

Good Faith and Reasonable Expectations

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I. INTRODUCTION

The recognition that there is an obligation of good faith in every contract has been regarded as one of the most important advances in contract law in the twentieth century. Nevertheless, a half-century after the doctrine's incorporation into the Restatement (Second) of Contracts and the Uniform Commercial Code, great controversy and confusion remain about it. Recent articles describe the doctrine as “a revered relic,” “a (nearly) empty vessel,” and “an underenforced legal norm.”¹ A scholarly dispute about the nature of the doctrine framed more than thirty years ago has hardly been advanced, much less resolved.² More importantly, although nearly every court has announced its support of the doctrine, often using similar language and familiar sources, many judicial opinions are confusing or confused.³

The controversy and confusion stem from a fundamental misunderstanding about the nature of the good faith obligation. That misunderstanding is a belief that good faith is a special doctrine that does not easily fit within the structure of contract law. Indeed, the doctrine is seen as potentially dangerous, threatening to undermine more fundamental doctrines and the transactions that they are designed to uphold. As a result, good

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1. See generally Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, 80 ST. JOHN'S L. REV. 559 (2006); Emily M.S. Houh, *The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?*, 2005 UTAH L. REV. 1; Paul MacMahon, *Good Faith and Fair Dealing as an Underenforced Legal Norm*, 99 MINN. L. REV. (forthcoming 2015).

2. See Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227, 228 (2005) (“[T]here is little agreement about how the common law duty of ‘good faith’ should be defined or what the duty of good faith requires.”).

3. As Judge Posner stated, “[t]he . . . cases are cryptic as to its meaning though emphatic about its existence.” *Mkt. St. Assocs. v. Frey*, 941 F.2d 588, 593 (7th Cir. 1991).

faith must be substantially restricted in its application. In particular, the doctrine needs to be closely tied to the terms of the contract, limited to cases in which a party has willfully violated its obligations under the contract, or both.

All of this is wrong. There is nothing special about the doctrine of good faith. It is continuous with the rest of contract doctrine. Although it is distinct from other doctrines, it is only distinct in the same way that the rules about formation are distinct from the rules about consideration. Good faith is simply another embodiment of the basic principle of contract law—the protection of reasonable expectations. The application of that principle through the good faith obligation leads to the proper understanding of the content of the doctrine and a rejection of many of the ways that courts improperly cabin it.

Part II of this article describes the controversy among scholars and the confusion in the courts about the obligation of good faith. Part III defines the protection of reasonable expectations as the fundamental principle of contract law and illustrates how that principle works in various doctrines in ways that resemble its role in good faith. Part IV applies the reasonable expectations principle to good faith and explains how it corrects the errors that courts make in applying the doctrine.

II. CONFUSION ABOUT GOOD FAITH

There is a longstanding and well-defined scholarly debate about good faith, conventionally characterized as a conflict between the “excluder” analysis pioneered by Robert Summers⁴ and the “foregone opportunities” approach described by Steven Burton.⁵ In a pair of landmark articles, Summers first described the doctrine of good faith in a way that is remarkable for an attempt to formulate a rule of law that may have contributed to the continual uneasiness about its status.⁶ Summers described good faith as “a phrase which has no general meaning or

4. See Robert S. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968).

5. See Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 374 (1980).

6. See generally Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982); Summers, *supra* note 4.

meanings of its own.”⁷ He then situated it among “a family of general legal doctrines, including implied promise, custom and usage, fraud, negligence and estoppel . . . [that] further the most fundamental policy objectives of any legal system—justice, and justice according to law.”⁸

The Restatement (Second) of Contracts adopted Summers’ analysis. The black letter of Section 205 imposes a “duty of good faith and fair dealing” without specifying the content of the duty.⁹ Most succinctly, the comments state:

Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness.¹⁰

The Restatement definition incorporates several elements. First, good faith entails conforming to the “justified expectations” arising from the contract.¹¹ Second, it also requires adherence to standards of conduct external to the contract.¹² Third, the standards are defined in opposition to bad faith.¹³

Burton criticized the Summers-Restatement formulation for its vagueness and for its reference to standards external to the contract, and he developed an approach that analogized breach of the good faith obligation to simple breach of an express term.¹⁴ In both instances, Burton suggested, a party attempts to recapture opportunities foregone as a result of the making of the contract.¹⁵ When a party enters into a contract, it makes choices among opportunities and commits resources to the choices made; in doing so, it creates expectations in its contracting partner.¹⁶ Bad faith constitutes an attempt to recapture the

7. Summers, *supra* note 4, at 196.

8. *Id.* at 198.

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

10. *Id.* § 205 cmt. a.

11. *See id.*

12. *See id.*

13. *See id.*

14. *See* Burton, *supra* note 5, at 373.

15. *See id.* at 378.

16. *See id.* at 377-78.

opportunities foregone.¹⁷ Although the foregone opportunities are defined in terms of “the expectations of reasonable persons in the position of the dependent parties,” Burton’s approach focuses quite narrowly on economic elements of the contract, rather than on standards of reasonableness and decency.¹⁸ He notes, for example, that his approach:

[E]nhance[s] economic efficiency by reducing the costs of contracting. The costs of exchange include the costs of gathering information with which to choose one’s contract partners, negotiating and drafting contracts, and risk taking with respect to the future. The good faith performance doctrine reduces all three kinds of costs by allowing parties to rely on the law in place of incurring some of these costs.¹⁹

Burton’s position is similar to the position adopted by Judges Posner and Easterbrook in a well-known series of Seventh Circuit cases. In their view, good faith is simply “a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute,” rather than an “injection of moral principles into contract . . . some newfangled bit of welfare-state paternalism” or “the sediment of an altruistic strain in contract law.”²⁰ Instead, the essential purpose of the obligation of good faith is to achieve efficiencies that the parties as rational maximizers would have agreed to at the time of contracting, such as “minimiz[ing] the costs of performance” by “reducing defensive expenditures.”²¹

Both the Summers and Burton positions are frequently cited by the courts.²² The approach to good faith taken in this article is closer to the Summers-Restatement formulation than to Burton’s. The principal problem with the development and application of good faith in the courts, however, is not that they disagree on which position to adopt or that one potentially inadequate position has prevailed over the other. Instead, the

17. *Id.* at 373.

18. *Id.* at 391.

19. Burton, *supra* note 5, at 393 (footnotes omitted).

20. *Mkt. St. Assocs. v. Frey*, 941 F.2d 588, 595 (7th Cir. 1991) (citation omitted).

21. *Id.*

22. *See, e.g., Ophthalmic Surgeons, Ltd. v. Paychex, Inc.*, 632 F.3d 31, 40 (1st Cir. 2011) (adopting the Summers-Restatement formulation); *Waste Connections of Kan., Inc. v. Ritchie Corp.*, 228 P.3d 429, 438-39 (Kan. Ct. App. 2010) (adopting Burton’s position).

problem is that although courts may cite one approach or the other, or sometimes both, they are routinely confused about the proper nature and scope of the doctrine. Both Summers and Burton advert to reasonable expectations, and courts often fail to consider the meaning of that principle.

A returned focus on reasonable expectations as the basis of good faith is necessary to clarify confusion and correct errors courts commit in the doctrine's statement and application. The confusion and error about good faith manifest around three issues: (1) What is the relation between the express terms of the contract and the obligation of good faith?; (2) Is subjective intention a necessary element of the violation of good faith?; and (3) What are the standards of behavior required to perform in good faith? These issues are fully developed in Part III, but as initial illustrations of the scope of the problem, consider two well-known cases in which courts produced lengthy discussions of good faith that are fundamentally unsound.

The first issue in good faith is the relation between the express terms of the contract and the obligation of good faith. *Burger King Corp. v. Weaver*²³ is one of many cases in which a franchisee alleged a violation of good faith by its franchisor. In *Burger King*, the court severely limited the scope of good faith by looking only at the express terms as the source of the obligation.²⁴

Weaver, a Burger King franchisee, operated two restaurants in Great Falls, Montana.²⁵ Burger King subsequently authorized the opening of a competing restaurant at Malmstrom Air Force Base in Great Falls, which Weaver regarded as an encroachment on his territory and a violation of Burger King's obligations.²⁶ Litigation ensued, as a part of which Weaver claimed that Burger King had violated the implied covenant of good faith and fair dealing.²⁷

The court began by noting prosaically that under Florida law, an implied covenant of good faith exists in every contract.²⁸

23. 169 F.3d 1310 (11th Cir. 1999).

24. *See id.* at 1318.

25. *See id.* at 1313.

26. *See id.*

27. *See id.*

28. *See Burger King Corp.*, 169 F.3d at 1315. Under a choice of law provision in the franchise agreement, Florida law, where Burger King's home office is located, governed the transaction. *Id.* at 1318.

In prior franchise encroachment cases, the courts had not applied the doctrine consistently,²⁹ but what the courts had held “unequivocally” was that “the rights conferred by the implied covenant of good faith and fair dealing are limited.”³⁰ Any obligation of good faith is subordinate to the express terms of the contract, and the only function of the doctrine is to require that obligations arising under the express terms be carried out in good faith.³¹ Therefore, no cause of action would lie for breach of the implied covenant of good faith in the absence of breach of an express term of the underlying contract.³² Because Weaver could not point to an express provision of the contract that Burger King had violated by authorizing the new restaurant, his claim for violation of the implied covenant failed as well.³³

Courts such as the *Burger King* court tie the good faith obligation so closely to the express terms of the contract that the good faith obligation is rendered superfluous. If there is an action available at all, it is for breach of an underlying express provision. Such a provision may not expressly define its own scope, and good faith comes in to serve that purpose.³⁴ In that respect, however, good faith is no more than an interpretation doctrine, reading into express terms a requirement that a party act honestly and cooperatively in fulfilling its obligations.

The second issue is whether a violation of the good faith obligation requires that the party subjectively intend to do so, and the third issue is how the standard of good faith is defined and what sources the courts look to in defining that standard. The difficulties courts have in resolving these issues are illustrated by *Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Center Associates*,³⁵ a case in which the New Jersey

29. *See id.* at 1315 (“In the Southern District of Florida, cases having very similar facts have come to very different conclusions.”).

30. *Id.* at 1316.

31. *See id.*

32. *See id.* at 1317-18 (“Where a party to a contract has in good faith performed the express terms of the contract, an action for breach of the implied covenant of good faith will not lie.”).

33. *See Burger King Corp.*, 169 F.3d at 1318.

34. *See* 17A AM. JUR. 2D *Contracts* § 370 (2004) (“When one undertakes to accomplish a certain result, he or she agrees by implication to do everything to accomplish the result intended by the parties.”).

