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Ten Questions About Good Faith and Fair Dealing in United States Contract Law

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SUMMARY

This paper continues the examination of open-textured terms begun at the 2001 Conference, asking 10 questions about the duty of good faith in the performance of contracts in American law.

In describing the scope of the duty, our courts have often stated that it requires a "legitimate business judgment". I discuss several cases that apply this standard to the exercise of discretion. I comment on subjective and objective aspects of good faith and on how good faith differs from best efforts.

I then turn to how courts have confined the scope of the duty by holding that it cannot support an "independent" duty or cause of action. I also discuss how the parties can confine the scope of the duty by the use of express contract language. These are both matters on which our courts differ.

American law knows no common law duty of good faith during negotiations, but our courts have enforced promises relied on during negotiations. Furthermore, many courts will enforce agreements to negotiate in good faith, and I consider examples of bad faith under such agreements.

Finally, I take up the reactions of judges – including some distinguished conservatives – to the duty of good faith.

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INTRODUCTION

I understand that this is the second round of your bout with open-textured contracting, the first having come courtesy of Professor Rickett and Judge Finn at last year's meeting.[1] I will add an American perspective, which seems appropriate since my country is notable among common law nations for its tendency to express contract law in terms of flexible standards rather than rigid rules. This open-textured formulation comports with scholarly visions of contract law as "relational" not "classic", as "dynamic" not "static". There is no better example of this than our duty of good faith and fair dealing in the performance of contracts.

This duty has, in a relatively few decades, become a cornerstone of American law. A party's breach of the duty may, as may the breach of any contract duty, both make that party liable for damages and excuse the aggrieved party's remaining duties of performance.

Although courts in a few States had long imposed a duty of good faith as a matter of common law, good faith came into its own in the second half of the twentieth century following the enactment of the Uniform Commercial Code. Every contract under the Code "imposes an obligation of good faith in its performance and enforcement".[2] Because *good faith* is also being used in contexts other than *performance*, in good faith *purchase*, it is often coupled with the term *fair dealing* when it is intended to be descriptive of performance.

I shall consider 10 questions about good faith and fair dealing in the United States.

TEN QUESTIONS

1. What Explains the Tendency to Express Contract Law in Terms of Flexible Standards?

First, there has been a change in the patterns of contracting. Compared to the classic example of a sale of a horse, parties have become more sophisticated, negotiations have become more protracted, contracts have become more complex, and contract terms have grown more prolix. It has become more difficult to take account of all possible contingencies and more attractive to leave the

[1] Charles E F Rickett, "Some Reflections on Open-Textured Commercial Contracting", [2001] AMPLA Yearbook 374 and Paul Finn, "Equity and Commercial Contracts: A Comment", [2001] AMPLA Yearbook 414.

[2] UCC, s 1-203.

resolution of some potential disputes to flexible standards such as good faith.

Second, when during the twentieth century many American judges became more activist and intrusive, they found much to their taste such flexible standards that permit judicial discretion. I will later give you some examples at the liberal and conservative ends of the spectrum. Those at the activist and intrusive end find support in flexible standards such as good faith that defer to judicial discretion.

Third, globalisation has encouraged this development. The idea of good faith performance is familiar to civil law systems, most notably the German.[3] Although the Vienna Convention, to which both our countries are parties, lacks a provision imposing a duty of good faith performance, the Unidroit Principles of International Commercial Contracts state that each party "must act in accordance with good faith and fair dealing in international trade".[4] The civil law acceptance of the concept of good faith has had at least some influence in the United States.

2. When Will Courts Impose a Duty of Good Faith and Fair Dealing?

The Code's provision on good faith appears in the general article of the Code and therefore is applicable throughout the Code's substantive articles – not just the provisions on the sale of goods. Furthermore, courts have been generous in imposing such a duty in cases not covered by the Code, whether as a matter of common law, by analogy to the Code, or both. The Restatement (Second) of Contracts incorporates a duty of good faith and fair dealing for all contracts,[5] and, for example, the Supreme Court of Wyoming recently followed the Restatement and held that parties to a paving contract – not covered by the Uniform Commercial Code – were bound by the duty.[6] Good faith and fair dealing has thus become an implied term in all contracts.

A court will not, however, impose a duty of good faith and fair dealing unless there is a contract. Therefore it will not, as we shall see, impose such a duty on parties to negotiations. Nor will most courts impose such a duty where there is only an agreement at-will. This is of particular importance in connection with employment agreements

[3] Article 242 of the German Civil Code imposes an obligation of "performance according to the requirements of good faith [*Treu and Glauben*], common habits being duly taken into consideration". Karl Llewellyn, Chief Draftsman of the Uniform Commercial Code, was familiar with and influenced by German law.

[4] Article 1.7(1).

[5] Section 205.

[6] *Scherer Constr v Hedquist Constr*, 18 P 3d 645 (Wyo 2001).

in the United States, where many such agreements are terminable at-will and courts have generally declined to condition the employer's right of termination on the exercise of good faith and fair dealing.[7]

3. What is the Scope of the Duty of Good Faith and Fair Dealing?

What does *good faith* mean? The Code's general definition says that good faith is "honesty in fact in the conduct or transaction concerned".[8] In an early article, I called this a definition that leaves the duty "so enfeebled that it could scarcely qualify … as an 'overriding' or 'super-eminent' principle".[9] Since then, judges and scholars have struggled to give content to the concept of good faith and fair dealing. It is certain that the standard is not as exacting as the standard of good faith applied to agents and other fiduciaries,[10] but what are its limits?

