla. 1993).

159. See, e.g., *Rothe v. Revco D.S., Inc.*, 976 F. Supp. 784, 794-95 (S.D. Ind. 1997) (holding that "bad faith only becomes an issue if a good faith clause was in the lease"), *aff'd*, 148 F.3d 672 (7th Cir. 1998); *Fodor v. First Nat'l Supermarkets, Inc.*, No. 58587, 1990 WL 93210, at \*3 (Ohio Ct. App. July 5, 1990), *aff'd*, 589 N.E.2d 17 (Ohio 1992).

160. See, e.g., *Riggs Nat'l Bank v. Linch*, 36 F.3d 370, 373 (4th Cir. 1994) (finding no duty of good faith with regard to a clause permitting adjustment of the interest rate under a loan agreement); *Tolbert v. First Nat'l Bank*, 823 P.2d 965, 968-71 (Or. 1991) (same as to banking fees). The issue of lender liability for breach of the duty

With this reemergence of the definitive power of text, the exclusion of parol evidence in good faith claims could not be far behind. Indeed, a number of courts have now expressly concluded that a party may not introduce extrinsic evidence to support a good faith claim in the face of an express contractual power.<sup>161</sup> The purity of this adherence to text thus permits a court to dispense with an analysis of good faith without even reviewing the context in which a discretionary power arose in the first place.

A recent decision of the Eighth Circuit, *Taylor Equipment, Inc. v. John Deere Co.*,<sup>162</sup> illustrates how little remains of the duty of good faith under this view. In *Taylor Equipment*, a jury found that a manufacturer breached the duty of good faith when

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of good faith performance has spawned a considerable body of scholarly analysis. See, e.g., PATTERSON, *supra* note 50; Werner F. Ebke & James R. Griffin, *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, 49 OHIO ST. L.J. 1237 (1989); Carolyn M. Edwards, *Article 3 Demand Notes and the Doctrine of Good Faith*, 74 MARQ. L. REV. 481 (1991); Fischel, *supra* note 125; Fure, *supra* note 152; 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); Nickles, *supra* note 141; Overby, *supra* note 125, at 1011-1016 (arguing that courts have substantially accepted a "passive/effectiveness of express terms' approach" to the duty of good faith in that context); Patterson, *supra* note 15; Jonathan K. Van Patten, *Lender Liability: Changing or Enforcing the Ground Rules?*, 33 S.D. L. REV. 387 (1988).

161. See, e.g., *Kamm v. Trust Co.*, No. 92-55289, 1994 WL 666081, at \*4 (9th Cir. Nov. 28, 1994) (precluding the introduction of parol evidence to support a claim based on duty of good faith); *Burnette Techno-Metrics, Inc. v. TSI Inc.*, 44 F.3d 641, 643 (8th Cir. 1994) (same); *H.L. Miller Mach. Tools, Inc. v. Davenport Mach.*, No. 97 C 5012, 1998 WL 341828, at \*3-4 (N.D. Ill. June 18, 1998) (same); *Physiotherapy Assocs. v. Patenaude*, No. C-95-20545 RMW, 1995 WL 381950, at \*3 (N.D. Cal. June 21, 1995) (same); *Implement Serv., Inc. v. Tecumseh Prods. Co.*, 726 F. Supp. 1171, 1179-80 (S.D. Ind. 1989) (holding that an express termination clause precluded the introduction of parol evidence to support a claim based on the duty of good faith); *Solar Motors, Inc. v. First Nat'l Bank*, 537 N.W.2d 527, 539 (Neb. Ct. App. 1995) (rejecting both a specific breach of contract and a breach of the duty of good faith claim "for the reason that the parol evidence rule prevents one from establishing a cause of action for contract upon a hodgepodge of negotiations and preliminary agreements"), *aff'd*, 545 N.W.2d 714 (Neb. 1996); *State Nat'l Bank v. Academia, Inc.*, 802 S.W.2d 282, 294 (Tex. App. 1990) ("[C]laims based on breach of [an] oral agreement would be contrary to the written contract, and therefore cannot form the basis for breach of the covenant of good faith and fair dealing . . .").

162. 98 F.3d 1028 (8th Cir. 1996) (applying South Dakota law), *cert. denied*, 117 S. Ct. 1553 (1997).

it arbitrarily invoked a contractual provision requiring its "written consent" for the assignment of a dealership.<sup>163</sup> The Eighth Circuit reversed, finding *as a matter of law* that the duty of good faith imposed no limitation on the manufacturer's conduct.<sup>164</sup> In pure textualist spirit, the court held that the absence of an express *limitation* meant that the manufacturer had an "absolute right" to refuse consent.<sup>165</sup> "Absent contractual limitation," the court reasoned, the contract gave the dealer no "justified expectation" that the manufacturer's discretion would be subject to any external limitation.<sup>166</sup> Without analyzing the context in which the consent clause arose, the court then quickly concluded with the now familiar statement that the duty of good faith "cannot block use of terms that actually appear in the contract."<sup>167</sup>

Under this textualist approach to the duty of good faith, in short, every express contractual power renders irrelevant any "implied" obligations imposed by the doctrine of good faith performance.<sup>168</sup> Indeed, as discussed in the introduction to this Article, recent courts have even begun to express frustration

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163. *See id.* at 1029-30.

164. *See id.* at 1031-35.

165. *Id.* at 1033; *see also id.* at 1034 ("The normal meaning of the approval clause . . . is that [the manufacturer] has an unrestricted right to withhold approval . . .").

166. *Id.* at 1032-33; *see also* Hubbard Chevrolet Co. v. General Motors Corp., 873 F.2d 873, 877 (5th Cir. 1989) (holding the same with regard to the relocation of an auto dealership under Michigan law). *But see* BURTON & ANDERSEN, *supra* note 71, at 132-33 (criticizing the Hubbard reasoning, if not the ultimate result, for failing to view such a discretionary power as subject to the duty of good faith).

167. *Taylor Equip.*, 98 F.3d at 1032 (quoting Continental Bank, N.A. v. Everett, 964 F.2d 701, 705 (7th Cir. 1992)).

168. Some scholars also accept the view that the duty of good faith becomes irrelevant in the face of "express terms" of a contract. *See, e.g.*, Diamond & Foss, *supra* note 79, at 587 & n.5 (arguing that the covenant of good faith is merely a residual "gap-filling default rule" that "cannot be used to override or contradict the express terms of the contract"); Overby, *supra* note 125, at 1023 (arguing that "[i]n the lending context, the 'effectiveness of express terms' approach, as set out in *Kham & Nate's*, is the preferable methodology to use in enforcing the parties' agreement"); *cf.* Fure, *supra* note 152, at 734 (arguing that "the duty of good faith is really nothing more than the basic contract principle that each party's reasonable expectations should be satisfied according to the agreement, as determined by manifestations of intent").

with suggestions to the contrary. Recall as a fitting conclusion to this stage of our analysis the Seventh Circuit's recent reprimand issued to a plaintiff: "More often than we care to recall, we have reminded litigants that . . . [they] may not seek to litigate issues of 'good faith' in lieu of abiding by explicit provisions of contracts."<sup>169</sup>

### *B. The Implications of the New Textualism for the Future of Good Faith*

Similar to the drift of contract interpretation in general, the rise of the new textualist approach to the duty of good faith signals a return to the formalist presumptions of late nineteenth-century contract law.<sup>170</sup> Like its classical ancestor, this rejuvenated textualism proceeds on the premise that every express contractual term reflects the parties' final agreement on the subject.<sup>171</sup> As a consequence, defining contractual rights and obligations involves little more than pressing the "meaning" (the "right answer") out of the words that appear in a contractual document.<sup>172</sup>

With this foundation, the implications for the textualist view of contractual good faith become clear: Because the parties are able to distill the totality of their understandings into express agreements, every grant of a contractual power is presumptively absolute. That is, the failure of the parties to include an express *limitation* on a discretionary power is taken as an affirmative agreement between them that no such limitation exists.<sup>173</sup> Mat-

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169. *L.A.P.D., Inc. v. General Elec. Corp.*, 132 F.3d 402, 404 (7th Cir. 1997); see also *supra* notes 1, 5 and accompanying text (noting that even Justice (then Judge) Scalia once warned that such a reliance on the authority of text will strip the doctrine of good faith of any power).

170. See *supra* notes 27-45 and accompanying text (discussing the traditional "plain meaning" and "parol evidence" rules); see also Patterson, *supra* note 15, at 515 (arguing that "[t]he opinion in *Kham [& Nate's]* is replete with statements that could have been uttered by any proponent of nineteenth-century formalism").

171. See *supra* notes 130-38 and accompanying text (noting an increasing judicial reliance on the express terms of a written contract as the definitive source of interpretive evidence).

172. See *supra* notes 27-29 and accompanying text.

173. See, e.g., *Taylor Equip. Inc. v. John Deere Co.*, 98 F.3d 1028, 1032-33 (8th Cir. 1996) (holding that the absence of an express limitation on a manufacturer's right to

ters of discretion in the performance of a contract in such cases thus provide no occasion for judicial analysis of good faith at all.<sup>174</sup>

Moreover, consonant with the spirit of the classical plain meaning and parol evidence rules, this new approach (in its extreme form) precludes consideration of any contextual evidence on the "implied" duty of good faith that would undermine the terms the parties have seen fit to reduce to writing.<sup>175</sup> One thus commonly finds in the new textualist case law on the sub-

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withhold consent to assignment meant that the right was unrestricted "as a matter of law"), *cert. denied*, 117 S. Ct. 1553 (1997); *General Aviation, Inc. v. Cessna Aircraft Co.*, 915 F.2d 1038, 1041 (6th Cir. 1990) (rejecting a claim of bad faith termination on the reasoning that "[i]f [plaintiff] had wanted specific provisions in the contract concerning what cause would be necessary for termination of the agreement, it could have insisted on the inclusion of those terms"); *Rothe v. Revco D.S., Inc.*, 976 F. Supp. 784, 794-95 (S.D. Ind. 1997) (holding with regard to a lease contract that "bad faith only becomes an issue if a good faith clause was in the lease"); *Barnes v. Burger King Corp.*, 932 F. Supp. 1420, 1436 (S.D. Fla. 1996) (rejecting a breach of good faith claim because the contract at issue did not expressly limit the defendant's right to take the challenged action); *Teachers Ins. & Annuity Ass'n of Am. v. Wometco Enters., Inc.*, 833 F. Supp. 344, 349 (S.D.N.Y. 1993) (stating with regard to a good faith claim that where the contract "lacks specific language preventing plaintiff from unreasonably withholding consent, the Court can not and should not rewrite the contract to include such language which neither of the parties saw fit to insert in the contract").

174. As recently as a few years ago, Professors Burton and Andersen were able to suggest that such a proposition had found little or no acceptance in the courts: "The courts could leave all discretion in performance unbridled. . . . Every instance of contracted flexibility or lack of clarity would be treated as an assumption of risk. No U.S. court now takes this approach, though many will respect a clear agreement of the parties that discretion should be unbridled." BURTON & ANDERSON, *supra* note 71, at 46-47. As noted in the previous footnote, however, a number of recent textualist courts have credited a failure to include an express limitation as such a "clear agreement" that contractual discretion should be insulated entirely from any obligations imposed by the doctrine of good faith performance.

175. In practical consequence, therefore, the "duty" of good faith is dismissed with a simple syllogism: The unambiguous terms of a writing reflect the final repository of the parties' agreement; the plain meaning and parol evidence rules preclude resort to any "implied" obligations that would undermine that agreement; as an "implied" term, therefore, good faith is irrelevant with regard to terms "that actually appear in the contract." *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990); *see also* Patterson, *supra* note 15, at 524 (observing that in *Kham & Nate's*, Judge Easterbrook "rejected the notion that the agreement of the parties is to be found anywhere other than in the express written terms of the parties' agreement").

ject the familiar adage of classical contract law that “[w]here parties have addressed an issue in the contract, ‘no occasion to divine their intent or supply implied terms arises.’”<sup>176</sup>

This new hostility to the duty of good faith has led a few courts to the point of near absurdity in the defense of express contract terms. Consider as an example the recent case of *Barnes v. Burger King Corp.*<sup>177</sup> The court in *Barnes* began an analysis of a breach of good faith claim with the stock statement that the duty of good faith cannot “override the express terms” of the parties’ agreement.<sup>178</sup> It then observed that a party cannot maintain such a claim “absent an allegation that an express term of the contract has been breached.”<sup>179</sup> This is a tidy logical circle: The duty of good faith performance cannot override an express term in a contract, and is irrelevant in absence of a breach of an express term. If a breach of an express term already exists, however, it is difficult to see where the duty of good faith would fit in the law of contracts at all.<sup>180</sup>

To be sure, some new textualists acknowledge a residual gap-filling role for the duty of good faith when “the contract is silent.”<sup>181</sup> Close examination, however, reveals that much of even this is a semantic distinction without a substantive difference. Recall that in *Kham & Nate’s*, for example, the Seventh Circuit

176. *Taylor Equip.*, 98 F.3d at 1032 (quoting *Cambee’s Furniture, Inc. v. Doughboy Recreational, Inc.*, 825 F.2d 167, 175 n.13 (8th Cir. 1987)).

177. 932 F. Supp. 1420 (S.D. Fla. 1996).

178. *Id.* at 1438.

179. *Id.* at 1439; see also *Miller v. United States Bank*, 865 P.2d 536 (Wash. Ct. App. 1994) (rejecting a good faith claim because there was no claim of a breach of an express term of the contract); cf. *BURTON & ANDERSEN*, *supra* note 71, at 414 n.1 (describing *Miller* as an “oddball” opinion).

180. *But see Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575, 587 (N.J. 1997) (holding that the defendant’s pretermination conduct in frustration of the plaintiff’s reasonable expectations breached the duty of good faith performance even though the conduct at issue did not violate any express contractual term); *Garrett v. BankWest, Inc.*, 459 N.W.2d 833, 841 (S.D. 1990) (allowing a claim for breach of the duty of good faith performance “even though the conduct failed to violate any of the express terms of the contract agreed by the parties”).

181. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990); see also *Taylor Equip.*, 98 F.3d at 1032 (observing that good faith is a “method to fill gaps” in a contract); *American Laser Prods., Inc. v. National Imaging Supplies Group, Inc.*, No. 94c 7624, 1996 WL 134256, at \*18 (N.D. Ill. Mar. 22, 1996) (“[T]he duty of good faith is used by courts solely to fill in gaps in the contract”).

described the duty of good faith as merely forbidding “opportunistic” conduct that “could not have been contemplated” at the time of drafting.<sup>182</sup> Assuming, as surely we must with Judge Easterbrook, that this is not simply shoddy drafting,<sup>183</sup> the duty of good faith would in fact authorize opportunistic advantage-taking, as long as the parties “could have” imagined it at the time of contracting. In the place of a *duty* of good faith, therefore, the law requires that the parties negotiate over and expressly proscribe all conceivable forms of “bad faith.”

This conceptualization of the gap-filling role of good faith nonetheless is fully consistent with the new textualist approach to the duty in general. Recall that this view proceeds from the premise that every express discretionary power is presumptively unlimited, and thus not subject to any “implied” limitations that could arise from a duty of good faith.<sup>184</sup> The consequence is that the burden of particularization, of identifying and describing in the text of the contract the specific *limitations* as to the future exercise of that discretion, falls on the “dependent” party.<sup>185</sup> As explained below, this stands the duty of good faith performance on its figurative head.<sup>186</sup>

At the core of the new textualism is a fear that the duty of good faith will become a means for judicial meddling with “solemn contracts” in the name of paternalism or mandated altruism.<sup>187</sup> Indeed, no less than the entire institution of contract

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182. *Kham & Nate's*, 908 F.2d at 1357.

