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ARTICLE

BONDAGE, DOMINATION, AND THE ART OF THE DEAL: AN ASSESSMENT OF JUDICIAL STRATEGIES IN LENDER LIABILITY GOOD FAITH LITIGATION

*A. BROOKE OVERBY**

In the 1980s the contractual obligation of good faith and fair dealing achieved preeminence in the area of lender liability. This raised concerns that expansive judicial interpretation of the obligation would, in effect, rewrite the parties' contracts and result in the imposition of undue economic liability upon lenders. In this Article Professor Overby first traces the statutory, common law, and theoretical attempts to provide transactors with legal standards of conduct through the obligation of good faith. She then examines the judicial approaches to good faith in the lending context, rejecting as unfounded concerns over economic liability or widespread judicial activism. Professor Overby demonstrates that the underlying divergence in the courts over proper interpretation of the obligation of good faith is the primary cause of the "lender liability crisis." Finally, the Article proposes an "effectiveness of express terms" approach to good faith lending under which the obligation of good faith in no way overrides the explicit terms of the lending agreement absent proof of opportunism.

INTRODUCTION

THE contractual obligation of good faith and fair dealing has become the subject of intense scrutiny in the area of law broadly denominated as "lender liability."[1] Good faith issues arise in lending relation-

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1. The term "lender liability" in its broadest sense refers to imposition of any legal liability on a lender. Theories of liability range from breach of contract, *see* Yankton Prod. Credit Ass'n v. Larsen, 365 N.W.2d 430, 433-34 (Neb. 1985), to breach of fiduciary duty and fraud, *see* Deist v. Wachholz, 678 P.2d 188, 192-95 (Mont. 1984), liability for hazardous waste clean-up costs under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"), *see, e.g.*, United States v. Fleet Factors Corp., 901 F.2d 1550, 1557 (11th Cir. 1990) (having security interest and becoming active in management of borrower results in liability of lender under CERCLA), *cert. denied*, 111 S. Ct. 752 (1991), and civil liability under the Racketeer Influenced and Corrupt Organizations Act ("RICO"), *see, e.g.*, Kehr Packages, Inc. v. Fidelcor, Inc., 926 F.2d 1406, 1411-13 (3d Cir.) (dismissing RICO claim), *cert. denied*, 111 S. Ct. 2834 (1991); Fleet Credit Corp. v. Sion, 893 F.2d 441, 447-48 (1st Cir. 1990) (sustaining RICO claim). *See generally* Helen D. Chaitman, The Law of Lender Liability (1990). Although the area of "lender liability" has been referred to as an "emerging" field, *see, e.g.*, 1-3 American Bar Association, Emerging Theories of Lender Liability (H. Chaitman ed. 1985) (materials from program on "emerging theories"); John O. Tyler, Jr., *Emerging Theories of Lender Liability in Texas*, 24 Hous. L. Rev. 411 (1987) (reviewing developments in "new" Texas lender liability cases), the contract law claims of wrongful conduct asserted

ships in a number of situations, such as when a lender refuses to make advances under a line of credit,[2] accelerates or demands payment of the debt due under a note,[3] attempts to foreclose on or to repossess collateral,[4] or refuses to renegotiate terms of the loan.[5] According to one writer, successful claims in the 1980s against lenders for breach of the obligation of good faith[6] "dramatically changed the conventional under-

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by borrowers are grounded in familiar doctrine such as the obligation of good faith, modification, waiver, estoppel, and fraud. *See, e.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 758-63 (6th Cir. 1985) (good faith); Alaska Statebank v. Fairco, 674 P.2d 288, 291-93 (Alaska 1983) (modification, waiver, and estoppel); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 680-82 (Tex. Ct. App. 1984) (fraud).

Despite its breadth, which encompasses a myriad of doctrinal areas, courts have increasingly used the catch-phrase "lender liability" to denote a discrete cause of action. *See* Richter, S.A. v. Bank of Am. Nat'l Trust & Sav. Ass'n, 939 F.2d 1176, 1179 (5th Cir. 1991); Sanders v. First Nat'l Bank, 114 B.R. 507, 509 (M.D. Tenn. 1990), *aff'd sub nom.* Sanders v. First Nat'l Bank & Trust Co., 936 F.2d 273 (6th Cir. 1991); Savers Fed. Sav. & Loan Ass'n v. Home Fed. Sav. & Loan Ass'n, 721 F. Supp. 940, 941 (W.D. Tenn. 1989); Daniels v. Army Nat'l Bank, 822 P.2d 39, 41 (Kan. 1991); Check Reporting Servs., Inc. v. Michigan Nat'l Bank - Lansing, 478 N.W.2d 893, 898 (Mich. Ct. App. 1991); Frank Lerner & Assocs. v. Merchants & Mechanics Fed. Sav. & Loan Ass'n, No. 90AP-1045, 1991 Ohio App. LEXIS 2938, at *3 (Ohio Ct. App. June 20, 1991); Nance v. Resolution Trust Corp., 803 S.W.2d 323, 326 (Tex. Ct. App. 1990). The growing trend toward classifying debtor-creditor issues under the category "Lender Liability" represents a movement toward a paradigmatic approach to classification on relational grounds. The conflict is placed initially within the ambit of the debtor-creditor relation rather than within a particular doctrinal area. *Cf.* Jay M. Feinman, *The Jurisprudence of Classification*, 41 Stan. L. Rev. 661, 715 (1989) (stating that relational paradigms reduce framing bias). Subsuming the doctrinal classifications into the relation emphasizes common norms within the relation rather than different norms embedded in the distinct doctrinal categories. *See id.* at 715-16.

2. *See* Reid v. Key Bank, Inc., 821 F.2d 9, 11 (1st Cir. 1987); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 754 (6th Cir. 1985); Taggart & Taggart Seed, Inc. v. First Tenn. Bank Nat'l Ass'n, 684 F. Supp. 230, 232 (E.D. Ark. 1988), *aff'd*, 881 F.2d 1080 (8th Cir. 1989); First Nat'l Bank v. Sylvester, 554 N.E.2d 1063, 1065-66 (Ill. App. Ct. 1990); Creeger Brick & Bldg. Supply Inc. v. Mid-State Bank & Trust Co., 560 A.2d 151, 153 (Pa. Super. Ct. 1989).

3. *See* Martin Specialty Vehicles, Inc., v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 764-65 (Bankr. D. Mass. 1988), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989); Pavco Indus., Inc. v. First Nat'l Bank, 534 So. 2d 572, 576 (Ala. 1988); Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1033-34 (Colo. Ct. App. 1987); Centerre Bank v. Distributors, Inc., 705 S.W.2d 42, 48-50 (Mo. Ct. App. 1985); Simon v. New Hampshire Sav. Bank, 296 A.2d 913, 915 (N.H. 1972); J.R. Hale Contracting Co. v. United N.M. Bank, 799 P.2d 581, 591 (N.M. 1990).

4. *See* Alaska Statebank v. Fairco, 674 P.2d 288, 297-99 (Alaska 1983); Van Bibber v. Norris, 419 N.E.2d 115, 122-23 (Ind. 1981); Black v. Peoples Bank & Trust Co., 437 So. 2d 26, 29-30 (Miss. 1983); Lachenmaier v. First Bank Sys., Inc., 803 P.2d 614, 617-18 (Mont. 1990); Production Credit Ass'n v. Ista, 451 N.W.2d 118, 122-23 (N.D. 1990); Clayton v. Crossroads Equip. Co., 655 P.2d 1125, 1128-29 (Utah 1982).

5. *See* Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517, 532-35 (Mo. Ct. App. 1986); Central Bank v. Eystad, 710 P.2d 710, 713-14 (Mont. 1985); Cascade Steel Fabricators, Inc. v. Citizens Bank, 612 P.2d 332, 332-33 (Or. Ct. App. 1980); Security Bank v. Dalton, 803 S.W.2d 443, 448-49 (Tex. Ct. App. 1991); Badgett v. Security State Bank, 807 P.2d 356, 359-61 (Wash. 1991); Lawrence v. Farm Credit Sys. Capital Corp., 761 P.2d 640, 651-52 (Wyo. 1988).

6. *See* Reid v. Key Bank, Inc., 821 F.2d 9, 12-16 (1st Cir. 1987); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 759-63 (6th Cir. 1985); *Martin Specialty Vehicles*, 87 B.R.

standing of the relationship between lenders and their borrowers."[7] As firms and individuals struggle with debts incurred in the last decade, allegations by borrowers of bad faith lender behavior show more potential for increase than for decline.[8] It is thus not surprising that both the banking bar[9] and academics[10] have paid considerable attention to the ob-

at 765-69; Ricci v. Key Bancshares Inc., 662 F. Supp. 1132, 1141 (D. Me. 1987); Farmers & Merchants Bank v. Hancock, 506 So. 2d 305, 311-14 (Ala. 1987).

7. Daniel R. Fischel, *The Economics of Lender Liability*, 99 Yale L.J. 131, 131 (1989).

8. [In the 1980s, c]onsumers, governments and businesses . . . borrowed as never before. It [was] the decade of the five-year Yugo loan, the leveraged-buyout loan, the unsecured bridge loan, the teaser-rate adjustable-rate mortgage loan, the rescheduled Brazilian or Mexican loan, the Sotheby's art-quality loan and the liposuction and breast-enlargement loan. It [was] the decade of retractable facsimile bonds, subordinated primary capital perpetual floating rate notes and collateralized fixed-rate multi-tranche tap notes. All in all, the 1980s [were] to debt what the 1960s were to sex.

James Grant, *Michael Milken, meet Sewell Avery*, Forbes 400, Oct. 23, 1989, at 60, 60; *see also* Stella Dawson, *Bankers Blame Credit Crunch on Weak Demand, Not Regulators*, Reuters, Oct. 7, 1991 ("The U.S. debt burden tripled in the 1980s as consumers borrowed on their homes [and] corporations took on more debt [from leveraged buyouts and restructurings]."); Parker v. Columbia Bank, 604 A.2d 521, 523 (Md. Ct. Spec. App. 1992) ("In these difficult economic times with falling real estate prices, lender liability suits have become one of the few 'growth industries.' ").

9. *See generally* Chaitman, *supra* note 1, ¶¶ 4.01-4.06; 1-3 American Bar Association, *supra* note 1; Scott L. Baena, *Emerging Theories of Lender Liability*, Fla. B.J., Jan. 1987, at 55; A. Barry Cappello, *Banking Malpractice?*, Case & Com., Sept.-Oct. 1986, at 3; John C. Chobot, *Objective Aspects of Good Faith in Insecurity Clause Debt Accelerations*, 94 Com. L.J. 13 (1989); Lawrence F. Flick, II & Dennis Replansky, *Liability of Banks to their Borrowers: Pitfalls and Protections*, 103 Banking L.J. 220 (1986); Loeb H. Granoff, *Emerging Theories of Lender Liability: Flawed Applications of Old Concepts*, 104 Banking L.J. 80 (1986); Janine S. Hiller, *Good Faith Lending*, 26 Am. Bus. L.J. 783 (1989); Ted T. Kitada, *Emerging Theories of Bank Liability—The Breach of the Covenant of Good Faith and Fair Dealing*, 103 Banking L.J. 80 (1986); Debra C. Moss, *Borrowers Fight Back with Lender Liability*, A.B.A. J., Mar. 1, 1987, at 64; Glenn D. West & Michael P. Haggerty, *The "Demandable" Note and the Obligation of Good Faith*, 21 UCC L.J. 99 (1988).