35. 864 A.2d 387 (N.J. 2005)

Supreme Court capped a line of lengthy opinions and summarized its law of good faith in two strange paragraphs.³⁶

In *Brunswick Hills Racquet Club*, a commercial tenant held an option that could only be exercised by giving notice and tendering a payment to the lessor.³⁷ The tenant gave the requisite notice but failed to make the payment, largely because of “a series of written and verbal evasions” by the lessor and its lawyer designed to defeat the exercise of the option, which was not in the lessor’s economic interest.³⁸ Under New Jersey law, the application of good faith was not limited to a gloss on express terms, as it was in *Burger King*. Instead, the lessor’s “demonstrable course of conduct . . . in total disregard of the harm caused to plaintiff” constituted a violation of good faith even though it was in accord with all of its obligations under the express terms.³⁹

The court’s explanation of good faith began with a cautionary note: “Good faith is a concept that defies precise definition.”⁴⁰ Then it recited partial definitions of good faith from traditional sources:

The Uniform Commercial Code, as codified in New Jersey, defines good faith as honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. Good faith conduct is conduct that does not violate community standards of decency, fairness or reasonableness. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party. The covenant of good faith and fair dealing calls for parties to a contract to refrain from doing anything which will have the effect of destroying or injuring the right of the other party to receive the benefits of the contract.⁴¹

Brunswick Hills Racquet Club is a fully developed opinion that is literally incoherent, in the sense that its particular elements do not cohere into a comprehensible whole. Good

36. *Id.* at 395-96.

37. *See id.* at 389.

38. *Id.* at 389, 398.

39. *See id.* at 399.

40. *Brunswick Racquet Club, Inc.*, 864 A.2d at 395.

41. *Id.* at 395-96 (internal quotation marks and citations omitted) (quoting various authority).

faith is indeed “a concept that defies precise definition.”⁴² But that is equally true of many other concepts in contract law and elsewhere. Contract formation requires definiteness, but definiteness defies precise definition; it is defined not formally but in terms of its purposes, as providing evidence of manifestation of assent and enabling the court to determine the existence of a breach and provide a remedy.⁴³ Avoiding a contract because of duress requires determining whether the contract was induced by an improper threat that left the threatened party no reasonable alternative but to accede;⁴⁴ “improper” and “reasonable” are incapable of precise definition. And so on.

This is not a mere rhetorical point. The statement that good faith defies precise definition is not simply prefatory throat-clearing but an expression of an attitude that there is something special or distinctive about good faith, that it is a troublesome, even threatening, doctrine that does not fit easily in the mainstream of contract law, unlike definiteness and duress. That attitude has much to do with the errors about the substance and application of the doctrine.

With respect to the scope of the standard, the court in *Brunswick Hills Racquet Club* cited three expanding sources in its definitional paragraph: (1) “the benefits of the contract;” (2) “reasonable commercial standards of fair dealing;” and (3) “community standards of decency, fairness or reasonableness.”⁴⁵ It did not clarify the relation among them or the extent to which good faith can be grounded in one or another.

Finally, the court reached its conclusion:

Proof of “bad motive or intention” is vital to an action for breach of the covenant. The party claiming a breach of the covenant of good faith and fair dealing “must provide evidence sufficient to support a conclusion that the party

42. *Id.* at 395.

43. See RESTATEMENT (SECOND) OF CONTRACTS § 33(2) (1981) (“The terms of a contract are reasonably certain if they provide a basis for determining the existence of a breach and for giving an appropriate remedy.”); U.C.C. § 2-204(3) (2012) (“Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.”).

44. RESTATEMENT (SECOND) OF CONTRACTS § 175(1) (1981).

45. See *Brunswick Racquet Club, Inc.*, 864 A.2d at 395-96 (internal quotation marks omitted) (quoting various authority).

alleged to have acted in bad faith has engaged in some conduct that denied the benefit of the bargain originally intended by the parties.” As a general rule, “[s]ubterfuges and evasions” in the performance of a contract violate the covenant of good faith and fair dealing “even though the actor believes his conduct to be justified.”⁴⁶

Here the court addressed the third issue—whether a violation of the good faith obligation requires that the party subjectively intend to do so—and concluded that subjective bad faith is required. In doing so, it negated the effect of all of the sources of good faith it just defined, and of half of the Restatement and UCC definitions, by requiring “proof of bad motive or intention.” Even though a party can be “denied the benefit of the bargain” by actions that are not taken with ill motive, the source of the requirement of subjective bad faith is not stated.

The UCC expresses both subjective standards (“honesty in fact”) and objective standards (“observance of reasonable commercial standards of fair dealing”) as independent requirements for judging a party’s good faith.⁴⁷ The thrust of the Restatement is similar. Following Summers, it defines good faith as the exclusion of bad faith and defines bad faith as involving either subjective or objective breaches: “Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness.”⁴⁸

Therefore, both the UCC and the Restatement state that good faith entails conforming to justified expectations arising from the contract and it also requires adherence to standards of conduct external to the contract; a party violates those expectations and standards when it acts with the intention of subverting its contracting partner’s legitimate expectations, and when it fails to adhere to the relevant standards of conduct,

46. *Id.* at 396 (alteration in original) (citations omitted) (quoting various authority).

47. *See* U.C.C. § 1-201(b)(20) (2012).

48. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981) (internal quotation marks omitted).

internal or external, even though it does not act with intention to do so.

Thus the court in *Brunswick Hills Racquet Club* cited the canonical UCC and Restatement definitions as authority and then negated them in its conclusion. And it is not unusual in that respect. Other courts make similar errors, and more.⁴⁹

III. REASONABLE EXPECTATIONS

The key to clarifying the confusion about good faith and correcting courts' errors in applying the doctrines lies in recognizing that good faith is continuous with the rest of contract doctrine in service of the principles underlying all of contract law. The core of those principles focuses on the parties' agreement and the desire to protect the reasonable expectations created by that agreement.

Begin at the beginning. Corbin entitled the first section of his treatise "The Main Purpose of Contract Law Is the Realization of Reasonable Expectations Induced by Promises."⁵⁰ Therefore, like everything else in contract law, the obligation of good faith arises from reasonable expectations.

Reasonable expectations as a concept divides handily, if not neatly, into two components: expectations and reasonableness.

49. See, e.g., *Mountain Funding, L.L.C. v. Evergreen Cmtys., L.L.C.*, No. 1CA-CV08-0648, 2009 WL 4547921, at *6-7 (Ariz. Ct. App. Dec. 3, 2009). In *Mountain Funding*, the court cited to both the Restatement and to *Burton* and upheld the following jury instruction:

The duty to act in good faith does not alter the express, specific obligations agreed to by the parties under the contract. Acting in accordance with the terms of the contract without more, cannot be bad faith. Conversely, because a party may be injured when the other party to a contract manipulates bargaining power to its own advantage, a party may nevertheless breach its duty of good faith without actually breaching an express covenant in the contract.

Id.

50. ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1.1 (one vol. ed. 1952) [hereinafter CORBIN, 1952 One Volume Edition]. Current revisions of the treatise retain the original heading and text and note the consistency between protection of reasonable expectations and of the reliance interest. See 1 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1.1 (Joseph M. Perillo ed., rev. ed. 1993) [hereinafter CORBIN, 1993 Perillo Revised Edition]. Current revisions also catalog applications of reasonable expectations throughout contract law's doctrinal structure, more discussion of which is included in Part III *infra*.

Expectations have an empirical base, in what the parties to a contract believe to be their understandings, promises, and obligations.⁵¹ Sometimes expectations arise from express representations or promises; other times they are implicit in words, conduct, or setting.⁵² Because these expectations in litigated cases always are defined by the courts retrospectively, they inevitably may be somewhat hypothetical. Nevertheless, what the parties understand or are assumed to understand provides the first step in constructing expectations.

But only reasonable expectations count. As with the construction of the reasonable person in the law of negligence, reasonableness is not an empirical question to be resolved by observation of behavior or a scientific survey. Corbin again:

It must not be supposed that contract problems have been solved by the dictum that expectations must be “reasonable.” Reasonableness is no more absolute in character than is justice or morality. Like them, it is an expression of customs and mores of men—the customs and mores that are themselves complex, variable with time and place, inconsistent and contradictory.⁵³

Therefore, reasonableness is contextual and evaluative.

Reasonableness is contextual because it depends on “customs and mores,” and customs and mores vary depending on time, place, setting, background, and experiences of contracting parties.⁵⁴ Whether it is reasonable to expect one’s contracting partner to do more than is explicitly required by the express terms of a contract, for example, depends on whether the partner is a low-level employee, highly paid professional, manufacturer of mass-produced goods, or craftsman producing a unique item; whether the parties engage in a one-off deal, one in a series of transactions, or a long-term relationship

51. See STEVEN J. BURTON & ERIC G. ANDERSEN, *CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT* 54 (1995) (“[T]his approach assumes a normal or ordinary course of events that the parties expect or should expect at the time of contract formation and with reference to which they implicitly contract, absent express terms to the contrary.”).

52. See *id.* (“[T]he ordinary or expected course includes not only actions and events, but also the reasons for which discretion may be exercised within the contract. That is, the express agreement of the parties may come together with promissory presuppositions.”).

53. CORBIN, 1950 One Volume Edition, *supra* note 50, § 1.1 (internal quotation marks omitted).

54. See BLACK’S LAW DICTIONARY 468 (10th ed. 2014) (defining “custom”).

encompassing complex performances and personal interactions; whether the parties have constructed a unique relationship or are members of an established commercial community; and more.

Understanding and constructing expectations from context is only the first step. Reasonable expectations are evaluative because context never determines reasonableness; the court filters the context through norms to reach a conclusion about reasonableness.

Consider the law of negligence in torts, in which there is a dominant norm that is simple in statement but complex in application. Whether stated as the reasonably prudent person or the product of a risk-utility balance, the general rule is that an actor creates an unreasonable risk of harm when the cost of avoiding the risk is lower than the probability and extent of the harm potentially caused.⁵⁵ What risks are foreseeable and how to value benefits and burdens creates difficulties in the application of the standards.

In contract law, the normative structure that defines reasonableness is both more complex and usually less formally and explicitly stated.⁵⁶ Some norms arise from the nature of exchange itself, such as the value of reciprocity, the effectuation of planning and consent, and flexibility.⁵⁷ Other norms are better seen as arising from sources external to the relation; such norms include principles of law that animate particular doctrines and principles that derive from nonlegal sources, including trade associations, professional standards, and values of society at large.⁵⁸ When stated at a general level, it is clear that the norms can be in tension; the effectuation of planning and consent will sometimes conflict with the demand for flexibility. The process of defining the reasonableness of expectations entails resolving those tensions based on an application of the norms in a particular context.⁵⁹

55. See RESTATEMENT (THIRD) OF TORTS § 3 (2010).

56. For a comprehensive analysis of “reasonableness,” see Ian R. Macneil’s *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* (1980). See generally Jay M. Feinman, *Relational Contract Theory in Context*, 94 NW. U. L. REV. 737 (2000); Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340 (1983) [hereinafter Macneil, *Values in Contract*].