Turning first to judicial attempts at definition, many courts have endorsed abstract and sweeping formulations. The implied covenant, it is said, enjoins each party "to do nothing destructive of the other party's right to enjoy the fruits of the contract and to do everything that the contract presupposes they will do to accomplish its purpose".[11]

A more helpful test was articulated by the Supreme Court of Pennsylvania in a case in which the lessee of premises for a car washing business discontinued that feature of its business except as incidental to waxing and polishing cars. This increased the lessee's profits but decreased the gross receipts, and the lessor, who was entitled to a percentage of the gross receipts as part of the rental, argued that this was a breach of the duty of good faith and fair dealing. The court held that there had been no breach because the lessee's discontinuance of car washing was not "taken other than in good faith and in the exercise of legitimate business judgment". [12]

[7] Representative recent cases include *Jose v Norwest Bank North Dakota*, 599 NW 2d 293 (ND 1999) ("we have rejected attempts to engraft an implied covenant of good faith and fair dealing into the employment context"); *City of Midland v O'Bryant*, 18 SW 3d 209 (Tex 2000) ("there is no cause of action in Texas based on a duty of good faith and fair dealing in the context of an employer/employee relationship," and there is "no distinction between government and private employers").

[8] UCC, s 1-201(19).

[9] Farnsworth, "Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code" (1963) 30 U Chi L Rev 666 at 674.

[10] *Hal Taylor Assocs v Unionamerica*, 657 P.2d 743 (Utah 1982) ("We find no Utah law which would raise this good faith duty [of principal to broker] to the higher standard imposed on those with fiduciary responsibilities").

[11] *Conoco v Inman Oil Co*, 774 F 2d 895 at 908 (8th Cir 1985).

[12] *Dickey v Philadelphia Minit-Man Corp*, 105 A 2d 580 (Pa 1954).

Other courts have echoed the term "legitimate business judgment". It is meant to suggest that one is permitted try to advance one's own commercial interests without attempting to advance the interests of the other party, at least as long as one does not act in a way destructive of those interests.

Two analyses by scholars are of special significance. One is by Robert Summers of Cornell and another is by Steven Burton of Iowa.

Summers developed an "excluder" analysis, arguing that the function of *good faith* is to rule out – to exclude – various kinds of behaviour according to its context.[13] The idea is that it is easier to spot *bad* faith than it is to define *good* faith, so good faith is the absence of bad faith. The commentary to the good faith provision in the Restatement Second reflects this excluder analysis, noting:

> "A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."[14]

Burton proposed a "forgone opportunity" analysis, under which the duty "limits the exercise of discretion in performance conferred on one party by the contract" so that it is bad faith to use discretion "to recapture opportunities forgone on contracting", as determined by the other party's "reasonable expectations".[15] Summers has faulted Burton's analysis as not "necessarily any more focused" than that of the Restatement Second "in a novel good faith performance case."[16] Courts have cited both analyses,[17] and other scholars have entered the fray.

Many of our "good faith" cases do involve discretion. When the Educational Testing Service (ETS) refused to release Brian Dalton's score the second time he took our standard test for admission to

[13] Summers, "'Good Faith' in General Contract Law and the Sales Provisions of the Uniform Commercial Code" (1968) 54 Va L Rev 195.

[14] Restatement (Second), s 205 cmt d. This list is taken almost verbatim from Summers's examples.

[15] Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980) 94 Harv L Rev 369 at 369, 372-373.

[16] Summers, "The General Duty of Good Faith -- Its Recognition and Conceptualization" (1982) 67 Cornell L Rev 810. Burton, in turn, has faulted Summers' analysis as implying that courts "typically use the doctrine to render agreed terms unenforceable or to impose obligations that are incompatible with the agreement reached at formation",rather than "to effectuate the intentions of the parties". Burton, "More on Good Faith Performance of a Contract: A Reply to Professor Summers" (1984) 69 Iowa L Rev 497 at 499.

[17] See *Foley v Interactive Data Corp*, 765 P 2d 373 (Cal 1988) (citing Burton and Summers). For an Australian discussion, see *Reynard Constrs (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 (Ct App) (Austl) (citing Farnsworth as well as Burton and Summers).

college, Dalton sued ETS, charging that it had failed to exercise its discretion in good faith, as it was required to do under their contract. ETS maintained that evidence, including a dramatic increase in his score compared to his score when he first took the test six months earlier, showed that someone else had taken the test for him the second time. But when Dalton exercised his contractual right to present contrary evidence, ETS failed, as a trial court later put it, "to make even rudimentary efforts to evaluate or investigate" that evidence. New York's highest court ruled for Dalton, reasoning that when ETS refused "to exercise its discretion … by declining even to consider relevant material submitted by the test-taker", it "failed to comply in good faith with its own test security procedures, thereby breaching its contract with Dalton". The court ordered ETS to give "good-faith consideration" to the material Dalton submitted.[18] You might stop here to consider whether the decision might not have been the same in an Australian court, though with different reasoning.

Interesting decisions involving discretion have resulted from claims by authors that their publishers have broken their contracts by rejecting manuscripts without offering sufficient editorial assistance: Does the duty of good faith, in this context, include a "duty to edit"? In a decision of great importance to the publishing industry, a federal Court of Appeals refused to go this far. The movie actor Tony Curtis (perhaps remembered for his role with co-star Marilyn Monroe in "Some Like It Hot") had a contract with Doubleday under which it was to publish his second novel conditional on the manuscript being "satisfactory" to it, according to the standard language of the industry. When he delivered his manuscript of a rags-to-riches story of a lascivious Hollywood starlet, Doubleday's editors were appalled and concluded that it was "junk, pure and simple" and could not be rewritten. Doubleday terminated the contract and Curtis claimed $150,000 damages for breach of contract. He appealed from dismissal of his claim. Although he did not maintain that his manuscript was of publishable quality, he argued that that but for Doubleday's failure to provide editorial assistance, the manuscript would have met the "satisfactory to publisher" condition. Curtis conceded that his proposed interpretation was not supported by a literal reading of the agreement, but he contended that the obligation was implicit in Doubleday's obligation of good faith.