10. *See, e.g.*, David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 375, 460-63 (1990); Werner F. Ebke & James R. Griffin, *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, 49 Ohio St. L.J. 1237 (1989) [hereinafter Ebke & Griffin, *Covenant to Duty and Beyond*]; Werner F. Ebke & James R. Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775 (1986) [hereinafter Ebke & Griffin, *Conceptual Framework*]; Carolyn M. Edwards, *Article 3 Demand Notes and the Doctrine of Good Faith*, 74 Marq. L. Rev. 481 (1991); Fischel, *supra* note 7; Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. Legal Stud. 535, 565-74 (1990); William H. Lawrence & Robert D. Wilson, *Good Faith in Calling Demand Notes and in Refusing to Extend Additional Financing*, 63 Ind. L.J. 825 (1988); Steve H. Nickles, *The Objectification of Debtor-Creditor Relations*, 74 Minn. L. Rev. 371 (1989); Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 Iowa L. Rev. 503 (1991) [hereinafter Patterson, *Easterbrook on Good Faith*]; Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 Tex. L. Rev. 169 (1989) [hereinafter Patterson, *Good Faith, Lender Liability*]; Dennis M. Patterson, *Wittgenstein and the Code: A Theory of Good Faith Performance and Enforcement Under Article Nine*, 137 U. Pa. L. Rev. 335 (1988) [hereinafter Patterson, *Wittgenstein and the Code*]; Tyler, *supra*

ligation of good faith and liability of lenders thereunder.

Whether the contractual obligation of good faith has generated a lender liability crisis is debatable. Despite a number of well-publicized jury decisions,[11] overall the reported cases decided in favor of the lender outnumber those in favor of the borrower by a margin of nearly three to one.[12] This margin reflects victories both on the merits and on procedural grounds. Lenders are and have been winning in the courts.

Nonetheless, the steadily increasing number of reported cases in the area evidences a lender liability litigation crisis.[13] *Micronesian Yachts Co. v. Bank of Guam*,[14] a recent case before the United States Court of Appeals for the Ninth Circuit, demonstrates the enormously time-consuming and costly nature of this litigation. In *Micronesian Yachts*, the Bank of Guam agreed on March 23, 1983 to lend $175,000 to Micronesian Yachts Company ("MYC"), with the first payment of principal and interest due from MYC in August 1983.[15] After MYC failed to make the required payment in August, the parties agreed in September of 1983 to delay payment of principal until November of that year.[16] In October, MYC made the first of what would be numerous demands over the next

note 1, at 413-31; Jonathan K. Van Patten, *Lender Liability: Changing or Enforcing the Ground Rules?*, 33 S.D. L. Rev. 387 (1988).

For a sampling of student works in the area, see Frances E. Freund et al., *Special Project: Lender Liability*, 42 Vand. L. Rev. 853 (1989); Jill P. Anderson, Comment, *Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 Emory L.J. 917 (1987); James R. Borders, Note, *The Growth of Lender Liability: An Economic Perspective*, 21 Ga. L. Rev. 723 (1987); Melissa Cassedy, Note, *The Doctrine of Lender Liability*, 40 U. Fla. L. Rev. 165, 189-200 (1988); Kenneth J. Goldberg, Note, *Lender Liability and Good Faith*, 68 B.U. L. Rev. 653 (1988); A.J. Herbert III, Comment, *Lender Liability: Good Faith and Demand Notes*, 64 Tul. L. Rev. 187 (1989); Note, *Lender Liability: Breach of Good Faith in Lending and Related Theories*, 64 N.D. L. Rev. 273 (1988); Patricia A. Milon, Recent Development, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?*, 40 Vand. L. Rev. 1197 (1987); Jane L. Rodda, Note, *The Role of Good Faith in Lender Liability Suits: Rising Star or Fading Gadfly?*, 31 Ariz. L. Rev. 939 (1989); Mark Snyderman, Comment, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. Chi. L. Rev. 1335 (1988).

11. *See, e.g.*, Nancy Blodgett, *Lender Liability Still Lurking*, A.B.A. J., May 1, 1988, at 42 (discussing Landes Constr. v. Royal Bank of Canada, 833 F.2d 1365 (9th Cir. 1987) and Penthouse Int'l v. Dominion Fed. Sav. & Loan, 665 F. Supp. 301 (S.D.N.Y. 1987)).

12. *See infra* app. A. A few authors have suggested that the lender liability explosion may in fact be a dud. *See, e.g.*, Elizabeth Warren & Jay L. Westbrook, The Law of Debtors and Creditors 46-47 (2d ed. 1991); Warren L. Dennis & Michael I. Endler, *Bank of America and Penthouse: Is the Lender Liability Pendulum Swinging Back?*, 43 Consumer Fin. L.Q. Rep. 3, 3 (1989); Mark Thompson, *Santa Barbara's Resident Barracuda*, Cal. Law., June 1989, at 63; Blodgett, *supra* note 11, at 42.

13. *See infra* app. A.

14. 952 F.2d 1399 (9th Cir. 1992) (reported as table case), No. 90-16663, 1992 U.S. App. LEXIS 865 (9th Cir. Jan. 15, 1992) (mem.).

15. *See Micronesian Yachts*, No. 90-16663, 1992 U.S. App. LEXIS 865, at *1 (9th Cir. Jan. 15, 1992).

16. *See id.* at *2.

two years that Bank of Guam aid it in securing alternative financing.[17] MYC's interest payments—and in fact all payments—stopped in December of 1983.[18] After nearly three years of negotiation and repeated requests from MYC that Bank of Guam aid in finding MYC alternative financing, in October 1986 the bank agreed to accept $228,800 to retire MYC's note[19] which, because of accrued interest, was worth over $247,000.[20]

The credit agreement in *Micronesian Yachts* expressly allowed the bank to accelerate all amounts outstanding upon default.[21] One unversed in lender liability law might, therefore, think the Bank of Guam either worthy of commendation for refraining from exercising its express rights under the agreement, or of condemnation for settling for less than full value. Bank of Guam instead received a complaint filed by MYC, alleging that Bank of Guam breached its contractual obligation of good faith and fair dealing.[22] The Bank of Guam's nearly decade-long,[23] and no doubt costly, legal odyssey seeking to defend its right to collect from MYC is instructive. Have lender liability cases in the area of contractual good faith, together with the relevant scholarship, facilitated the efficient, predictable, and fair resolution of such disputes? That the dispute required the intervention of the second highest court in the United States indicates that over a decade of lender liability litigation, and an even longer period of theoretical attempts to conceptualize the obligation of good faith and fair dealing,[24] have come up short.

17. *See id.* at *2-*4. The financing would be used to pay off the loan from Bank of Guam. At no time did MYC seek out alternative financing on its own.

18. *See id.* at *4 n.5. MYC only paid $22.73 of the $175,000 principal. *See id.*

19. *See id.* at *3-*4. $28,800 of the settlement was in the form of a promissory note guaranteed by MYC's president and principal shareholder, which note was in default at the time the case was ultimately decided. *See id.* at *13 n.7.

20. *See id.* at *13.

21. *See* Plaintiffs'-Appellants' Excerpts of Record at 29, *Micronesian Yachts* (No. 90-16663).

22. *See Micronesian Yachts*, 1992 U.S. App. LEXIS 865, at *5. MYC alleged "that since the 3/23 contract allowed MYC to prepay the loan, the bank had a duty not to frustrate MYC's attempts at refinancing and had a duty to take reasonable measures to assist MYC in obtaining refinancing." *Id.* at *12. In addition, MYC alleged that the bank delayed in finding it alternative financing in order to take advantage of the higher interest rates on the loan. MYC also alleged breach of contract, intentional and negligent misrepresentation, fraud, and antitrust violations under the Bank Holding Company Act, 12 U.S.C. § 1972 (1988). *See id.* The president and principal shareholder of MYC claimed "that as a result of the bank's outrageous conduct, he has suffered many sleepless nights and stomach upset," resulting in the Bank's liability for negligent infliction of emotional distress. *Id.* at *16.

23. After a three day trial in 1990, the United States District Court of the North Mariana Islands entered judgment for the Bank of Guam, *see id.* at *5, and in 1992 the United States Court of Appeals affirmed the trial court's judgment. *See id.*

24. *See generally* Eric G. Andersen, *Good Faith in the Enforcement of Contracts*, 73 Iowa L. Rev. 299 (1988); Steven J. Burton & Eric G. Andersen, *The World of a Contract*, 75 Iowa L. Rev. 861 (1990); Steven J. Burton, *Racial Discrimination in Contract Performance: Patterson and a State Law Alternative*, 25 Harv. C.R.-C.L. L. Rev. 431 (1990) [hereinafter Burton, *Racial Discrimination in Contract Performance*]; Steven J. Burton,

This Article, based upon a survey of over 200 good faith lending cases,[25] traces the theoretical and judicial dissensions over the appropriate conceptualization of the contractual obligation of good faith in the lender liability area. The crux of the lender liability debate lies in the relationship between the express terms of a lending agreement and the limitations, if any, that good faith may impose on a lender's invocation of those terms. Dissensions over this issue, rather than over lenders' economic liability, lie at the heart of the lender liability crisis. Accordingly, criticisms of recent pro-borrower good faith cases are unwarranted to the extent grounded in concerns that good faith has become a "loose can-

More on Good Faith Performance of a Contract: A Reply to Professor Summers, 69 Iowa L. Rev. 497 (1984) [hereinafter Burton, *Reply*]; Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 Iowa L. Rev. 1 (1981) [hereinafter Burton, *Article 2 Good Faith*]; Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369 (1980) [hereinafter Burton, *Common Law Good Faith*]; Russell A. Eisenberg, *Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem*, 54 Marq. L. Rev. 1 (1971); E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666 (1963); Fischel, *supra* note 7; Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 Duke L.J. 619; Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 Minn. L. Rev. 521, 552-72 (1981); Patterson, *Wittgenstein and the Code*, *supra* note 10; B.J. Reiter, *Good Faith in Contracts*, 17 Val. U. L. Rev. 705 (1983); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 Cornell L. Rev. 810 (1982) [hereinafter Summers, *Recognition and Conceptualization*]; Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of The Uniform Commercial Code*, 54 Va. L. Rev. 195 (1968) [hereinafter Summers, *"Good Faith" in General Contract Law*]. *See generally* sources cited *supra* note 10.

25. The sheer volume of claims against lending institutions grounded in good faith necessitated limiting the survey to a lender's contractual obligation of good faith under lending agreements. For example, the following areas were omitted from the scope of the survey: (1) claims clearly asserted only in tort not bearing significantly on the scope of the contractual obligation of good faith, *see, e.g.*, Brown-Marx Assocs., Ltd. v. Emigrant Sav. Bank, 527 F. Supp. 277 (N.D. Ala. 1981) (refusing to apply bad faith tort to a refusal to lend situation), *aff'd*, 703 F.2d 1361 (11th Cir. 1983); (2) claims of bad faith in precontractual negotiation or based upon a commitment letter rather than upon a credit agreement, *see, e.g.*, Sterling Faucet Co. v. First Mun. Leasing Corp., 716 F.2d 543 (8th Cir. 1983); (3) bad faith repossession under Article 9 of the U.C.C., particularly U.C.C. § 9-504, *see, e.g.*, Suffield Bank v. LaRoche, 752 F. Supp. 54 (D.R.I. 1990); (4) good faith obligations toward a guarantor rather than the principal debtor, *see, e.g.*, Continental Bank, N.A. v. Modansky, 129 B.R. 159, 161-62 (N.D. Ill. 1991); (5) holder in due course requirements under Article 3 of the U.C.C., *see, e.g.*, Bowling Green Inc. v. State Street Bank & Trust Co., 425 F.2d 81 (1st Cir. 1970); (6) bank/depositor relationships under Article 4 of the U.C.C., *see, e.g.*, Best v. United States Nat'l Bank, 739 P.2d 554 (Or. 1987); (7) a creditor's alleged bad faith filing of an involuntary bankruptcy petition, *see, e.g.*, *In re* K.P. Enter., 135 B.R. 174 (Bankr. D. Me. 1992); (8) exercise of due on sale clauses prior to or as permitted by the Garn-St. Germain Depository Institutions Act of 1982, *see, e.g.*, Century Fed. Sav. & Loan Ass'n v. Van Glahn, 364 A.2d 558 (N.J. Super. Ct. Ch. Div. 1976); (9) intercreditor disputes, *see, e.g.*, Walter E. Heller W. Inc. v. Tecrim Corp. 241 Cal. Rptr. 677 (Cal. Ct. App. 1987); (10) preclusion of good faith claims under the *D'Oench Duhme* doctrine, *see, e.g.*, Baumann v. Savers Fed. Sav. & Loan Ass'n, 934 F.2d 1506 (11th Cir. 1991), *cert. denied*, 112 S. Ct. 1936 (1992); and (11) bond financings (which usually involve the good faith of the borrower), *see, e.g.*, Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

non" decimating scores of financial institutions with exorbitant damages awards[26] or that courts have engaged in widespread remaking of contracts based upon personal notions of fairness.[27] The obligation of good faith has proven problematic in lender liability law not because it results in expansive liability but rather because it generates inconsistent, unpredictable rules of conduct.