57. See Macneil, *Values in Contract*, *supra* note 56, at 347 (listing “ten common contract norms”).

58. See *id.* at 367-68.

59. See *id.* at 402-03 n.193.

Thus, reasonable expectations, contract law, and ultimately good faith share the same characteristics. Whatever the source of the parties' expectations, in words or conduct, the transformation of those expectations into legal liability is contextual—"customs and mores"—and evaluative—"justice and morality."⁶⁰

The embodiment of reasonable expectations in the doctrine of good faith is simply another manifestation of the principle's application throughout contract doctrine.⁶¹ Reasonable expectations permeate contract law. Chronologically, the concept animates the concept of manifestation of assent in formation doctrine at the first stage in making a contract, and it defines the normal measure of damages in the event of breach.⁶² In each step, the law constructs the parties' agreement through a concept of reasonable expectations.⁶³ At each point, the parties' expressions are the beginning but not the end of analysis; it is necessary to refer to something beyond those expressions to determine the parties' legal obligations, and that "something" includes elements of their context and a normative structure through which the expressions and context can be evaluated.

Three instances along this chronological progression—formation, consideration, and the spectrum of gap-fillers supplied by courts from interpretation through constructive conditions—illustrate. Each also reflects the link between good faith and reasonable expectations.

A. Formation

Contract is a legal obligation that begins with a promise or an agreement.⁶⁴ A promise is a "manifestation of intention to act or refrain from acting in a specified way, so made as to justify a promisee in understanding that a commitment has been made."⁶⁵ An agreement is "the bargain of the parties in fact, as

60. *See id.* at 403 ("[I]t is what good faith means in a particular context that can power it.").

61. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981) ("Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party . . .").

62. *See* 1 CORBIN, 1993 Perillo Revised Edition, *supra* note 50, § 1.1 (discussing various situations in which courts protect reasonable expectations).

63. *See id.*

64. RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981).

65. *Id.* § 2(1).

found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade.”⁶⁶ And an “offer” is “the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it.”⁶⁷ That manifestation need not be in words alone, or words at all; it may be inferred from conduct.⁶⁸ A “promise,” “agreement,” or “offer,” therefore, is not a fact; it is an inference based on reasonable expectations—an inference that the person to whom it is directed expects that a commitment has been made and that the commitment is worthy of legal enforcement. The court attaches that inference where it is justified that what the parties said and did, and the context in which they said and did them, lead to the conclusion that liability should attach, according to community standards of responsibility.

The point is even clearer in considering contracts made by conduct without verbal expression. Consider the following illustration.⁶⁹ A passes a store where he has an account, takes an apple from a display from a box labeled “25¢ each” and shows it to a store clerk, *B*, who nods in acknowledgment. A contract has been made for the purchase of the apple at the stated price. Suppose the box had no price label. The same result occurs at the then-prevailing price at the store. Change the hypothetical so a driver comes to a self-service gas station, fills her tank, and wishing to pay cash, does not insert her credit card. Again, the same result follows—a promise to pay the listed price. Suppose the price is, through some error, not listed. She has made a promise to pay at whatever the usual price is at the gas station. What is happening here is a determination of expectations that arise from context and the application of norms that determine the reasonableness of those expectations.

The shift from enforcement of reasonable expectations created by words to reasonable expectations created by conduct demonstrates an important point about contractual obligation in general and the good faith obligation in particular. The distinctions often drawn in categorizing contracts and contract terms are facilitative but artificial. There is a distinction

66. U.C.C. § 1-201(b)(3) (2012).

67. RESTATEMENT (SECOND) OF CONTRACTS § 24 (1981).

68. *Id.* § 19.

69. This illustration may be found in *id.* § 4 cmt. a, illus. 2.

between express and implied contracts and contract terms;⁷⁰ the former is a contract, or part of one, made by words, the latter made by conduct. In both cases, however, there are acts to which the court attaches legal significance because the acts raise expectations that are worthy of protection in the circumstances.⁷¹ The hoary maxim that “a court will make not make a contract for the parties”⁷² is absurd, because of course that is what happens in every case; it is just that in cases labeled “express contract” or “express terms,” the inference about expectations and their reasonableness is typically easier to draw.⁷³

The distinction some courts draw in good faith cases between the duties created by the express terms of the contract and the obligation of good faith is equally misguided. Enforcement of the obligation of good faith is just like the enforcement of the obligation created by the express terms. In each instance, the court makes judgments about the reasonableness of expectations based on words and conduct and the context in which those words and conduct occur.⁷⁴

B. Consideration

Good faith is usually thought of as a distinct contract law doctrine, but it also is a principle that contributes to the formulation of other doctrines. This occurs most notably in the area of consideration.⁷⁵ A promise in exchange for a promise constitutes consideration except where that return promise is no real promise at all—an illusory promise.⁷⁶ An apparently illusory promise, however, can be made binding by an inference of good faith in order to protect reasonable expectations.⁷⁷

70. *See id.* § 19 cmt. a (noting the distinction).

71. *See id.*

72. *See* 11 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 31:5 (Richard A. Lord ed., 4th ed. 2012) (describing this principle).

73. *Cf.* RESTATEMENT (SECOND) OF CONTRACTS § 4 cmt. a (1981).

74. *See* 23 WILLISTON, *supra* note 72, § 63:22 (“In determining whether a party has breached the obligation or covenant of good faith and fair dealing, a court must examine not only the express language of the parties’ contract, but also any course of performance or course of dealing that may exist between the parties.”).

75. *See* 2 CORBIN, 1993 Perillo Revised Edition, *supra* note 50, § 5.27 (“Frequently this implied obligation provides consideration for the contract.”).

76. *See id.*

77. *See id.*

An early example is the venerable *Wood v. Lucy, Lady Duff-Gordon*.⁷⁸ Lucy granted Wood the exclusive right to market her designs and endorsements, but she subsequently violated his exclusive right by endorsing goods without his knowledge and without sharing the profits.⁷⁹ Wood sued for damages, and Lucy defended on the basis that the contract was unenforceable because Wood's promise was illusory and therefore provided no consideration for her promise of exclusivity; although he had the right to market her designs, he had not actually promised to do so.⁸⁰

Justice Cardozo, then sitting on the New York Court of Appeals, acknowledged that Wood had not promised "in so many words" to use reasonable efforts to market Lucy's endorsements.⁸¹ Nevertheless, he concluded:

[S]uch a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view today. A promise may be lacking, and yet the whole writing may be instinct with an obligation, imperfectly expressed.⁸²

Lucy expected Wood to use reasonable efforts to market her designs.⁸³ The expectation was based on the terms of the contract and the situation-sense of the transaction.⁸⁴ The contract recited that Wood possessed a business organization suitable for marketing her endorsements, implying that the organization would be used for that purpose.⁸⁵ It also specified that he would account monthly for money received and would take out patents and trademarks as necessary, demonstrating the parties' expectation that he owed duties that would generate income and would necessitate protection of her designs.⁸⁶ Given these terms, the expectation was reasonable. Moreover, the exclusivity of the arrangement put Lucy at Wood's mercy unless he was obligated to act, so implying a reciprocal promise to

78. 118 N.E. 214 (N.Y. 1917).

79. *Id.* at 214.

80. *See id.*

81. *See id.*

82. *Id.* (internal quotation marks omitted) (quoting various authority).

83. *See Wood*, 118 N.E. at 215.

84. *Id.* at 214-15.

85. *Id.* at 214.

86. *Id.* at 215.

market her designs gave the arrangement “such business efficacy, as both parties must have intended.”⁸⁷ Therefore, the contract embodied a promise by Wood that provided consideration for the return promise she violated.

An example of broader application, first changed by the common law and then by the UCC, concerns requirements contracts.⁸⁸ A buyer’s promise to buy its requirements of a certain good is arguably no promise at all because it may have no requirements, either because of a lack of need or because it may go out of business altogether.⁸⁹ The answer to the consideration problem is to read into the contract an obligation by the buyer to determine its requirements in good faith.⁹⁰ The same logic cures any indefiniteness problem. That obligation rests on reasonable expectations created by the “commercial background and intent” of requirements contracts.⁹¹

The issue then becomes defining the scope of good faith. That process first looks at any aids the parties themselves have provided; for example, the parties may have included a “stated estimate” or “normal or otherwise comparable . . . requirements” that could act as reference points.⁹² The definition of good faith is broader, however. The parties’ course of dealing or course of performance is always relevant, as are “reasonable commercial standards of fair dealing.”⁹³ The comments to Section 2-306 of the UCC further fill out what those standards might be; increased requirements due to normal expansion of a factory are in good faith, for example, but a “sudden” and presumably large expansion would not.⁹⁴ On the downside, modernization of machinery that reduces demand may be in good faith, and even shutdown of a factory for business reasons external to the

87. *Id.* at 214-15 (internal quotation marks omitted).

88. See JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 4-13 (3d ed. 1987) (discussing requirements contracts); E. ALLAN FARNSWORTH, *CONTRACTS* § 2.15 (4th ed. 2004) (same).

89. See FARNSWORTH, *supra* note 88, § 2.15 (“The argument in the case of a requirements contract is that the buyer’s promise is illusory because it can perform without taking any goods at all, if it chooses instead to go out of the business that requires them.”).

90. The UCC has adopted this approach. See U.C.C. § 2-306(1) (2012).

91. See U.C.C. § 2-306 cmt. 1.

92. U.C.C. § 2-306(1).

93. See U.C.C. § 1-201(b)(20) (2012) (incorporating the phrase into the definition of “good faith”).

94. See U.C.C. § 2-306 cmt. 2 (2012).

contract may occur in good faith.⁹⁵ All of these limitations on the buyer's flexibility are the product of an understanding of this contract in the context of such contracts as a whole imposing on the buyer a standard of "business reasonableness."

The consideration cases demonstrate that good faith cannot be bounded by the express terms of the contract. In the requirements contracts cases, the courts construct good faith from reasonable expectations in a way that defines the content and limits of the express terms. In "business efficacy" cases, such as *Wood v. Lucy, Lady Duff-Gordon*, the operation of good faith is broader still; although Cardozo looked to the text of the contract for clues about the scope of the parties' duties, in the end the decision rested on an understanding of the nature of exclusive dealing arrangements as the basis for reasonable expectations and consideration.⁹⁶

C. Interpretation and Omitted Cases

The role of reasonable expectations is very clear in considering the spectrum of doctrines and judicial actions that involve interpretation and omitted cases. It is customary to distinguish, along the spectrum, between "interpretation," which connotes finding the meaning of words,⁹⁷ and "gap-filling" or "supplying omitted terms," which are strategies that are employed when words fail.⁹⁸ The distinction is potentially misleading because the parties' expressions are not self-executing but need to be assessed and evaluated by the court in every case,⁹⁹ though more in some cases than others; for present purposes, it makes more sense to see all of these cases as continuous rather than discrete, as situated in a portion of the continuum from formation forward through which courts attach liability consistent with reasonable expectations.

As usual, Corbin makes the point:

When a court finds a promise by implication, its procedure may be nothing more than the ordinary interpretation of word symbols; it may be the interpretation of a person's

95. CALAMARI & PERILLO, *supra* note 88, § 4.13(d).

96. *See* *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214, 214-15 (N.Y. 1917).

97. 6 PETER LINZER, CORBIN ON CONTRACTS § 26.1 (Joseph M. Perillo ed., rev. ed. 2010).