183. This language in the *Kham & Nate's* opinion, in any event, has now been embraced by a number of subsequent courts. *See, e.g.*, *Jones Distrib. Co., v. White Consol. Indus., Inc.*, 943 F. Supp. 1445, 1465-66 (N.D. Iowa 1996); *Waslow v. MNC Commercial Corp. (In re M. Paoella & Sons, Inc.)*, 161 B.R. 107, 123 (E.D. Pa. 1993); *Bennett v. Genoa Ag. Ctr. Inc. (In re Bennett)*, 154 B.R. 140, 153-54 (Bankr. N.D.N.Y. 1992); *Ed Schory & Sons, Inc. v. Society Nat'l Bank*, 662 N.E.2d 1074, 1082-83 (Ohio 1996); *see also MJ & Partners Restaurant Ltd. Partnership v. Zadikoff*, 995 F. Supp. 929, 933 (N.D. Ill. 1998) (holding that a trademark licensor's exercise of a discretionary power was not subject to the duty of good faith because the possibility that it might act “unreasonably” in this regard “was one that clearly could have been contemplated at the time of drafting”).

184. *See supra* notes 173-76 and accompanying text.

185. The designation “dependent” party for the party that is subject to another's exercise of contractual discretion derives from Professor Steven Burton. *See Burton, Reply, supra* note 89, at 507.

186. *See infra* notes 264-79 and accompanying text.

187. *See Market Street Assocs. Ltd. Partnership v. Frey*, 941 F.2d 588, 595 (7th

hangs in the balance of this debate. "Unless pacts are enforced according to their terms," Judge Easterbrook warned in *Kham & Nate's*, "the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized."<sup>188</sup> In the buzzwords of classical formalism, to do otherwise "would reduce commercial certainty and breed costly litigation."<sup>189</sup>

What remains, then, is a "duty" of good faith performance that only rarely applies and is of limited force when it does. Although one of its prime functions is to limit the abuse of discretionary powers, the new textualist approach views all such express powers as entirely beyond the influence of the duty of good faith.<sup>190</sup> Even as a "residual" gap-filling tool, the duty can only discipline conduct that the parties "could not have contemplated" at the time of drafting.<sup>191</sup> This continuing contraction of the scope of the duty of good faith has led at least one prominent judge to conclude that modern contract law "could of course do without the term 'good faith,' and maybe even without the doctrine."<sup>192</sup>

Cir. 1991) (Posner, J.) ("The contractual duty of good faith is . . . not some newfangled bit of welfare-state paternalism or . . . the sediment of an altruistic strain in contract law"); *Kham & Nate's*, 908 F.2d at 1357 ("[K]nowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of 'kindness' in performance, or of judicial oversight into whether a party had 'good cause' to act as it did."); *General Aviation, Inc. v. Cessna Aircraft Co.*, 703 F. Supp. 637, 644 (W.D. Mich. 1988) ("The implied covenant of good faith cannot be used by the Court as a tool for rewriting the parties' Agreement based on unspecified notions of fairness."), *aff'd*, 915 F.2d 1038 (6th Cir. 1990).

188. *Kham & Nate's*, 908 F.2d at 1357 ("Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of 'good faith.'").

189. *Id.* Some recent courts even have attempted to return the duty of good faith to its modest beginnings. Echoing its historical antecedent in classical contract law, one recent court has suggested that the duty of good faith "requires *only* 'that one party not make it impossible for the other party to perform the contract.'" *Burnette Techno-Metrics, Inc. v. TSI Inc.*, 44 F.3d 641, 643 (8th Cir. 1994) (emphasis added) (quoting *American Warehousing & Distrib., Inc. v. Michael Ede Management, Inc.*, 414 N.W.2d 554, 557 (Minn. Ct. App. 1987)); *see also* *H Enters. Int'l, Inc. v. General Elec. Capital Corp.*, 833 F. Supp. 1405, 1420 (D. Minn. 1993) (same). *But see* *White Stone Partners, LP v. Piper Jaffray Cos.*, 978 F. Supp. 878, 881 n.2 (D. Minn. 1997) (suggesting that these cases misread Minnesota law).

190. *See supra* notes 168-74 and accompanying text.

191. *See supra* notes 181-83 and accompanying text.

192. *Market Street Assocs.*, 941 F.2d at 596 (Posner, J.) (affirming nonetheless a denial of summary judgment on a good faith claim because of opportunistic behavior



In this light, the quotation from then-Judge Antonin Scalia with which this Article began takes on a meaning beyond mere rhetorical hyperbole.<sup>193</sup> To be sure, there is a core of truth in the argument that contracting parties retain the ability, through sufficiently explicit and informed agreements, to grant to one (or both) of them an unrestricted discretionary power on a specific subject.<sup>194</sup> Moreover, not all courts have fallen to the allure of textualism in the analysis of contractual good faith.<sup>195</sup> Nonetheless, if the extreme form of the new restrictive trend continues to gain momentum, we should take seriously the admonition that to view every express contractual power as absolute and

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by the defendant years after the conclusion of the contract at issue). This is simply an express statement of what is implicit in much of the new textualist approach to the duty of good faith. Judge Posner has suggested that contract law would be equally well served with a return to the common-law notions of strict interpretation and a reliance on "such implied conditions as are necessary to make sense of the contract." *Id.*

193. See *supra* note 1 and accompanying text (quoting the relevant passage in full). In *Tymshare*, Justice Scalia himself appeared to endorse the view that the doctrine of good faith is merely a modern version of the expanded "implied promise theory" as reflected in the early stages of the doctrine. See *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1152-54 (D.C. Cir. 1984) (suggesting that good faith may be synonymous with the notion of "implied contractual obligations and limitations"); see also *supra* notes 68-72 and accompanying text (discussing the early recognition of the doctrine of good faith).

194. See *infra* notes 282-325 and accompanying text. Even this power is subject to the limitation that such delegated discretion cannot render the parties' agreement illusory. See *infra* note 292 and accompanying text.

195. See, e.g., *Olympic Chevrolet, Inc. v. General Motors Corp.*, 959 F. Supp. 918, 922 (N.D. Ill. 1997) (holding that, although an automobile manufacturer "reserve[d] to itself discretion in accepting orders and distributing Motor Vehicles, and [deemed] its judgments and decisions [] final," such discretion was nonetheless subject to the duty of good faith); *Amoco Oil Co. v. Ervin*, 908 P.2d 493, 499 (Colo. 1995) (en banc) (affirming a jury verdict against lessor for bad faith calculation of rental charges even though contract granted lessor the discretion to set rent); *Olympus Hills Shopping Ctr., Ltd. v. Smith's Food & Drug Ctrs., Inc.*, 889 P.2d 445, 451 (Utah Ct. App. 1994) (affirming a jury verdict that supermarket breached duty of good faith by converting to discount store even though the contract permitted it to operate "any lawful retail selling business"); cf. *Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575, 587 (N.J. 1997) ("The obligation to perform in good faith exists in every contract, including those contracts that contain express and unambiguous provisions permitting either party to terminate the contract without cause."). For further cases in the same vein, see *infra* note 300. See also *infra* note 301 (citing cases that have held that even "sole discretion" clauses are subject to the duty of good faith).

unrestricted “is virtually to read the doctrine of good faith . . . out of existence.”<sup>196</sup>

### III. TEXT, EXPECTATION, AND THE “IMMUTABILITY” OF GOOD FAITH

It should not come as a surprise that the doctrine of good faith and fair dealing has become a focal point for controversy amidst the rising tide of textualism in contract law. At its core, the doctrine reflects the conviction that—in the case of discretionary powers at least—the interests of parties to contractual relationships are best served by a presumption in favor of flexibility over one of certainty, of fair and reasonable conduct over unrestricted self-interest. At some ill-defined level, therefore, this “mandatory” duty of good faith operates as an external standard that is not entirely dependent upon the force of party autonomy.

Adding fuel to the controversy is the fact that the doctrine of good faith admits of almost infinite elasticity. “[I]t is a chameleon,” as Judge Posner once famously described it.<sup>197</sup> As with all broad abstractions designed to govern practical circumstances, in other words, notions such as “good faith” and “fair dealing” mean little in isolation; they take on functional content only in the context of a specific human relation and the particular circumstances of their application.<sup>198</sup> Such doctrinal abstraction likewise creates a risk of “self-deception” by scholars and judges as they seek to give content to its amorphous directives.<sup>199</sup>

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196. *Tymshare*, 727 F.2d at 1154.

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

198. It is this fact in particular that has frustrated attempts to distill from the doctrine of “good faith” a unified, comprehensive norm that broadly requires cooperation and continual adjustment of contractual obligations, or that alternatively merely advances a goal of contractual “efficiency.” See *supra* note 116 (discussing relational contract theory), and 125 (discussing an economic approach to good faith). For an interesting analysis of the similarities between these two broad theories, see Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 275-78 (1992) (suggesting, with the assumption that most commercial parties would prefer efficient “default rules,” that a relational approach founded on the presumed intentions of the parties is essentially the same as a law and economics approach).

199. See Kent Greenawalt, *Discretion and Judicial Decision: The Elusive Quest for*

This Part examines the particular forms of “self-deception” at the core of the new textualist approach to the duty of good faith performance. The first section examines the textualist misapprehension of the nature of the expectations protected by the duty of good faith. The second section then turns to an analysis of this new restrictive trend’s flawed factual and normative foundations.

This Part concludes with a positive examination of the power of the parties to influence the content of their obligation of good faith. In the final section, we will see that contractors may indeed agree to confer on one party a discretionary right that is insulated from external standards of fair and reasonable conduct. I argue there, however, that the burden of expression to achieve that end should be a substantial one, and should fall decidedly on the party seeking to secure such rights.

#### A. “Interpretation,” Good Faith, and the Force of Expectation

Like many misguided theories, the primary error in the new textualist approach to the duty of good faith lies less in the logic of its analysis than in the assumptions with which that analysis begins. The first such premise is that the only relevant understandings and expectations in interpretive inquiries are those that have found their way into the express terms of the parties’ writing.<sup>200</sup> From this foundation, it is indeed but a small step to the conclusion that an express contractual power permits an interpreter to dispense with an analysis of “good faith” in the exercise of that power.<sup>201</sup>

This approach fundamentally misapprehends the nature of the expectations protected by the duty of good faith performance. The new textualism in fact goes astray even at the level of “interpretation” in the narrow sense of divining the “meaning” of contractual text. As shown above, the flexible interpretive approach sanctioned in the *Uniform Commercial Code*,<sup>202</sup> now fol-

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*the Fetters That Bind Judges*, 75 COLUM. L. REV. 359, 397 (1975) (“[O]ur capacity for self-deception increases as the level of abstraction gets higher.”).

200. See *supra* notes 168-69 and accompanying text.

201. See *supra* notes 171-80 and accompanying text.

202. See *supra* notes 49-58 and accompanying text.

lowed in substance by the *Second Restatement of Contracts*,<sup>203</sup> rejects the rigid formalism of classical common-law interpretation. Instead, the Code embraces a flexible, contextual understanding of contractual obligations.<sup>204</sup> Thus, the determinative inquiry into the actual "agreement" of the parties is not limited to the language the parties employ; rather, it extends to understandings that arise by implication from other circumstances as well, including the past experiences, practices, and relationship of the parties.<sup>205</sup>

The express terms of a writing remain, of course, the prime source for interpretive evidence.<sup>206</sup> The core message here, however, is that the modern approach to interpretation sweeps away the classical premise that express terms reflect the final repository of relevant evidence for defining contractual rights and obligations.<sup>207</sup> In its place now stands a flexible search for content and meaning, in text and context, experience and practice, and even the conduct of the parties in performance.<sup>208</sup>

Properly appreciated, the doctrine of good faith performance serves as a final, flexible component in this realist understanding of the contracting process. At its most elemental level, the

203. See *supra* notes 59-63 and accompanying text.

204. See U.C.C. § 1-102 (1995) (explaining that the purposes of the Code are to "permit the continued expansion of commercial practices through custom, usage and agreement of the parties" and that the provisions of the Code are to "be liberally construed").

205. *Id.* § 1-201 cmt. 3 (stating that the Code concept of agreement "is intended to include full recognition of usage of trade, course of dealing, course of performance and the surrounding circumstances as effective parts thereof"); see *supra* notes 50-52, 55-58 and accompanying text (discussing the significance of the parties' "bargain in fact" in defining contractual rights and obligations).

206. See *supra* notes 64-65 and accompanying text (discussing the significance of express terms under both the UCC and the *Second Restatement*). The precept of the primary importance of express terms also operates subject to the more powerful directive that an interpreter first exhaust all reasonable means of reconciling the various interpretive sources. See *supra* note 64 and accompanying text (citing U.C.C. §§ 1-205(4), 2-208(2), and RESTATEMENT (SECOND) OF CONTRACTS § 202(5) (1981)); see also PEB COMMENTARY NO. 10, *supra* note 15, at 4 ("The concept of agreement is not limited to the terms of the parties' writing; it includes a variety of elements, all of which must be synthesized."); Patterson, *supra* note 15, at 524 (providing the source from which this statement clearly is derived).

207. See *supra* notes 46-63 and accompanying text.

208. See *id.*

doctrine reflects the simple idea that some expectations may be so fundamental or obvious to the parties that neither sees a necessity to raise them in negotiations (if negotiations occur at all), nor certainly to demand that they be reduced to writing.<sup>209</sup> Beyond even the notions of usage of trade and its conceptual cousins,<sup>210</sup> the duty of good faith thus enriches our understanding of the circumstances that can explain, supplement, or even qualify the express terms of the parties' agreement.<sup>211</sup> The duty operates, in other words, as an unspoken clarifier and qualifier, as an indispensable adjective in a field of the parties' agreed nouns.

In this sense, then, the duty of good faith repudiates the textualist notion that an interpreter can wring the full volume of the parties' contractual relationship from the skin of their express contract.<sup>212</sup> The essential function of that duty is, rather, to direct attention to the spirit of the parties' deal,<sup>213</sup> to the less

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209. Arthur Corbin long ago recognized that such considerations lie at the heart of the duty of good faith. See 3 CORBIN, *supra* note 86, § 570(A) (Supp. 1998) (arguing that the duty of good faith "is but a recognition that the parties occasionally have understandings or expectations that were so fundamental that they did not need to negotiate about those expectations"); see also *infra* notes 247-63 (exploring this point in greater detail).

210. See U.C.C. § 1-203 cmt. (noting that the duty of good faith is not limited to, but is only "further implemented" by Section 1-205 on course of dealing and usage of trade" and that the doctrine of good faith "directs a court towards interpreting contracts within the commercial context in which they are created" (emphasis added)).

211. See *supra* notes 52-54, 63 (explaining that under both the UCC and the *Second Restatement*, implied terms such as usages of trade and courses of dealing and performance can "give[] meaning to or supplement [] or qualify[]" the terms of the parties' agreement).

212. What is particularly astonishing about the rise of the new textualism is that this point found recognition—although in limited fashion—in some of the earliest treatments of the duty of good faith:

[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.

Summers, *supra* note 89, at 233; see also Burton, *supra* note 79, at 371 ("[E]xpress contract terms alone are insufficient to determine a party's good faith in performance."); *id.* at 380 n.44 (recognizing that "express language . . . will fail to set forth all of the specific undertakings of the parties").