A comprehensive examination of the extent to which current theories have been adopted by courts reveals contradictory judicial positions on good faith. These positions are consciously chosen and irreconcilable on a theoretical level. For example, the perceived crisis of the 1980s has generated a discernible judicial shift toward a more restrictive, literalist interpretation of the obligation of good faith.[28] Increasingly, courts are questioning the celebrated 1985 case of *K.M.C. Co. v. Irving Trust Co.*,[29] the vanguard of pro-borrower forces. In *K.M.C.*, the United States Court of Appeals for the Sixth Circuit expansively applied the obligation of good faith when it held that good faith required the lender to give

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26. *See* William D. Warren, *Good Faith Under the Uniform Commercial Code, in* 1 American Bar Association, *supra* note 1, at 58; J. Anderson, Comment, *supra* note 10, at 918; Cassedy, Note, *supra* note 10, at 200 (borrowers have had "phenomenal success" using good faith); Herbert, Comment, *supra* note 10, at 188-89; Milon, Recent Development, *supra* note 10; Rodda, Note, *supra* note 10, at 958; Snyderman, Comment, *supra* note 10, at 1337.

27. *See, e.g.*, Ebke & Griffin, *Covenant to Duty and Beyond*, *supra* note 10, at 1247-49; Ebke & Griffin, *Conceptual Framework*, *supra* note 10, at 798 ("[T]he actionable theory of good faith and fair dealing is too broad and inconcrete . . . ."); Fischel, *supra* note 7, at 142-46 (criticizing decisions); Lawrence & Wilson, *supra* note 10, at 825-26; Tyler, *supra* note 1, at 447 (criticizing "unbridled expansion" of duty of good faith where fact finder decides on what seems fair); Robert C. Williamson, Jr. & Brenda Kay Tanner, *Lender Liability in Mississippi: A Survey, Comparison and Comment*, 57 Miss. L.J. 1, 21 (1987) (criticizing the superimposition of "an ambiguous duty of fairness"); C. Anderson, Note, *supra* note 10, at 313-14; J. Anderson, Comment, *supra* note 10, at 966-70; Borders, Note, *supra* note 10, at 740-42 (courts have extended obligation beyond intended scope); Herbert, Comment, *supra* note 10, at 214 (good faith too broad and inconcrete); Snyderman, Comment, *supra* note 10, at 1338 (good faith "allows judges and juries to substitute their conceptions of reasonableness and fairness for those of [the] parties").

Criticism of imposing liability on banks, however, has not been entirely unanimous. *See* Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 Wash. & Lee L. Rev. 697, 734-36 (1990) (imposing liability consistent with legal obligation of good faith); Cappello, *supra* note 9, at 7 ("The banks' days of treating borrowers as second-class citizens are over."); Nickles, *supra* note 10, at 385 (net economic cost of lender liability cases is justified); Van Patten, *supra* note 10, at 436 (lender liability cases curb abuses and unfair conduct and hold banks accountable for actions); Goldberg, Note, *supra* note 10, at 680 (good faith polices over-aggressive financial institutions).

28. *See infra* text accompanying notes 271-308.

29. 757 F.2d 752 (6th Cir. 1985); *see, e.g.*, Fasolino Foods Co. v. Banca Nazionale del Lavoro, 961 F.2d 1052, 1057-58 (2d Cir. 1992); Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1358 (7th Cir. 1990); National Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 680 (S.D.N.Y. 1991), *aff'd sub nom.* Yaeger v. National Westminister, 962 F.2d 1 (2d Cir. 1992); Spencer Cos. v. Chase Manhattan Bank, N.A., 81 B.R. 194, 199 (D. Mass. 1987); East Lansing State Bank v. Red Cedar Constr. Co. (*In re* Red Cedar Constr. Co.), 63 B.R. 228, 235-38 (Bankr. W.D. Mich. 1986); Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336, 1341 (Fla. Dist. Ct. App. 1986); Centerre Bank of Kan. City, N.A. v. Distributors, Inc., 705 S.W.2d 42, 48 (Mo. Ct. App. 1985).

notice prior to refusing to make advances under a line of credit.[30] *K.M.C.*, taken with the backlash against it, illustrates the absence of synthesis in current good faith law. Depending upon the court, good faith in lending relationships may now impose a nebulous obligation of "fundamental integrity"[31] on the lender. Alternatively, good faith may preclude "objectively oppressive and unfair"[32] behavior or may merely be just a small part of a larger "fable[]"[33] fascinating to children but put aside by adults.

Thus, the current state of good faith law in lending arrangements contravenes the essential, recognized need in contract law for uniformity and certainty.[34] Inconsistent views in the courts on the meaning of good faith provide little guidance for transactors, leading to cases such as *Micronesian Yachts*. Irreconcilable judicial attitudes also offer borrowers a potentially loaded gun in the form of a threat of litigation[35] yet, concurrently, fail to provide lenders with standards by which they can act to avoid litigation. The failure of lender liability cases to generate predictable rules of good faith conduct demands a reassessment of the appropriate scope of the obligation of good faith.

Part I of this Article sets forth the current leading statutory and theoretical attempts to conceptualize the obligation of good faith.[36] Part II assesses the extent to which courts have implemented the competing theoretical conceptualizations.[37] This Part points out that although each theory has garnered some support in the courts, no clear consensus has emerged. Part III analyzes the doctrinal implications of the current judicial approaches to good faith issues.[38] Part IV advocates adoption of the

30. *See K.M.C.*, 757 F.2d at 759-60; *see also infra* text accompanying notes 193-227.

31. Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846, 851 (3d Cir. 1964).

32. Martin Specialty Vehicles, Inc., v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 766 (Bankr. D. Mass. 1988), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989).

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

34. *See, e.g.*, U.C.C. § 1-102(2) (1990); Summers, *Recognition and Conceptualization*, *supra* note 24, at 823; *see also* Randy E. Barnett, *Conflicting Visions: A Critique of Ian Macneil's Relational Theory of Contract*, 78 Va. L. Rev. 1175, 1193-94 (1992) ("[I]t would seem desirable to have discernable legal precepts by which lawyers could advise both behemoths and individuals alike as to whether they are exposing themselves to the weight of legal coercion.").

35. *See, e.g.*, Howard Oaks, Inc. v. Maryland Nat'l Bank, No. S 92-3331, 1993 U.S. Dist. LEXIS 287, at *2 (D. Md. Jan. 13, 1993) ("Indeed, the very filing of [a lender malpractice] suit, in which the borrower essentially blames the lender for its business failure, might remind the lay observer of Danton's famous exhortation to the Legislative Assembly, 'Il nous faut de l'audace, encore de l'audace, toujours de l'audace'. . . .") (quoting Bartlett's Familiar Quotations 412 n.1 (15th ed. 1980)); *In re* Hanson Indus., Inc., 88 B.R. 942, 948 (Bankr. D. Minn. 1988) (threat of huge judgments and pro-borrower juries "is precisely [the] type of concern which has caused the Bank to offer the settlement it has offered in this case").

36. *See infra* text accompanying notes 40-158.

37. *See infra* text accompanying notes 159-308.

38. *See infra* text accompanying notes 309-55.

"effectiveness of express terms" judicial approach to good faith.[39] Finally, this Article concludes that, absent adoption of the effectiveness of express terms approach, the failure of courts to generate a consistent body of good faith law supports abolishing the obligation of good faith in lending arrangements.

I. CURRENT STANDARDS/THEORIES

Any claim that a lender acted in bad faith necessarily stems initially from the statutory and common law provisions imposing the obligation of good faith in lending agreements. This Section will first set forth the current statutory and common law requirements for contractual good faith.[40] A synopsis of the principal academic theories of good faith, inextricably linked to imposition of the legal obligation, will then follow.[41]

A. *Statutory and Common Law Provisions on Good Faith*

Both the Uniform Commercial Code[42] (the "Code") and the Restatement (Second) of Contracts[43] (the "Restatement") impose an obligation of good faith and fair dealing in the performance and enforcement of contracts.[44] However, the Code and the Restatement take divergent

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39. *See infra* text accompanying notes 356-78.

40. *See infra* text accompanying notes 42-72.

41. *See infra* text accompanying notes 73-158.

42. Section 1-203 of the Uniform Commercial Code provides: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203 (1990).

In late 1992, while this Article was in the process of publication, the Permanent Editorial Board of the Code began consideration of a PEB Commentary on § 1-203. The proposed commentary rejects the proposition that § 1-203 creates an independent cause of action:

> Rather, [§ 1-203] means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed and enforced.

PEB Commentary on § 1-203 (Draft Proposal) at 11-12 (on file with the *Fordham Law Review*).

The proposed commentary adopts the deeply interpretivist approach to good faith, *see infra* text accompanying notes 105-15, which has achieved only nominal judicial acceptance in the lender liability area, *see infra* note 252 and accompanying text, and which this Article rejects, *see infra* text accompanying notes 356-78.

43. Section 205 of the Restatement provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Restatement (Second) of Contracts § 205 (1981).

44. The general good faith obligation in U.C.C. § 1-203 only refers to "good faith," while the general Restatement obligation encompasses both "good faith" and "fair dealing." *See supra* notes 42-43. The U.C.C. definitions of good faith only encompass "fair dealing" with respect to merchants involved in exchanges covered by Article 2 of the U.C.C. and with respect to transactions covered by Articles 2A (Leases), 3 (Negotiable Instruments), 4 (Bank Collections), and 4A (Electronic Transfers). *See* U.C.C. §§ 2-103(1)(b), 2A-103(3), 3-103(a)(4), 4-104(c), 4A-105(a)(6) (1990); *see also* Burton, *Article 2 Good Faith, supra* note 24, at 26-27, 26 n.146 (discussing tension between §§ 1-203 and

views on the definition and interpretation of the obligation.

The Code adopts a definitional approach to good faith. Other than with respect to merchants under Article 2, and other than generally under Articles 2A, 3, 4, and 4A of the Code, the Code standard for "good faith" is defined as "honesty in fact in the conduct or transaction concerned."[45] In the remaining areas, good faith not only includes honesty in fact but also "observance of reasonable commercial standards of fair dealing."[46] In good faith lending cases, the proper application of the Code's "honesty in fact" standard, rather than the broader standard of "observance of reasonable commercial standards of fair dealing," has been the main source of judicial debate.[47] For example, courts have applied conflicting standards for when a lender acts "honest[ly] in fact."