98. FARNSWORTH, *supra* note 88, § 7.16.

99. *See* 6 LINZER, *supra* note 97, § 26.1.

acts and other conduct not including words; it may be the judicial determination that a legal duty exists, stating the result in the language of promise without doing anything that can properly be called interpretation; or it may be a combination of any two of these or of all three at once.¹⁰⁰

1. Words and Meaning

Perhaps the most famous case involving the provision of meaning to words is the casebook chestnut *Raffles v. Wichelhaus*.¹⁰¹ *Raffles* dealt with the issue of whether a contract may be avoided because of a mutual mistake of the parties concerning a material fact.¹⁰² The modern expression of the principle rests on who should reasonably bear the risk of mistake, and that principle resolves both formation cases like *Raffles* itself¹⁰³ and interpretation cases which also involve mutual mistake.¹⁰⁴

Having contracted for the sale of cotton to arrive from Bombay on the ship *Peerless*, the parties in *Raffles* discovered that there were two such ships.¹⁰⁵ The buyer had in mind the October ship, and the seller the December ship.¹⁰⁶ The permutations of mistaken knowledge are many, but the immediately relevant limiting case is where neither party knew of the misunderstanding but one party, say, the seller, had reason to know, but did not actually know, of the other party's different meaning.¹⁰⁷ The accepted result is that a contract is made on the buyer's terms because the buyer neither knew nor had reason to know of the mistake.¹⁰⁸ Farnsworth states the principle that is now widely acknowledged as "the most satisfactory rationalization of this result," namely the fault of the seller.¹⁰⁹

100. *Id.*

101. (1864) 159 Eng. Rep. 375 (Exch.) 375; 2 Hurl. SC. 906.

102. *See id.* at 375.

103. *See* RESTATEMENT (SECOND) OF CONTRACTS § 20 (1981) (stating prevailing rule). *Raffles* and other early interpretations embodied other rationales. *See* OLIVER WENDELL HOLMES, THE COMMON LAW 242 (Mark DeWolfe Howe ed., 1963).

104. *See* RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981) (stating prevailing rules).

105. *See Raffles*, 159 Eng. Rep. at 375.

106. *See id.*

107. *See* RESTATEMENT (SECOND) OF CONTRACTS § 20(2)(b) (1981) (addressing this situation).

108. *See id.*

109. *See* FARNSWORTH, *supra* note 88, § 7.9 (internal quotation marks omitted).

Consider why this is “the most satisfactory rationalization.” Analysis begins with the terms of the contract.¹¹⁰ Context about the world—the existence of two ships *Peerless* sailing from Bombay with cotton—reveals that the words do not provide a clear basis for imposing obligation.¹¹¹ More context is relevant—what the parties knew.¹¹² Then even more—given the practices of the time, what each party had reason to know.¹¹³ But that context is insufficient to solve the problem. Instead, a norm must be used, the norm that the party should bear the loss who, through negligence or intentional wrongdoing, is derelict in failing to clear up a misunderstanding, rather than the party who is innocent.¹¹⁴

Seen broadly, this rule is a species of the principle that contract is about fault rather than consent. Stewart Macaulay and his casebook co-authors caption Judge Learned Hand’s famous quote to this point as “committing contracts,” or “[c]ontract as a type of tort.”¹¹⁵ One “commits” a contract just as one commits a tort, by acting unreasonably. In the contractual setting, unreasonableness consists of raising reasonable expectations and then disappointing them; that is, by creating expectations which, according to the norms of evaluation applied by the court, are sufficiently reasonable so that they justify legal obligation.¹¹⁶ In the mistake cases, those expectations are raised and then disappointed by not acting on what one knows or should know to be the true state of affairs. In good faith cases, the expectations inhere in the context as viewed through similar norms of evaluation.

110. *See id.* (“[T]he search for meaning begins with the meaning attached by both parties to the contract language . . .”).

111. *See id.* (considering *Raffles*).

112. *See id.*

113. *See id.*

114. *See* RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981) (addressing this situation).

115. 2 STEWART MACAULAY ET AL., *CONTRACTS: LAW IN ACTION* 8 (2d ed. 1995) (quoting *Hotchkiss v. Nat’l City Bank of N.Y.*, 200 F. 287, 293 (S.D.N.Y. 1911)).

116. Adherents of plain meaning claim to focus solely on the words of the parties to enforce the deal they have made. But these cases are not different. Instead, they merely rely on a different fault principle, namely that parties are at fault in using language in a way that departs from the court’s perception of its dictionary definition. Evaluative, certainly, even though it uses a view of context limited to language understood through a general dictionary.

2. Gap-Filling

Gaps in contracts less obviously tied to the words the parties have used arise either because the parties foresee a potential dispute at the time of contracting but, for reasons of economy or otherwise, decide not to address it, or because they do not foresee that the potential issue may arise.¹¹⁷ The events precipitating the gap may arise from sources such as technological change, change in market conditions, or specific events of which the parties are unaware at the time of contracting or which arise subsequently.¹¹⁸ What is important for present purposes is the way the courts respond to such gaps, which they do in particular cases and in classes of cases, the latter by default rules.¹¹⁹

Gap-filling rests on reasonable expectations. The Restatement suggests that there are cases in which “a term can be supplied by logical deduction from agreed terms and the circumstances.”¹²⁰ The process described is neither simply logical nor wholly deductive, something that is inherent in the terms and circumstances;¹²¹ instead, the approach is the now-familiar process of defining obligations arising from reasonable expectations. More generally, the principle underlying gap-filling is simple to state but difficult to apply, and the principle leads directly to the doctrine of good faith: “A court faced with an ‘omitted case,’ ‘seeks a fair bargain,’ by ‘extrapolating,’ from the ‘essence of the agreement.’”¹²² In doing so, “the court should supply a term which comports with community standards

117. See RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. b (1981); FARNSWORTH, *supra* note 88, § 7.15.

118. See FARNSWORTH, *supra* note 88, § 7.15 (providing additional illustrations).

119. See *id.* (“In both types of situations, courts supply rules that are commonly described as *default* rules . . .”).

120. RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. c (1981).

121. The same problems infect the hypothetical contract approach, attempting to fill a gap by hypothesizing the term the parties would have agreed to if they had considered the issue. The Restatement rejects this approach and Farnsworth provides two possible explanations. First, it would be naïve to assume that a court can make that determination. Second, even though one party can exercise its bargaining advantage to impose an unreasonable term, it would be unjust for a court to do the same. FARNSWORTH, *supra* note 88, § 7.16.

122. *Computer Assocs. Int’l v. State St. Bank & Trust Co.*, 789 F. Supp. 470, 476 (D. Mass. 1992) (citations and internal quotation marks omitted).

of fairness and policy.”¹²³ More specifically, as Farnsworth stated:

[B]asic principles of justice [should] guide a court in extrapolating from the situations for which the parties provided to the one for which they did not. . . . Where do courts find these basic principles of justice? Often they look to the idea of fairness in the exchange. In searching for what Lord Mansfield called the essence of the agreement, a court seeks a fair bargain—a bargain that an economist would describe as maximizing the expected value of the transaction. A court may, for example, justify the term it supplies on the ground that the term prevents one party from being in a position of economic servility and completely at the mercy of the other. It may supply a term that is suitable for a particular market or other segment of society or even for society in general.¹²⁴

Courts supply omitted terms through this process both in unique cases and in situations that recur frequently.¹²⁵ For example, the UCC employs its assumption that parties contract against a background of commercial reasonableness to reject narrow requirements of definiteness and conclude that a contract can be formed even though the parties have not agreed on the price or the time of performance; the norm of reasonableness establishes that, unless the parties have agreed otherwise, a reasonable price and reasonable time are to be read into the contract.¹²⁶

The same principle creates implied warranties, and a useful contrast exists between the implied warranties of merchantability and of fitness for purpose.¹²⁷ The warranty of fitness is specific to the transaction, arising “[w]here the seller at the time of contracting has reason to know any particular purpose for which the goods are required and that the buyer is relying on the seller’s skill or judgment to select or furnish

123. RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. d.

124. FARNSWORTH, *supra* note 88, § 7.16 (footnotes and internal quotation marks omitted).

125. *See id.* (discussing the process used by courts when supply implied terms).

126. *See* U.C.C. § 2-305 (2012) (open price term); U.C.C. § 2-309 (2012) (absence of time for shipment or delivery).

127. *See* U.C.C. § 2-314 (2012) (implied warranty of merchantability); U.C.C. § 2-315 (2012) (implied warranty of fitness for a particular purpose).

suitable goods.”¹²⁸ The warranty of merchantability is more general. In its original understanding, warranty arose “basically on the meaning of the terms of the agreement as recognized in the trade,”¹²⁹ reflecting Llewellyn’s emphasis on commercial practice and trade usage as the source of obligation.¹³⁰ More broadly, the warranty of merchantability imposes uniform standards based on the representation and understanding of products in the marketplace.¹³¹ Buyers expect products to be what they appear to be and to do what products of that type are understood to do. Therefore, merchantability is both broad and difficult to disclaim.¹³² Moreover, the warranty of merchantability embodies a loss-spreading and enterprise liability norm, imposing on the seller a non-disclaimable obligation to bear the cost of personal injuries resulting from a breach of warranty.¹³³

Some classes of recurring cases are so general that they give rise to substantial bodies of doctrine that are not always recognized as supplying omitted terms. Two of the most prominent are excuse by reason of impracticability or frustration and constructive conditions, especially the satisfaction of a condition through substantial performance.

In its classic formulation in the music hall case of *Taylor v. Caldwell*,¹³⁴ the court based what would become the doctrine of impracticability on the parties’ beliefs, actual or hypothetical.¹³⁵

[W]hen entering into the contract, they must have contemplated such continuing existence [of the music hall] as the foundation of what was to be done . . . [so that the contract was] subject to an implied condition that the parties shall be excused in case, before breach, performance becomes impossible from the perishing of the thing without default of the contractor. There seems little doubt that this

128. U.C.C. § 2-315 (2012).

129. U.C.C. § 2-314 cmt. 2 (2012).

130. See Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 470 (1987) (“The merchant rules are grounded in Llewellyn’s belief that legal rules must relate to the facts and must fit the realities of the transactions they govern.”).

131. See U.C.C. § 2-314(c) (2012).

132. See U.C.C. § 2-316(2) (2012) (requiring an explicit mention of merchantability to negate the warranty and conspicuous language in the case of a writing).

133. See U.C.C. § 2-318 (2012).

134. (1863) 122 Eng. Rep. 309 (K.B.), Best & Smith 826.