The court began by concluding that the requirement be "satisfactory" to the publisher imposed only a subjective standard, so that the publisher's "honest" dissatisfaction would suffice. Nonetheless, authors were not "at the unbridled mercy of their

[18] *Dalton v Educational Testing Service*, 663 NE 2d 289 at 293, 294 (NY 1995).

editors". "A corollary of this duty to appraise a writing honestly is an obligation on the part of the publisher not to mislead an author deliberately regarding the work required for a given project. A willful failure to respond to a request for editorial comments on a preliminary draft may, in many instances, work no less a hardship than would an unjustifiable rejection of a final manuscript." But the court declined "to extend that requirement to include a duty to perform skillfully…. To imply a duty to perform adequate editorial services in the absence of express contractual language would, in our view, represent an unwarranted intrusion into the editorial process". The court upheld the finding that Doubleday acted in good faith.[19] You might stop here to ask yourselves what decision an Australian court would have reached and what advice it would have given to publishers.

A particularly interesting example of the use of good faith in connection with discretion involves requirements and output contracts. A buyer under a requirements contract and a seller under an output contract have analogous discretion in determining their requirements and output. The Code explicitly limits that discretion by providing that such quantities must be those that "may occur in good faith".[20]

Gulf Oil Corporation sought to take advantage of this provision in connection with a long-term contract to supply all of Eastern Air Lines' requirements of fuel at designated airports. During the oil crisis of the 1970s, Gulf sought release from its contract on the ground that Eastern had broken the contract by its practice of "fuel freighting" – manipulating its requirements by varying its liftings from airport to airport depending on whether fuel at Gulf airports cost it more or less than fuel at other airports. Gulf argued that this was a breach of Eastern's duty of good faith. The court rejected this argument, noting that Gulf was aware that "airlines' liftings of fuel by nature have been subject to substantial daily, weekly, monthly and seasonal variations," and Gulf had not complained about large "swings" in the past, apparently accepting this as normal procedure. The court concluded "that fuel freighting is an established industry practice, inherent in the nature of the business, … for many years accepted as a fact of life by Gulf without complaint".[21]

Are there limits to how far a requirements buyer can reduce its requirements without running afoul of the requirement of good faith? In a recent Illinois case the court concluded that a requirements buyer that had "suffered dramatic declines in its sales … had a legitimate

[19] *Doubleday & Co v Curtis*, 763 F 2d 495 (2d Cir 1985).
[20] UCC, s 2-306(1).
[21] *Eastern Air Lines v Gulf Oil Corp*, 415 F Supp 429 (SD Fla 1975).

business reason for discontinuing its requirements business".[22] But American Bakeries found out otherwise.

After a sharp rise in gasoline prices in 1979 and 1980, American Bakeries decided to convert its fleet of more than 3,000 vehicles to propane. It contracted to buy from Empire Gas "approximately three thousand (3,000) [conversion] units, more or less depending on requirements", along with propane, for four years. Within days after signing the contract, it decided not to convert to propane, but gave no reason. A federal Court of Appeals held that American Bakeries had gone too far:

> "If no reason at all need be given for scaling back one's requirements even to zero, then a requirements contract is from the buyer's standpoint just an option to purchase up to … the stated estimate on the terms specified in the contract, except that the buyer cannot refuse to exercise the option because someone offers him better terms. This is not an unreasonable position, but it is not the law."

American Bakeries "introduced no evidence" and "does not suggest that it has a case under the standard we have adopted, which requires at a minimum that the reduction of requirements not have been motivated solely by a reassessment of the balance of advantages and disadvantages under the contract to the buyer".[23] The burden of establishing that its decision not to convert to propane was *made in good faith* was put on American Bakeries, which had not even attempted to show that it had exercised a "legitimate business judgment". (Recall, in this regard, the Supreme Court of Pennsylvania's use of the same words in the car-wash case.) You might ask yourselves how these claims under requirements contracts would be dealt with by an Australian court:

Courts have often been perplexed as to whether good faith is to be judged solely by the traditional subjective standard of honesty or also by an objective standard of reasonableness.[24] Increasingly, the duty of good faith has come to include a component of fair dealing. Recall that in Tony Curtis's case, the court concluded that the publisher's honest dissatisfaction with the manuscript would suffice, but that a failure to respond to a request for editorial comments on a preliminary draft might be a breach of the publisher's duty. The Restatement (Second)'s

[22] *Schawk, Inc v Donruss Trading Cards*, 746 NE 2d 18 (Ill App 2001).

[23] *Empire Gas Corp v American Bakeries Co*, 840 F 2d 1333 at 1339, 1341 (7th Cir 1988) (Posner J).

[24] Compare *Doubleday & Co v Curtis*, 763 F 2d 495 (2d Cir 1985) (test of honest dissatisfaction is "especially appropriate in construing publishing agreements" to avoid placing "authors at the unbridled mercy of their editors"), with *Random House v Gold*, 464 F Supp 1306 (SDNY) ("publisher's financial circumstances and the likelihood of a book's commercial success" need not be excluded from consideration), aff'd mem, 607 F 2d 998 (2d Cir 1979).

formulation speaks of "good faith and fair dealing"[25] and current proposals for revision of the Uniform Commercial Code would make generally applicable the requirement of fair dealing, now applicable only to merchants engaged in sale of goods.[26] A requirement of fair dealing arguably incorporates an objective standard and may invite expert testimony as to the practices of a particular trade or profession.[27]

4. How Does the Scope Differ from that of a Duty of Best (Reasonable) Efforts?

Another flexible contract term is one imposing a duty of "best" or "reasonable" efforts. (It does not seem that under American law there is a difference between "best" and "reasonable" in this connection.) Unlike the duty of good faith and fair dealing, however, it is not implied in every contract but must be based on explicit language or on particular circumstances. Such a duty requires a party to make such efforts as are reasonable in the light of that party's ability and the means at its disposal and of the other party's justifiable expectations. Although the scope of this duty is no better defined than is the scope of the duty of good faith, it is clear that the duty of best efforts is more onerous than that of good faith.[28] Although good faith and fair dealing may not require one to attempt to advance the interests of the other party, best efforts clearly does require such an attempt.