2-103(1)(b) and between U.C.C. and common-law interpretations of good faith and fair dealing).

45. U.C.C. § 1-201(19) (1990). Prior to the 1990 revisions to Articles 3 and 4, those articles also used the "honesty in fact" definition of good faith. *See* U.C.C. § 3-103 cmt. 4 (1990).

Although the general Article 1 definition reads in full that " 'Good faith' means honesty in fact in the conduct or transaction concerned," U.C.C. § 1-201(19) (1990), at least two writers have suggested that the Article 1 definition only sets a threshold standard of behavior and is not limited by definition solely to "honesty." *See* Bruce A. Campbell, *Contracts Jurisprudence and Article Nine of the Uniform Commercial Code: The Allowable Scope of Future Advance and All Obligations Clauses in Commercial Security Agreements*, 37 Hastings L.J. 1007, 1036 (1986); Patterson, *Wittgenstein and the Code*, *supra* note 10, at 383. These authors rely on comment 19 to § 1-201, which provides in part that " 'Good faith' . . . means at least [honesty in fact]." U.C.C. § 1-201 cmt. 19 (1990). However, comment 19 reads in pertinent part as follows:

> "Good faith", whenever it is used in the Code, means at least what is here stated. In certain Articles, by specific provision, additional requirements are made applicable . . . . To illustrate, in the Article on Sales, section 2-103, good faith is expressly defined as including in the case of a merchant observance of reasonable commercial standards of fair dealing in the trade, so that throughout that Article wherever a merchant appears in the case an inquiry into his observance of such standards is necessary to determine his good faith.

Id. It is clear from comment 19, when read as a whole, that the words "at least" were intended to mean that, although the general Code standard is honesty in fact, other articles and sections of the Code may expressly implement a higher standard. *See* United States Nat'l Bank of Or. v. Boge, 814 P.2d 1082, 1089 (Or. 1991). However, the phrase "unless the context otherwise requires" which prefaces § 1-201 does provide support for implying a higher standard of good faith with respect to other sections of the Code, even in the absence of express language. *See* Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1032-33 (Colo. Ct. App. 1987) (using language of preface to impose objective standard of good faith).

46. U.C.C. §§ 2-103(1)(b), 2A-103(3), 3-103(a)(4), 4-104(c), 4A-105(a)(6) (1990).

47. The "honesty in fact" standard applies to Article 9 (Secured Transactions), thus making the scope of that standard arguably the issue in secured lending. Whether the Code universally governs every aspect of lending transactions, however, is debatable. While a separate security agreement in personal property or fixtures is clearly covered by the Code, *see* U.C.C. § 9-102(1), (2) (1990), it is less than settled that a credit agreement pursuant to which that security agreement was executed is governed by the Code rather than the common law. *See* Proposed PEB Commentary, *supra* note 42, at n.1 (Code governs security agreement while common law governs credit agreement financial covenants); *see also* Carrico v. Delp, 490 N.E.2d 972 (Ill. App. Ct. 1986) (applying common law to secured credit agreement); Components Direct, Inc. v. European Am. Bank &

Some courts have adopted an entirely subjective standard for honesty in fact,[48] which looks "to the intent or state of mind of the party concerned."[49] Others have utilized an objective standard under which a lender is required to observe reasonable commercial standards.[50] Still others have relied on a "mixed" subjective and objective standard under which honesty in fact, while ultimately a determination into an actor's subjective state of mind, can be assessed through an examination of the surrounding facts and circumstances.[51]

The subjective/objective controversy most frequently arises under sec-

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Trust Co., 572 N.Y.S.2d 359 (App. Div. 1991) (same). In addition, real property secured transactions are not governed by the Code. *See* U.C.C. § 9-104(j) & cmt. 2 (1990).

48. *See* Adams v. First State Bank, 778 S.W.2d 611, 614 (Ark. 1989); Quest v. Barnett Bank, 397 So. 2d 1020, 1022 (Fla. Dist. Ct. App. 1981); Jackson v. State Bank, 488 N.W.2d 151, 156 (Iowa 1992); Farmers Coop. Elevator, Inc. v. State Bank, 236 N.W.2d 674, 678 (Iowa 1975); Daniels v. Army Nat'l Bank, 822 P.2d 39, 43 (Kan. 1991); Karner v. Willis, 710 P.2d 21, 23 (Kan. 1985); Fort Knox Nat'l Bank v. Gustafson, 385 S.W.2d 196, 200 (Ky. 1964); Diversified Foods, Inc. v. First Nat'l Bank, 605 A.2d 609, 613 (Me. 1992); Sievert v. First Nat'l Bank, 358 N.W.2d 409, 414 (Minn. Ct. App. 1984); United States Nat'l Bank. v. Boge, 814 P.2d 1082, 1091 (Or. 1991); State Bank v. Woolsey, 565 P.2d 413, 418 (Utah 1977); Van Horn v. Van De Wol, Inc., 497 P.2d 252, 254 (Wash. Ct. App. 1972); Niemuth v. Medford Nat'l Bank, 459 N.W.2d 259 (Wis. Ct. App. 1990) (unpublished opinion, text in Westlaw). However, in some cases a secured creditor may be held to a higher standard of good faith even if a purely subjective standard is applied to unsecured creditors. *See Karner*, 710 P.2d at 24 (Herd, J., dissenting) (secured creditor should have higher burden); McKay v. Farmers & Stockmens Bank of Clayton, 585 P.2d 325, 327 (N.M. Ct. App.) (reversing summary judgment for secured creditor), *cert. denied*, 582 P.2d 1292 (N.M. 1978); *Van Horn*, 497 P.2d at 254 ("A secured creditor must show more compelling facts because he is in a less precarious position than is an unsecured creditor.").

49. United States Nat'l Bank v. Boge, 814 P.2d 1082, 1091 (Or. 1991) (quoting Community Bank v. Ell, 564 P.2d 685 (Or. 1977)).

50. *See, e.g.*, Sheppard Fed. Credit Union v. Palmer, 408 F.2d 1369, 1371 & n.2 (5th Cir. 1969); Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1033 (Colo. Ct. App. 1987); Smith v. Union State Bank, 452 N.E.2d 1059, 1064 (Ind. Ct. App. 1983); Universal C.I.T. Credit Corp. v. Shepler, 329 N.E.2d 620, 623-24 (Ind. Ct. App. 1975); Black v. Peoples Bank & Trust Co., 437 So. 2d 26, 29-30 (Miss. 1983); Mitchell v. Ford Motor Credit Co., 688 P.2d 42, 45 (Okla. 1984); Richland Nat'l Bank & Trust v. Swenson, 816 P.2d 1045, 1051 (Mont. 1991); American Bank v. Waco Airmotive, Inc., 818 S.W.2d 163, 172 (Tex. Ct. App. 1991); *see also* James J. White & Robert S. Summers, Uniform Commercial Code § 25-3, at 1192 (3d ed. 1988) (stating that drafters of Code intended an objective standard). The parties nonetheless may adopt by agreement an objective standard in some jurisdictions. *See* Bartlett Bank & Trust Co. v. McJunkins, 497 N.E.2d 398, 404 (Ill. App. Ct. 1986).

51. *See, e.g.*, Reid v. Key Bank, Inc., 821 F.2d 9, 15 (1st Cir. 1987); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 761 (6th Cir. 1985); Petra Int'l Banking Corp. v. First Am. Bank of Va., 758 F. Supp. 1120, 1142 (E.D. Va. 1991); Martin Specialty Vehicles, Inc. v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 766 (Bankr. D. Mass. 1988) (applying Massachusetts law), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989); Watseka First Nat'l Bank v. Ruda, 552 N.E.2d 775, 781 (Ill. 1990); Tri-Company Constr., Inc. v. Farmers & Merchants State Bank, No. 64-872, 1991 Kan. App. LEXIS 1, at *17-*18 (Kan. Ct. App. Jan. 2, 1991); Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517, 533-34 (Mo. Ct. App. 1986); J.R. Hale Contracting Co. v. United N.M. Bank, 799 P.2d 581, 591 (N.M. 1990); Canterbury Realty & Equip. Corp. v. Poughkeepsie Sav. Bank, 524 N.Y.S.2d 531, 536 (App. Div. 1988); Schaller v. Marine Nat'l Bank, 388 N.W.2d 645, 651 (Wis. Ct. App. 1986); *see also* White & Summers, *supra*

tion 1-208 of the Code when a lender seeks to accelerate a loan based on an insecurity clause in the credit agreement.[52] A court adopting an objective standard for the Code's definition of good faith would require a bank that accelerates a loan because of insecurity to have some objectively reasonable basis to believe that the prospect of payment or performance has become impaired. In contrast, under a subjective approach the bank must merely act upon "an honest belief, based on whatever information it has, that the ability of the debtor to repay the debt has in some way become impaired."[53]

Conflicts have arisen not only with respect to the proper Code standard for the obligation of good faith but also with respect to the more basic issue of when the obligation even applies in lending relationships. The comment to section 1-208, which seems to exclude demand notes from section 1-208,[54] provides the principal point of contention. A growing majority of cases rely upon the comment to find that the Code does not impose any obligation of good faith with respect to demand notes.[55]

note 50, § 25-3, at 1192 (honesty in fact standard "seems to lie somewhere between a strict objective test (reasonable prudent man) and a thoroughly subjective one (whim)").

Some courts have chosen to avoid entirely the subjective/objective controversy. For example, some Montana courts have defined "honesty in fact" under U.C.C. § 1-201(19) as "faithfully carrying out the terms of the agreement." Coles Dep't Store v. First Bank (N.A.), 783 P.2d 932, 935 (Mont. 1989); Shiplet v. First Sec. Bank, Inc., 762 P.2d 242, 246 (Mont. 1988). Good faith may also, in the words of one court, prohibit "objectively oppressive and unfair" behavior. *Martin Specialty Vehicles*, 87 B.R. at 766. These definitional turns place a common law gloss on the Code definition of good faith. *See also Watseka First Nat'l Bank*, 552 N.E.2d at 781 (U.C.C. § 1-103, providing for incorporation of common law unless specifically displaced by Code, plays "a moderating influence" on subjective standard for good faith). Similarly, other courts while applying the Code seem to have incorporated the more flexible Restatement formulation of good faith as a supplement to the U.C.C. § 1-203 obligation. *Cf.* Bank of China v. Chan, 937 F.2d 780, 789 (2d Cir. 1991) (letter of credit case); United States v. H & S Realty Co., 837 F.2d 1, 4 (1st Cir. 1987) (applying Restatement approach to Code standard). *But see Boge*, 814 P.2d at 1090 (statutory duty of good faith under Code displaces common law duty of good faith).

52. Section 1-208 provides:

> A term providing that one party . . . may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have the power to do so only if he in good faith believes that the prospect of payment or performance is impaired.

U.C.C. § 1-208 (1990).

53. *Watseka First Nat'l Bank*, 552 N.E.2d at 779. Pre-Code cases appear to have applied an objective standard for determining insecurity. *See* Feller v. McKillip, 81 S.W. 641, 643 (Kan. Ct. App. 1904).

54. The comment to § 1-208 states that the section "[o]bviously . . . has no application to demand instruments or obligations whose very nature permits call at any time with or without reason." U.C.C. § 1-208 cmt. (1990).