135. *Id.* at 312.

implication tends to . . . fulfill the intention of those who entered into the contract.¹³⁶

It is now understood that this description of the process is inapt in its emphasis on what the parties must have contemplated. The UCC and Restatement move only one step away, shifting from the “implied term” concept to one “under which the ‘central inquiry’ is whether the non-occurrence of the circumstance was a ‘basic assumption on which the contract was made.’”¹³⁷ “Assumption” connotes a focus on the thought processes of the parties, explicit or implicit. More accurately, as Farnsworth describes it, “[t]he new synthesis candidly recognizes that the judicial function is to determine whether, in the light of exceptional circumstances, justice requires a departure from the general rule that a promisor bears the risk of increased difficulty of performance.”¹³⁸ In exercising that function, “a court will look at all circumstances,” including the terms of the contract, the foreseeability of the supervening event, the bargaining position of the parties, and available risk-spreading mechanisms, through the market or otherwise.¹³⁹

As a final example, a court may read a constructive condition into a contract either “because the court believes that the parties would have intended it to operate as such if they had thought about it at all, or because the court believes that by reason of the *mores* of the time justice requires that it should so operate.”¹⁴⁰ Where the parties have not specified an order of performance, a paying party’s duty to tender payment typically is constructively conditional on the performing party’s tender of performance.¹⁴¹ In construction cases and some others, courts established the doctrine that the constructive condition is met by

136. *Id.*

137. RESTATEMENT (SECOND) OF CONTRACTS ch. 11, intro. note (1981).

138. FARNSWORTH, *supra* note 88, § 9.6. More grandly, the court must balance the conflicting maxims of *clausa rebus sic stantibus*, “every contract is subject to the implied condition . . . that circumstances in existence at its conclusion would not change” and *pacta sunt servanda*, “[a contract] requires faithful performance of contractual obligations, except when physically impossible.” See Peter Hay, *Frustration and Its Solution in German Law*, 10 AM. J. COMP. L. 345 (1961).

139. RESTATEMENT (SECOND) OF CONTRACTS ch. 11, intro. note (1981).

140. FARNSWORTH, *supra* note 88, § 8.9 (quoting Arthur L. Corbin, *Conditions in the Law of Contracts*, 28 YALE L.J. 739, 743-44 (1919)) (internal quotation mark omitted).

141. See *id.* § 8.15 (“Under the concept of constructive conditions of exchange, the owner’s payment of progress payments is an implied condition of the builder’s duty to continue to work.”).

substantial rather than literal performance.¹⁴² The constructive condition is as “an instrument of justice,” but literal enforcement would transform it into “a vehicle for injustice.”¹⁴³ As Farnsworth put it, “[p]lainly a test as flexible as substantial performance sacrifices predictability to achieve justice.”¹⁴⁴

Reasonable expectations resonate throughout the spectrum of contract doctrines, from formation to consideration and through to performance.¹⁴⁵ The principle of reasonable expectations is necessarily formulated in and applied through particular doctrines; a complex body of law must function through defined rules and standards, and types of situations recur with sufficient frequency to allow the development of doctrines that embody contexts and norms. Reasonable expectations also provide the need for the obligation of good faith and the means of its definition.

IV. GOOD FAITH REVISITED

The fundamental principle of contract law is the protection of reasonable expectations. To protect reasonable expectations, a court begins with the parties’ expressions, situates those expressions in a context, and applies norms arising from the context and from external sources to determine the extent of liability. The essential argument of this article is that good faith applies the same principle and approach that are applied elsewhere in contract law.

The obligation of good faith applies in a variety of circumstances that may arise during the performance of a contract,¹⁴⁶ and the variety is so great that it is impossible to

142. See, e.g., *Robinson v. Beaty*, 181 P. 941, 942 (Okla. 1919).

143. See CALAMARI & PERILLO, *supra* note 88, § 11.8 (“If the condition is imposed by law to do justice, it is a constructive condition, sometimes called a condition implied in law.”).

144. FARNSWORTH, *supra* note 88, § 8.12.

145. In ways not discussed here, it also permeates to remedies. For example, the two-fold rule of *Hadley v. Baxendale* determines the extent of damages based on reasonable expectations. General damages are reasonably expected in the class of cases and special damages in the particular context. See (1854) 156 Eng. Rep. 145, (Exch.); 9 Ex. 341.

146. Good faith is a performance doctrine that only operates once a contract is made; there are obligations that might be described as “good faith” during the negotiation or formation of a contract, but those obligations are defined by other doctrines such as misrepresentation. See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1981). As a performance doctrine, good faith continues to operate through the termination of a

catalog the applications. The applications are more fully explored in considering the content of the doctrine in the sections that follow. However, the doctrine's origin in reasonable expectations suggests some general points about its application.

Reasonable expectations are constructed both from the express terms of an agreement and from sources beyond those terms. If a court is comfortable in finding an obligation explicitly stated in the express terms of the contract, ordinary formation and interpretation doctrines are sufficient to the task so resort to good faith is unnecessary.¹⁴⁷ If the court does not find an obligation that is explicit in the express terms, then good faith is one of the doctrines that can be employed to determine the proper extent of the obligation.¹⁴⁸ In some cases, good faith determines the extent of obligation arising from an express term; a classic use of good faith is to cabin the discretion vested in a party by an express term. In other cases, good faith is farther removed from an express term; the concept of "instinct with an obligation" in cases such as *Wood v. Lucy Lady Duff-Gordon* rests on giving the transaction "business efficacy" without resting on a particular term of the contract.¹⁴⁹

In all of its applications, the content of good faith rests on reasonable expectations. What expectations there are and whether they are reasonable depend on the context of the contract and so are highly variable. In other doctrinal contexts, however, that variability has not prevented the formulation of rules and standards for recurring situations. Constructive conditions about order of performance, for example, have been constructed so that in a one-shot sales contract, tender of each performance is constructively conditional on tender of the other, while performance of a service which can occur only over time is the constructive condition of the paying party's duty to pay

contract and therefore covers claims of termination or "the assertion, settlement and litigation of contract claims and defenses" that are not in good faith. *Id.* § 205 cmt. e.

147. FARNSWORTH, *supra* note 88, § 7.17.

148. Summers points out that even when alternative concepts are available to achieve the same end, the concept chosen may have consequences. Because judges may be less willing to remake the parties' agreement, a focus on implied terms may end up being more restrictive than a focus on duties of good faith. *See* Summers, *supra* note 4, at 233.

149. *See* FARNSWORTH, *supra* note 88, § 7.17 ("Since [Lady's] remuneration depended entirely on [Wood's] efforts, the court supplied a term requiring that Wood use his best efforts to sell her fashions.").

for the performance and not vice-versa. Therefore, there ought to be at least some general statements about the content of good faith recognizing that the precise definition always awaits individual cases.

The ability to generalize about good faith has long been a point of contention in the academic debate. The Summers-Restatement approach rests on the belief that “good faith is an excluder. . . . a phrase without general meaning (or meanings) of its own and [only] serves to exclude a wide range of heterogeneous forms of bad faith.”¹⁵⁰ The Burton “foregone opportunities” approach, on the other hand, states a principle of good faith, the narrowness of which imbues it with relative definiteness.¹⁵¹ Under that approach, bad faith constitutes an attempt to recapture opportunities foregone as a result of the making of the contract,¹⁵² although the opportunities foregone are defined in terms of “the expectations of reasonable persons in the position of the dependent parties,”¹⁵³ those expectations include only economic elements of the contract, so that the effect of good faith is “to enhance economic efficiency by reducing the costs of contracting.”¹⁵⁴

One certain element of good faith is a requirement that a party must act honestly in the performance of its contract. Even before the 2001 amendments to the UCC extended the sales definition of good faith to other articles of the Code, “honesty in fact” was a universal requirement.¹⁵⁵ It could hardly be otherwise; it is hard to conceive of a contract in which the parties agree that each can deliberately lie to the other. In a typical case, a party who is permitted to exercise discretion must do so honestly; a seller who has the contractual right to demand cash or security before shipping goods if the buyer’s credit or financial security is impaired may make the demand “only if that party in good faith believes that the prospect of payment or performance is impaired,”¹⁵⁶ not if the expressed belief is a

150. Summers, *supra* note 4, at 201 (footnotes and internal quotation marks omitted).

151. See Burton, *supra* note 5, at 391.

152. *Id.* at 373.

153. *Id.* at 391.

154. *Id.* at 393.

155. See U.C.C. § 1-201(19) (revised 2001).

156. U.C.C. § 1-309 (2012).

subterfuge for regret about entering the transaction in the first place.

Honesty alone is not the limit of good faith.¹⁵⁷ A related requirement of good faith on which all courts and commentators agree is a prohibition against acting opportunistically. Opportunism is the practice of exploiting circumstances for selfish advantage without regard for prior commitment, colorfully defined in the transaction-cost economics literature as “self-interest seeking with guile.”¹⁵⁸ In entering into a contract, a party limits its future freedom of action in exchange for a benefit promised by the other party to the contract.¹⁵⁹ A deliberate attempt to retain that benefit while avoiding the limits on its own freedom violates the essential nature of the contract and therefore the reasonable expectations of the other party, whether the limits and benefits are defined in the express terms of the agreement or are implicit in the obligation of good faith.¹⁶⁰

The ambit of good faith becomes murkier in moving beyond dishonesty and opportunism. The comments to the Restatement (Second) of Contracts helpfully state that “[g]ood faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.”¹⁶¹ Reasonable expectations are made up of “an agreed common purpose” and of “justified expectations,” which, by necessary implication, must come from a source broader than the agreed common purpose.¹⁶² That source, as the comments explain, lies in “community standards of decency, fairness or

157. This point was manifest in the 2001 amendments to Article 1 of the Uniform Commercial Code, which included “observance of reasonable commercial standards of fair dealing” in the general definition of good faith. This supplemented “honesty in fact,” a point that had previously been included only in the Article 2 definition. Compare U.C.C. § 1-201(b)(20) (2012), with U.C.C. § 1-201(19) (revised 2001), and U.C.C. § 2-103(1)(b) (revised 2003).

158. Oliver E. Williamson, *Opportunism and its Critics*, 14 *MANAGERIAL & DECISION ECON.* 97, 97 (1993).

159. See Burton, *supra* note 5, at 387-88 (“[E]ach party must forgo some future opportunity upon formation and thus restrain its future freedom in some way.”).

160. See *id.* at 378.

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

162. *Id.*

reasonableness”¹⁶³ or, as stated in the UCC, “reasonable commercial standards of fair dealing.”¹⁶⁴

The difficult task is to supply the content of terms such as “justified expectations,” “community standards,” and “reasonable commercial standards” in different fact situations. Although Summers offered an excluder analysis that on its face defies conceptualization, one of his seminal articles described affirmative obligations rather than just listing excluded types of bad faith.¹⁶⁵ His list includes interpreting contract language fairly, acting cooperatively and diligently, and having reasons for the exercise of discretion.¹⁶⁶ Macneil’s contract norms can be translated into a general and comprehensive statement of the content of good faith, including, for example, reciprocity and flexibility.¹⁶⁷ Because practically all cases in which good faith is a disputed issue are to some extent relational contracts, Macneil’s relational norms—role integrity, preservation of the relation, harmonization of relational conflict, propriety of means, and harmonization with norms external to the contract—play a particularly important role.¹⁶⁸

Rather than attempt a precise conceptual definition of the content of good faith—a task that Summers warns risks “spiral[ing] into the Charybdis of vacuous generality or collid[ing] with the Scylla of restrictive specificity”¹⁶⁹—the sections that follow focus on the central issues that define good faith in the courts. These issues are the relation between the express terms of the contract and the obligation of good faith, whether subjective intention is a necessary element of the violation of good faith, and the standards of behavior required to perform in good faith. In each case, courts err when they fail to adhere to the principle of reasonable expectations, and the cure for their errors is to recognize that good faith is similar to every other contract law doctrine in its embodiment of that principle.