213. See 3 CORBIN, *supra* note 86, § 570(A) (Supp. 1998) (arguing that the duty of good faith directs an interpreter to be sensitive to the "spirit of the bargain" over

tangible expectations that coalesce around the formation of their relationship.<sup>214</sup>

Indeed, on this point (like few others) one finds a noteworthy harmony in the case law and literature. Among commentators<sup>215</sup> and the courts<sup>216</sup> alike there is now substantial agreement that

“the technicalities of the language”); Summers, *supra* note 9, at 827 (“[I]t is one function of the good-faith performance doctrine to enforce the spirit of deals, including their unspecified inner logic.”). Courts also have recognized this function of good faith. *See Hoffman-La Roche, Inc. v. Campbell*, 512 So. 2d 725, 738 (Ala. 1987) (describing the duty of good faith as “the obligation to preserve the spirit of the bargain rather than the form”); *Fisher v. Toombs County Nursing Home*, 479 S.E.2d 180, 184 (Ga. Ct. App. 1996) (“‘Good faith’ is a shorthand way of saying substantial compliance with the spirit, and not merely the letter, of a contract.”); *Hilton Hotels Corp. v. Butch Lewis Prods, Inc.*, 808 P.2d 919, 922-23 (Nev. 1991) (holding that a breach of the duty of good faith and fair dealing occurs when “one party to the contract deliberately countervenes the intention and spirit of the contract”).

214. Discussion of the duty of good faith is entirely inapt in the context of the parol evidence rule, whatever its particular manifestation; that rule merely targets prior or contemporaneous “agreements” between the parties. *See* U.C.C. § 2-202; RESTATEMENT (SECOND) OF CONTRACTS, § 213 (1981); *cf.* WHITE & SUMMERS, *supra* note 102, at 83 (arguing that even a perfectly worded merger clause “would not keep out evidence . . . introduced to impose rights and duties [on the parties] that arise by operation of law”). Nor would it seem appropriate to consider good faith as an implied “term” at all, for the definition of that concept merely returns the analysis to the parties’ “agreement.” *See* U.C.C. § 1-201(42) (defining a “term” merely as “that portion of an agreement which relates to a particular matter”).

215. *See* BURTON & ANDERSEN, *supra* note 71, at 52-57 (focusing even more directly on the parties’ “justified expectations”); Burton, *supra* note 79, at 389-91 (describing the “foregone opportunities” approach in light of the reasonable expectations at the time of performance); Farnsworth, *supra* note 15, at 669 (arguing that good faith “require[s] cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations”); Overby, *supra* note 125, at 978 (asserting that “[a] consensus may be drawn that the obligation of good faith serves to protect the ‘reasonable expectations of the parties’” (citation omitted)). Although adhering to the view that the concept of good faith is incapable of precise articulation, Professor Summers also has recognized that “[i]n most cases the party acting in bad faith frustrates the justified expectations of another.” Summers, *supra* note 89, at 263. *But see* Diamond & Foss, *supra* note 79, at 593-94 (arguing that a reasonable expectations approach fails to provide courts with sufficient guidance on the application of the duty of good faith).

216. Recent years, in particular, have witnessed a strong and growing consensus in the courts that the duty of good faith is directed at the protection of justified or reasonable expectations. *See, e.g.,* McIlravy v. Kerr-McGee Corp., 119 F.3d 876, 881-82 (10th Cir. 1997); MJ & Partners Restaurant Ltd. Partnership v. Zadikoff, 995 F. Supp. 929, 932-33 (N.D. Ill. 1998); Ruffalo v. CUC Int’l, Inc., 989 F. Supp. 430, 435 (D. Conn. 1997); Riddell Sports, Inc. v. Brooks, No. 92 Civ. 7851 (JGK), 1997 WL 148818, at \*2 (S.D.N.Y. Mar. 27, 1997); Fusion, Inc. v. Nebraska Aluminum Cast-

the doctrine of good faith performance protects the “reasonable” or “justified” expectations of the contracting parties.<sup>217</sup> Similarly, the *Second Restatement*, though adhering in principle to Professor Summers’s “excluder analysis,” emphasizes such notions in its description of the duty of good faith.<sup>218</sup> A recent Commentary by the Code’s Permanent Editorial Board likewise concluded that the protection of reasonable expectations lies at the foundation of the Code’s conceptualization of good faith.<sup>219</sup>

The duty of good faith performance applies, of course, against the background of the parties’ formal agreement. That is, the express terms of the parties’ agreement remain a prime source for creating (and limiting) their expectations as to future performance.<sup>220</sup> Some commentators have sought to ease the tension here by emphasizing, at least within the scope of the Code, the breadth of the notion of “agreement.”<sup>221</sup> Under this view, the

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ings, Inc., No. 95-2366-JWL, 1997 WL 51227, at \*17 (D. Kan. Jan. 23, 1997); Infomax Office Sys., Inc. v. MBO Binder & Co. of Am., 976 F. Supp. 1247, 1251 (S.D. Iowa 1997); Amoco Oil Co. v. Ervin, 908 P.2d 493, 499 (Colo. 1995) (en banc); Kirkwood Kin Corp. v. Dunkin’ Donuts, Inc., No. 94C-03-189-WTQ, 1997 WL 529587, at \*15 (Del. Super. Ct. Jan. 29, 1997); Citicorp Savings v. Rucker, 692 N.E.2d 1319, 1324 (Ill. App. Ct. 1998). For a list of earlier cases holding to the same effect, see BURTON & ANDERSEN, *supra* note 71, at 54 n.39; Diamond & Foss, *supra* note 79, at 594 n.2.

217. Another common judicial formulation is that the duty of good faith prohibits conduct that would deprive a party of the “fruits” or “benefits” of the contract. *See, e.g.,* Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 139 F.3d 1396, 1403 (11th Cir. 1998); Chambers Dev. Co. v. Passaic County Utils. Auth., 62 F.3d 582, 587 (3d Cir. 1995); Public Serv. Co. v. Burlington N.R.R. Co., 53 F.3d 1090, 1097 (10th Cir. 1995); *see also* Diamond & Foss, *supra* note 79, at 597-98, nn. 53-54 (citing further cases). This approach does not differ appreciably from the “reasonable expectations” view, and in fact is often cited merely as another formulation of the same standard. *See, e.g.,* Premier Technical Sales, Inc. v. Digital Equip. Corp., No. 96-21054 SW, 1998 WL 296732, at \*2 (N.D. Cal. May 22, 1998); Sons of Thunder, Inc. v. Borden, Inc., 690 A.2d 575, 589 (N.J. 1997); PDQ Lube Ctr., Inc. v. Huber, 949 P.2d 792, 797 (Utah Ct. App. 1997).

218. *See supra* note 113 and accompanying text (observing that under the *Second Restatement* good faith “emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party”).

219. *See* PEB COMMENTARY NO. 10, *supra* note 15 (concluding that “as expressed in the Code, [good faith] serves as a directive to protect the reasonable expectations of the contracting parties”).

220. *See supra* notes 64-65 and accompanying text (discussing the significance of express terms under both the UCC and the *Second Restatement*).

221. *See* PEB COMMENTARY NO. 10, *supra* note 15; PATTERSON, *supra* note 50, at 20-30;

flexible definition of agreement embraces the duty of good faith as part of the broader examination of the parties' "bargain in fact."<sup>222</sup> Such reasoning has led the Code's Permanent Editorial Board, for instance, to conclude—without an apparent intent to dilute the force of good faith—that there is a direct link between the content of the parties' agreement and that of the duty of good faith.<sup>223</sup>

Properly understood, this observation is not inaccurate.<sup>224</sup> It nonetheless unnecessarily creates the impression that content of the duty of good faith is derived solely from, and thus in every case is limited by, an interpretation of the formal "bargain" between the parties. In doing so, this approach may invite the precise kind of formalist manipulation of the duty of good faith reflected in the textualist approach to the doctrine. Indeed, the common refrain of the new textualists is that an express term in a contract reflects the totality of the parties' "agreement" on the subject, and thus by definition renders any contrary expectation of the dependent party "unreasonable."<sup>225</sup>

Constructing the determinative expectations solely on the foundation of the parties' formal "agreement" thus may distort the analysis of the duty of good faith before it begins.<sup>226</sup> The

Patterson, *supra* note 15, at 523-24.

222. See PEB COMMENTARY NO. 10, *supra* note 15; Patterson, *supra* note 15, at 523-24.

223. See PEB COMMENTARY NO. 10, *supra* note 15 ("[I]t is important to recognize that one acts in good faith relative to the agreement of the parties. To decide the question whether a party has acted in good faith, a court must first ascertain the substance of the parties' agreement."); see also Patterson, *supra* note 15, at 523 (providing the source from which this observation of the PEB is derived).

224. The Commentary elsewhere suggests that good faith has a "conceptual content" that merely is "related to that of agreement." See PEB COMMENTARY NO. 10, *supra* note 15, at 2 (emphasis added).

225. See *Barnes v. Burger King Corp.*, 932 F. Supp. 1420, 1438 (S.D. Fla. 1996) ("The implied covenant of good faith should not be invoked to override the express terms of the *agreement* between the parties." (emphasis added)); *James v. Whirlpool Corp.*, 806 F. Supp. 835, 844 (E.D. Mo. 1992) (explaining that the implied duty did not "override express terms of the *agreement*" between the parties (emphasis added)); *supra* notes 151-69.

226. See Burton, *supra* note 79, at 5 ("The content [of good faith] should be determined with reference to the agreement of the parties. However, the obligation could be deleted from the [Code] without material effect if this were *all* that good faith performance meant.").



analysis would begin on a sounder footing if it considered contractual expectations in all their complexity. Like most social facts, such expectations can appear in a broad continuum of generality and specificity. Some may indeed be “agreement-like”—well-formed and consciously shared by the parties.<sup>227</sup> Similarly, some may arise under the influence of less tangible, yet still well-recognized implied sources such as usages of trade.<sup>228</sup>

The important message here is that these forms of expectation are illustrations not limitations. Indeed, the duty of good faith will have its most significant impact—in the case of discretionary contractual powers in particular<sup>229</sup>—when the expectations that arise from experience, relationship, and context have not been distilled into fixed, shared understandings between the parties. A party thus can have protected expectations in absence of a conforming common practice in the relevant trade<sup>230</sup> or even of a formal “sequence of previous conduct”<sup>231</sup> with her trading partner.<sup>232</sup> Nor should the duty of good faith require for its oper-

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227. In fact, the overlay of good faith may add little to the analysis in this context, for the standard rules of contract interpretation will protect the shared expectations of the parties independent of the duty of good faith. Admittedly, the line between the shared expectations that are enforceable under standard rules of contract interpretation and those protected by good faith may be a blurry one. See W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21 (1984) (providing a comprehensive argument that the “new meaning” in contract law broadly gives effect to “reasonable expectations”); see also John E. Murray, Jr., *The Article 2 Prism: The Underlying Philosophy of Article 2 of the Uniform Commercial Code*, 21 WASHBURN L.J. 1, 17 (1981) (arguing that the Code’s conception of bargain includes even those “reasonable expectations” that are not fully formed at the time of contract formation); Barry Reiter & John Swan, *Contracts and the Protection of Reasonable Expectations*, in *STUDIES IN CONTRACT LAW* 1, 11 (Barry J. Reiter & John Swan eds., 1980) (arguing that the protection of reasonable expectations is evident throughout contract law).

228. See U.C.C. § 1-203 cmt. (1995) (noting that the obligation of good faith merely is “further implemented” by usages of trade and its conceptual relatives).

229. For more on the significance of discretionary powers, see *infra* notes 244-63 and accompanying text.

230. See *supra* note 52 and accompanying text (discussing the Code’s definition of a usage of trade in section 1-205(2)).

231. U.C.C. § 1-205(1); see *supra* note 53 and accompanying text (discussing the Code’s definition of a course of dealing in section 1-205(1)).

232. See Summers, *supra* note 89, at 199 (stating that a court may rely on good faith “to enforce the unspecified ‘inner logic’ of a deal when custom and usage are

ation that both parties “agree” on, or even have actual knowledge of, the expectations of the other.

At this level, in other words, we depart the realm of interpretation in the narrow sense of divining “meaning” from contractual text and enter under the influence of the “reasonableness” or “justifiability” of party expectations.<sup>233</sup> That is, beyond even the standard rule of interpretation according to shared expectations, the duty of good faith may well protect *unilaterally-held* expectations that arise in the contracting process.<sup>234</sup> Indeed, as the parties’ willingness and ability to contemplate future events in concrete terms wears thin, the doctrine of good faith supplies what might be seen as a “presumed expectation.” That “expectation” is the minimum standard of reasonableness and fair dealing in the relevant community in which the parties’ contractual obligations arose and are to be performed.<sup>235</sup>

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silent and when the true basis for implying a promise is that good faith requires as much”); see also Farnsworth, *supra* note 15, at 677 (arguing that the Code’s definition of good faith applicable to merchants—which now applies with a much broader scope under the Code, see *supra* notes 94-96 and accompanying text—“requires only a showing of ‘reasonable commercial standards of fair dealing,’ which is presumably something less than proof of a course of dealing or usage of the trade”).

233. Indeed, the very concept of “discretion” in performance is that the parties have not given a final “meaning” to the express terms that define their relationship at the formation stage. See *Amoco Oil Co. v. Ervin*, 908 P.2d 493, 498 (Colo. 1995) (en banc) (observing with regard to the duty of good faith performance that the “reasonable expectations doctrine often ‘fails to give effect to some hornbook rules governing the construction of contracts,’ including ‘the precept that contracts which are free from ambiguity are to be enforced as written’” (quoting *Davis v. M.L.G. Corp.*, 712 P.2d 985, 990 & n.7 (Colo. 1986))). See also *infra* notes 255-62 and accompanying text.

234. See RESTATEMENT (SECOND) OF CONTRACTS, § 205 cmt. a (1981) (noting that good faith emphasizes faithfulness to the justified expectations “of the other party”). Although good faith permits a focus on the expectations of even one of the parties, the standard is an objective one for that party’s expectations. Thus, unreasonable subjectively held expectations will not find protection under the duty of good faith.

235. One might reformulate aspects of Professor Summers’s “excluder analysis” to accommodate this point. Although he may not embrace a comprehensive use of “expectation” terminology, Professor Summers recognized that one of the essential functions of the duty of good faith is to supply a minimum standard of fair dealing in contractual relationships. See Summers, *supra* note 9, at 812; see also RESTATEMENT (SECOND) OF CONTRACTS, § 205 cmt. a (describing good faith in light of “community standards” of fairness and reasonableness); HILLMAN ET AL., *supra* note 99, ¶ 6.03[2] (arguing that “[t]he underlying basis” for a decision concerning the duty of good faith “is often determined on fundamental notions of fairness”).

Consider as an illustration the case of *Best v. United States National Bank*.<sup>236</sup> In that case, bank depositors alleged a breach of the duty of good faith in the bank's post-formation adjustment of the service charge for checks drawn against insufficient funds.<sup>237</sup> The significant aspect of the Oregon Supreme Court's opinion was its recognition that the duty of good faith can derive independent force from *both* extant community standards of fairness *and* the parties' more concrete expectations that arise in the formation of their relationship.<sup>238</sup> Thus, although the court noted that commercial parties ordinarily can expect performance in a "commercially reasonable" manner, it found that "the reasonable expectations of the parties need not be so limited."<sup>239</sup> In the process, the court also properly focused the analysis on the reasonable expectations of *the depositors* as to the bank's exercise of its contractual discretion.<sup>240</sup> It ultimately affirmed a denial of the bank's motion for summary judgment, even though the parties' contract defined no limitation on the bank's discretion in setting insufficient fund fees.<sup>241</sup>

The essential point here is that the expectations that are protected by the duty of good faith are not necessarily constructed by a formal process of "agreement" between the parties. To be

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236. 739 P.2d 554 (Or. 1987).

237. *See id.* at 556-57.

238. *See id.* at 557-58.

239. *Id.* at 558. In a more problematic passage, the court also opined that in some cases external standards of fairness may operate to discipline extreme abuses of a discretionary power even apart from the reasonable expectations of the other party. *See id.* at 559 ("When a party has the contractual right to specify a price term, the term specified may be so high or low that the party will be deemed to have acted in bad faith regardless of the reasonable expectations of the other party.").

240. *See id.* at 558-60; *see also* *Maljack Prods., Inc. v. Motion Picture Ass'n of Am.*, 52 F.3d 373, 375-76 (D.C. Cir. 1995) (focusing on allegations regarding the plaintiff's reasonable expectations in denying a motion to dismiss a breach of duty of good faith claim).