55. *See, e.g.*, Mirax Chem. Prod. Corp. v. First Interstate Commercial Corp., 950 F.2d 566, 570 (8th Cir. 1991); Greenberg v. Service Business Forms Indus., Inc., 882 F.2d 1538, 1540 (10th Cir. 1989), *cert. denied*, 493 U.S. 1045 (1990); Citibank, N.A. v. Field, No. 91-6290, 1992 U.S. Dist. LEXIS 3621, at *16 (E.D. Pa. March 25, 1992); Whitney Nat'l Bank v. J.E. Stack, No. 91-1320, 1991 U.S. Dist. LEXIS 16877, at *9 (E.D. La. Nov. 15, 1991); Bankers Trust Co. v. F.D. Rich Co., No. 90 Civ. 4827, 1991

Other courts take a more moderate approach and impose good faith limitations on calling demand notes.[56] To avoid the issue of good faith limitations on calling demand notes, many courts will find that the note at issue, although expressly payable on demand, was in fact a term note and, therefore, subject to the Code's general obligation of good faith.[57]

Section 1-208 also has generated divergent views regarding a lender's exercise of its express right to accelerate upon a specified event of default other than insecurity. The majority approach applies the general Code obligation of good faith to such accelerations.[58] In contrast, some courts

U.S. Dist. LEXIS 14682, at *12 (S.D.N.Y. Oct. 11, 1991); Taggart & Taggart Seed, Inc. v. First Tenn. Bank Nat'l Ass'n, 684 F. Supp. 230, 235 (E.D. Ark. 1988), *aff'd*, 881 F.2d 1080 (8th Cir. 1989); Spencer Cos. v. Chase Manhattan Bank, N.A., 81 B.R. 194, 199 (D. Mass. 1987); Power Equip. Co. v. First Ala. Bank, 585 So. 2d 1291, 1297 (Ala. 1991); Pavco Indus., Inc. v. First Nat'l Bank, 534 So. 2d 572, 577 (Ala. 1988); Fleet Bank, N.A. v. Czaplicki, No. PJR CV-91-0702261S, 1991 Conn. Super. LEXIS 2553, at *2 (Conn. Super. Ct. Nov. 5, 1991); Flagship Nat'l Bank v. Gray Distribution Sys., Inc. 485 So. 2d 1336, 1340 (Fla. Dist. Ct. App. 1986); Fulton Nat'l Bank v. Willis Denney Ford, Inc., 269 S.E.2d 916, 918 (Ga. Ct. App. 1980); Diversified Foods, Inc. v. First Nat'l Bank, 605 A.2d 609, 613-14 (Me. 1992); Check Reporting Servs., Inc. v. Michigan Nat'l Bank, 478 N.W.2d 893, 898-99 (Mich. Ct. App. 1991); Centerre Bank, N.A. v. Distributors, Inc., 705 S.W.2d 42, 47-48 (Mo. Ct. App. 1985); Simon v. New Hampshire Savs. Bank, 296 A.2d 913, 915 (N.H. 1972); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 518 P.2d 734, 738 (Wash. Ct. App.), *cert. denied*, 419 U.S. 967 (1974)

56. *See* Reid v. Key Bank, Inc., 821 F.2d 9, 14-15 (1st Cir. 1987); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 759-60 (6th Cir. 1985); Martin Specialty Vehicles, Inc. v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 765 (Bankr. D. Mass. 1988), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989); Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1032 (Colo. Ct. App. 1987); Watseka First Nat'l Bank v. Ruda, 552 N.E.2d 775, 778 (Ill. 1990); Van Bibber v. Norris, 419 N.E.2d 115, 124 (Ind. 1981); Karner v. Willis, 700 P.2d 582, 583 (Kan. Ct. App. 1985); Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517, 526 n.7 (Mo. Ct. App. 1986); Motion for summary judgment, First Fidelity Bank v. People Care, Inc., No. L-001554-90 (N.J. Super. Ct. May 3, 1991); Canterbury Realty & Equip. Corp. v. Poughkeepsie Sav. Bank, 524 N.Y.S.2d 531, 535 (App. Div. 1988); Clayton v. Crossroads Equip. Co., 655 P.2d 1125, 1129 (Utah 1982); Van Horn v. Van De Wol, Inc., 497 P.2d 252, 254 (Wash. Ct. App. 1972).

57. *See* U.C.C. § 1-203 (1990). For example, the court in Reid v. Key Bank, Inc., 821 F.2d 9 (1st Cir. 1987), held that although the note at issue expressly seemed to give the lender the right to demand immediate repayment, the presence of default terms in the note limited the right to demand and thus the general obligation of good faith applied irrespective of § 1-208. *See id.* at 13-14; *see also* Bank One, N.A. v. Taylor, 970 F.2d 16, 31-32 (5th Cir. 1992) (applying *Reid*); Martin Specialty Vehicles, Inc. v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 765 (Bankr. D. Mass. 1988) (using *Reid* approach), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989); Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 951 (Mo. Ct. App. 1986) (finding no demand note); Bottrell v. American Bank, 773 P.2d 694, 701 (Mont. 1989) (same). *But see* Housatonic Bank & Trust Co. v. Jaser, No. CV90 03 34 88S, 1990 Conn. Super. LEXIS 1491, at *10 (Oct. 25, 1990) (contrary to *Reid* approach); Simon v. New Hampshire Savs. Bank, 296 A.2d 913, 915 (N.H. 1972) (same).

58. *See, e.g.*, Bank One, N.A. v. Taylor, 970 F.2d 16, 32 (5th Cir. 1992); Reid v. Key Bank, Inc., 821 F.2d 9, 13-14 (1st Cir. 1987); Spencer Cos. v. Chase Manhattan Bank, N.A., 81 B.R. 194, 198-199 (D. Mass. 1987) (holding that although no duty of good faith under demand note, duty still applies to term note); Bank One, Cleveland, NA v. Grantham, Inc., Nos. 90-6-1555, 90-6-1556, 1991 Ohio App. LEXIS 4722, at *16-*17 (Ohio Ct. App. 1991), *vacated*, 588 N.E.2d 127 (Ohio 1992). Even if the general § 1-203 obligation

use section 1-208 to find that no obligation of good faith exists even in accelerating a term note upon a specified default within the control of the debtor.[59] Yet other courts rely upon section 1-208 to find that a lender's acceleration upon a non-insecurity event of default must be based upon a good faith belief that the prospect of payment or performance is impaired.[60]

The limited scope of the Code, particularly as it governs banking arrangements,[61] makes the common law obligation of good faith, which is recognized by a majority of jurisdictions,[62] applicable in lending disputes. Unlike the Code, the Restatement does not attempt to define the meaning of good faith and fair dealing, on the basis that the precise meaning of the obligation will vary depending on the context in which it arises.[63] The Restatement views good faith as "emphasiz[ing] faithfulness to an agreed common purpose and consistency with the justified expectations of the other party" and "exclud[ing] a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."[64] Comment d to section 205 provides examples of conduct amounting to bad faith: "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."[65] The Restatement thus sacrifices the definitional precision of the Code in favor of a more open-ended approach.

The disparity between the Code and Restatement approaches to the meaning of good faith might result in inconsistent determinations of a

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applies, the remaining hurdle of what that section means, e.g., subjective honesty in fact or otherwise, must be crossed. *See supra* notes 48-51 and accompanying text.

59. *See* Greenberg v. Service Business Forms Indus., 882 F.2d 1538, 1541 (10th Cir. 1989), *cert. denied*, 493 U.S. 1045 (1990); Bowen v. Danna, 637 S.W.2d 560, 563 (Ark. 1982); Don Anderson Enters. v. Entertainment Enters., 589 S.W.2d 70, 73 (Mo. Ct. App. 1979); Brummund v. First Nat'l Bank, 656 P.2d 884, 887-88 (N.M. 1983); Fay v. Marina, Inc. 6 U.C.C. Rep. Serv. (Callaghan) 516, 516 (N.Y. Sup. Ct. 1969); Crockett v. First Fed. Sav. & Loan Ass'n, 224 S.E.2d 580, 588 (N.C. 1976); Barker v. Agee, 378 S.E.2d 566, 569 (N.C. Ct. App. 1989); *In re* Sutton Investments, Inc., 266 S.E.2d 686, 690 (N.C. Ct. App. 1980); *see also* Production Credit Ass'n v. Van Iperen, 396 N.W.2d 35, 39 (Minn. Ct. App. 1986) (rejecting as "irrelevant" evidence of bad faith in acceleration after payment default).

60. *See, e.g.*, Brown v. AVEMCO Inv. Corp., 603 F.2d 1367, 1379-80 (9th Cir. 1979) (due-on-lease clause); Williamson v. Wanlass, 545 P.2d 1145, 1148-49 (Utah 1976) (late payments).

61. *See supra* note 47.

62. *See* Burton, *Common Law Good Faith*, *supra* note 24, at 369 & app.

63. *See* Restatement (Second) of Contracts § 205 cmt. a.

64. *Id.*

65. *Id.* § 205 cmt. d. The Restatement's approach to the obligation of good faith and fair dealing relies significantly on Professor Summers' "excluder analysis" of the meaning of good faith, discussed *infra* text accompanying notes 75-88. *See id.* § 205 cmt. a ("[Good faith] excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."); *see also* Summers, *Recognition and Conceptualization*, *supra* note 24, at 818-21.

party's good faith depending on whether or not the transaction at issue is covered by the Code. A lender acting pursuant to a secured loan agreement,[66] for example, may be limited only by the subjective "honesty in fact" standard of the Code.[67] In contrast, a court could[68] apply the broader Restatement principles to assess a lender's good faith under an unsecured credit agreement providing for non-negotiable promissory notes.[69] Curiously, this outcome is inconsistent with the transactional structure of lending arrangements.[70] A secured lender exercises far greater leverage and control over a borrower than an unsecured lender by virtue of the secured lender's security interest in assets of the borrower.[71] One therefore would expect that, because of this control, a secured lender's obligation of good faith would be measured by at least the same standard as that applied to an unsecured lender, if not a higher standard.[72] Application of the Code and the Restatement, however, leads to the opposite result—the secured lender's duty can be governed by the more lenient "honesty in fact" standard of the Code.

66. *See* U.C.C. §§ 1-203 (general obligation of good faith), 9-102 (1990) (Article 9 applies to secured transactions).

67. *See generally* cases cited *supra* note 48.

68. Some jurisdictions, however, have simply refused to recognize a cause of action based upon an implied obligation of good faith and fair dealing in lending agreements. *See, e.g.*, Bank of New York v. Sasson, 786 F. Supp. 349, 354 (S.D.N.Y. 1992) (applying Michigan law); Power Equip. Co., Inc. v. First Ala. Bank, 585 So. 2d 1291, 1297 (Ala. 1991) (discussing Alabama precedent); Security Bank v. Dalton, 803 S.W.2d 443, 449 (Tex. Ct. App. 1991) (holding that good faith is required only in a special relationship); *see also* Capri Jewelry, Inc. v. Chayavi, 503 N.Y.S.2d 370, 373 (N.Y. App. Div. 1986) (Code provisions on good faith and unconscionability generally concern sales contracts, not negotiable instruments).

69. *See* U.C.C. §§ 3-102(a) (application of Article 3), 3-104(a) (1990) (requirements for negotiability).

70. Given that the recent revisions to Articles 3 and 4 of the Code incorporate the broader U.C.C. definition of good faith—reasonable commercial standards of fair dealing—the "honesty in fact" definition appears to be on the wane, with Article 9 being the only major Article of the Code still using the definition. The § 1-201 definition of "honesty in fact" was included because of bank lobby concerns over too broad a duty of good faith under Article 3 holder in due course provisions. *See* Robert Braucher, *The Legislative History of the Uniform Commercial Code*, 58 Colum. L. Rev. 798, 813 (1958); *see also* U.C.C. § 3-302 (1990) (holder in due course provisions). Because the 1990 revisions to Articles 3 and 4 reject the principal justification for the drafter's inclusion of the "honesty in fact" definition in § 1-201(19), the value of the definition as applied to Article 9 has been further undermined. *Cf.* Patterson, *Wittgenstein and the Code*, *supra* note 10, at 382-83 (application of § 1-201(19) definition to Article 9 good faith questionable).