163. *Id.*

164. U.C.C. § 1-201(b)(20) (2012).

165. *See* Summers, *supra* note 4, at 203 (listing eight such obligations).

166. *Id.*

167. *See* Macneil, *Values in Contract*, *supra* note 56, at 347.

168. *See id.* at 361.

169. Summers, *supra* note 4, at 206.

A. Express Terms and Good Faith

The first issue is the relationship between the express terms of the contract and the obligation of good faith. Here, the error that some courts commit is to tie the good faith obligation too closely to the express terms of the contract. These courts invest the purported bargaining process with great weight and therefore constrict the operation of good faith relative to the express terms. The classic aphorism expressing this view comes from Judge Easterbrook: “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.’”¹⁷⁰ Under a reasonable expectations approach, by contrast, the obligation of good faith sometimes gives content to duties created by the express terms, but it also expands obligation beyond those duties.

The most obvious application of the restricted view limits the operation of good faith when there appears to be a conflict between the face of a provision of the contract and a party’s claim that the operation of that provision is limited by the obligation of good faith. In the lender-liability cases, the text of the agreement gives the lender the power to call a demand loan, to declare a loan in default and demand payment, or pursue some of its remedies rather than others; the textualist focus holds that good faith imposes no limitation on the exercise of those powers.¹⁷¹ In other types of cases, particularly those involving franchise contracts, a party’s stated power to terminate a contract is held to not be restricted by the obligation of good faith with respect to reasons for termination.¹⁷²

An equally troubling application of this view of the relationship between text and good faith holds that good faith creates no duty unless that duty can be tied to a specific term of the contract. Under this approach, the duty of good faith must “relate to the performance of an express term of the contract and

170. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (internal quotation marks omitted).

171. *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting* is a classic example. For a recent example with citations, see *Martin v. Hamilton State Bank*, 723 S.E.2d 726, 728 (Ga. Ct. App. 2012).

172. See, e.g., *Amoco Oil Co. v. Burns*, 437 A.2d 381, 383 (Pa. 1981). Oil companies as franchisors of service stations are often limited by statute in their ability to terminate, typically by the exercise of good faith. See *id.* at 384.

is not an abstract and independent term of a contract which may be asserted as a source of breach when all other terms have been performed pursuant to the contract requirements.”¹⁷³ For example, a franchisee has no cause of action for breach of good faith when the franchisor establishes new franchises that encroach on its territory, in the absence of express terms granting it exclusive rights.¹⁷⁴ Under this view, the entire scope of good faith is to control the exercise of discretion under a particular contract term.¹⁷⁵

Taken to its most extreme, this position goes beyond the requirement that good faith be tied to a specific provision of the contract. Some Florida opinions, for example, do not allow a claim for breach of good faith “absent an allegation that an express term of the contract has been breached.”¹⁷⁶ At this point, the good faith obligation becomes superfluous, as there is an action available for breach of the underlying express provision.¹⁷⁷

Some courts appear to take a broad view of the relation between the implied covenant and the text but actually restrict the application of good faith. In Utah, for example, “[t]o determine the legal duty a contractual party has under [the

173. *QBE Ins. Corp. v. Chalfonte Condo. Apartment Ass’n*, 94 So. 3d 541, 548 (Fla. 2012) (quoting *Ins. Concepts & Design, Inc. v. Healthplan Servs., Inc.*, 785 So. 2d 1232, 1235 (Fla. Dist. Ct. App. 2001)) (internal quotation marks omitted).

174. *See Burger King Corp. v. Weaver*, 169 F.3d 1310, 1317 (11th Cir. 1999); *see also In re Magna Cum Latte, Inc.*, No. 07-03304, 2007 WL 4412143, at *4 (Bankr. S.D. Tex. Dec. 13, 2007) (“[T]he implied covenant informs the contractual language so that it conforms to what the parties, bounded by norms of good faith and fair-dealing, contemplated.”); *Sanders v. FedEx Ground Package Sys., Inc.*, 188 P.3d 1200, 1203, 1206 (N.M. 2008) (holding evidence of the parties’ discussion at the time of contracting and the practices of the defendant with respect to similarly situated plaintiffs is admissible only to aid in the understanding of a specific term of the contract in order to define the scope of the good faith obligation).

175. *See Meruelo v. Mark Andrew of Palm Beaches, Ltd.*, 12 So. 3d 247, 251 (Fla. Dist. Ct. App. 2009) (“[Good faith] is usually raised ‘when a question is not resolved by the terms of the contract or when one party has the power to make a discretionary decision without defined standards.’ . . . This ‘discretion’ concept applies only where there is an express contractual duty or obligation over which one party has sole discretion.” (quoting *Publix Super Mkts., Inc. v. Wilder Corp. of Del.*, 876 So. 2d 652, 654 (Fla. Dist. Ct. App. 2004))); *see also Wells Fargo Bank v. Ariz. Laborers*, 38 P.3d 12, 30 (Ariz. 2002) (holding similarly).

176. *See Ins. Concepts & Design, Inc.*, 785 So. 2d at 1234.

177. *See Carma Developers, Inc. v. Marathon Dev. Cal., Inc.*, 826 P.2d 710, 727 (Cal. 1992) (en banc) (“It is universally recognized the scope of conduct prohibited by the covenant of good faith is circumscribed by the purposes and express terms of the contract.”).

obligation of good faith], a court will assess whether a party's actions [are] consistent with the agreed common purpose and the justified expectations of the other party."¹⁷⁸ However:

While a covenant of good faith and fair dealing inheres in almost every contract, some general principles limit the scope of the covenant First, this covenant cannot be read to establish new, independent rights or duties to which the parties did not agree *ex ante*. Second, this covenant cannot create rights and duties inconsistent with express contractual terms. Third, this covenant cannot compel a contractual party to exercise a contractual right "to its own detriment for the purpose of benefitting another party to the contract." Finally, we will not use this covenant to achieve an outcome in harmony with the court's sense of justice but inconsistent with the express terms of the applicable contract.¹⁷⁹

These restricted approaches to good faith focus on text to the exclusion of extrinsic evidence and attempt to clearly distinguish between internal and external, or between the parties' agreement and the imposition of obligation from outside their agreement. The recognition that the good faith obligation is simply another manifestation of the protection of reasonable expectations, on the other hand, dissolves the boundaries between text and context and between internal and external. A contracting party's obligation is not only defined and circumscribed by the text of the contract; as in other areas, it is defined by reasonable expectations created by words, conduct, and context.

A modest use of good faith in relation to the text arises when an express term confers on one party the power to exercise discretion, which good faith then operates to limit. In *Cox v. CSXI Intermodal, Inc.*,¹⁸⁰ for example, truck owner-operators had contracted to transport freight for CSXI under a contract term that stated, in part, "[t]his Agreement shall in no way be construed as an agreement by CSXI to furnish . . . any specific amount of freight or number of loads for transport by [the

178. *Oakwood Vill., L.L.C. v. Albertsons, Inc.*, 104 P.3d 1226, 1239-40 (Utah 2004) (third alteration in original) (quoting *St. Benedict's Dev. Co. v. St. Benedict's Hosp.*, 811 P.2d 194, 200 (1991)) (internal quotation marks omitted).

179. *Id.* at 1240 (citations omitted) (quoting *Olympus Hills Shopping Ctr. v. Smith's Food & Drug Ctrs.*, 889 P.2d 445, 457 n.13 (Utah Ct. App. 1994)).

180. 732 So. 2d 1092 (Fla. Dist. Ct. App. 1999).

contractor] at any particular time or to any particular place.”¹⁸¹ The plaintiffs alleged that CSXI had only allocated less lucrative short-haul loads to them, which constituted a breach of the obligation of good faith.¹⁸² The court held that although good faith could not vary the express terms, it did limit a party’s ability “to act capriciously to contravene the reasonable contractual expectations of the other party.”¹⁸³ It cited an opinion by Justice Souter, who, while on the New Hampshire Supreme Court, stated:

[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.¹⁸⁴

When good faith operates to limit discretion granted under a provision of the text, it is in effect expanding the duties created by the express terms, although in a way tied closely to the text. But its ambit is not limited to such uses. In many cases, reasonable expectations create a duty of good faith beyond the text, either to perform contractual duties in good faith or to observe new duties. Many of these cases involve termination of contracts. Even though a party does not breach its contract by exercising an express power of termination, the course of conduct leading up to the termination may constitute bad faith. That course of conduct may include failing to hold up its end of a bargain¹⁸⁵ and encouraging the other party to invest in the contract knowing that termination is on the horizon.¹⁸⁶ Indeed,

181. *Id.* at 1094.

182. *See id.* at 1098.

183. *Id.* at 1097-98.

184. *Id.* at 1097 (alteration in original) (quoting *Centronics v. Genicom Corp.*, 562 A.2d 187, 193 (N.H. 1989)).

185. *See, e.g., United Roasters, Inc. v. Colgate-Palmolive Co.*, 649 F.2d 985, 990 (4th Cir. 1981) (“What is wrong with [defendant’s] conduct in this case is not its failure to communicate a decision to terminate arrived at before the end of March, but its cessation of performance.”).

186. *See, e.g., Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575, 589 (N.J. 1997) (holding breach of covenant of good faith could be found where party engaged in conduct inconsistent with its contractual obligations and with knowledge it would soon terminate the agreement).

good faith can give rise to duties even after a proper termination. In *Carmichael v. Adirondack Bottled Gas Corp. of Vermont*,¹⁸⁷ a gas distributorship agreement contained a “key man” clause terminating the agreement on the death of the owner of the distributorship.¹⁸⁸ Upon the owner’s death, his widow expressed a desire to continue the business, but Adirondack, the supplier, offered to purchase the business for a price that had previously been rejected, indicated its intention to cut off her supplies, and was uncooperative in subsequently helping her wind up the business.¹⁸⁹ The court held that specific duties of Adirondack after termination, such as turning over business records, carried an obligation of good faith.¹⁹⁰ Even more, it held that the “key man” provision:

[D]id not extinguish the context of prior dealings between the parties. These dealings might have legitimately led [Plaintiff] to expect that Adirondack 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.¹⁹¹

The “specific facts” included “the relational context within which the termination clause went into effect” under the Restatement’s reasonable expectations approach.¹⁹²

Because reasonable expectations arise not only from express terms, but also from implied terms and the context in which the contract is made, limitations on good faith that give excessive deference to express terms are incorrect. The obligation of good faith rests on reasonable expectations that can create duties that go beyond those specified in the express terms of the contract, including duties that limit a party’s ability to exercise rights apparently created by the express terms. Even a narrow view of the content of the good faith obligation, such as Judge Posner’s theory of the hypothetical contract that minimizes joint costs of performance, recognizes this possibility; in *Market Street Associates v. Frey*,¹⁹³ Judge Posner

187. 635 A.2d 1211 (Vt. 1993).

188. *Id.* at 1213.