In determining just what a duty of "best efforts" requires in a particular case, courts have often looked to the behaviour of others engaged in like activities. In considering what efforts would be required of a brewer of beer, a federal Court of Appeals referred to the performance of "'the average prudent comparable' brewer".[29] The Unidroit Principles require "such efforts as would be made by a reasonable person of the same kind in the same circumstances".[30]

In *Zilg v Prentice-Hall, Inc*,[31] a federal Court of Appeals melded best efforts with good faith. Prentice-Hall had agreed to publish Zilg's book *Behind the Nyon Curtain,* an extensively researched but harshly critical history of the role of the DuPont family in America,

[25] Section 205.

[26] Section 2-103(1)(b) (merchant's duty of good faith includes "the observance of reasonable commercial standards of fair dealing in the trade").

[27] *May v ERA Landmark Real Estate*, 15 P 3d 1179 (Mont 2000) ("expert testimony on the issue of reasonable commercial standards … was proper"). In contrast to testimony to establish trade usage, testimony that goes to the standard of fair dealing need not be limited to the period before the making of the contract but may extend up to the time of the claimed breach.

[28] *TSI Holdings v Jenkins*, 924 P 2d 1239 (Kan 1996) (best efforts provision "created a standard of conduct … above and beyond the implied obligation of good faith").

[29] *Bloor v Falstaff Brewing Corp*, 601 F 2d 609 fn 7 (2d Cir 1979).

[30] Article 5.4(2).

[31] 717 F 2d 671 (2d Cir 1973), cert denied, 466 US 938 (1984).

characterised by one book-club judge as "300,000 words of pure spite". Because the contract gave the publisher an exclusive right on a royalty basis, New York common law imposed a duty of best efforts on the publisher. However, the written contract gave the publisher discretion to determine the number of copies to be printed and the level of promotional expenditures. After protests from the DuPonts and a book club's withdrawal of its selection of the book, the publisher reduced the first printing and the advertising budget. When Zilg sued for breach of contract, the court had to reconcile this clause with the common law duty of best efforts in order to determine how much the publisher was required to do in promoting the book.

The court concluded that during the initial promotional period, the publisher had the common law duty of best efforts in order to give the book "a reasonable chance to catch on with the reading public". But "once the obligation to undertake reasonable initial promotional activities has been fulfilled, the contractual language dictates that a business decision by the publisher to limit the size of a printing or advertising budget is not subject to second guessing by a trier of fact as to whether it is sound or valid". After the "initial obligation [of best efforts] is fulfilled, all that is required is a good faith business judgment". (Recall again, in this regard, the Supreme Court of Pennsylvania's language in the car-wash case, "legitimate business judgment".) The court held that Zilg had not shown that the publisher had failed to meet either of these obligations. It would be interesting to know how an Australian court would have dealt with this case.

5. How Have Courts Confined This Duty?

"[I]mplying obligations based on the covenant of good faith and fair dealing is a cautious enterprise", said the Supreme Court of Delaware a few years ago.[32] Courts sharing this view have held that the Code's provision on good faith does not create "independent" rights separate from those created by the provisions of the contract. As one federal Court of Appeals has put it, the Code provision "only guides the construction of contracts and does not create independent duties".[33] However, not all courts have felt so constrained. An important area of disagreement involves complaints by franchisees that franchisors have authorised competing franchises in violation of the franchisors' duties of good faith and fair dealing, even though the complaining franchisors can point to no provision prohibiting such competition.

In a case that came before a federal Court of Appeals in 1999, the holder of two Burger King franchises in Great Falls, Montana, claimed

[32] *Cincinnati SMSA Ltd Partnership v Cincinnati Bell Cellular Sys Co*, 708 A 2d 989 (Del 1998).
[33] *Echo, Inc v Whitson Co*, 121 F 3d 1099 (7th Cir 1997).

that Burger King's authorisation of a third franchise at the local Air Force base was a breach of Burger King's obligation of good faith and fair dealing under his two franchise agreements. Neither agreement gave him an exclusive right or contained a provision on competition. The court, applying Florida law, held for Burger King. Although, under Florida law, "the implied covenant of good faith and fair dealing is a part of every contract", the court held that "no independent cause of action exists under Florida law for breach of the implied covenant of good faith and fair dealing. 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". The franchisee's "failure to identify an express contractual provision that has been breached dooms his claim for breach of the implied covenant of good faith and fair dealing".[34] Not all courts hold the same view and a few have granted relief to complaining franchisees.[35]

In 1994, the Uniform Commercial Code's Permanent Editorial Board gave support to this restriction on good faith by issuing a Commentary, seeking to make clear "that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached".[36] It resulted in the addition of language to the Official Comment stating that the section "does not support an independent cause of action for failure to perform or enforce in good faith".

Nevertheless, the extent to which the duty of good faith and fair dealing must be tied to some explicit contract language is a matter on which courts differ.

6. How Can the Parties Confine the Duty?

The obligation of good faith is often called a *default rule,* suggesting that, like the default settings on a computer, it applies if

[34] *Burger King Corp v Weaver*, 169 F 3d 1310 (11th Cir 1999) (finding *Scheck* "unconvincing" because "no independent cause of action exists in Florida law for breach of the implied covenant of good faith and fair dealing").

[35] *Scheck v Burger King Corp*, 798 F Supp 692 (SD Fla 1992). See *Camp Creek Hospitality Inns v Sheraton Franchise Corp*, 139 F 3d 1396 (11th Cir 1998) (summary judgment inappropriate where contract was "simply silent on the issue of whether or where [franchisor] and its affiliates can establish properties that compete"); *In re Vylene Enters*, 90 F 3d 1472 (9th Cir 1996) (franchisor's building and operating competing restaurant, with better menu, within one and a half miles of franchisee's restaurant was breach of duty of good faith and fair dealing).