However, not all jurisdictions have adopted the objective standard for good faith when enacting the revised versions of Articles 3 and 4. *See, e.g.*, 1992 La. Sess. Law Serv. 1823, at 1824, 1852 (West) (not enacting objective good faith provisions).

71. *See, e.g.*, Gillette, *supra* note 10, at 568-74 (discussing role of security interest); William H. Lawrence, *Lender Control Liability: An Analytical Model Illustrated with Applications to the Relational Theory of Secured Financing*, 62 S. Cal. L. Rev. 1387, 1399 (1989) (control arising from blanket security interest); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 Colum. L. Rev. 901, 932-33 (1986) (same).

72. Perhaps in recognition of this problem, some courts, in interpreting the Code definition of "honesty in fact," have implemented a higher, less subjective standard of good faith in the case of secured creditors. *See supra* note 48.

B. *Current Theories of Good Faith*

Largely in response to the conflicting Code and Restatement standards, conceptualizing and defining an operational standard for when a contract has been performed or enforced in good faith has been the subject of extensive commentary.[73] A consensus may be drawn that the obligation of good faith serves to protect the "reasonable expectations of the parties."[74] Four principal arguments have arisen in attempting to provide some content to this vague standard, each of which differs as to conceptualization and implementation.

1. Contractual Morality

There have been assertions that it is impossible to define independently the meaning of good faith, as the Code attempts. This argument is based on the contention that:

> good faith is an "excluder." It is a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogenous forms of bad faith. In a particular context the phrase takes on specific meaning but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out.[75]

According to this view, the obligation of good faith not only serves generally to exclude particular forms of misconduct and facilitate "contractual morality"[76] in transactions, but also, more specifically, to preclude "misconduct which is neither fraudulent nor negligent."[77] Additionally,

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73. *See generally* sources cited *supra* note 24.

74. *See* Burton, *Common Law Good Faith, supra* note 24, at 387; Patterson, *Wittgenstein and the Code, supra* note 10, at 384; Summers, *"Good Faith" in General Contract Law, supra* note 24, at 263; Summers, *Recognition and Conceptualization, supra* note 24, at 832.

75. Summers, *"Good Faith" in General Contract Law, supra* note 24, at 201. Summers' work provided the basis for the Restatement's provision on good faith and fair dealing. *See supra* note 65. Dennis Patterson recently has argued that Summers has misapplied J.L. Austin's argument on excluders. The core of Patterson's objection to Summers' views is that "good faith" cannot be applied to Austin's view of excluders:

> If "good faith" were an excluder, it would have meaning only in relation to other legal concepts, but in Summers' analysis, it does not. Consider the following:
> Real (Good faith) Duck (Variant meanings of bad faith)
> In order for the excluder analysis to work with a concept like good faith, Summers needs an analogue to the excluder term "real" in "real duck." He does not supply one. Instead, he claims that good faith "takes on specific and variant meanings by way of contrast with the specific and variant forms of bad faith which judges decide to prohibit." But this simply will not work: there must be some concept (a substantive) upon which good faith is parasitic in just the way that "real" is parasitic on "duck." It makes no more sense to say that "good faith" is the opposite of "bad faith" than it does to say that a decoy is the "opposite" of a real duck. But that is precisely the claim that Summers makes.

Patterson, *Wittgenstein and the Code, supra* note 10, at 349-50 (citations omitted). For a discussion of Patterson's view on good faith, see *infra* text accompanying notes 105-15.

76. *See* Summers, *Recognition and Conceptualization, supra* note 24, at 811.

77. Summers, *"Good Faith" in General Contract Law, supra* note 24, at 199.

good faith "enforce[s] the unspecified 'inner logic' of a deal,"[78] and "prevent[s] the abuse of powers conferred by contract."[79] The obligation therefore acts to impose separate moral standards for conduct in relation to the parties' agreement and may act to override the express terms of that agreement.[80]

This excluder approach to good faith contends that it is impossible for either courts or parties to a contract to know in advance whether particular conduct constitutes good faith. The approach denies the possibility that good faith has a "single, positive, and unified general meaning."[81] The scope of the obligation can only decisively be determined in court, where the judge (who must first "appreciate[] the implications of the excluder analysis"[82]) uses analogy to and deduction from precedent to reach a conclusion as to whether the conduct in the case at bar constitutes "bad faith."[83]

Courts and transactors are not entirely without guidance in assessing whether particular conduct constitutes extracontractual "bad faith." In addition to the criteria mentioned in the comment to the Restatement's obligation of good faith and fair dealing,[84] three subsidiary areas of "good faith law" exist. First, there is a "vast accumulation of holdings with stated reasons" assessing the bad faith *vel non* of particular conduct.[85] Second, there are compilations of generalized "lists of criteria" for identifying specific forms of bad faith conduct.[86] Finally, "the accumulation of experience with respect to some contexts might be specifically extensive, and the circumstantial attributes of these contexts sufficiently amenable, to permit the formulation of *detailed rules* that rule out specific forms of bad faith."[87] These three areas of "good faith law," together with the Restatement provision imposing an obligation of good faith and fair dealing and the comments thereto, protect against the strongest criticism raised against excluder analysis—that it provides little assistance to judges in cases involving conduct not clearly covered by "good faith law" and invites judicial inconsistency.[88]

78. *Id.*

79. *Id.* For other types of bad faith conduct under this view, see *supra* text accompanying note 65 (Restatement provisions).

80. *See, e.g., id.* at 234-35 (acting to "evade the spirit of the deal" may override the agreement).

81. Summers, *Recognition and Conceptualization, supra* note 24, at 820.

82. Summers, *"Good Faith" in General Contract Law, supra* note 24, at 206.

83. *See id.* at 206-07.

84. *See supra* text accompanying note 65.

85. Summers, *Recognition and Conceptualization, supra* note 24, at 822 (emphasis omitted).

86. *See id.* (emphasis omitted).

87. *Id.*

88. *Id.* at 823; *see* Burton, *Common Law Good Faith, supra* note 24, at 369-70 ("The good faith performance doctrine consequently appears as a license for the exercise of judicial or juror intuition, and presumably results in unpredictable and inconsistent applications."); Gillette, *supra* note 24, at 650 ("Summers' advocacy of good faith as a means for excluding certain conduct from acceptable commercial behavior appears to be predi-

2. Agreement/Interpretivist

Other theories reject the view that the obligation of good faith should impose requirements of contractual morality upon transactors.[89] Instead they view good faith as a doctrine that facilitates, rather than hinders, enforcement of the parties' agreement. Consensus exists, however, that a court should enforce the reasonable expectations of the parties.[90] The agreement/interpretivist approaches differ primarily with respect to the interpretive bounds of the parties' legally enforceable agreement.

a. *"Reasons Available" Interpretive Approach*

One interpretivist approach begins with the construction of a "multifaceted expectation interest" which dictates what "reasonable expectations" of the parties the good faith doctrine should protect.[91] As a matter of general contract interpretation, "[w]hen the express terms of a contract do not obviously resolve the difficulty, the best response is to embed the dispute in its proper context and to seek guidance for its resolution by interpretation with continued sensitivity to the intentions of the parties and their reasonable expectations."[92] A promisee's expectation interest includes both the subject matter to be received under the contract and the anticipated costs of performance by the other party.[93] This perspective on the expectation interest leads to the conclusion that good faith behavior "depends on the *reasons available* to justify the action under the circumstances,"[94] which reasons are "grounded in the world represented by the contract as made by the parties."[95] Recognition that the expectation interest encompasses or precludes certain reasons for action[96] suggests the implementation of two interpretive standards for good

cated on the ability of and desirability for judges to make ad hoc determinations of whether permitting specific commercial conduct would be 'just.' "); Patterson, *Wittgenstein and the Code*, *supra* note 10, at 350-51 ("The flaw in Summers' analysis is that he believes that the excluder analysis provides judges with sufficient material from which to fashion analogies between old and new instances of bad faith.").

89. *See* Burton, *Reply*, *supra* note 24, at 499-500.

90. *See, e.g.*, Burton & Andersen, *supra* note 24, at 862-63; Burton, *Reply*, *supra* note 24, at 499; Patterson, *Wittgenstein and the Code*, *supra* note 10, at 384.

91. Burton & Andersen, *supra* note 24, at 867.

92. *Id.* at 866.

93. *See* Burton, *Common Law Good Faith*, *supra* note 24, at 387.

94. Burton & Andersen, *supra* note 24, at 867.

95. *Id.*

96. Initially it seemed that only certain economic reasons for action were excluded. *See, e.g.*, Burton, *Common Law Good Faith*, *supra* note 24, at 387 n.80 ("Noneconomic factors so rarely are evidenced in the reported cases, however, that the focus of the theory must be on economic motives."). However, acting for noneconomic motives "are likely to run afoul of the good faith performance doctrine . . . ." *See id.*; *see also* Burton, *Racial Discrimination in Contract Performance*, *supra* note 24, at 451-54 ("abusive practices" and racial discrimination impermissible reasons). In lending cases, courts allude to noneconomic factors which might bear on the reasons for the lender's behavior. *See, e.g.*, Reid v. Key Bank, Inc. 821 F.2d 9, 11-12 (1st Cir. 1987) (allegations that lender's actions were racially motivated); Quality Automotive Co. v. Signet Bank, 775 F. Supp. 849, 853 (D. Md. 1991) (bank allegedly terminated line of credit because borrower had done busi-

faith—one for performance[97] and one for enforcement.[98]

Bad faith performance occurs when a party exercises discretion to recapture a foregone opportunity.[99] This may include acting for specific reasons foregone upon contracting, thereby harming the non-discretionary party's expectation interest.[100] The interpretive methodology for performance, therefore, would be first to determine whether a particular

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ness with competitor bank); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 97 B.R. 420, 422-23 (Bankr. N.D. Ill. 1989) (bank decided it should not do business on Chicago's South Side and "Debtor should go back to its own neighborhood"), *vacated*, 908 F.2d 1351 (7th Cir. 1990); Ricci v. Key Bancshares, Inc., 662 F. Supp. 1132, 1141 (D. Me. 1987) (discrimination on basis of national origin); Alaska Statebank v. Fairco, 674 P.2d 288, 290 (Alaska 1983) (in seizing collateral, banker "conducted himself with an air of self-importance and appeared to be 'charged up' by the takeover"); Security Pac. Nat'l Bank v. Williams, 262 Cal. Rptr. 260, 270 (Cal. Ct. App. 1989) (bank officer told borrower, a former friend, that "he was closing the place down; and there was not a 'fucking thing' [the borrower] could do about it"); Karner v. Willis, 710 P.2d 21, 25 (Kan. 1985) (Herd, J., dissenting) (bank accelerated due to garnishment lien on unsecured assets); Noonan v. First Bank, 740 P.2d 631, 636 (Mont. 1987) (Sheehy, J., dissenting) ("The president of the Bank became furious when he learned that the [borrowers] had been borrowing money from other banks."); First Nat'l Mont. Bank v. McGuiness, 705 P.2d 579, 581 (Mont. 1985) (bank suggested collateral be sold to bank officer who was director's nephew); Security Bank v. Dalton, 803 S.W.2d 443, 445 (Tex. Ct. App. 1991) (through bank officer's mistake, loans exceeded loans to one borrower ratio).

97. *See generally* Burton, *Common Law Good Faith*, *supra* note 24.

98. *See generally* Andersen, *supra* note 24.