241. *See Best*, 739 P.2d at 557 (affirming the denial of the motion for summary judgment even though "[n]othing in the depositors' account agreement with the Bank expressly limited the Bank's authority to set [nonsufficient fund] fees"). Unfortunately, in subsequent years the Oregon Supreme Court apparently also has fallen under the influence of the new textualism in contract. For a critical review of this apparent trend, see Webster, *supra* note 20, at 541-48 (discussing, in particular, *Uptown Heights Assocs. Ltd. Partnership v. Seafirst Corp.*, 891 P.2d 639 (Or. 1995), and *Tolbert v. First Nat'l Bank*, 823 P.2d 965 (Or. 1991)).

sure, the express agreement of the parties will influence the reasonableness of specific expectations, a point addressed in greater detail below.<sup>242</sup> Contrary to the animating philosophy of the new textualism, however, the face of that express agreement alone cannot determine the full force of the protected expectations. The core function of the duty of good faith, rather, is to permit the parties to have legally cognizable expectations (if “reasonable” under the circumstances) that do not necessarily find expression in the parties’ formal agreement.<sup>243</sup>

## *B. Examining the Factual and Normative Premises of Textualism*

### *1. Discretion and “Hidden Gaps” in Contracts*

The second major misapprehension of the new textualist approach to the duty of good faith lies in its assumptions about the context in which discretionary rights arise. Recall that the common premise on this score is that every express contractual power is absolute.<sup>244</sup> That is, consonant with their fixation on express terms, the new textualists credit a failure to incorporate an *express* limitation on discretion as an “agreement” between the parties that no such limitation exists.<sup>245</sup> Because the duty of good faith does not create an independent obligation of fairness or altruism, they reason, the law provides no conceptual tools for judicial “second-guessing” of the “privileges expressly reserved” in the parties’ writing.<sup>246</sup>

The textualist approach to the duty of good faith also founders on the frailty of this factual foundation. In particular, the new

242. See *infra* notes 321-25 and accompanying text.

243. This is not to say that the duty of good faith creates free-floating obligations that are separate from the parties’ actual contractual relationship. See U.C.C. § 1-203 cmt. (noting that the duty of good faith “does not create a separate duty of fairness and reasonableness which can be independently breached”) (added by PEB COMMENTARY NO. 10, *supra* note 15). It merely means that, contrary to the presumption of textualism, the *expectations* as to the exercise of contractual discretion cannot be divined solely from a review of the express terms of a contract.

244. See *supra* notes 171-74 and accompanying text.

245. See *supra* notes 184-85 and accompanying text.

246. See *Kham & Nate’s Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990); see also *supra* notes 184-86 and accompanying text (discussing the textualist conception of discretion).

textualist view entirely disregards the now well-accepted fact that there are significant limitations in any negotiation and drafting process.<sup>247</sup> The imprecision of language itself precludes the parties from reducing even complete, determinate understandings into words that are unambiguous to independent interpreters.<sup>248</sup> Moreover, as other scholars have amply demonstrated, necessary information for accurate decisionmaking may be dispersed too greatly or not available to the parties at all.<sup>249</sup> Limitations on human rationality itself<sup>250</sup> will also constrain the ability of transactors to contemplate future events, and thus to provide for all relevant contingencies in their express agreement.<sup>251</sup> Even if theoretically possible, it simply is impractical or

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247. Indeed, much of the voluminous literature on identifying the appropriate default rules for incomplete contracts is founded on this notion. For an introduction into this literature, see Ayers & Gertner, *supra* note 13, at 92 n.29 (discussing the ways in which contracts are incomplete); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1819-20 (1991) (concluding that “[a]s a practical matter . . . most contracts are quite incomplete”). For a comprehensive analysis of the subject of incomplete contracts, see Symposium, *Default Rules and Contractual Consent*, 3 S. CAL. INTERDISC. L.J. 1 (1993).

248. This of course is one of the core tenets of the realist criticism of the interpretive rules of classical formalism. See *supra* notes 47-48 and accompanying text; see also David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373, 462 (1990) (“[G]iven the inherent imprecision of even highly technical legal language, it is impossible for transactors to craft language so precisely that it is certain to cover the exact scope of the contingency intended to be covered . . . .”); Goetz & Scott, *supra* note 49, at 265-73 (examining the impediments to accurate signaling of the parties’ actual agreement); Murray, *supra* note 35, at 1344 (“The parties may attempt to state their agreement in clear and unambiguous words; but try as they may they will fail, for scarcely any word is capable of denoting one thought.”).

249. See Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 831-35 (1992) (discussing the “[l]imited [a]ccessibility of [p]ersonal and [l]ocal [k]nowledge”); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 393-96 (1993) (analyzing the substantial informational barriers to full negotiation).

250. See generally Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995); Zamir, *supra* note 135, at 1793-95 (observing that “many studies demonstrate the limited cognitive capabilities of people” and citing extensive literature on the subject). See also Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices*, 59 S. CAL. L. REV. 329 (1986) (discussing the effect of limited rationality on decisionmaking).

251. Allan Farnsworth aptly has described this phenomenon in terms of the “limited attention” of transactors. See Farnsworth, *Omission*, *supra* note 29, at 868-71 (ar-

too costly for them to negotiate over every potentially relevant detail.<sup>252</sup>

These limitations on the agreement process may apply, significantly, even where the parties' writing grants to one party an otherwise unrestricted discretionary power. Even if the parties recognize the breadth of such a power, it simply may be impractical or too costly to negotiate over all of the implications covered by the general language. Similarly, the parties may altogether fail to foresee the implications from the use of a general term, even for the circumstances known at the time of a drafting.<sup>253</sup> Finally, and perhaps most significantly in the present context, one or both of the parties may refrain from raising issues that might call into question the good faith of the other, for fear of appearing untrustworthy or litigious themselves.<sup>254</sup>

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going that this limited attention precludes transactors from forming expectations as to all possible future contingencies, and from reducing even all of their actual expectations into formal contract language in any event).

252. Even a brief list of such practical impediments to full negotiation would include the following: increased expenses and inconvenience of investigating the background of the other party, time and personnel costs of negotiation, drafting costs of distilling all details into contract language, legal fees for resolving unclear issues of law, costs of researching and assessing all potential contingencies (both their magnitude and the likelihood of their occurrence), and monitoring and verification costs. *See also* Ayres & Gertner, *supra* note 13, at 92-93 (describing the various transaction costs that give rise to contractual incompleteness); Charny, *supra* note 247, at 1819 ("In almost all transactions, it would be extremely costly to draft a contract that purported explicitly to address the obligations of the parties for all conceivable future contingencies.").

253. *See* RESTATEMENT (SECOND) OF CONTRACTS § 203 cmt. e (1981) ("People commonly use general language without a clear consciousness of its full scope and without awareness that an exception should be made."). Other scholars also have recognized the phenomenon of "gaps" even in express contractual terms. *See* Ayres & Gertner, *supra* note 13, at 92 n.29 (observing that gaps can arise even when the "parties' duties are fully specified" if "those specified duties are not tailored to economically relevant future events"); Farnsworth, *Omission*, *supra* note 29, at 875, n.86 (describing this problem as an "overstatement" of the parties' shared expectation); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 272 (1992) (arguing that gaps can exist where the parties define their respective obligations "too coarsely").

254. *See* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 765 (1992) (arguing that where general terms are once proposed, the parties "may be reluctant to suggest alternative provisions . . . because to do so might indicate that the individual is more litigious or more rigidly deontological, and thus more costly to deal with"); Farnsworth, *Omission*, *supra* note 29, at 872 (suggesting that parties may prefer not to reduce

In any case, what may well remain even with otherwise unqualified language in a writing is what might be termed a "hidden gap" in the parties' contract.<sup>255</sup> The gap here, to be sure, does not appear on the face of the contract's terms; what emerges on detailed inspection, rather, is a gap in the parties' actual shared understandings. The risk of such gaps in understanding will only increase with the complexity of the specific contractual relationship as well as under the corrosive effect of the passage of time.<sup>256</sup>

These observations take on particular significance when one party is granted a discretionary power to control an aspect of the parties' relationship after formation. Indeed, the very circumstances that preclude precise articulation of the parties' agreement on an issue suggest that a good faith limitation is a necessary companion of contractual discretion.<sup>257</sup> One recent court's distillation of this thought is worthy of quotation:

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expectations to express terms in order to avoid unnecessary delay or a frustration of the proposed deal); *cf.* RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. b (observing with regard to omissions in contracts that the parties may fail to manifest an expectation "because discussion of it might be unpleasant or might produce delay or impasse").

255. For a similar analysis of the "hidden gaps" in a treaty or statute, see Van Alstine, *supra* note 3, at 768-75.

256. The particular case of long-term contracts has provoked a spirited debate in the literature. Compare Robert A. Hillman, *Court Adjustment of Long-Term Contracts: An Analysis Under Modern Contract Law*, 1987 DUKE L.J. 1 (arguing in favor of judicial adjustment of long-term contractual relationships under certain circumstances), and Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 NW. U. L. REV. 369 (1981) (same), with Clayton P. Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521 (1985) (disagreeing with Professor Speidel). See generally Macneil, *Adjustment*, *supra* note 116, at 854 (examining judicial adjustment of long-term contracts under the various prominent approaches to the issue); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987) (analyzing the decisionmaking strategies of parties to long-term commercial contracts).

257. See B.J. Reiter, *Good Faith in Contracts*, 17 VAL. U. L. REV. 705, 727 (1983). Mr. Reiter argues that:

[Good faith] reminds us of the incompleteness of written or even oral records of contracts. The limits of human foresight, the costs and threat to solidarity of increased specificity, and the insurmountable barrier to complete communication attributable to our individuality ensure that no record of a contract can be complete and identically understood by all.

*Id.* The emphasis on the role of good faith in limiting discretionary powers is one of

The implied covenant of good faith and fair dealing particularly comes into play in those circumstances where the parties to the contract realize detailed provisions on performance would be ineffectual, frustrating, or impractical. The parties are then forced to confer control of a contract term . . . upon one another, leaving each to depend on the good faith of the other.<sup>258</sup>

Every contractual right admits, of course, of some form of discretion for its beneficiary. Even a fixed price term, for instance, permits the buyer the "discretion" not to insist on strict enforcement, or to acquiesce expressly in requested adjustments.<sup>259</sup> This, however, is a discretion of a different nature. In that case, the parties have defined an obligation (a set amount of U.S. Dollars, for example) whose content is determinable by a fixed standard external to their control. Such an obligational term can take effect (and be enforced judicially), therefore, *without* the exercise of discretion by either party.<sup>260</sup> In this situation,

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the key contributions of Professor Steven Burton. See BURTON & ANDERSEN, *supra* note 71, at 45-51 (discussing "discretion in performance"); Burton, *supra* note 79, at 372-73 (discussing the importance of contractual discretion for good faith analysis); Burton, *Reply*, *supra* note 89, at 501-03 (elaborating on the notion of "discretion in performance"); *supra* notes 121-24 and accompanying text.

258. *Pizza Management, Inc. v. Pizza Hut, Inc.*, 737 F. Supp. 1154, 1178 (D. Kan. 1990).

259. Commercial parties, in fact, commonly accede to such requests for a variety of nonlegal reasons, chief among them reputational concerns and the interests of amicable relations in the future. See Charny, *supra* note 248, at 392-97 (analyzing the various nonlegal incentives for cooperation such as reputational and relational concerns); Gillette, *supra* note 256, at 556-59 ("Commercial actors do tend to work out difficulties that result from disruptive events, to renegotiate previously struck bargains, and to resolve disputes amicably without resort to legal process."); James J. White, *Contract Law in Modern Commercial Transactions, An Artifact of Twentieth Century Business Life?*, 22 WASHBURN L.J. 1, 6-10 (1982) (discussing the same phenomenon).

260. A similar point can be made about contractual clauses that take effect automatically upon the occurrence of some external event and thus do not depend for their application on an affirmative exercise of discretion by either of the parties. The duty of good faith *performance* may not apply, for example, when a contract terminates on the basis of an event external to the control of the parties (often, the mere passage of time) and without an exercise of discretion by either of them. See, e.g., *Blue Cross & Blue Shield Mutual v. Blue Cross & Blue Shield Ass'n.*, 110 F.3d 318, 331 (6th Cir. 1997) (finding no breach of good faith when contract terminated automatically upon a third party's petition for appointment of a trustee over the



the duty of good faith does not operate, as the new textualists seem to fear, as a universal solvent capable of dissolving the express "agreements" of the parties.<sup>261</sup>

Matters are different, however, when a contractual provision permits an exercise of discretion by one party in the first instance. In contrast to our fixed price term, a clause granting, for example, a right to determine the timing of performance, or a power to terminate a contract or to consent to assignment, becomes relevant only *through* a party's affirmative exercise of discretion. Here, the very content of the parties' obligations remains indeterminate at the time of formation, for one of them retains a power to control that aspect of their relationship through unilateral action. The very existence of post-formation discretion means that the parties' express agreement lacks a fixed standard that is external to their control. At some undefined level, therefore, the value of the contractual relationship to one of the parties remains subject to the will of the other.

This lack of a defined external standard to govern the discretion gives rise with particular force to the concerns discussed above about an *absence* of agreement between the parties. To say that the content of the contract is subject to one party's discretion, in other words, tells us little about the parties' actual expectations concerning the exercise of that discretion.<sup>262</sup>

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plaintiff's assets); *Elliott & Frantz, Inc. v. Svedala Indus., Inc.*, No. CIV.A. 97-3804, 1997 WL 799449, at \*4 (E.D. Pa. Dec. 30, 1997) (finding that good faith did not apply to an automatic termination provision); *Farris v. Hutchinson*, 838 P.2d 374, 376-77 (Mont. 1992) (same). Even in this situation, however, a duty of good faith in the *enforcement* of the contract may well apply. See BURTON & ANDERSEN, *supra* note 71, at 306-11. Moreover, the required examination of contextual evidence may reveal, for example, a prior course of dealing to the effect that the parties' relationship was a continuing one subject to a "discretionary" right of termination. For a comprehensive analysis of the issues surrounding the termination of contractual relationships, see Robert A. Hillman, *An Analysis of the Cessation of Contractual Relations*, 68 CORNELL L. REV. 617 (1983).

261. Other contract doctrines, most notably unconscionability, may apply in such a case, however. See, e.g., U.C.C. § 2-302 (1995). See also *infra* notes 353-55 and accompanying text.

262. Cf. *Tymshare, Inc. v. Covell*, 727 F.2d 1145, 1154 (D.C. Cir. 1984) (Scalia, J.) (noting that even in administrative law an agency's expressly conferred powers are subject to an "abuse of discretion" standard).

The new textualist approach to good faith thus founders on this essential point as well. The observation that one of the parties has “reserved a privilege” to take a certain action merely begs the question of what standards (if any) should govern the exercise of such discretion. The parties may well have agreed that the discretionary power was to be absolute and unrestricted; indeed, in some circumstances it may be in the best interest of both parties to do so.<sup>263</sup> To say that this follows from the mere fact of discretion, however, is to begin the analysis with its own conclusion.

## 2. *Exposing Textualism’s Flawed Normative Foundation*

Stripped of its factual assumptions, the new textualism in contract merely offers a normative conclusion about the bargaining process: Where a contract grants to a party an express discretionary power, the burden should fall to the *other party* to negotiate an express limitation.