[36] Commentary No 10 on UCC, s 1-203. See *Best Distrib Co v Seyfert Foods*, 714 NE 2d 1196 (Ind App 1999) ("confirming the comment"); *Diamond Surface v State Cement Plant Commn*, 583 NW 2d 155 (SD 1998) (fn 7: looking to Commentary No 10 "for guidance").

not changed. This, however, ignores the restraint in the Uniform Commercial Code, under which the obligation of good faith "may not be disclaimed by agreement".[37] At least one court has imposed a similar restriction outside the scope of the Code.[38] And under the Unidroit Principles the parties "may not limit or exclude" the duty of good faith and fair dealing.[39] It is sometimes no simple matter to reconcile this mandatory character of the duty of good faith with the principle, announced by many courts, that there is no such duty if it would conflict with an express provision of the contract.[40] Here is another matter on which there has been substantial disagreement among courts.

Conservative courts have been firm in upholding the view that express provisions control. Judge Frank Easterbrook, for example, has affirmed that "principles of good faith … do not block use of terms that actually appear in the contract". Under this view, while one cannot disclaim the obligation of good faith, one can undercut it by the use of express provisions. As a federal Court of Appeals noted recently, Pennsylvania "would not extend the limited duty to perform a contract in good faith to a situation … in which the parties in great detail set forth their mutual obligations and rights".[41] On the other hand, the obligation is omnipresent and as the same court acknowledged a few years earlier, though it "cannot be used to negate specific contractual powers, even if the exercise of those powers causes harsh results …, the terms in the parties' contracts leave great room for discretion and thus for the application of the implied covenant".[42]

The Supreme Court of New Jersey, one of our most liberal States in dealing with good faith, has gone well beyond this. Over a quarter of a century ago, that court invoked good faith in holding a manufacturer's failure to give notice of termination of an

[37] UCC, s 1-102(3). However, "the parties may by agreement determine the standards by which the performance of [that obligation] is to be measured if such standards are not manifestly unreasonable".

[38] *Carmichael v Adirondack Bottled Gas Corp*, 635 A 2d 1211 (Vt 1993) (though contract with distributor terminated with his death, supplier still owed "duties with respect to winding down", and "duty of good faith is imposed by law and is not a contractual term that the parties are free to bargain in or out as they see fit").

[39] Article 1.7(2).

[40] *Riggs Natl Bank of Washington v Linch*, 36 F 3d 370 (4th Cir 1994) ("implied duty of good faith cannot be used to override or modify explicit contractual terms"). For an attempt at reconciliation see *Third Story Music v Waits*, 48 Cal Rptr 2d 747 (Ct App 1995) (faced with "apparent inconsistency between the principle that the covenant of good faith should be applied to restrict exercise of a discretionary power and the principle that an implied covenant must never vary the express terms of the parties' agreement," courts prefer the latter course only when necessary to prevent unenforceability of the agreement).

[41] *Northview Motors v Chrysler Motors Corp*, 227 F 3d 78 (3d Cir 2000).

[42] *Kaplan v First Options of Chicago*, 143 F 3d 807 (3d Cir 1998).

exclusive distributorship agreement was a breach where the distributor had undertaken a major expansion of its storage facilities. The agreement had no provision as to notice of termination, and, though the manufacturer "ordinarily would be under no strictly legal obligation to inform [the distributor] that it was about to terminate its exclusive distributorship", its "selfish withholding from [the distributor] of its intention seriously to impair its distributorship although knowing [the distributor] was embarking on an investment substantially predicated upon its continuation constituted a breach of the implied covenant of dealing in good faith." The court gave the breach "substantial weight in determining the reasonableness of a period of notice of termination" decided that 20 months was appropriate.[43]

In 1997 the New Jersey Supreme Court revisited that case and concluded that it supports "the proposition that a party to a contract may breach the implied covenant of good faith and fair dealing in performing its obligations even when it exercises an express and unconditional right to terminate". The court then held that despite a clause providing for cancellation on 90 days notice, the jury could find that a buyer's termination was in bad faith – "was not 'honest in fact' as required by the UCC" – because its conduct destroyed its supplier's "reasonable expectations and right to receive the fruits of the contract".[44] As the same court explained last year, in New Jersey, unlike many other States, a party may breach the obligation of good faith and fair dealing even though party exercises an express right to terminate.[45] I wonder how Australian lawyers would react to such a decision.

This is a second area of substantial disagreement among courts.

7. Will Courts Impose a Duty to Negotiate in Good Faith Absent Agreement?

Under the Unidroit Principles, the duty of good faith and fair dealing extends to negotiations, and a party "who negotiates or breaks off negotiations in bad faith is liable for the losses caused by the other party".[46] Although this reflects the view of many civil law systems, it is not the law in the United States.[47] Under both the Uniform Commercial Code and the Restatement (Second), the duty of good faith and fair dealing applies only when there is a contract

[43] *Bak-A-Lum Corp v Alcoa Bldg Prods*, 351 A 2d 349 (NJ 1976).

[44] *Sons of Thunder v Borden, Inc*, 690 A 2d 575 (NJ 1997). Sons of Thunder was the romantic name of a boat for harvesting clams and of the corporation that owned the boat. New Jersey is by far the leading clam supplier to the world.

[45] *Wilson v Amerada Hess Corp*, 773 A 2d 1121 (NJ 2001).

[46] Article 2.15(2).