99. A party has "discretion" when it "has a legal power in effect to specify a term of the contract during the performance stage of the contract," Burton, *Racial Discrimination in Contract Performance*, *supra* note 24, at 452; *see also* Burton, *Common Law Good Faith*, *supra* note 24, at 380-85 (same), such as when the contract expressly allows one party to dictate a term, *see, e.g.*, U.C.C. § 2-305(2) (1990) (price term), or as a result of "a lack of clarity and completeness in the express terms, which may become apparent only as events unfold after formation." Burton, *Racial Discrimination in Contract Performance*, *supra* note 24, at 452; *see also* Burton, *Common Law Good Faith*, *supra* note 24, at 380 & n.44 (same).

Much of the analysis to date has focused solely upon the former type of discretion rather than the latter. *See generally* Burton, *Common Law Good Faith*, *supra* note 24. Another articulation of discretion provides that a "party enjoys discretion in the relevant sense whenever the express terms of the contract do not specify that one party is entitled to receive some particular benefit from the other party who, nonetheless, is under a contractual duty of good faith." Burton & Andersen, *supra* note 24, at 868. Hence, the notion of "discretion" in this context substitutes for what is commonly referred to as "gaps" with the "foregone opportunities" analysis being used to fill the gap. Some interpretive problems remain as yet unresolved with respect to the concept of "discretion" as it applies to lending agreements. For example, if a loan agreement provides that "the Borrower shall not sell any collateral without the Lender's written consent," is the Lender's right "discretionary" or absolute? *See* Quintana v. First Interstate Bank, 737 P.2d 896, 898 (N.M. Ct. App. 1987) (mortgagee's consent not limited by good faith). If absolute, it follows that the lender in that case may withhold consent for any reason or no reason at all, a view in which this Article concurs. However, some courts have found a lender's refusal to lend under the terms of a credit agreement to be a "discretionary" event. *See* Richland Nat'l Bank & Trust Co. v. Swenson, 816 P.2d 1045, 1052 (Mont. 1991).

100. *See* Burton, *Common Law Good Faith*, *supra* note 24, at 385-86. The test is both subjective and objective, in that it demands (i) a subjective inquiry in the determination of the purpose in the discretion-exercising party's purpose in acting and (ii) an objective

party used "discretion" and, second, whether that discretion was exercised to recapture an opportunity foregone upon contracting.

Recognizing the distinction made in the Code and the Restatement between good faith performance and enforcement,[101] a separate analysis under this approach applies with respect to exercise of an "enforcement term" in an agreement. Good faith in the enforcement of a contract occurs if, under the circumstances existing at the time enforcement is sought, invocation of an enforcement term would primarily advance the purposes for which it was included in the agreement without imposing needless costs on the non-enforcing party.[102] The sometimes extremely difficult[103] determination of whether a contract term is an "enforcement term" or a "performance term," which is crucial for determining which standard of good faith applies, focuses upon whether the term assures due performance through the power to change the legal relationship of the parties."[104] If an enforcement term is involved, further analysis is required to determine whether enforcement would primarily serve the purposes for which the term was included in the agreement (necessitating

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inquiry as to whether the purpose was within the reasonable contemplation of the parties at the time of contract formation. *See id.* at 386.

101. *See supra* notes 42-43. The Code originally limited the obligation of good faith to "performance" of contracts within the Code *See* Braucher, *supra* note 70, at 813. The obligation of good faith in "enforcement" of contracts arose from a concern that Article 2 of the Code failed to provide adequate protection to a defaulting buyer when the seller failed to mitigate damages. *See id.*; 1951 ABA Section Report 162, 195-96.

102. *See* Andersen, *supra* note 24, at 306, 312. The test seeks to balance the principle of fulfilling expectations with that of mitigation of damages. *See id.* at 306.

103. *See, e.g., id.* at 302 (stating that in many cases "it may not be obvious when performance ends and enforcement begins"); Burton & Andersen, *supra* note 24, at 874 (stating that distinguishing between performance and enforcement may be difficult).

104. Andersen, *supra* note 24, at 304. Again, interpretive difficulties arise here, perhaps if only because the terminology is grounded in the language of sales transactions rather than lending transactions. A "performance term" "take[s] the form of an express or implied promise that an event shall occur, failing which the promisor will be liable for breach unless excused or discharged." *Id.* Initially, then, it appears that affirmative and negative covenants in a credit agreement would be performance terms. However, a lender's acceleration after failure of the borrower to comply with a specified affirmative or negative covenant would constitute invocation of an enforcement term. *See id.* at 342-45. Under this view a lender may only accelerate when it would advance the interests that the enforcement term (exercised in light of the specified event of default) is intended to protect. Arguably, though, since the interest which any lender has upon acceleration after a specified event of default is only preservation of security or protecting an impaired prospect of payment, this approach would adopt the holding of Brown v. AVEMCO Inv. Corp., 603 F.2d 1367 (9th Cir. 1979), which has been argued to be inconsistent with the textual language of U.C.C. § 1-208. *See* Snyderman, Comment, *supra* note 10, at 1357-59 (discussing *Brown* and § 1-208); *see also supra* text accompanying notes 52-60 (divergent views on § 1-208). If this is so, the approach attempts to implement a doctrine of substantial performance of covenants into lending transactions. If a provision in the agreement that conditions the lender's obligation to lend upon the absence of an event of default would also constitute an enforcement term (a "power to change the legal relationship"), under this view the lender would have a duty to lend if the conditions were substantially performed. *But see* Richland Nat'l Bank & Trust Co. v. Swenson, 816 P.2d 1045, 1052 (Mont. 1991) (refusal to lend is discretionary).

an examination of the enforcer's reasons for acting) and to assess the costs imposed by enforcement.

b. *"Deeply" Interpretive Approach*

The deeply interpretive approach to good faith focuses specifically on lender liability cases governed by the Code.[105] Employing a purposive methodology for determining the meaning of good faith under Article 9 of the Code,[106] this approach seeks to justify incorporation of the Restatement's standard of good faith and fair dealing[107] into the Code as a means to "create[ ] new possibilities for answering the question of what good faith means in a given context."[108] The reconstructed Code provisions on good faith lead to the conclusion that "the justified expectations of the parties become a test of the good faith of each."[109] In addition to protecting justified expectations of the parties, the Restatement incorporates into the Code community standards of decency, fairness, and reasonableness as subsidiary purposes for the good faith doctrine.[110]

The expanded definition of good faith under the deeply interpretive view acts in relation to the expansive Code definition of "agreement."[111] Advocating a deeply interpretive role for the courts in determining the meaning of "agreement" and good faith principally from the borrower's perspective,[112] this approach asserts that "[n]o litmus test exists for ascertaining what, in all cases, will constitute the 'reasonable' expectations

105. *See generally* Patterson, *Wittgenstein and the Code, supra* note 10; *see also generally* Patterson, *Easterbrook on Good Faith, supra* note 10; Patterson, *Good Faith, Lender Liability, supra* note 10. Patterson's views on good faith in the area of lender liability are synthesized in Dennis M. Patterson, Good Faith and Lender Liability (1990) [hereinafter Patterson, Good Faith].

106. *See* Patterson, *Wittgenstein and the Code, supra* note 10, at 370-73.

107. *See supra* text accompanying notes 64-65.

108. Patterson, *Wittgenstein and the Code, supra* note 10, at 384, 394. *But see* United States Nat'l Bank of Or. v. Boge, 814 P.2d 1082, 1090 (Or. 1991) (concluding that the Code displaces the Restatement definition). Other theories suggest that the Code provisions on good faith are largely irreconcilable with the common-law standards. *See, e.g.*, Burton, *Article 2 Good Faith, supra* note 24, at 22-24 (suggesting revision of Code definition); Summers, *Recognition and Conceptualization, supra* note 24, at 215 (criticizing Code approach).

109. Patterson, *Wittgenstein and the Code, supra* note 10, at 384.

110. *See id.* at 385-86. The relevant community is the "financial community" and reasonable conduct is that being consistent with similarly situated lenders. *See id.*

111. *See id.* at 403-07; Patterson, *Good Faith, Lender Liability, supra* note 10, at 185-202; Patterson, *Easterbrook on Good Faith, supra* note 10, at 513. The Code specifically states that one acts in good faith relative to an "agreement." *See* U.C.C. § 1-203 (1990). An "agreement," under the Code, "means the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act (sections 1-205 and 2-208)." U.C.C. § 1-201(3) (1990). Although open to question, "course of performance" specifically applies only to transactions falling within Article 2. U.C.C. § 2-208 (1990); *see* Patterson, *Wittgenstein and the Code, supra* note 10, at 416-17.

112. *See* Patterson, Good Faith, *supra* note 105, at 144 ("real question is what it was reasonable for the debtor to believe vis-à-vis its 'Agreement' ").

of the debtor."[113] Rather, only "parameters" for judicial determination of the good faith of the parties can be set.[114] The Code's command that courts perform this interpretive role overrides any countervailing social, economic, or institutional concerns.[115]

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113. Patterson, *Wittgenstein and the Code*, *supra* note 10, at 421, 425 ("[I]t is difficult, if not impossible, to state in advance when and under what conditions courts should refrain from enforcing anti-waiver clauses.").

114. *See id.* at 422; Patterson, Good Faith, *supra* note 105, at 193-95. In the context of the enforceability of anti-waiver clauses, the following considerations arise under the deeply interpretive approach:

> 1. Was there anything in the circumstances that would put the debtor on notice that the secured party would not refrain from exercising its rights upon default?
> 2. Did the secured party ever tell the debtor it believed her to be in default?
> 3. Did the debtor have any prior credit experiences that would have alerted her to the fact that failure to pay on time (as opposed to failure to pay at all) exposed her property to the risk of repossession without prior notice?
> 4. Did the secured party ever notify the debtor that late payments were a breach of the security agreement?
> 5. Was the anti-waiver clause a negotiated term of the security agreement?
> 6. Did the secured party's loan officer ever bring the anti-waiver clause to the debtor's attention?
> 7. Is the debtor sufficiently experienced (sophisticated) in credit matters to know that late payments are an indulgence on the part of the secured creditor and not a waiver of any written terms of the security agreement?
> 8. Did the secured party ever afford the debtor the opportunity to obtain credit elsewhere before moving against the collateral?
> 9. Is the debtor more than one or two payments in arrears?

Patterson, Good Faith, *supra* note 105, at 193-95. Even if "[a]rguments over meaning are not reducible to questions of Pareto optimality, wealth maximization or efficiency," *id.* at 155, nonetheless the deeply interpretive approach has both social effects on relationships not yet in dispute and economic effects on lending transactions subsequent to any particular decision. For example, a lender wishing to act in good faith under the above parameters might be advised to: (1) enforce rights immediately, (2) immediately give notice of default, (3) refuse to lend to (or charge higher interest rates on loans to) parties with poor credit histories, (4) send immediate written notices of default, (5,6) have clauses initialled and in conspicuous language, (7) refuse to lend to (or charge higher interest rates on loans to) unsophisticated borrowers, (8) allow time for refinancing (which is inconsistent with (1) and (9)), and (9) enforce rights immediately.

115. *See* Patterson, Good Faith, *supra* note 105, at 155; Patterson, *Wittgenstein and the Code*, *supra* note 10, at 393 (purposive, interpretive approach "affords judges the opportunity to engage in substantive, normative construction"). Some jurists would strongly disagree:

> The intrusion of courts into every aspect of life, and particularly into every type of business relationship, generates serious costs and uncertainties, trivializes the law, and denies individuals and businesses the autonomy of adjusting mutual rights and responsibilities through voluntary contractual arrangements.
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> . . . . [A test of] whether conduct "offends accepted notions of business ethics". . . gives judges license to rely on their gut feelings in distinguishing between a squabble and [the tort of bad faith denial of a contract]. As a result, both the commercial world and the courts are needlessly burdened: The parties are hamstrung in developing binding agreements by the absence of clear legal principles; overburdened courts must adjudicate disputes that are incapable of settlement because no one can predict how—or even by what standard—they will be decided.