Like so much of the new textualist approach, this notion traces its lineage to classical formalism.<sup>264</sup> It thus should not be surprising that the new textualist case law finds its animating tenet on this score in an opinion from 1933: “[I]n commercial transactions it does not in the end promote justice to seek strained interpretations in aid of those who do not protect themselves.”<sup>265</sup> Under this view, in short, the limitations on discretion

263. Cf. Charny, *supra* note 248, at 458 (arguing against an overly broad interpretation of the duty of good faith because borrowers may “rationally want to delegate discretion to the bank — for example, to signal their superior reliability or to induce the bank to accept arrangements that are riskier in other respects”); Fischel, *supra* note 125, at 142 (arguing in the lender-creditor context that a grant of discretion to the lender in extending and terminating financing is “best understood as [a] bonding mechanism[] used by the borrower to obtain more favorable credit terms”).

264. See *supra* notes 41-43 and accompanying text (discussing the presumption of classical formalism that every right or obligation was absolute in absence of an express limitation or qualification).

265. Taylor Equip. v. John Deere Co., 98 F.3d 1028, 1034 (8th Cir. 1996) (quoting James Baird Co. v. Gimbel Bros., 64 F.2d 344, 346 (2d Cir. 1933)); see also Kham & Nate’s Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990) (same); Industrial Representatives, Inc. v. CP Clare Corp., No. 94 C 6601, 1995 WL 348049, at \*4 (N.D. Ill. June 6, 1995) (quoting the same language with approval); National Educ. Corp. v. Martin, No. 93 C 6247, 1994 WL 317733, at \*7 (N.D. Ill. June 22, 1994) (same). A particularly blunt statement of this approach is found in *Rothe v.*

that lie at the core of good faith only apply if the dependent party bargains for their express inclusion.<sup>266</sup> This Part demonstrates that, even at this normative core, the new textualism in contract misapprehends the effect of the duty of good faith performance on the burden of expression in the law of contracts.

There is an important subtlety in the nature of the doctrine of good faith as a duty imposed on the parties by the force of law. Recall that UCC section 1-102(3), for example, forbids a broad disclaimer of that duty, but permits the parties to define the "standards" against which their conduct is to be measured.<sup>267</sup> Surprisingly little case law exists on the interplay between these two principles.<sup>268</sup> Close examination nonetheless reveals an important message for the new textualist approach to the duty of good faith. That message is a reversal of the classical presumptions about the burden of expression<sup>269</sup> in the contracting process.

This conclusion emerges even from a simple structural view of the Code provisions governing the interaction of party autonomy

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*Reuco D.S., Inc.*, 976 F. Supp. 784, 794-95 (S.D. Ind. 1997) (holding with regard to a lessee's right to cease operations under a lease that "bad faith only becomes an issue if a good faith clause was in the lease"), *aff'd*, 148 F.3d 672 (7th Cir. 1998).

266. See *Larese v. Creamland Dairies, Inc.*, 767 F.2d 716, 718 (10th Cir. 1985).

267. See U.C.C. § 1-102(3) ("[T]he obligation[] of good faith . . . prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligation[] is to be measured . . . ."); *supra* notes 85-87 and accompanying text; *cf.* U.C.C. § 1-102 cmt. 2 (observing that the section "recognizes the prevailing practice of having agreements set forth standards by which due diligence is measured and explicitly provides that, in the absence of a showing that the standards manifestly are unreasonable, the agreement controls"). The section also provides that such standards are not enforceable if they are "manifestly unreasonable." See *infra* note 354 and accompanying text.

268. Section 1-102(3) addresses not only good faith, but also the duties of "care," "diligence," and "reasonableness" imposed by the Code. See U.C.C. § 1-102(3). Although a number of cases have cited the provision, none has offered an analysis of the interaction of the principle of nondisclaimability with the power of the parties to set "standards" for good faith. The only case worthy of note in this regard is *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 139 n.10 (5th Cir. 1979) (suggesting that a clause permitting termination without cause could be a standard in the sense of § 1-102(3)).

269. The term "burden of expression" derives from Allan Farnsworth. See E. ALLAN FARNSWORTH, *CONTRACTS* 548 (2d ed. 1990); see also Farnsworth, *Omission*, *supra* note 29, at 884-87 (discussing "burden of expression").

with good faith. We have seen above that the duty of good faith performance is “imposed” on the parties by force of UCC section 1-203, and thus without the need for any affirmative action on their part.<sup>270</sup> When considered carefully, then, a good faith limitation on the exercise of discretionary powers inheres from the very inception of the contractual relationship.<sup>271</sup> With this foundation, UCC section 1-102(3) only permits the parties to define by affirmative agreement the contours of those good faith obligations in specific contexts.<sup>272</sup> The short of the matter is that the law begins with a presumption of good faith limitations on discretionary rights; it admits of a deviation from such limitations only upon affirmative proof of a corresponding agreement between the parties.

Although less clearly articulated in the case law, the result under the common law of contracts should be no different. The presumption of a good faith limitation on discretionary powers follows from the established prudential notion that law will not easily assume that one party has put itself at the mercy of another.<sup>273</sup> Building on this foundation, the common law of con-

270. See *supra* notes 10-13, 75-77 and accompanying text.

271. See *supra* note 12 and accompanying text.

272. Indeed, the notion of a good faith limitation on discretionary rights pervades the Code. When a contract grants one party a power to set the price, quantity, timing, or other aspects of performance after formation, the Code subjects the exercise of that discretion to a duty of good faith. See, e.g., U.C.C. § 2-305(2) (stating that unilateral power to define price is subject to duty of good faith); *id.* § 2-306(1) (same as to quantity); § 2-309(1) (same as to time of performance); *id.* § 2-306(1) (same as to quantity); *id.* § 2-311(1) (same as to other particulars of performance). For a more detailed analysis of these provisions of the Code, see Burton, *supra* note 86, at 6-13. The same applies even to otherwise-unrestricted discretionary powers to accelerate the performance obligations of the other party. See U.C.C. § 1-208 (subjecting rights of acceleration “at will” to (subjective) good faith); *id.* § 2A-109 (subjecting rights of acceleration of lease obligations “at will” to (objective) good faith).

273. This precept traces its lineage to the early exposition of a duty of “best efforts” when a contract grants one party apparent discretion in deciding whether to perform under an exclusive dealing arrangement. See *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 214 (N.Y. 1917); see also *Morin Bldg. Prods. Co. v. Baystone Constr., Inc.*, 717 F.2d 413, 414-15 (7th Cir. 1983) (holding on this basis that a reasonableness standard applied even to an express clause providing that one party’s “decision in matters relating to artistic effect shall be final”); *Popkin v. National Benefit Life Ins. Co.*, 711 F. Supp. 1194, 1202 (S.D.N.Y. 1989) (holding that the imposition of good faith and “reasonable efforts” obligations in an agency contract followed from the premise that “[w]e are not to suppose that one party was to be

tracts, like the Code, "imposes" a duty of good faith by force of law.<sup>274</sup> Here, too, the law thus properly begins with a presumption of good faith limitations on discretionary powers, and without requiring an affirming intention of the parties.<sup>275</sup>

The essential message that emerges is that the duty of good faith performance reverses the classical notions of the burden of expression on which the new textualism is based. The law presumes a duty of good faith in the exercise of discretionary powers; it therefore relieves the dependent party of any obligation to "protect herself" through negotiation of a corresponding express limitation on that discretion (though she remains free, of course, to bargain for greater protection).<sup>276</sup> To such extent, therefore, one might conceive of the doctrine of good faith as imposing on the party with discretion the obligation to "purchase egotism," and, derivatively, as freeing the other party from a duty to "purchase cooperation."<sup>277</sup>

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placed at the mercy of the other") (quoting *Wood*, 118 N.E. at 214)); *Iowa Fuel & Minerals, Inc. v. Iowa State Bd. of Regents*, 471 N.W.2d 859, 863 (Iowa 1991) ("[A] contract will not be interpreted giving discretion to one party in a manner which would put one party at the mercy of another, unless the contract *clearly requires* such an interpretation." (emphasis added)); *supra* notes 68-70 and accompanying text (discussing *Wood*).

274. See *supra* notes 79, 86 and accompanying text.

275. It is important to note the difference between the duty of good faith performance and that of good faith enforcement in this regard. See BURTON & ANDERSEN, *supra* note 71, at 291-92 (arguing with regard to the occurrence of an event that is beyond a party's control in the first place that "[o]nce it is established that the event triggering an enforcement right has occurred, the party invoking an apparent enforcement term should be entitled to prevail unless the opponent can prove the absence of good faith"). The important contrast here is between enforcement of rights that arise in this fashion and an exercise of a discretionary power permitted or contemplated by the parties' contract with regard to performance in the first instance.

276. See *id.* at 47 (arguing that "contractual discretion is presumptively bridled by the law of contracts—by the covenant of good faith implied in every contract").

277. The "to such extent" limitation, of course, is an important one. Although the duty of good faith performance places limits on discretionary powers, it does not sanction judicial adjustment of fixed contractual obligations not subject to the post-formation control of either party. See *supra* notes 259-61 and accompanying text. For an analysis of the tension between "egotism" and "cooperation" in selecting general default rules in contracts, see Gillette, *supra* note 116, at 552-62 (concluding that the particular facts of each contractual relationship will preclude distillation of a general background norm in favor of either extreme). While Professor Gillette's observations may be true as a general proposition, the duty of good faith performance

Viewed in this light, the doctrine of good faith is more than a simple “residual gap-filling default rule of contract law.”<sup>278</sup> Rather, the doctrine also operates in the foreground of the parties’ relationship in the nature of a legal presumption:<sup>279</sup> any post-formation discretionary power to affect the parties’ relative jural positions is subject to the external obligations imposed by good faith and fair dealing, unless the party seeking such discretion herself achieves an agreed limitation on such obligations in a sufficiently explicit and prominent manner.

To be sure, the burden to establish an actual *breach* of the duty of good faith—an exercise of discretion contrary to protected expectations—in a particular factual circumstance will remain with the dependent party.<sup>280</sup> The simple existence of a discretionary power, even one that is subject to no restriction on its face, however, does not render all such expectations irrelevant based on a normative duty to bargain for such express “good faith” obligations in the first instance.<sup>281</sup> Rather, the burden of expression to effect a displacement of the duty of good faith will fall to the party seeking discretion, a point addressed

supplies the limiting norm in the specific case of a discretionary contractual power, at least in absence of proof of an explicit, affirmative agreement to the contrary. See *infra* notes 282-325 and accompanying text (analyzing the necessary conditions for bargaining around the duty of good faith); cf. Steven J. Burton, *Default Principles, Legitimacy, and the Authority of a Contract*, 3 S. CAL. INTERDISC. L.J. 115, 159-65 (1993) (arguing for a general background norm of cooperation for gaps in contracts); Gillette, *supra* note 116, at 581 (suggesting “that cooperation may have some special appeal in the realm of remote events”). *But see* Diamond & Foss, *supra* note 79, at 594 n.41 (citing Gillette and arguing, incorrectly in my view, that such reasoning renders any analysis of reasonable expectations in the context of the duty of good faith performance inherently misguided).

278. *Infomax Office Sys., Inc. v. MBO Binder & Co. of Am.*, 976 F. Supp. 1247, 1251 (S.D. Iowa 1997) (quoting Diamond & Foss, *supra* note 79, at 586).

279. In this sense, the “nondisclaimable” doctrine of good faith functions similar to what Richard Craswell has referred to as “agreement rules.” See Craswell, *supra* note 125, at 503-04. Such rules—for example, the rules of offer and acceptance, and the doctrines of unconscionability and undue influence—define the conditions under which contractors will be allowed to vary otherwise-applicable background rules. See *id.* at 503-04, 514-15.

280. For a more detailed analysis of this point, see *infra* notes 322-24 and accompanying text.

281. See PEB COMMENTARY NO. 10, *supra* note 15, at 3 (“It is . . . wrong to conclude that as long as [an] agreement allows a party to do something, it is under all terms and conditions permissible.”).

in more detail immediately below. Even at its normative foundation, in short, the new textualism in contract misapprehends the essential function of the duty of good faith performance in contractual relations.

### *C. Good Faith, Party Autonomy, and the Burden of Expression*

The analysis to this point has demonstrated the flaws in the factual and normative assumptions of a textualist approach to the duty of good faith performance. As we have seen, however, the Code at some ill-defined level subjects the duty of good faith to the force of party autonomy.<sup>282</sup> The common law also flows in the same direction.<sup>283</sup> The question thus left unanswered is whether (and if so how) transactors may ever grant to one (or both) of them a specific discretionary power that is insulated from the duty of good faith performance.<sup>284</sup>

There is persuasive force in the argument that informed parties should be able to agree at the formation stage on a contractual power whose exercise is not subject to subsequent review under external standards of “fair” and “reasonable” conduct.

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282. See *supra* notes 85-87 and accompanying text (discussing UCC § 1-102(3) (1995)).

283. See *Flight Concepts Ltd. Partnership v. Boeing Co.*, 38 F.3d 1152, 1157 (10th Cir. 1994) (“Although the doctrine [of good faith] is generally implied for all contract provisions, it is irrelevant where the contract is drawn so as to leave a decision to the ‘uncontrolled discretion’ of one of the parties.”); *Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc.*, 826 P.2d 710, 728 (Cal. 1992) (concluding in a detailed opinion—although littered with overstatements—that the duty of good faith “is plainly subject to the exception that the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise have been forbidden by an implied covenant of good faith and fair dealing” (quoting *VTR, Inc. v. Goodyear Tire & Rubber Co.*, 303 F. Supp. 773, 777-78 (S.D.N.Y. 1969))). Though flawed in its point of departure, this, of course, is the ultimate destination of the textualist approach to the duty of good faith. See *supra* notes 144-92 and accompanying text.

284. See BURTON & ANDERSEN, *supra* note 71, at 63-68 (arguing for a “[p]riority of [e]xpress [t]erms,” but emphasizing the need for flexible interpretation of the parties’ actual agreement); Burton, *supra* note 79, at 371-72 n.14 (arguing that the parties “are free to determine by agreement what good faith will permit or require of them” and citing cases); Diamond & Foss, *supra* note 79, at 624-27 (arguing that the duty of good faith can be waived through explicit language); see also Farnsworth, *supra* note 15, at 678-79 (arguing for a restrictive construction of the nondisclaimability language of UCC section 1-102(3)).

This Part argues, however, that the burden of expression to accomplish that end should be a substantial one, and should include requirements not only of clarity, but also of effective notice.

### 1. *Negating Expectations: The Burden of Expression*

One of the principal objectives of the doctrine of good faith performance is to protect contracting parties from unfair surprise.<sup>285</sup> In its more concrete manifestation, this notion is reflected in the growing consensus that the doctrine serves to protect the “justified” (or “reasonable”) expectations of the parties that arise in the formation of their relationship.<sup>286</sup> As the Code’s sales provisions in particular recognize, this goal of protection against surprise takes on special significance when one party is granted a discretionary power to control an aspect of performance after formation.<sup>287</sup> Such an approach, not surprisingly, is also fully consonant with the philosophy expressed by the Code’s principal author, Karl Llewellyn, from the earliest stages of the Code’s creation.<sup>288</sup>

At its most elemental level, the duty of good faith performance fulfills this function by protecting reasonable expectations as to a future exercise of discretion without the need for a correspond-

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285. See Robert Dugan, *Good Faith and the Enforceability of Standardized Terms*, 22 WM. & MARY L. REV. 1, 39 (1980) (arguing that the prevention of surprise “represents the principal objective of the good faith obligation”); Patterson, *supra* note 48, at 200 (“Good faith means lack of surprise.”).

286. See *supra* notes 215-19 and accompanying text.

287. See U.C.C. § 2-311 cmt. 1 (emphasizing that a party with a discretionary power to specify the particulars of performance “is required to exercise good faith and to act in accordance with commercial standards so that there is no surprise”); *id.* § 2-309 cmt. 3 (stating with regard to the timing of shipment or delivery that “[t]he applicable principles . . . make it clear that surprise is to be avoided”); *id.* § 2-608 cmt. 5 (stating with regard to a revocation of acceptance that the content of the required notice “is to be determined in this case as in others by considerations of good faith [and] prevention of surprise”); *supra* notes 229-43 and accompanying text.