189. *See id.* at 1217-18.

190. *Id.* at 1217 (“All of this post-termination activity was subject to good faith and fair dealing.”).

191. *Id.*

192. *Carmichael*, 635 A.2d. at 1217.

193. 941 F.2d 588 (7th Cir. 1991).

held that a party had a duty not expressed in the contract to notify its contracting partner that it had not taken necessary steps to invoke a right under the contract.¹⁹⁴

Therefore, the aphorisms quoted above that courts often recite to favor express terms and to limit good faith¹⁹⁵ are inconsistent with the basic principle of reasonable expectations. This restricted approach rests on an impoverished view of the relationship between express terms and reasonable expectations and should be rejected.

B. Subjective Intention

The second issue is whether a violation of good faith requires that the party subjectively intend to do so. Many courts hold that the only actionable type of breach is an intentional or reckless violation of the standards of behavior—subjective bad faith. Under this view, dishonesty in service of opportunism is the sole measure of bad faith.

Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Center,¹⁹⁶ the New Jersey Supreme Court case discussed earlier, illustrates. There the court stated, “[p]roof of ‘bad motive or intention’ is vital to an action for breach of the covenant.”¹⁹⁷ The opinion does little to justify that position; indeed, other elements of its definition of good faith lead in the other direction. The UCC definition that the court quoted had the alternative requirements of dishonesty or failure to observe the objective “reasonable commercial standards of fair dealing.”¹⁹⁸ The court also cited the Restatement, which contemplates breach of good faith by violation of community standards that are not

194. *See id.* at 596-98.

195. *See, e.g.,* *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (“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.’”); *QBE Ins. Corp. v. Chalfonte Condo. Apartment Ass’n*, 94 So. 3d 541, 548 (Fla. 2012) (“[Good faith] is not an abstract and independent term of a contract which may be asserted as a source of breach when all other terms have been performed pursuant to the contract requirements.”); *Oakwood Vill. L.L.C. v. Albertsons, Inc.*, 104 P.3d 1226, 1240 (Utah 2004) (“[T]his covenant cannot be read to establish new, independent rights or duties to which the parties did not agree *ex ante*.”).

196. 864 A.2d 387 (N.J. 2005).

197. *Id.* at 396 (quoting *Wilson v. Amerada Hess Corp.*, 773 A.2d 1121, 1130 (N.J. 2001)).

198. *Id.* at 395 (quoting N.J. STAT. ANN. § 12A:2-103(b)(1) (West 2014)).

limited to subjective bad faith.¹⁹⁹ Remarkably, it even noted that “[s]ubterfuges and evasions” constitute bad faith “even though the actor believes his conduct to be justified,” which is the antithesis of bad motive or intention.²⁰⁰

Brunswick Hills Racquet Club also is typical in that it announces the requirement of a subjective intention although the facts of the case actually involved subjective bad faith, so the requirement was not necessary to the court’s holding. In that case, a commercial tenant had an option that could only be exercised by giving notice and tendering a payment to the lessor.²⁰¹ The tenant gave the requisite notice but failed to make the payment, largely through what the court described as “a series of written and verbal evasions” by the lessor and its lawyer designed to defeat the exercise of the option, which was not in the lessor’s economic interest.²⁰² That conduct constituted subjective bad faith.²⁰³

This duality of citing objective standards but requiring subjective violations is unfortunately too typical. In *In re Magna Cum Latte, Inc.*,²⁰⁴ for example, the court, applying California law, stated that breach of the implied covenant requires:

[A] failure or refusal to discharge contractual responsibilities, prompted not by an honest mistake, bad judgment or negligence but rather by a conscious and deliberate act, which unfairly frustrates the agreed common purposes and disappoints the reasonable expectations of the other party thereby depriving that party of the benefits of the agreement.²⁰⁵

Under this approach, the common purposes of the contract can be frustrated and a party’s reasonable expectations can be disappointed only by a conscious and deliberate act of

199. See *id.* at 395-96 (citing RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981)).

200. *Id.* at 396 (alteration in original) (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981)).

201. See *Brunswick*, 864 A.2d at 389.

202. *Id.*

203. *Id.* at 399 (“[D]efendant’s conduct amounted to a clear breach of the implied covenant of good faith and fair dealing.”).

204. No. 07-03304, 2007 WL 4412143 (Bankr. S.D. Tex. Dec. 13, 2007).

205. *Id.* at *4 (quoting *Careau & Co. v. Sec. Pac. Bus. Credit, Inc.*, 222 Cal. App. 3d 1371, 1395 (Dist. Ct. App. 1990)).

dishonesty. That is, a party can reasonably expect only that its contracting partner will not lie, cheat, or steal.

The idea that good faith only guards against opportunism, and so requires no more than honesty, often will be inconsistent with reasonable expectations. A party certainly expects that its contracting partner will not act opportunistically, but often it expects more—that its partner will act consistent with expectations of the relationship and reasonable commercial norms. That is, of course, why the UCC states the norm of requiring both the subjective requirement of “honesty in fact” and the objective requirement of adherence to “reasonable commercial standards of fair dealing.”²⁰⁶ The rule in Code cases is clear, and it is paradoxical for courts to observe that rule in some cases and to state a much narrower rule in others.

Under a reasonable expectations approach, a subjective intention to subvert the aims of the contract is not always required to violate good faith.²⁰⁷ Good faith is defined by reasonable expectations, so in every case, or in classes of cases, a full exposition of the context and its normative structure dictates whether a violation of objective standards of good faith is enough or whether subjective intention is required. In many cases, a failure to adhere to objective standards of good faith constitutes a breach even if the party lacked the subjective intention to do so. “[F]air dealing may require more than honesty.”²⁰⁸

A common set of cases involves the evaluation of the exercise of discretion by one party to the contract in determining whether a condition of its own duty of performance has been satisfied.²⁰⁹ Good faith based on reasonable expectations defines the limits of discretion. In some cases of this type, the requirement of subjective bad faith is consistent with reasonable expectations because the parties’ reasonable expectations are that a discretion-exercising party’s subjective satisfaction is the appropriate measure to be applied. In these cases, the discretion is inherently personal or subjective, “involving fancy, taste, or

206. U.C.C. § 1-201(b)(20) (2012).

207. See *Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc.*, 826 P.2d 710, 727 (Cal. 1992) (“[T]he covenant of good faith can be breached for objectively unreasonable conduct, regardless of the actor’s motive.”).

208. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1981).

209. See *Doubleday & Co., v. Curtis*, 763 F.2d 495, 500 (2d Cir. 1985).

judgment.”²¹⁰ Standard publishing contracts, for example, allow a publisher to reject an author’s manuscript unless it is “satisfactory to [the] [p]ublisher in content and form.”²¹¹ In a classic case involving the actor Tony Curtis, the Second Circuit held “a publisher may, in its discretion, terminate a standard publishing contract, provided that the termination is made in good faith and that the failure of an author to submit a satisfactory manuscript was not caused by the publisher’s bad faith.”²¹²

In other cases, however, reasonable expectations dictate that satisfaction is to be judged according to an objective standard because the condition to be determined is “commercial value or quality, operative fitness, or mechanical utility.”²¹³ This is hornbook law:

When it is a condition of an obligor’s duty that he be satisfied with respect to the obligee’s performance or with respect to something else, and it is practicable to determine whether a reasonable person in the position of the obligor would be satisfied, an interpretation is preferred under which the condition occurs if such a reasonable person in the position of the obligor would be satisfied.²¹⁴

In *Markham v. Bradley*,²¹⁵ for example, a seller of real estate was authorized by the agreement to cancel the prospective sale if the buyer’s credit report was “not acceptable to [the] [s]eller.”²¹⁶ The court held that this was subject to an objective standard of creditworthiness.²¹⁷ Otherwise, the promise to sell would be rendered illusory.²¹⁸ This is the case even in jurisdictions that have a constricted concept of the relation of the good faith obligation to the express terms. In *Smith v. Arrington Oil & Gas, Inc.*,²¹⁹ landowners brought an action against the lessee of oil and gas leases for failure to make payments, and the lessee defended on the basis that the lessors had not secured the

210. *Mattei v. Hopper*, 330 P.2d 625, 627 (Cal. 1958).

211. *Doubleday & Co.*, 763 F.2d at 497 (internal quotation marks omitted).

212. *Id.* at 501.

213. *See Mattei*, 330 P.2d at 626-27.

214. RESTATEMENT (SECOND) OF CONTRACTS § 228 (1981).

215. 173 P.3d 865 (Utah Ct. App. 2007).

216. *Id.* at 872.

217. *Id.*

218. *Id.*

219. 664 F.3d 1208 (8th Cir. 2012).

approval of title, which was a condition of the leases.²²⁰ The court rejected the lessee's argument that its action did not violate good faith as long as it was not "arbitrary or capricious."²²¹ Moreover, it would not satisfy the obligation of good faith that the lessee had business reasons for failing to make the approvals; reasonableness required that it have "relevant" business reasons, or those that were consistent with the reasonable expectations of the parties at the time of contracting.²²²

The contrast also can be seen in the line of cases involving a lessor's ability to refuse to consent to a sublease. The parties may, if they choose to do so, vest the lessor with discretion to refuse to consent for any reason at all.²²³ But where the lessor has not been vested with that "sole discretion," a standard of commercial reasonableness applies to determine the good faith of the decision to reject a sublease.²²⁴

Ordinarily, the subjective standard is the narrower one; as long as the party exercising discretion acted honestly, an objectively unreasonable decision still constitutes good faith. But reasonable expectations dictate that the subjective and objective tests are independent and can be applied differently in different cases. In *Storek & Storek, Inc. v. Citicorp Real Estate, Inc.*,²²⁵ for example, disappointed investors in a real estate development project sued Citicorp for its refusal to continue financing the project.²²⁶ The loan agreement contained conditions precedent for continued financing, including a condition that Citicorp determine that the project funding was not "out of balance."²²⁷ The court concluded that "[t]he decision to be made by Citicorp as to whether the project budget was in balance was a matter entirely of financial concern and had no

220. *Id.* at 1212.

221. *See id.* at 1216-17.

222. *Id.* at 1217 (emphasis omitted).

223. *See Shoney's L.L.C. v. Mac E., L.L.C.*, 27 So. 3d 1216, 1223 (Ala. 2009) ("[A]n unqualified express standard such as 'sole discretion' is also to be construed as written.")

224. *See Homa-Goff Interiors, Inc. v. Cowden*, 350 So. 2d 1035, 1038 (Ala. 1977) ("The landlord's rejection should be judged under a test applying a reasonable commercial standard.")

225. 122 Cal. Rptr. 2d 267 (Dist. Ct. App. 2002).

226. *Id.* at 270.