[47] *Copeland v Baskin Robbins*, 117 Cal Rptr 2d 875 (Ct App 2002) (rejecting "this theory of liability").

and does not extend to precontractrual negotiations. (When parties to an existing contract negotiate for its modification, however, they are bound by a duty of good faith imposed by that contract.) As a general rule, a party is free to break off negotiations at any time and for any reason. Under this "aleatory" view, a party undertakes precontractual negotiations as a gamble. Courts have, however, made exceptions for cases of unjust enrichment resulting from negotiations, misrepresentations made during the negotiations, and specific promises made during the negotiations.[48]

The last of these is the most important. It was the basis of an important federal Court of Appeals decision in 1995. After extended negotiations between Grumman, which had a defense contract, and Cyberchron, which sought to be Grumman's subcontractor to supply a "rugged computer work station," Grumman delivered a purchase order to Cyberchron. However, Cyberchron did not accept it because the parties were unable to agree on provisions concerning the weight of the work station. In mid-July of 1990, a Grumman representative directed Cyberchron to proceed with production of the station as if there had been agreement on the weight issue, asserting that the terms of the purchase order would be determined later. The dispute over the weight issue was never resolved and in late September Grumman abruptly broke off the negotiations and arranged to obtain the work station elsewhere. Cyberchron sued and prevailed on the ground of promissory estoppel.

The Court of Appeals accepted the trial court's determination that "starting in mid-July there was … a clear and unambiguous promise" on which Cyberchron had relied, and allowed damages measured by Cyberchron's reliance on that promise beginning at the time when it was made.[49] In a proper case, reliance might include not only out-of-pocket expenses but also lost opportunities to make other contracts.[50]

In my view there is ample justification for judicial reluctance to impose a general obligation of fair dealing on parties to precontractual negotiations. Imposing an obligation on negotiating parties might have an undesirable chilling effect, discouraging parties from entering into negotiations if chances of success were slight, and also an undesirable accelerating effect, increasing the pressure on parties to bring negotiations to a final if hasty conclusion. Furthermore, from a practical point of view, the

[48] See E Allen Farnsworth, *Contracts* §3.26 (2nd ed, 1998, Little Brown & Co. Boston).
[49] *Cyberchron Corp v Calldata Systems Development, Inc*, 47 F 3d 39 at 45 (2d Cir 1995).
[50] *Copeland v Baskin Robbins*, 117 Cal Rptr 2d 875 (Ct App 2002) ("measure encompasses the plaintiff's out-of-pocket costs … may or may not include lost opportunity costs").

difficulty of determining a point in the negotiations at which the obligation of fair dealing arises would create uncertainty. I assume that there is agreement on this in Australia. This difficulty disappears, however, if, as in the case of Cyberchron and Grumman, liability is based on a specific promise, and I wonder how Australian lawyers react to the decision in that case.

8. Will Courts Enforce an Agreement to Negotiate in Good Faith?

The hard question for American courts is not whether a court should undertake on its own to impose a duty of good faith and fair dealing during precontractual negotiations, but whether it should honor an agreement by the parties explicitly undertaking to abide by such a duty. Is the rule that there is no obligation of good faith and fair dealing during precontractual negotiations merely a default rule out of which the parties can contract? As to this, our courts have disagreed.

A seminal case favoring enforceability of agreements to negotiate in good faith was decided by a federal Court of Appeals in 1986. It arose out of a dispute over leasing a store in a mall. After several months of negotiations, the prospective lessor signed a letter of intent that covered most of the significant lease terms and provided that the prospective lessor would "withdraw the Store from the rental market and … negotiate … the leasing transaction to completion". When the prospective lessor broke off the negotiations and leased the store to a competitor of the prospective tenant, the prospective tenant sought an injunction. The trial court denied the injunction on the ground that the letter of intent was unenforceable, but the Court of Appeals reversed, concluding that the record supported "a finding that the parties intended to enter into a binding agreement to negotiate in good faith" and that "the agreement had sufficient specificity to make it an enforceable contract".[51] Although not all courts have shared this willingness to enforce agreements to negotiate,[52] the trend clearly favours enforceability, at least where the parties have reached agreement on a significant number of the major terms of the ultimate agreement.[53] As a federal trial judge said in an influential case:

> "Notwithstanding the importance of protecting the negotiating parties from involuntary judicially imposed contract, it is equally

[51] *Channel Home Centers v Grossman*, 795 F 2d 291 at 300 (3d Cir 1986). For an earlier case, see *Itek Corp v Chicago Aerial Indus*, 248 A 2d 625 at 629 (Del 1968). See also *Coal Cliff Collieries Pty Ltd v Sijehama Pty Ltd* (1991) 24 NSWLR 1 (Austl).

[52] *C & S Acquisitions Corp v Northwest Aircraft*, 153 F 3d 622 (8th Cir 1998) (under Minnesota law, "agreements to negotiate in good faith … are unenforceable"); *John Wood Group USA v ICO*, 26 SW 3d 12 (Tex App 2000) ("under Texas law, an agreement to negotiate … is unenforceable").

[53] As to the importance of reaching agreement on major terms, see *Teachers Ins & Annuity Assn v Tribune Co*, 670 F Supp 491 (SDNY 1987) (describing preliminary agreement "that expresses mutual commitment to a contract on agreed major terms").

> important that courts enforce and preserve agreements that were intended as binding, despite a need for further documentation or further negotiation."[54]

Courts that have rejected this view have advanced two reasons.

One is that a court cannot fashion an appropriate remedy for the breach of such a duty because there is no way to know what ultimate agreement, if any, would have resulted had there been no bad faith.[55] The response to this is that damages can be measured, as in the case of a specific promise, by reliance losses, including in a proper case lost opportunities to make other contracts. Reliance damages are particularly appropriate here since a party generally perceives an agreement to negotiate as protecting just that interest, should the other pull out of the negotiations. Precontractual liability will not generally support recovery measured in the most generous way, by the expectation interest.

The other reason is that a court cannot determine the scope of the obligation of fair dealing under such an agreement. This was the explanation of a federal Court of Appeals, which explained that because "in a business transaction both sides presumably try to get the best of the deal, … one cannot characterize self-interest as bad faith…. The proper recourse is to walk away from the bargaining table, not to sue for 'bad faith' in negotiations".[56] However, courts generally demand less definiteness when damages are measured by reliance than when they are measured by expectation. Furthermore, American courts have not balked at applying a standard of "good faith" or "best efforts" under an existing contract. As a California court said earlier this year, "we disagree with those who say the courts … are ill-equipped to determine whether people are negotiating with each other in good faith".[57] Would an Australian court agree?