288. See Karl Llewellyn, *Selected Comments to Uniform Revised Sales Act, General Comment on Parts II and IV*, reprinted in PATTERSON, *supra* note 50, app. 2 at 209-32 (arguing that “good faith [and] avoidance of surprise are pervading principles of [the] Act” (emphasis omitted)).



ing agreement of the parties.<sup>289</sup> That is, when the content of a contractual relationship remains subject to the post-formation control of one of the parties, the doctrine of good faith operates as a presumptive right of the other party not to be subject to a surprise exercise of such discretion.<sup>290</sup> Moreover, this protection may not be dispensed with in its entirety; to do so would jeopardize the very idea of *pacta sunt servanda* (the obligation to keep one's agreements) on which enforceable contractual obligations principally depend.<sup>291</sup> In the same vein, truly unlimited discretion on an essential term (price, subject, timing)—even if expressly, knowingly, and freely granted—would dissolve the irreducible core of an enforceable contractual relationship.<sup>292</sup>

Subject to these limitations, the right of protection against unfair surprise (protection of a party's "reasonable expectations") granted by the doctrine of good faith may be a proper subject of negotiation. The presumptive nature of the duty of good faith performance, however, imposes important qualifications in this regard.

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289. See *supra* notes 264-79 and accompanying text.

290. See *supra* notes 258-60 and accompanying text.

291. See Burton, *supra* note 86, at 4; Summers, *supra* note 9, at 862; see also Burton, *supra* note 277, at 131 n.43 ("If a contract consists of commitments to keep promises, a contract clause disclaiming any obligation to keep a promise would be a contradiction in terms. It is mainly for this reason that the covenant of good faith may not be disclaimed by agreement of the parties."); cf. Barnett, *supra* note 249, at 883 n.164 (arguing against the validity of any disclaimer of the duty of good faith and observing that "[i]f any such expressed clause appeared in a writing, we would strongly suspect either that it went unread or that some serious defect in the bargaining process was responsible for its inclusion").

292. This of course is the point of the rules in the Code that subject discretionary powers as to timing, quantity, or price to an obligation of good faith. See, e.g., U.C.C. §§ 2-305(2), 2-306(1), 2-309(1). In contrast, some common law courts continue to view unfettered discretion on such an essential contractual term to be an unenforceable, "illusory" promise. See FARNSWORTH, *supra* note 269, at 75-78 (citing cases but noting the growing tendency to view such contracts as enforceable in light of the limitation imposed by the doctrine of good faith). Similarly, where an agreement purports to grant one party unfettered discretion with regard to the satisfaction of a condition precedent to performance, courts often find an implied good faith limitation in order to avoid a conclusion that the agreement is "illusory." See, e.g., *White Stone Partners v. Piper Jaffray Cos.*, 978 F. Supp. 878, 881-82 (D. Minn. 1997); *Horizon Corp. v. Westcor, Inc.*, 688 P.2d 1021, 1025-28 (Ariz. Ct. App. 1984) (surveying the case law on this issue).

The first arises from the nature of the expectations protected by the duty of good faith. By definition, any affirmative “agreement”—at least one that is worth the trouble of negotiating—insulating a party’s future exercise of a discretionary power will seek to narrow the expectations of reasonableness that would otherwise arise in the formation of the parties’ relationship.<sup>293</sup> Indeed, the very premise of the duty of good faith performance, as we have seen, is that such expectations are so fundamental (or obvious) that the parties rarely mention them in negotiations, and almost never distill them through express discussion into fixed “contractual” understandings.<sup>294</sup>

This premise is a refined reflection of the traditional maxim that the law should not assume that one party has put itself at the mercy of another.<sup>295</sup> Properly understood, the modern doctrine of good faith fulfills a similar function: It operates as a presumption against the recognition of an “agreement” that would sanction an exercise of discretion at variance from otherwise-extant expectations of fair and reasonable conduct.

The second, closely related, qualification is implicit in much of the analysis to this point, but is nonetheless worthy of express reemphasis here: The burden of expression regarding an agreed displacement of the external standards of good faith and fair dealing with respect to a particular discretionary power will fall to the party seeking to obtain such discretion.<sup>296</sup> That is, when one party seeks to insulate her discretion on a given subject from subsequent review under the doctrine of good faith performance, the burden should be hers to secure a sufficiently explicit, knowing agreement from the other party on that score.<sup>297</sup>

293. Cf. U.C.C. § 1-203 cmt. (stating that the duty of good faith “directs a court towards interpreting contracts within the commercial context in which they are created, performed and enforced”).

294. See *supra* notes 209-11 and accompanying text.

295. See *supra* notes 70, 273-77 and accompanying text.

296. See *supra* notes 264-81 and accompanying text (arguing that a good faith limitation on even an express discretionary power applies without the need for any affirmative action by the parties).

297. This does not mean that there is a duty of good faith in the negotiation of a contractual relationship in the first instance. For a comprehensive analysis of the limited role of good faith and fair dealing in negotiation, see BURTON & ANDERSEN, *supra* note 71, at 327-90; E. Allan Farnsworth, *Precontractual Liability and Prelimi-*

What emerges from the confluence of these considerations is what might be termed a "burden of bargaining." This burden proceeds from the prudential notion that the expectations of good faith performance are so fundamental that any attempt to deviate from them by agreement should be subject to heightened obligations of explicitness and prominence.<sup>298</sup> When a party seeks to secure truly unrestricted discretion on a subject, this burden should be a heavy one indeed. On the level of explicitness, it will require more than a mere agreement that a party *has* discretion. To secure a discretionary power insulated from subsequent review, rather, that party should be required to negotiate a clear and unambiguous agreement that the subsequent exercise of such discretion will not be subject to any external standards of reasonable conduct.<sup>299</sup> Anything less than an explicit agreement permitting exercise "for any reason" or "with or without cause"<sup>300</sup> should not satisfy this exacting standard.<sup>301</sup>

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*nary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217, 239-43 (1987). The duty of good faith performance simply requires that if a party wishes to secure an agreement at the formation stage that would insulate a future exercise of a discretionary power from subsequent review, the burden of expression on that score will be hers.

298. See *Foster Enters., Inc. v. Germania Fed. Sav. & Loan Ass'n*, 421 N.E.2d 1375, 1380 (Ill. App. Ct. 1981) ("There cannot be any doubt that a covenant of . . . good faith is implied into every contract absent express disavowal.").

299. Similarly, an explicit agreement that an exercise of discretion is to be absolute and unrestricted also may suffice. See *Diamond & Foss*, *supra* note 79, at 626-27 (arguing that a waiver of the obligation of good faith performance should be effective "[o]nly if the contract unambiguously evidences an intent by the parties to make such discretion absolute," but intimating, incorrectly in my view, that review of contractual text alone may suffice in this regard).

300. A number of cases have concluded that such language insulated an exercise of discretion from external standards of reasonableness. Unfortunately, most have done so without an analysis of the context in which such a discretionary clause came into being. See, e.g., *Burnette Techno-Metrics, Inc. v. TSI Inc.*, 44 F.3d 641, 643 (8th Cir. 1994) (finding that a clause expressly permitting termination without cause precluded assertion of claim based on duty of good faith); *Samuels v. Old Kent Bank*, No. 96 C 6667, 1997 WL 458434, at \*7 (N.D. Ill. Aug. 1, 1997) (involving clause permitting termination "at any time at the will of either party"); *Infomax Office Sys., Inc. v. MBO Binder & Co. of Am.*, 976 F. Supp. 1247, 1249-50 (S.D. Iowa 1997) (involving clause permitting termination without cause); *Implement Serv., Inc. v. Tecumseh Prods. Co.*, 726 F. Supp. 1171, 1179-80 (S.D. Ind. 1989) (finding that a clause permitting termination "for any reason or without any reason whatsoever" precluded breach of good faith claim). Cf. *Bertera Chrysler Plymouth, Inc. v. Chrysler Corp.*, 992 F. Supp. 64, 73 (D. Mass. 1998) (interpreting Michigan law as holding that the

The burden of bargaining should not end, however, with a reliance on text alone. The duty of good faith performance also implies that any "explicit" displacement of its strictures must reflect a sufficiently informed agreement of the other party.<sup>302</sup> That is, inspired by the goal of protecting fundamental expectations, the presumptive nature of the duty should also require that attention be drawn to any attempt to insulate a future exercise of discretion from external review. This conception of the force of good faith resonates with what Karl Llewellyn once generally referred to as an obligation of "attention-calling."<sup>303</sup> Llewellyn argued that the law should require a party to call affirmative attention to any desire to contract at variance from extant community (in specific, commercial) standards of fairness and reasonableness.<sup>304</sup> For the law to permit otherwise, he reasoned, would result in the frustration of the actual expectations that may arise in the relational and commercial context.<sup>305</sup>

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covenant of good faith and fair dealing does not attach when bargaining parties have "unmistakably expressed" their rights regarding a specific discretionary power).

301. Even a clause permitting an action in one party's "sole" discretion should not satisfy the required threshold of clarity. Such a provision may indeed indicate that the decision on exercise of the related contractual power is to be made solely by that party. As Professors Diamond and Foss have correctly observed, however, such a "sole discretion" clause remains ambiguous on the essential issue of whether that party may disregard the expectations of the other party in doing so. *See* Diamond & Foss, *supra* note 79, at 627 n.199; *see also* Travelers Int'l v. Trans World Airlines, Inc., 41 F.3d 1570, 1575 (2d Cir. 1994) (finding sole discretion clause subject to duty of good faith exercise); Big Horn Coal Co. v. Commonwealth Edison Co., 852 F.2d 1259, 1269 (10th Cir. 1988) (same). The proper focus here, in other words, is not merely on a party's "discretion," but rather on an explicit agreement that the *reasons* for the exercise of the discretion will not be subject to subsequent review under external standards of "reasonableness." *See* BURTON & ANDERSEN, *supra* note 71, at 51-52 (emphasizing the importance of the reasons for exercising discretion for good faith performance).

302. *See* Llewellyn, *supra* note 288, at 217 (urging a requirement of "attention-calling" when a party seeks to deviate from extant commercial standards).

303. *See id.*

304. *See id.* (arguing that "[a]ttention must be called to a desire to contract at material variance from the accepted commercial pattern of contract or use of language") (emphasis omitted); *see also* Slawson, *supra* note 227, at 56 (emphasizing the importance of the "conspicuousness" of agreements under the Code and observing that "[t]he conspicuousness of something deals with the likelihood of a party having been aware of it"); *infra* notes 318-25 (analyzing the conspicuousness requirement regarding the analogical case of exculpatory clauses in contracts).

305. *See* PEB COMMENTARY NO. 10, *supra* note 15 (observing that Karl Llewellyn

An attempt to contract at variance from otherwise-extant standards of good faith and fair dealing should be subject to no less exacting standards. Thus, when one party seeks to obtain such insulated discretion on a given subject, the burden should be hers to draw affirmative attention to the displacement of the external standards of fair and reasonable conduct in the exercise of that discretion. In this way, the burden of bargaining will operate to ensure against the factual predicate on which subsequent surprise (that is, a frustration of reasonable expectations) would be based.<sup>306</sup> It is also for this reason that a clause granting a party simple "discretion" alone is insufficient to eliminate the expectations protected by the duty of good faith performance.<sup>307</sup>

An illustration should aid in the understanding of this burden of bargaining in action. Consider the case of *Larese v. Creamland Dairies, Inc.*<sup>308</sup> At issue in *Larese* was the common claim that a franchisor's refusal to consent to an assignment of the franchise violated the duty of good faith and fair dealing.<sup>309</sup> The franchisor's response also was the customary one: It cited an express clause in the franchise agreement that required its "written consent" for such assignments.<sup>310</sup>

The Tenth Circuit's opinion in *Larese* is significant for its recognition of the bargaining obligations that attend any attempted displacement of the good faith limitations on discretionary powers.<sup>311</sup> The court first acknowledged that a contract provision may indeed grant "an absolute right to refuse to consent," as long as "such an agreement [is] freely negotiated."<sup>312</sup> It none-

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"recognized that parties develop expectations over time against the background of commercial practices and that if commercial law fails to account for those practices, it will cut against the parties' actual expectations"); see also Patterson, *supra* note 48, at 199-200 (providing the source of these statements of the PEB).

306. Even here, however, expectations created in the course of performance as a result of waivers or estoppels may operate to (re)impose such limitations on the exercise of discretion. See *infra* note 355 and accompanying text.

307. See *supra* notes 298-301 and accompanying text.

308. 767 F.2d 716 (10th Cir. 1985).

309. See *id.* at 716-17.

310. See *id.*

311. See *id.* at 717-18.

312. *Id.* at 718. At the time of the decision in 1985, the court first had to endorse

theless quickly concluded that the simple clause requiring consent for assignment at issue in that case did not satisfy that standard.<sup>313</sup> To the contrary, the court viewed the duty of good faith as fulfilling a more important notification function for the other party. To achieve an “absolute right” of discretion insulated from the obligations of reasonable conduct, the court reasoned, “the franchisor must bargain for a provision expressly granting the right to withhold consent unreasonably, *to insure that the franchisee is put on notice.*”<sup>314</sup>

Such is the proper understanding of the obligations imposed by the doctrine of good faith in the case of discretionary powers.<sup>315</sup> Animated by the goal of protecting against unfair

the now well-accepted proposition that the franchisor-franchisee relationship also is “one which requires the parties to deal with one another in good faith and in a commercially reasonable manner.” *Id.* at 717.

313. *See id.* at 718.

314. *Id.* (emphasis added). A few more recent cases have applied similar reasoning. *See, e.g.,* Kaplan v. First Options, Inc. (*In re Kaplan*), 143 F.3d 807, 818-19 (3d Cir. 1998) (holding that although the terms of a margin account agreement left “great room for discretion,” the agreements “[did] not give [the defendant] the right to act in bad faith or in a commercially unreasonable manner”); Sterling Nat’l Mortgage Co. v. Mortgage Corner, Inc., 97 F.3d 39, 42-44 (3d Cir. 1996) (holding that a clause providing simply that a party “may” take a certain action was not a grant of absolute discretion to preclude application of duty of good faith); Duffield v. First Interstate Bank, N.A., 13 F.3d 1403, 1405 (10th Cir. 1993) (observing that the duty of good faith set forth in UCC section 1-203 “on its face appears to apply in all situations—including when a contract’s express terms do not limit either party’s right to act unreasonably”).

315. Support for this approach also is found in the approach of a number of courts to clauses requiring the consent of a lessor for an assignment of a lease. A solid minority in the case law now holds that a duty of reasonable conduct applies to the exercise of a discretionary power to withhold such consent. *See, e.g.,* Warner v. Konover, 553 A.2d 1138, 1140-41 (Conn. 1989) (holding that a landlord must exercise his “discretion in a manner consistent with good faith and fair dealing”); Kendall v. Ernest Pestana, Inc., 709 P.2d 837, 842 (Cal. 1985) (en banc) (surveying authorities and concluding that landlord’s discretion was subject to duty of good faith and fair dealing); Newman v. Hinky Dinky Omaha-Lincoln, Inc. 427 N.W.2d 50, 53-55 (Neb. 1988) (following *Kendall*); *see also* Castle v. McKnight, 866 P.2d 323, 326 (N.M. 1993) (following *Kendall*). *But cf.* Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc., 826 P.2d 710, 727 (Cal. 1992) (holding that the reasonableness standard of *Kendall* does not apply when a clause explicitly grants the lessor the right to refuse consent for the specific reason in dispute). For a comprehensive analysis of this issue, see Alex M. Johnson, Jr., *Correctly Interpreting Long-Term Leases Pursuant to Modern Contract Law: Toward a Theory of Relational Leases*, 74 VA. L. REV. 751 (1988).

surprise (justified expectations), the presumptive nature of the duty of good faith performance fulfills what is in effect a cautionary function.<sup>316</sup> It does so by requiring that attention be drawn to any attempt to exclude otherwise applicable expectations of fair and reasonable conduct.