227. *Id.* at 272.

implications for aesthetics or other aspects of personal taste.”²²⁸ Therefore, subjective good faith was not at issue; the sole issue was whether Citicorp’s decision was objectively reasonable.²²⁹

It may be argued that the satisfaction cases involve interpretation, not good faith. Courts and even the Restatement are ambiguous in their characterization of the question. From the perspective of this article, that issue is irrelevant. Interpretation and good faith are simply different ways of constructing and enforcing the parties’ reasonable expectations. Good faith is to be preferred here for two reasons. First, it more aptly describes the process at work, in which the court looks at the parties’ words and conduct and the context in which they were used to determine the scope of obligation. That is especially important as interpretive approaches tend toward plain meaning, which is markedly unhelpful in this context. Second, these inquiries tend to be fact-intensive and therefore are more appropriate for determination by a jury. Good faith is a question of fact for the jury, whereas interpretation of a written document is ordinarily a question of law for the court.²³⁰

C. Standards for Good Faith

The third issue is how the standard of good faith is defined and what sources the courts look to in defining that standard. In constructing the standards of good faith, some courts may look beyond the express terms of the contract, but often they will not look very far.²³¹ Like the varying ways to emphasize express terms as limits on the good faith obligation, this approach defines the parties’ contract and their objectives narrowly and therefore limits the sources and scope of the good faith obligation.

One commonly cited source of this error lies in the “foregone opportunities” approach to good faith which Steven Burton offered in opposition to the Summers-Restatement

228. *Id.* at 280.

229. *See id.* at 281-82.

230. *Carmichael v. Adirondack Bottle Gas Corp. of Vt.*, 635 A.2d 1211, 1217 (Vt. 1993) (citing *CALAMARI & PERILLO*, *supra* note 88, § 11-38(c)).

231. *See* Frank J. Cavico, *The Covenant of Good Faith and Fair Dealing in the Franchise Business Relationship*, 6 BARRY L. REV. 61, 98 (2006) (stating that courts first look to the express language of the contract, but if the language “lacks pertinent express terminology, is deemed ambiguous, or reposes discretion in one party,” the court will look to other sources to discern the meaning of the terms at issue).

analysis.²³² In Burton's view, bad faith only constitutes an attempt to recapture the opportunities which were foregone at the time of contracting, with a focus on economic elements of the contract.²³³

*Young Living Essential Oils, L.C. v. Marin*²³⁴ is instructive. In that case, a supplier sued its distributor for failure to meet sales quotas specified in the distributorship agreement.²³⁵ The distributor defended on the basis that the supplier had failed to provide him with marketing materials it had promised, and the obligation of good faith made the provision of those materials a condition of his duty to meet the quotas.²³⁶ The court rejected the distributor's contention because it failed to pass the "high bar" Utah law set for the invocation of good faith.²³⁷ "[T]he court may recognize a covenant of good faith and fair dealing where it is clear from the parties' course of dealings or a settled custom or usage of trade that the parties undoubtedly would have agreed to the covenant if they had considered and addressed it."²³⁸ Echoing Judge Posner, the court limited good faith to terms "the parties would doubtless have adopted"²³⁹ and "would certainly have agreed to if they had thought to address it."²⁴⁰ And although good faith is necessarily broader than the express terms, the good faith obligation may not conflict with an express term of the contract; otherwise, its effect would be "completely negated."²⁴¹ The distributor's argument failed because the obligation he asserted was not "based in a universally accepted obligation established through industry custom or the parties' course of dealing."²⁴²

232. See *supra* notes 14-22 and accompanying text.

233. Burton, *supra* note 5, at 395.

234. 266 P.3d 814 (Utah 2011).

235. See *id.* at 815.

236. See *id.* at 817-18.

237. See *id.* at 817.

238. *Id.* (internal quotation marks omitted).

239. See *Young Living Essential Oils, L.C.*, 266 P.3d at 817.

240. *Id.* at 818.

241. See *id.* at 817 n.4.

242. *Id.* at 817; see also *Waste Connections of Kan., Inc. v. Ritchie Corp.*, 228 P.3d 429, 439 (Kan. Ct. App. 2010) (holding that a property owner cannot structure a transaction with a potential buyer so that it maximizes its profits at the expense of the holder of a right of first refusal where doing so would amount to an attempt to recapture an opportunity foregone at the time of contracting).

This approach is unsound. The standards of behavior that provide the content of good faith are not properly defined either by the text of the contract or by a narrow and largely hypothetical view of the parties' bargain. Instead, they are defined by reasonable expectations, and reasonable expectations can be constructed from words, conduct, and context, including what is often referred to as the need to give "business efficacy" to the contract and the normative structure in which the parties' relation is enmeshed.

The Restatement itself illustrates:

A, owner of a shopping center, leases part of it to B, giving B the exclusive right to conduct a supermarket, the rent to be a percentage of B's gross receipts. During the term of the lease A acquires adjoining land, expands the shopping center, and leases part of the adjoining land to C for a competing supermarket. Unless such action was contemplated or is otherwise justified, there is a breach of contract by A.²⁴³

A's obligation of good faith in this illustration is not defined by express terms, by A's "foregone opportunities,"²⁴⁴ or by terms "the parties would doubtless have adopted."²⁴⁵ Instead, it is defined by B's reasonable expectations, which are constructed after the fact by the court based on its understanding of the "business efficacy" of the transaction.

Under the reasonable expectations approach, the standards begin with "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party" and extend to "community standards of decency, fairness or reasonableness."²⁴⁶ This recognizes that a normative structure is part of the context with respect to which parties contract.²⁴⁷ Therefore, embedded in every contract is a set of evaluative norms. The norms vary among broad classes of contracts—relational or discrete is a key distinction.²⁴⁸ Some norms arise from the nature of exchange itself, such as the need for

243. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d, illus. 2 (1981).

244. See *Waste Connections of Kan., Inc.*, 228 P.3d at 438.

245. *Young Living Essential Oils L.C.*, 266 P.3d at 817.

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

247. See Macneil, *Values in Contract*, *supra* note 56, at 346 ("The common norms are essential to any behavior we might be willing to call contractual . . .").

248. See *id.* at 347 ("The common contract norms are then, in my view, the values in the internal . . . arenas of contracts whether the contracts are discrete or relational.").

reciprocity. Others arise from the parties' experience and their particular relationship, which the UCC defines as course of dealing and course of performance. Still others are better seen as arising from sources external to the relationship, such as trade usage on which the Code so heavily relies: "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."²⁴⁹

In this way, some of the vagueness of the Restatement standard and the distinction in expression between it and the UCC provisions also are clarified. The Restatement comments' reference to "community standards of decency, fairness or reasonableness"²⁵⁰ suggests the kind of moralism that Judge Posner criticized.²⁵¹ But the Code's statement of "reasonable commercial standards of fair dealing"²⁵² better captures the concept. There are standards that derive from the context, and the standards must be fair and decent when measured against more general community norms. Although those standards do not arise from the immediate expressions of assent of the parties, they are still properly regarded as part of the parties' contract because their reasonable expectations always include the context of which the normative structure is an essential part.

A consequence is that the view that contracting parties are "value maximizers" who simply seek to prevent opportunistic behavior or to minimize joint costs fails to capture the richness of their situation. As a general matter, it is impossible to construct the parties' contract, be it express, implied, or hypothetical, without referring to the context in which that contract is enmeshed, and the context must be defined broadly to include facts and norms beyond those expressed by the parties.

The core of the standards of behavior under this view are the reasonable expectations of the parties. In *Best v. U.S. National Bank of Oregon*,²⁵³ the Oregon Supreme Court adopted the Summers-Restatement view that good faith is an "excluder doctrine" and noted:

249. U.C.C. § 1-201(20) (2012).

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

251. See *Mkt. St. Assocs. v. Frey*, 941 F.2d 588, 594-95 (7th Cir. 1991).

252. U.C.C. § 1-201(b)(20) (2012).

253. 739 P.2d 554 (Or. 1987).

This does not mean that decisions as to what constitutes bad faith must be *ad hoc* and standardless. Without attempting to give positive content to the phrase “good faith,” it is possible to set forth operational standards by which good faith can be distinguished from bad faith within a particular context.²⁵⁴

The court concluded that, “in line with the Restatement and traditional principles of contract law,” good faith aims “to effectuate the reasonable contractual expectations of the parties.”²⁵⁵

Best and a companion case, *Tolbert v. First National Bank of Oregon*,²⁵⁶ illustrate the application of reasonable expectations. Both cases concerned the defendant banks’ setting of fees for processing checks drawn against nonsufficient funds (“NSF”).²⁵⁷ The contrasting decisions rested on different determinations of depositors’ reasonable expectations.

In *Best*, when depositors opened their accounts, the only account fees discussed were the Bank’s monthly and per-check charges.²⁵⁸ The only reference to NSF fees was contained in the account agreement signed by the depositors, which obligated them to pay the Bank’s “service charges in effect at any time.”²⁵⁹ In reaching its holding, the court reasoned:

Because NSF fees were incidental to the Bank’s principal checking account fees and were denominated service charges, a trier of fact could infer that the depositors reasonably expected that NSF fees would be special fees to cover the costs of extraordinary services. This inference could reasonably lead to the further inference that the depositors reasonably expected that the Bank’s NSF fees would be priced similarly to those checking account fees of which the depositors were aware—the Bank’s monthly checking account service fees and per check fees, if any. By priced similarly, we mean priced to cover the Bank’s NSF check processing costs plus an allowance for overhead

254. *Id.* at 558.

255. *Id.*

256. 823 P.2d 965 (Or. 1991).

257. *See id.* at 966-67; *Best*, 739 P.2d at 555.

258. *Best*, 739 P.2d at 559.

259. *Id.* (internal quotation marks omitted).

costs plus the Bank's ordinary profit margin on checking account services.²⁶⁰

In *Tolbert*, by contrast, the court found the “objectively reasonable expectations” of the parties to be different, leading to a different result:

Unlike the situation in *Best*, where the depositors were aware of the pricing mechanism for some service charges, and were entitled reasonably to expect that similar charges would be priced accordingly, in this case there is no evidence that depositors were aware of any particular pricing formula. Accordingly, it would be unreasonable for depositors to have any expectation that changes in NSF fees would be pursuant to any particular formula.²⁶¹

If the bank gave depositors prior notice of the change in NSF fees and the depositors maintained their accounts, their objectively reasonable expectations were met.²⁶²

V. CONCLUSION

The obligation of good faith is indefinite, but no more so than other doctrines of contract law. It also is like other doctrines in that it emanates from the protection of reasonable expectations, which is the basic principle of contract law. Therefore, finally and fully, the appropriate standard for good faith includes being honest and avoiding opportunism, but that is only a starting point. “[C]onsistency with the justified expectations of the other party”²⁶³ is the core, where those expectations are justified by the fact that the contract properly understood is embedded in a context and is not just concerned with the recapture of foregone opportunities. Observing “reasonable commercial standards of fair dealing” is a part, in which there is recognition of both the application of commercial standards embedded in a full, contextual understanding of the parties’ contract and a necessity of evaluating the fairness of those standards by harmonizing with broader social norms. “[C]ommunity standards of decency, fairness or reasonableness”²⁶⁴ are relevant in this respect, not because they

260. *Id.* at 555-56. (internal quotation marks omitted).

261. *Tolbert*, 823 P.2d at 970.

262. *See id.*

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

264. *Id.*

are an external source of standards but because parties always contract in an environment penetrated by such standards.