[54] *Teachers Ins & Annuity Assn v Tribune Co*, op cit n 53 at 497-498.

[55] *Ohio Calculating v CPT Corp*, 846 F 2d 497 (8th Cir 1988) ("impossible … to determine what would have happened had [parties] negotiated"). See *Courtney & Fairbairn Ltd v Tolaini Bros* [1975] 1 WLR 297 (CA 1974) (Lord Denning: "No court could estimate the damages because no one can tell … what the result would be.") Richard Posner, responding to that objection, explained that "if the plaintiff can prove that had it not been for the defendant's bad faith the parties would have made a final contract, then the loss of the benefit of the contract is a consequence of the defendant's bad faith, and, provided that it is a foreseeable consequence, the defendant is liable for that loss – liable, that is, for the plaintiff's consequential damages. … The difficulty, which may well be insuperable, is that since by hypothesis the parties had not agreed on *any* of the terms of their contract, it may be impossible to determine what those terms would have been and hence what profit the victim of bad faith would have had. … But this goes to the practicality of the remedy, not the principle of it: *Venture Assocs Corp v Zenith Data Corp*, 96 F 3d 275 (7th Cir 1996).

[56] *Feldman v Allegheny Intl*, 850 F 2d 1217 at 1223 (7th Cir 1988).

[57] *Copeland v Baskin Robbins*, 117 Cal Rptr 2d 875 (Ct App 2002).

9. What is the Scope of the Duty to Negotiate in Good Faith?

We have as yet only a small number of cases that have actually confronted this question. Rarely can one find an outright refusal to negotiate. Hard bargaining is to be expected. Negotiation with competitors is permitted absent a provision for exclusivity. Only occasionally can one characterise a negotiating stance as so outrageous as to exceed the bounds of good faith and fair dealing. A federal Court of Appeals has suggested that "injecting new demands, such as an increase in price, late in the negotiating process can constitute bad faith in some circumstances".[58] And a federal trial court held that a party "breached its obligation to negotiate in good faith" a sublease of part of a building "by ignoring custom and usage" and "insisting on arbitrary clauses".[59] The Supreme Court of Colorado, addressing a contention that negotiations were broken off in bad faith, imported from labor law the concept of impasse, saying that it "presupposes a reasonable effort of good faith bargaining to reach agreement".[60] The court found that there was a question of fact as to whether an impasse had been reached or whether the party that broke off negotiations had refused to negotiate. An interesting and unanswered question is whether good faith and fair dealing might require a party, before breaking off negotiations to accept a competing proposal, to give the other party to a "last look" – to disclose enough of the competing proposal to afford the other party a last chance to sweeten its own proposal.

The most interesting cases involve reneging on agreed terms. Since an agreement to negotiate usually sets out terms on which the parties have reached agreement, is it unfair dealing to renege on one of those terms even though these terms are not binding? It might seem so, since a common reason for making the agreement to negotiate is to prevent reopening of matters on which agreement has been reached. Nevertheless, a party should be free to make creative proposals that may be advantageous to both parties.[61] It should therefore be permissible to offer a

[58] *Venture Assocs Corp v Zenith Data Sys Corp*, 987 F 2d 429 at 433 (7th Cir 1993).
[59] *Evans, Inc v Tiffany & Co*, 416 F Supp 224 at 240 (ND Ill 1976).
[60] *Vigoda v Denver Urban Renewal Auth*, 646 P 2d 900 at 904 (Colo 1982).
[61] See *Teachers Ins & Annuity Assn v Coaxial Communications*, 799 F Supp 16 (SDNY 1992) ("positions taken solely for the purpose of negotiations cannot be treated as evidence of what ought to be done absent agreement without exerting a chilling effect on contractual negotiations" since a "party able to have its demands tentatively accepted first would enjoy an advantage", encouraging agenda manipulation and disputes over order of issues discussed).

concession in return for modification of a term already settled in the agreement. It is, after all, permissible for a party to any contract to do the same in return for a modification of a term of the contract. But this is not the same as an outright refusal to abide by a term on which agreement has been reached unless the other party makes a concession on a matter still to be negotiated. Even though the agreement is only one to negotiate, the imposition of such a condition would seem, especially if the negotiations are advanced, to amount to a refusal to negotiate fairly and therefore also to be a repudiation and a breach. Courts have come to this conclusion, noting that the obligation of good faith does "bar a party from … insisting on conditions that do not conform to the preliminary agreement".[62]

10. What Have Been the Reactions of Judges and Scholars to These Trends?

With respect to judges, the answer to this question patently depends, as would be true in Australia, on the particular judge. You have already seen some of the more novel creative applications of the duty, for example from the Supreme Court of New Jersey. Other judges have taken a more restrictive view of the duty. I give you a few remarks from three distinguished conservatives (all former law professors): Antonin Scalia, now of the Supreme Court, and Frank Easterbrook and Richard Posner, both of the federal Court of Appeals for the Seventh Circuit.

The conservative approach begins with the view that the duty adds little to established law. Antonin Scalia, when sitting on a federal Court of Appeals, said that the duty of good faith is "simply a rechristening of fundamental principles of contract law".[63] Richard Posner agrees that the "contractual duty of good faith is … not some newfangled bit of welfare-state paternalism or … the sediment of an altruistic strain in contract law, and we are therefore not surprised to find the essentials of the modern doctrine well established in nineteenth-century cases".[64] (In this vein, the Supreme Court of Wyoming in 1977 had recourse to what its predecessor had said about good faith a century before in 1877.[65]) Contract law does not, Posner

[62] *Teachers Ins & Annuity Assn v Tribune Co*, 670 F Supp 491 (SDNY 1987), followed in *P A Bergner & Co v Martinez*, 823 F Supp 151 (SDNY 1993); *Pan Am Corp v Delta Air Lines*, 175 Bankr 438 (SDNY 1994) (neither party to agreement to negotiate "may repudiate those major terms" on which they have previously agreed); *Teachers Ins & Annuity Assn v Ormesa Geothermal*, 791 F Supp 401 (SDNY 1991) (borrower "attempted to change and undercut terms that had been agreed to" in commitment letter).