A necessary corollary of this directive is a consideration of the context in which even explicit contractual text came into being.<sup>317</sup> Thus, for example, an inconspicuous clause in the boilerplate of a standard form (taken alone) rarely will satisfy the attention-drawing obligation imposed on a party seeking insulated discretion on a given subject.<sup>318</sup> In such a case, even an explicit "for any reason" clause will be inherently ambiguous on the essential issue of whether such an attempted displacement of good faith limitations on discretion reflects an actual, knowing agreement of the other party.<sup>319</sup> In the case of a contract that arises from express bargaining between sophisticated parties, in contrast, such an explicit clause granting unrestricted discretion may be effectively dispositive on this score.<sup>320</sup>

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316. Lon Fuller first articulated the concept of a "cautionary function" in his classic analysis of the functions of legal formalities. See Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800 (1941). For a more complete review of Professor Fuller's insights, see *infra* note 339.

317. See *supra* notes 210-14, 234-35 and accompanying text (discussing the required consideration of the context in interpretive inquiries).

318. Cf. Llewellyn, *supra* note 288, at 217 (noting with regard to his "attention-calling" requirement the "strikingly diverse significance" of a negotiated term as compared to a term in a form contract "to which the attention of the other party is never directed").

319. For cases addressing such "for any reason" clauses, see *supra* note 300.

320. In rare cases, an exclusion of the good faith limitations may arise when a party is able to establish that the contract at issue by its very nature suggests an actual agreement granting an unrestricted discretionary right. This is the standard explanation for removing "demand notes" from the scope of the duty of good faith. See U.C.C. § 1-208 cmt. (1995) (stating that a duty of good faith in the exercise of a discretionary right of acceleration "obviously . . . has no application to demand instruments or obligations whose very nature permits call at any time with or without reason"); *supra* note 143 (providing case law to this effect). In such rare cases, however, the burden of attention-drawing will gain particular significance. That burden may well require not only an explicit demand clause but also proof that the right to demand immediate payment actually was brought to the attention of the borrower in the course of contract formation. In other words, in the absence of such satisfaction of the burden of bargaining, even here the required consideration of the context of the parties' relationship required by the Code's flexible concept of agreement may re-

To be sure, the applicable standard here will remain an objective one. Nonetheless, the application of the "attention-drawing" obligation must be calibrated to the particular contractual relationship at issue. A negotiated deal between sophisticated parties may require little (or no) affirmative actions from the party seeking discretion, beyond the appropriately explicit agreement on her unrestricted discretion. In the case of a repeat player dealing with a party who rarely is in the relevant contractual setting, in contrast, the burden of bargaining may require a particularly clear and conspicuous "for any reason" clause, and in extreme cases perhaps even an affirmative disclosure of the existence of the otherwise-applicable obligation of good faith itself.<sup>321</sup>

One should emphasize here, finally, that a failure to satisfy the burden of bargaining does not lead to the conclusion of an actual *breach* of the duty of good faith performance. It simply means that the party with discretion has failed to satisfy the strict conditions for a sufficiently explicit and informed agreement insulating the later exercise of such discretion from external review.<sup>322</sup> The consequence, in other words, is that the exercise of the discretion will be subject to the full force of the rea-

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veal protected expectations of good faith conduct. *See* Patterson, *supra* note 48, at 186-202 (elaborating on this point in connection with the acceleration of performance obligations); *see also* Bank One, Texas, N.A. v. Taylor, 970 F.2d 16, 31-32 (5th Cir. 1992) (concluding, after reviewing contextual evidence, that a promissory note with a "demand" clause was subject to the duty of good faith); Reid v. Key Bank, Inc., 821 F.2d 9, 13-16 (1st Cir. 1987) (same); PATTERSON, *supra* note 50, at 125-55 (discussing "failure to fund" cases).

321. *See infra* note 347 and accompanying text.

322. This is the point of UCC section 1-208. Although that provision imposes a good faith limitation even on a discretionary right of acceleration, it states that the burden of establishing an actual breach of the duty in the specific factual circumstances of each case is on the dependent party. *See* U.C.C. § 1-208 ("The burden of establishing lack of good faith is on the party against whom the power has been exercised."); *see also* U.C.C. § 2A-109 (stating the same rule for an exercise of a discretionary power to accelerate lease obligations, although switching the burden of establishing in the context of consumer transactions). The comment to section 1-208 further states that the section "obviously . . . has no application to . . . obligations whose very nature permits call at any time with or without reason." U.C.C. § 1-208 cmt. The comment fails to state, however, which party has the burden of proof on whether an obligation is of this nature (and thus displaces the duty of good faith in its entirety). That is the point of the burden of expression discussed in the text.



sonable expectations protected by the duty of good faith performance. The other party will then bear the burden of establishing that the particular exercise of discretion at issue (failure to consent to assignment, unexpected termination, etc.) frustrated the protected expectations that arose around the formation of the parties' relationship,<sup>323</sup> as influenced by the extant community standards of reasonableness and fair dealing.<sup>324</sup>

The express terms of the parties' contract will remain an important consideration, of course, in influencing the reasonableness of the other party's expectations. The important message here is that a failure to satisfy the burden of bargaining will mean that the other party may well have protected expectations as to an exercise of discretion, even in the case of an otherwise unrestricted contractual power.<sup>325</sup>

## *2. Examining Parallels to Other Burdens of Expression in Contract Law*

The "burden of bargaining" in the context of the duty of good faith also is consonant with broader conceptions of the burden of expression in contract law. In a variety of contexts, the law imposes a heightened burden of negotiation or explicitness in drafting in situations in which one party has control over the definition of contractual obligations. Consider as a prominent example the established precept that a writing is to be interpreted against its drafter (the rule of *contra preferentem*).<sup>326</sup>

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323. See *supra* notes 209-19, 226-43 and accompanying text. In the rare cases in which it remains relevant, the applicable standard under the Code may be simply the minimalist duty of "honesty in fact" in the exercise of such discretion. See, e.g., U.C.C. § 1-208 (imposing a subjective standard of good faith for "at will" and like clauses permitting the acceleration of performance obligations). But see *supra* notes 90-102 and accompanying text (discussing the decreasing relevance of this subjective standard of good faith); *supra* note 320 (noting that protected reasonable expectations may exist even in such a case).

324. See *supra* note 235 and accompanying text; see also BURTON & ANDERSEN, *supra* note 71, at 107-08 (agreeing that the party claiming an actual breach of the duty of good faith bears the burden of proof in this regard, although not discussing the burden of expression for a complete displacement of the external standards of reasonableness at the time of contract formation).

325. For an examination of reasonable expectations analysis, see *supra* notes 209-43 and accompanying text.

326. See RESTATEMENT (SECOND) OF CONTRACTS, § 206 (1981) (stating that among

Underlying this rule is the normative concern that a party with control over the articulation of an agreement “may leave meaning deliberately obscure, intending to decide at a later date what meaning to assert.”<sup>327</sup> Similar concerns animate the related issue of the treatment of surprise terms in standardized forms not subject to negotiation between the parties.<sup>328</sup> In this case as well, the law will refuse to give effect to those terms in standard forms that are beyond the reasonable expectations of the adhering party.<sup>329</sup>

The effect in each of these examples is to protect reasonable expectations of a party when the party in control of the articulation of the parties’ contractual obligations fails to secure a sufficiently explicit, informed agreement to the contrary.<sup>330</sup> Certainly,

reasonable meanings of a contract term “that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds”). This rule has been applied repeatedly in the case law. *See, e.g., Caldwell v. KFC Corp.*, 958 F. Supp. 962, 973-74 (D.N.J. 1997); *In re Riconda*, 688 N.E.2d 248, 253 (N.Y. 1997).

327. RESTATEMENT (SECOND) OF CONTRACTS, § 206 cmt. a; *cf.* Charny, *supra* note 247, at 1855-56 (arguing that the *contra preferentem* rule should apply “where it can serve to supplement a strong duty to explain the force of terms”).

328. *See* Dugan, *supra* note 285, at 13-28.

329. *See, e.g., American Bankers Mortgage Corp. v. Federal Home Loan Mortgage Corp.*, 75 F.3d 1401, 1412 (9th Cir. 1996); *Allan v. Snow Summit, Inc.*, 59 Cal. Rptr. 2d 813, 824 (Ct. App. 1996); *see also* Dugan, *supra* note 285 (analyzing the role of good faith in the interpretation of standard form contracts); Slawson, *supra* note 227, at 23-31, 64-70 (providing a comprehensive analysis of the “reasonable expectations” approach to standard form contracts); *id.* at 31-46 (canvassing the prominent approaches to the treatment of standard forms). The *Second Restatement* provides a more limited approach. *See* RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (stating that where a party utilizing a standardized contract “has reason to believe that the party manifesting . . . assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement”); *see also* Slawson, *supra* note 227, at 60-64 (criticizing the *Second Restatement’s* requirement that the using party have “reason to believe” that the other would not have assented).

330. It is for this reason that the *contra preferentem* rule does not apply if the drafter can establish that the other party was informed of, or otherwise knowledgeable concerning, the provision in dispute. *See United States v. Continental Oil Co.*, 237 F. Supp. 294, 298 (W.D. Okla. 1964) (noting “the exception to the general rule that a writing is construed most strongly against the draftsman when the words involved are the common language of both parties or the contract is the joint effort of the attorneys and technicians for both sides”), *aff’d*, 364 F.2d 516 (10th Cir. 1966); *E.I. du Pont de Nemours & Co. v. Shell Oil Co.*, 498 A.2d 1108, 1114 (Del. 1985) (explaining that there is no reason to construe a contract against the draftsman where all parties are knowledgeable); *Wall v. Firelands Radiology, Inc.* 666

the duty of good faith performance stakes a claim to no less of an increased burden of expression on the party with actual control over the content of the performance obligations themselves.

Indeed, contract law already imposes a heightened burden of expression in the closely analogous setting of exculpatory clauses in contracts. The effect of such clauses is to relieve a contracting party *in advance* of responsibility for its own negligent conduct. Such clauses, in other words, seek to insulate a party's future conduct from review under the external standards of culpability otherwise imposed by law, a consequence the Texas Supreme Court has described as "an extraordinary shifting of risk."<sup>331</sup> Precisely because of this, common-law courts have long required that such exculpatory clauses be not only explicit, but also "clear, unambiguous, unmistakable, and conspicuous."<sup>332</sup> The purpose of the conspicuousness requirement, in particular, is to put the dependent party on "fair notice" of the risks of permitting the beneficiary to act in the future without fear of liability for its own negligence.<sup>333</sup>

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N.E.2d 235, 244 (Ohio Ct. App. 1995) (same).

331. *Dresser Indus. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 507-511 (Tex. 1993).

332. *Alack v. Vic Tanny Int'l of Mo., Inc.*, 923 S.W.2d 330, 337 (Mo. 1996) (en banc); see also *Kissick v. Schmierer*, 816 P.2d 188, 191 (Alaska 1991) (holding with regard to exculpatory clauses that "to be enforced the intent to release a party from liability for future negligence must be conspicuously and unequivocally expressed"); *Leon v. Family Fitness Ctr. (No. 107), Inc.*, 71 Cal. Rptr. 2d 923, 925 (Ct. App. 1998) (holding that an exculpatory clause "should be placed in a position which compels notice and must be distinguished from other sections of the document. . . . [It] is unenforceable if not distinguished from other sections . . . [or] if not likely to attract attention because it is placed in the middle of a document" (quoting *Conservatorship of Estate of Link*, 205 Cal. Rptr. 513, 515 (Ct. App. 1984))); *Gross v. Sweet*, 400 N.E.2d 306, 309 (N.Y. 1979) ("[I]t has been repeatedly emphasized that unless the intention of the parties is expressed in unmistakable language, an exculpatory clause will not be deemed to insulate a party from liability for his own negligent acts."); *Dresser Indus.*, 853 S.W.2d at 507-09 (describing the requirements that the exculpatory intent must be expressed "in specific terms within the four corners of the contract" and that it be done "conspicuously"); *Colgan v. Agway, Inc.*, 553 A.2d 143, 145 (Vt. 1988) ("[A] greater *degree* of clarity is necessary to make [an] exculpatory clause effective than would be required for other types of contract provisions.").

333. See *Dresser Indus.*, 853 S.W.2d at 507-09 (discussing the "fair notice" requirement for exculpatory clauses).

A heightened burden of expression applies even for the negation of certain significant “implied” terms such as usages of trade and courses of dealing. Recall that under the contextual approach of the Code, these implied terms set the foundational context for the interpretation of commercial relationships.<sup>334</sup> Given this essential role, the Code provides that such terms will take effect unless they are “carefully negated.”<sup>335</sup>

Support for a heightened burden of expression in the context of the duty of good faith performance can also be found in the somewhat unexpected source of some advocates of an economic analysis of contract law. Professors Ian Ayres and Robert Gertner, for example, have suggested the notion of a “penalty default” as a tool for protecting against “strategic” contractual behavior.<sup>336</sup> Professors Ayres and Gertner offer this concept as a challenge to the accepted view among efficiency theorists that, in filling gaps in incomplete contracts, decisionmakers should choose the default rule that a majority of transactors “would have contracted for” if they could bargain free of all transaction costs.<sup>337</sup>

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334. See *supra* notes 51-63 and accompanying text. Under similar reasoning, UCC section 2-316(2) requires that a written disclaimer of statutory warranties must be “conspicuous.” See U.C.C. § 2-316(2); see also *id.* § 1-102(10) (defining “conspicuous”).

335. See U.C.C. § 2-202 cmt. 2 (1995); see also *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772 (9th Cir. 1981) (holding that even an express price term was subject to a contrary usage of trade that was not carefully negated); *Provident Tradesmens Bank & Trust Co. v. Pemberton*, 173 A.2d 780, 784 (Pa. Super. Ct. 1961) (holding that an express term did not “carefully negate[]” a usage of trade because it did not specifically refer to the usage itself). Another prominent example is the right of a seller to cure under UCC section 2-508. The comments to section 1-203 expressly identify that right as a “particular application[]” to the “general principle” of good faith. See U.C.C. § 1-203 cmt. The comments to section 2-508 then state that the seller’s right to cure will apply unless there is a “deliberate inclusion” of a contrary provision in the parties’ contract. See *id.* § 2-508 cmt. 2; cf. *id.* § 2-309 cmt. 3 (stating with regard to the timing of delivery and shipment that “[t]he applicable principles . . . make it clear that surprise is to be avoided . . . and notice or negotiation to reduce the uncertainty to certainty is to be favored”).

336. See Ayres & Gertner, *supra* note 13, at 95.

337. As examples of the “would have wanted” school, Professors Ayres and Gertner cite some of the leading scholars in the law and economics field. See Ayres & Gertner, *supra* note 13, at 89-90 nn.19-21 (citing RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 322 (3d ed. 1986); Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835-36 (1985); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General*

Professors Ayres and Gertner suggest, in contrast, that in some situations the law would better serve the interests of the parties by setting default rules that *create* incentives to bargain for at least one of the parties.<sup>338</sup> Such “penalty defaults” are particularly appropriate, they urge, when a relatively better informed party has an opportunity to take strategic advantage of contractual gaps and ambiguities (so-called “strategic incompleteness”).<sup>339</sup> To limit such behavior, a penalty default, if properly structured, will induce the more knowledgeable party to reveal relevant information in the course of satisfying the conditions for contracting around the default.<sup>340</sup>

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*Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983)); see also POSNER, *supra* note 125, at 92-94 (discussing the grounds for using efficiency analysis to fill gaps in contracts); Charny, *supra* note 247, at 1840-48 (discussing the efficiency grounds for judicial imposition of such hypothetical bargains).