[63] *Tymshare v Covell*, 727 F 2d 1145 at 1152 (DC Cir 1984).

[64] *Market St Assocs v Frey*, 941 F 2d 588 (7th Cir 1991).

[65] *Wendling v Cundall*, 568 P 2d 888 at 890 (Wyo 1977) (requiring "an honest intention to abstain from taking any unconscientious advantage of another, even through the technicalities of law, together with an absence of all information or belief of facts which would render the transaction unconscientious", quoting *Cone v Iwinson*, 33 P 31 at 34 (Wyo 1893), which quoted from *Gress v Evans*, 46 NW 1132 at 1134 (Dak Terr 1877).

continued, impose a duty to "be reasonable" and "does not require parties to behave altruistically toward each other" or "proceed on the philosophy that I am my brother's keeper," a philosophy that "may animate the law of fiduciaries".[66] Certainly many of the uses to which the new concept of good faith is put today do not go beyond those to which the traditional techniques of filling gaps, witness Antonin Scalia's endorsement of the perception "that the significance of the doctrine is 'in implying terms in the agreement'".[67]

A cornerstone of the conservative view is the preeminence of the language of the agreement. Here is Frank Easterbrook on the conflict between that language and the duty of good faith and fair dealing:

> "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.' Although courts often refer to the obligation of good faith that exists in every contractual relation, … this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document …. When the contract is silent, principles of good faith … fill the gap. They do not block use of terms that actually appear in the contract."[68]

It would, however, be misleading to suggest that judges of the stripe of Easterbrook and Posner have grudgingly applied the duty of good faith and fair dealing. An opinion by Posner is graphic. A shopping-center lessee had the right to ask its lessor for financing of improvements and, if turned down, to exercise an option to purchase the property. Twenty years later, a successor of the lessee requested financing, making no reference to the option provision in the lease, and, when the lessor refused the request, the lessee's successor exercised the option and sought specific performance when the lessor refused to convey. The trial court found that the lessee's successor did not want financing, but "just wanted an opportunity to buy the property at a bargain price and hoped that the [lessor] wouldn't realize the implications of turning down the request for financing".

On appeal, the Court of Appeals for the Seventh Circuit, through Richard Posner, held that, on these facts, there would have been a breach of the lessee's successor's duty of good faith: "it is one thing to say that you can exploit your superior knowledge of the market," but "another thing to say that you can take deliberate advantage of an

[66] *Original Great American Chocolate Chip Cookie Co v River Valley Cookies*, 970 F 2d 273 (7th Cir 1992).
[67] *Tymshare v Covell*, 727 F 2d 1145 at 1152 (DC Cir 1984).
[68] *Kham & Nate's Shoes v First Bank of Whiting*, 908 F 2d 1351 at 1357 (7th Cir 1990).

oversight by your contract partner concerning his rights under the contract". Summary judgment was refused because a trial was held necessary to determine whether the lessee's successor was "dishonest or opportunistic,"[69] and at that trial the lessor prevailed and specific performance was denied.[70] Might an Australian court have reached the same result, and if so on what ground?

Five years later, Frank Easterbrook had the occasion to cite Posner's decision in discussing opportunism:

> "'Opportunism' in the law of contracts usually signifies one of two situations. First, there is effort to wring some advantage from the fact that the party who performs first sinks costs, which the other party may hold hostage by demanding greater compensation in exchange for its own performance. The movie star who sulks (in the hope of being offered more money) when production is 90% complete, and reshooting the picture without him would be exceedingly expensive, is behaving opportunistically in this sense…. Second, there is an effort to take advantage of one's contracting partner 'in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties' [citing the Posner opinion]…. Contract law does not require parties to be fair, or kind, or reasonable, or to share gains or losses equitably…. It does require parties to avoid taking advantage of the opportunities that arise from sequential performance, when the contract does not cover a particular subject."[71]

Richard Posner has expressed a similar hostility to such opportunism in saying that good faith "means in this context not trying to take advantage of the vulnerabilities created by the sequential character of performance".[72]

CONCLUSION

In conclusion, it is safe to say that the introduction of a general principle of good faith and fair dealing has not resulted in the general disintegration of American contract law, nor caused it to be mired in uncertainty. Some of the cases I have discussed would surely have been decided in the same way without such a principle. Others, I believe, would not.

[69] *Market St Assocs v Frey*, 941 F 2d 588 at 592, 594 (7th Cir 1991). But cf *National Data Payment Sys v Meridian Bank*, 212 F 3d 849 (3d Cir 2000) (seller "had no duty…to remind [buyer] of the approaching termination date" and buyer "cannot blame [seller] for its failure to 'focus' on this unambiguous clause").

[70] *Market St Assocs v Frey*, 817 F Supp 784, 788 (ED Wis 1993), aff'd, 21 F 3d 782 (7th Cir 1994).

[71] *Industrial Representatives, Inc v CP Clare Corp*, 74 F 3d 128 at 129-130, 132 (7th Cir 1996).

[72] Richard Posner, *Economic Analysis of Law,* (5th ed, 1998), at 103.

Judges of both a liberal and a conservative stripe seem to be comfortable with the general principle and have been able to reformulate it to accord with their tenets. As is true for most legal principles of importance – especially flexible ones – there is room for dispute. Our courts have differed in connection with "independent" duties of good faith and fair dealing, in connection with the relation between good faith and fair dealing and the explicit language of the contract, and in connection with what, if anything, is required by an agreement to negotiate in good faith.

I hope that this examination of my 10 questions has given you a better understanding of good faith and fair dealing in my country and, perhaps, some insights into how such a principle would work out in your country.

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