338. Ayres & Gertner, *supra* note 13, at 91.

339. See *id.* at 94. It is interesting to note the parallel here with the normative foundation for the *contra preferentem* rule discussed above. See *supra* notes 326-27 and accompanying text (noting the concern that a drafter may leave a term deliberately ambiguous with an intent to decide at a later date what meaning to assert). There are also similarities between this approach and Lon Fuller's classic examination of the functions of legal formalities. Indeed, explicitly following on Fuller's analysis, Ayres and Gertner suggest that the necessary and sufficient conditions for contracting around default rules may serve “evidentiary,” “cautionary,” and “channeling” functions. See Ayres & Gertner, *supra* note 13, at 124. A properly structured penalty default will serve an evidentiary function, they argue, by encouraging the disclosure of relevant information to the courts and the parties through the contract itself. See *id.* At the same time, such a required disclosure (as appropriate, even of the existence of the default rule itself) will fulfill a cautionary function. That is, by requiring disclosure of necessary information, the penalty default will protect the other party from uninformed and incautious decisions in the contracting process. See *id.* (noting, importantly, that “[t]o caution is to give information”); Fuller, *supra* note 316, at 801 (contending that legal formalities ensure sufficient reflection before parties enter into binding contractual relationships). Finally, Professors Ayres and Gertner argue that an information-enhancing default rule can serve what Lon Fuller termed a “channeling function.” This function stimulates transactors to sort themselves into recognizable groups, differentiated, for example, by their reliance on legal versus nonlegal enforcement mechanisms for their agreements. See Ayres & Gertner, *supra* note 13, at 124-25; Fuller, *supra* note 316, at 800-01.

340. See Ayres & Gertner, *supra* note 13, at 91 (“Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision they prefer.”); cf. Charny, *supra* note 247, at 1859-60 (arguing that if usages of trade and customary terms are efficient, “then adjudicators, in reconstructing the bargain as a matter of interpretation, should place extra constraints on the ability of the parties to modify

Even if one were to view discretionary contractual powers solely through an efficiency lens,<sup>341</sup> there may be a compelling argument for a heightened burden of expression for any attempt to “contract around” the protections afforded by the duty of good faith performance.<sup>342</sup> Although the doctrine of good faith performance is not so limited, the risk of strategic conduct created by discretionary contractual powers is fairly one of the concerns that animates the imposition of good faith limitations in the first instance.<sup>343</sup> Properly appreciated, this concern is simply part of the broader observation that the duty of good faith performance protects against the frustration of the other party’s reasonable expectations as to the future exercise of such discretion.<sup>344</sup>

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[the] customary terms”).

341. A number of scholars have suggested that the duty of good faith performance may be an “efficient” background rule for contractual relationships. *See, e.g.*, BURTON & ANDERSEN, *supra* note 71, at 58-60 (agreeing that the duty of good faith may promote efficiency by relieving the parties of the costs of investigation and negotiation); Fischel, *supra* note 125, at 140-41 (arguing that a properly structured good faith performance rule will permit parties to avoid the costs of detailed drafting). The contractual duty of good faith, however, does not depend solely on such a justification. *See supra* notes 206-43 and accompanying text (analyzing, in the context of the duty of good faith, the propriety of the protection of reasonable expectations aroused in the formation of a contractual relationship).

342. Admittedly, the “penalty” here is a mild one. The penalty aspect arises from the fact that the party with discretion (typically the party with the stronger bargaining position) will be subject to the strictures of “reasonableness” in the exercise of such discretion whenever she fails to secure an explicit agreement from the weaker party to the contrary. For critical examinations of the value of a broad “penalty default” approach, see Patterson, *supra* note 13, at 250-57; W. David Slawson, *The Futile Search for Principles for Default Rules*, 3 S. CAL. INTERDISC. L.J. 29, 35-38 (1993).

343. In this respect, one may find a degree of congruence between the reasoning of recent textualists and the broader view of the centrality of reasonable expectations advanced here. *See supra* notes 181-86 and accompanying text (discussing the arguments by textualists that the duty of good faith prohibits opportunistic advantage-taking); *supra* notes 253-58, 262-63 and accompanying text (arguing that the duty of good faith protects reasonable expectations even as to the exercise of an apparently unrestricted discretionary powers). The failure of the textualist approach lies in the view that this function of good faith *only* applies in the rare case of a true gap in a contract. *See supra* note 181 and accompanying text; *see also supra* notes 244-63 and accompanying text (observing that even an otherwise unrestricted discretionary power does not necessarily reflect an “agreement” between the parties that will not be subject to the strictures of the duty of good faith performance).

344. *See supra* notes 229-35 and accompanying text.

Even viewed in this more limited light, the duty of good faith performance thus should impose a heightened burden of expression for the recognition of an agreed exclusion of its normative force. These heightened conditions should properly include both a requirement of explicitness and the satisfaction of what is in effect a cautionary function.<sup>345</sup> Their goal is to create incentives for explicit bargaining and for the disclosure of relevant information (including as appropriate the existence of the duty of good faith itself) whenever a party desires to contract at variance from otherwise applicable expectations of fair and reasonable conduct.<sup>346</sup> The burden in this regard, finally, should appropriately fall to the party seeking to obtain such an agreement on an unrestricted discretionary power. It is this party, after all, who likely will be the best informed about the circumstances in which such a discretionary power may become relevant in the actual performance of the parties' contractual relationship.<sup>347</sup>

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345. See *supra* notes 293-307 and accompanying text. Even in the case of a truly unrestricted discretionary right, significant nonlegal sanctions may limit "unreasonable" conduct. See generally Charny, *supra* note 248 (discussing the force of nonlegal sanctions such as reputational concerns). Not surprisingly, recent textualist courts have emphasized the force of such nonlegal enforcement mechanisms in arguing for a limited understanding of the doctrine of good faith. See, e.g., *First Nat'l Bank v. Atlantic Tele-Network Co.*, 946 F.2d 516, 520 (7th Cir. 1991) (noting "the effect of a concern with reputation in limiting opportunistic behavior by commercial enterprises which hope that the current contract is not their last"); *United States v. Stump Home Specialties Mfg., Inc.*, 905 F.2d 1117, 1122 (7th Cir. 1990) (making similar observations); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 438 (7th Cir. 1987) (same).

346. Allan Farnsworth has suggested a similar proposition founded on his notion of the "burden of expression." Professor Farnsworth argues that in filling contractual gaps, courts should structure the background rule to put the burden of expression on the party best able to ensure an accurate expression of the parties' agreement. See FARNSWORTH, *supra* note 269, at 548 (arguing that "[a] court may . . . consider the realities of the negotiating and drafting processes and supply a term that will put the burden of expression on the party that can better cope with it because of bargaining power and drafting skill").

347. See BURTON & ANDERSEN, *supra* note 71, at 60 (arguing similarly that the party best able to assume the costs of negotiation concerning the duty of good faith performance would be "the discretion-exercising party, who would have far better information concerning its own alternative opportunities and the probability that a later opportunity will prove more attractive"). This conclusion should pertain in particular where the party with discretion is a repeat player dealing with a party who is not. See Ayres & Gertner, *supra* note 13, at 98 ("If one side is repeatedly in the relevant contractual setting while the other side rarely is, it is a sensible presumption that the former is better informed than the latter.").

### 3. *The Irreducible Core of the Duty of Good Faith*

The above discussion of the power of contracting parties to define the standards to govern an exercise of discretion requires a few final observations about the force of good faith. The first is perhaps the most important: Even an explicit agreement that satisfies the stringent standards of the burden of bargaining will be limited to its particular subject matter. That is, even in such a case the broader, nondisclaimable aspect of the duty of good faith<sup>348</sup> will prohibit any affirmative actions by a party to prevent or interfere with performance by the other.<sup>349</sup>

Similarly, an unrestricted discretionary power as to one aspect of the parties' relationship (most notably, a right of termination) will not displace the duty of good faith performance in other contexts. A number of courts properly have found a breach of good faith in this sense when a party with such a discretionary power engaged in affirmative bad faith conduct prior to,<sup>350</sup> or active deception in connection with,<sup>351</sup> its use.<sup>352</sup>

348. See *supra* notes 11, 85-86 and accompanying text.

349. See *First Texas Sav. Assoc. v. Comprop Investment Prop. Ltd.*, 752 F. Supp. 1568, 1573-74 (M.D. Fla. 1990) (denying summary judgment on breach of good faith claim based on evidence that a bank in a foreclosure action frustrated performance of a loan contract by debtor); *Ally Gargano/MCA Adver., Ltd. v. Cooke Properties, Inc.*, No. 87 Civ. 731, 1989 WL 126066, at \*15 (S.D.N.Y. Oct. 13, 1989) (finding a breach of the duty of good faith in conduct by landlord that frustrated attempts by tenant to exercise right to sublease premises).

350. See *Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575, 587-89 (N.J. 1997) (affirming a finding of breach of the duty of good faith notwithstanding an explicit clause permitting termination without cause because of bad faith conduct of defendant prior to termination); *Roli-Blue, Inc. v. 69/70th St. Assocs.*, 506 N.Y.S.2d 159, 161 (App. Div. 1986) (finding that a landlord breached the duty of good faith when the landlord's "affirmative action . . . render[ed] illegal the contemplated use of the demised premises" even though contract contained an express disclaimer of a warranty of use).

351. See *Caton v. Leach Corp.*, 896 F.2d 939, 946-47 (5th Cir. 1990) (denying summary judgment on breach of good faith claim in spite of an "absolute" right to terminate sales representative, because of allegations that manufacturer engaged in active deception prior to termination); *Travel Servs. Network, Inc. v. Presidential Fin. Corp.*, 959 F. Supp. 135, 143-44 (D. Conn. 1997) (concluding that even where a loan contract permits termination in its sole discretion, a bank could breach duty of good faith through "active deception" prior to termination); *Hentze v. Unverfehrt*, 604 N.E.2d 536, 538-40 (Ill. App. Ct. 1992) (holding defendant liable for breach of good faith despite absolute right of termination because of a variety of bad faith acts, including deceptive communications, prior to termination).

352. An additional potential function of the duty of good faith is to protect against



Moreover, an express agreement granting an absolute discretionary power will be subject to review under the unconscionability doctrine.<sup>353</sup> This is also the proper understanding of the (somewhat obscure) final proviso of U.C.C. section 1-102(3), which renders unenforceable even agreed "standards" of good faith conduct if "manifestly unreasonable."<sup>354</sup> Like any other contractual provision, even an otherwise unrestricted discretionary right will also be subject to the limitations that arise through the force of waivers or estoppels in the course of the parties' performance.<sup>355</sup> Finally, good faith will continue to play

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coerced modifications of contracts. See U.C.C. § 2-209 cmt. 2 (1995) (dispensing with the requirement of consideration but subjecting a modification to an obligation of good faith); Jason Scott Johnston, *Default Rules/Mandatory Principles: A Game Theoretic Analysis of Good Faith and the Contract Modification Problem*, 3 S. CAL. INTERDISC. L.J. 335, 375-80 (1993). But see Robert A. Hillman, *Contract Modification Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 680, 702-03 (1982) (arguing that contract modifications under the Second Restatement of Contracts should be analyzed not under the duty of good faith but rather in terms of economic duress); Robert A. Hillman, *Policing Contract Modifications under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849, 879-80 (1979) (advancing a similar argument for the Code).

353. See BURTON & ANDERSEN, *supra* note 71, at 65 (noting the distinction between good faith analysis and the unconscionability doctrine); see also Burnette Technometrics, Inc. v. TSI Inc., 44 F.3d 641, 643 (8th Cir. 1994) (observing that a clause permitting termination without cause may be subject to unconscionability analysis); Gianni Sport Ltd. v. Gantos, Inc., 391 N.W.2d 760, 761-62 (Mich. Ct. App. 1986) (affirming a conclusion that an at-will termination clause in a distribution agreement was unconscionable); U.C.C. § 2-309(3) (imposing an obligation to give reasonable notice of termination but stating that "an agreement dispensing with notification is invalid if its operation would be unconscionable"). Unlike good faith analysis, the unconscionability doctrine also focuses on the absence of meaningful choice at the time the contract was made. See U.C.C. § 3-302; FARNSWORTH, *supra* note 269, at 332-35.

354. See U.C.C. § 1-102(3) ("[T]he parties may by agreement determine the standards by which the performance of [good faith] is to be measured if such standards are not manifestly unreasonable").

355. See BURTON & ANDERSEN, *supra* note 71, at 69 ("It should . . . go without saying that express terms may be negated by subsequent events giving rise to waivers and estoppels."). As one Court noted in a case involving a long-term relationship, an express termination provision

did not extinguish the context of prior dealings between the parties. These dealings might have legitimately led [the plaintiff] to expect that [defendant] might negotiate a new agreement with her, or that it might arrange to buy her out at a fair price, or that it might allow her sufficient time to negotiate a sale of the business to a third party.

a significant role in filling true gaps in incomplete contracts.<sup>356</sup> Indeed, the significance of this function of the duty of good faith will grow with the length of the parties' contractual relationship,<sup>357</sup> as the corrosive effect of time reveals such gaps in their express deal with increasing frequency.

### CONCLUSION

"The half truths of one generation," Benjamin Cardozo warned early in this century, "tend at times to perpetuate themselves in the law as the whole truth of another, when constant repetition brings it about that qualifications, taken once for granted, are disregarded or forgotten."<sup>358</sup> In the case of the new textualist approach to the contractual duty of good faith, this phenomenon threatens to occur in substantially less than a generation. Although asserted with conviction only a decade ago, in recent years a rising chorus of courts has chanted the refrain that notions of "good faith" and "fair dealing" have no role to play in the face of an express contractual power.

This common repetition of the textualist creed increasingly has obscured important qualifications. The duty of good faith fulfills its essential function in protecting the reasonable expectations that arise in the formation of a contractual relationship. What is now commonly overlooked in the mechanical application of the textualist approach is that such protected expectations can exist even in the case of a discretionary power otherwise left unrestricted on the face of contractual text. That is, contrary to the animating tenet of textualism, the presumption of a good

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Carmichael v. Adirondack Bottled Gas Corp., 635 A.2d 1211, 1217-18 (Vt. 1993).

356. See *supra* note 82 and accompanying text.

357. One of the best descriptions of the increased significance of this function of good faith in long-term contracts comes, ironically, from Judge Richard Posner's opinion in *Market Street Associates Limited Partnership v. Frey*, 941 F.2d 588 (7th Cir. 1991). Judge Posner observed that "[a]s performance unfolds" in such relationships "circumstances change, often unforeseeably; the explicit terms of the contract become progressively less apt to the governance of the parties' relationship; and the role of implied conditions—and with it the scope and bite of the good faith doctrine—grows." *Id.* at 595-96.

358. *Allegheny College v. National Chautauqua County Bank*, 159 N.E. 173, 174 (N.Y. 1927).

faith limitation on a discretionary power relieves the dependent party of any obligation to negotiate corresponding express limitations on such discretion.

There is indeed merit in the view that informed parties should be able to confer on one or both of them a specific discretionary power whose exercise is insulated from review under the external standards of "fair" and "reasonable" conduct. The law should not easily assume, however, that one party would put itself at the mercy of another in such a fashion. Properly appreciated, the doctrine of good faith performance reflects this essential, prudential notion; it does so by imposing a heightened burden of expression for bargaining around its strictures with respect to discretionary contractual powers.

This "burden of bargaining" at the core of the duty of good faith extends beyond a requirement of explicitness in the granting of contractual discretion. Inspired by the goal of protecting against unfair surprise, it also implies a duty to draw attention to any attempt to contract at variance from fundamental expectations of good faith and fair dealing. A failure to satisfy this heightened burden of expression will mean that a party's exercise of discretion in performance will be subject to the full force of the reasonable expectations protected by the duty of good faith performance, even in the case of an otherwise unrestricted contractual power.