3. Relational Contract Theory

In contrast to neoclassical contract theory, relational contract theory[116] lacks a comprehensive description of the obligation of good faith.[117] According to relational theory, classical and neoclassical contract law express a transactional view of exchange premised on the notion that contracts are "discrete," separate from prior, contemporaneous, and subsequent events.[118] Although discrete transactions do exist in

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Oki America, Inc. v. Microtech Int'l, 872 F.2d 312, 315 (9th Cir. 1989) (per curiam) (Kozinski, J., concurring) (citation omitted).

116. References to "relational contract" and "relational contract theory" largely are to the relational contract theories of Ian Macneil and others. Relational contract ideas are also employed by Professors Goetz and Scott. *See* Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089 (1981). Although the question of who "invented" relational contract is an open issue, *see* Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 Wis. L. Rev. 483, 483; Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 Cal. L. Rev. 2005, 2009 n.9 (1987), the two schools of relational theory have different focal points. The Goetz and Scott approach employs the relational idea of gaps in contracts, *see infra* text accompanying notes 127-31, as a basis for economic analysis of incomplete contracting. *See* Goetz & Scott, *supra*, at 1091 ("A contract is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations."). Macneil and others, on the other hand, present and employ a broader sociological theory of contract that is not based merely upon the existence of gaps in contracts. To some extent, though, Macneil's relational approach and the law and economics relational approach are beginning to coalesce. *See* Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. Legal Stud. 271, 275-78 (1992). For discussions of the distinctions between the two types of relational contract theory, see Macneil, *supra*, at 496; G. Richard Shell, *Substituting Ethical Standards for Common Law Rules in Commercial Cases: An Emerging Statutory Trend*, 82 Nw. U. L. Rev. 1198, 1205 n.38 (1988).

117. For applications of relational contract theory to other areas of law, see Patricia A. Brown & Jay M. Feinman, *Economic Loss, Commercial Practices, and Legal Process:* Spring Motors Distributors, Inc. v. Ford Motor Co., 22 Rutgers L.J. 301, 348-59 (1991) (availability of tort actions for economic loss); Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stan. L. Rev. 927, 955-70 (1990) (franchises); Roderick W. Macneil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 Stan. L. Rev. 303, 366-89 (1986) (Chinese contract law); Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 Nw. U. L. Rev. 369, 400-04 (1981) (price adjustments under sales contracts) [hereinafter *Price Adjustments*]; Richard E. Speidel, *Excusable Nonperformance in Sales Contracts: Some Thoughts About Risk Management*, 32 S.C. L. Rev. 241 (1980) (nonperformance in long-term contracts). *See generally* Symposium, *Law, Private Governance and Continuing Relationships*, 1985 Wis. L. Rev. 461, 483-622 (1985).

118. *See* Ian R. Macneil, The New Social Contract 60 (1980); Ian R. Macneil, *The Many Futures of Contracts*, 47 S. Cal. L. Rev. 691, 693 (1974) [hereinafter Macneil, *Many Futures*]. Discrete transactions are characterized by their (1) short duration, (2) limited personal interaction, (3) easy, precise measurement of objects of exchange, (4) requirement of only a minimum of future cooperation between the parties, (5) failure to require benefit or burden sharing, and (6) lack of an expectation of altruistic behavior by the parties to the contract. *See* Ian R. Macneil, *Restatement (Second) of Contracts and Presentiation*, 60 Va. L. Rev. 589, 594 (1974) [hereinafter Macneil, *Presentiation*]. Because even the most discrete of exchanges occurs within contractual relations, all exchanges are "relational" in one sense. *See* Ian R. Macneil, *Relational Contract Theory as Sociology: A Reply to Professors Lindenberg and de Vos*, 143 J. Institutional & Theoretical Econ. 272, 276 (1987) [hereinafter Macneil, *Reply*]. Thus, an exchange exhibiting

fact, relational contract theory denies that all exchanges are discrete.[119] For example, parties may enter into long-term business arrangements or may have extensive prior dealings. Relational theory, therefore, rejects the reliance that more traditional consent[120] or agreement-based theories place upon principles such as freedom of contract and exercise of choice. According to relational theory, those principles

> can never be the absolutes they tend to be in a system of discrete transactional law. They can prevail only so long as they sufficiently avoid conflict with other normative principles, else the relation will fall apart. In relational contract law there is thus always a preliminary question about party allocations of power: How do they fit with the remainder of the relation?[121]

In lieu of the traditional focus upon consent, relational contract theory substitutes a complex system of norms reflecting actual contractual behavior, and establishing normative principles of appropriate contractual behavior.[122] Common contract norms apply to all contracting behavior,[123]

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more relational characteristics is perhaps more appropriately called an "intertwined exchange." *See id.* In addition, an individual exchange relation may have highly discrete and/or highly intertwined facets. *See id.* at 277. For a chart fully depicting the attributes of the intertwined (relational) and discrete (transactional) poles of exchange, see Macneil, *Many Futures*, *supra*, at 738-40; Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854, 902-05 [hereinafter Macneil, *Adjustment of Long-Term Relations*].

119. *See, e.g.*, Gidon Gottlieb, *Relationism: Legal Theory for a Relational Society*, 50 U. Chi. L. Rev. 567, 569 (1983) ("Emphasis on discrete transactions abstracted from the ongoing relationships in which they occur distorts the character of the transactions and of the relationships themselves.").

120. Professor Randy Barnett argues that Macneil's treatment of the bounds of consent often is inconsistent, and in many respects comports with Barnett's own consent theory of contract. *See generally* Barnett, *supra* note 34, at 1182-94.

121. Ian R. Macneil, The New Social Contract 86 (1980).

122. *See id.* at 37-39.

123. For full discussions of common contract norms, see Macneil, *supra* note 121, at 40-59; Ian R. Macneil, *Values in Contract: Internal and External*, 78 Nw. U. L. Rev. 340, 347-66 (1983) [hereinafter Macneil, *Values in Contract*]. The norms common to any contract are (1) implementation of planning, which encompasses both the planning of the performance of the exchange and the structuring of operating relations within the exchange, *see* Macneil, *supra* note 121, at 47; (2) effectuation of consent, which, based upon the parties' exercise of choice, is distinct from the more extensive effectuation of planning, *see id.* at 48-50; (3) restitution, reliance, and expectation, *see id.* at 52-53; (4) role integrity, which encompasses a pattern of expected behavior, *see id.* at 40-44; (5) reciprocity, "the principle of getting something back for something given," Macneil, *Values in Contract*, *supra*, at 347; (6) flexibility, which conflicts with the norms of implementation of planning and effectuation of consent and differs when operating within discrete and relational exchanges, *see* Macneil, *supra* note 121, at 50; (7) contractual solidarity, the common belief "in effective future interdependence," *id.* at 91, and the equivalent of trust, *see* Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfall and the Need for a "Rich Classificatory Apparatus"*, 75 Nw. U. L. Rev. 1018, 1047 (1981); (8) creation and restraint of power resulting from the interplay of the other norms in successful contractual relations, *see* Macneil, *supra* note 121, at 56-57; (9) propriety of means, which connotes principles of procedural justice, *see* Macneil, *Values in Contract*, *supra*, at 347; and (10) harmonization with the social matrix, which requires

while discrete[124] and relational[125] contract norms apply to discrete and more relational contracting, respectively. Yet, the extent and method by which this normative structure is intended to provide a framework for judicial dispute resolution has not been entirely resolved.[126]

Relational contract theory's emphasis on the relational qualities of exchange parallels closely, in one respect, the current academic literature recognizing "gaps" in contracting.[127] As an exchange exhibits more relational characteristics, the parties' ability to "presentiate," that is, to bring the future into the present effectively and thereby deal with the future as though it were the present, deteriorates.[128] Since the parties are unable to take into account elements they are unable to presentiate, this deterio-

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at least partial incorporation of societal norms as internal norms of the contract, *see* Macneil, *supra* note 121, at 58.

124. The common contract norms of implementation of planning and effectuation of consent intensify and merge in discrete transactions. The result is a "discrete norm" of enhancing discreteness and presentiation. *See* Macneil, *supra* note 121, at 59-60. The remaining eight common norms discussed above are reduced in the context of discrete transactions to providing a backdrop for the implementation of the discrete norm, *see* Macneil, *Values in Contract*, *supra* note 123, at 360-61, reinforcing its operation rather than promoting values independent of discreteness and presentiation. *See id.*

125. When an exchange exhibits more relational characteristics the common contract norms of role integrity, contractual solidarity, and harmonization of the social relation intensify. *See generally* Macneil, *supra* note 121, at 66-70. This results in the emergence of relational contract norms of intensified role integrity, preservation of the relation (an enhancement of the common norm of contractual solidarity), and harmonization of relational conflict, propriety of means, and supracontractual norms, such as liberty and dignity. *See id.*; Macneil, *Values in Contract*, *supra* note 123, at 350.

126. *See* Barnett, *supra* note 34, at 1178-79 (stating that norms are critical), 1190-94 (discussing the limitations of relational theory in contract enforcement). Macneil himself rejects the notion that positive law should reflect, or has progressed toward, the relational pole of contracting at the expense of discreteness. *See* Macneil, *Reply*, *supra* note 118, at 280-82. In Macneil's view, relational contract theory has shifted the starting point for the determination of what contract law reinforces: "The 'progress' is towards law reinforcing the calculating rationality of people within relations with high levels of discreteness of various kinds, including discrete transactions, but always treating the discreteness as an integral part of the relations subject to considerable regulation . . . ." *Id.* at 282.

127. *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989); Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821 (1992); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815 (1991); Schwartz, *supra* note 116.

128. *See* Macneil, *Adjustment of Long-Term Relations*, *supra* note 118, at 863; Macneil, *supra* note 121, at 60; *see also* Macneil, *Presentiation*, *supra* note 118, at 589 ("Presentiation is thus a recognition that the course of the future is bound by present events, *and* that by those events the future has for many purposes been brought effectively into the present."). Complete promissory presentiation is impossible even in the most discrete of exchanges. *See* Macneil, *supra* note 121, at 8. Promise-making is inherently fragmentary due to the limits of the human mind and the inherent unknowability of the future. *See id.* As developed more fully in the law and economics/incomplete contracting literature, identified causes of incompleteness include (1) ambiguous language, (2) oversight, (3) excessive costs of completion (which is largely coextensive with an imperfectly knowable future), (4) asymmetric information, and (5) a party's preference for anonymity. *See* Schwartz, *supra* note 116, at 278-80; *see also* Barnett, *supra* note 127, at 821-22 (discussing causes of incompleteness); Macneil, *Many Futures*, *supra* note 118, at

ration results in gaps in planning.[129] For example, contracting parties might fail to include an express term in a long-term, relational contract because they are unable to perceive of a future event that would render that term transactionally necessary.[130] Moreover, "gaps" may exist even with respect to express terms in the agreement. An express term intended to handle a potential future issue is presentiated only with respect to that future capable of being brought into the present at the time of planning ("Future A"). To the extent that Future A fails to occur, and instead "Future B" occurs, there is a gap in the term with respect to its scope as applied to Future B.[131]

If relational contract theory is intended not only to be critical but also to provide a foundation for judicial gap-filling, it has not succeeded in advancing a satisfactory response. One application of relational theory might provide that a judge should apply "norms that transcend the relationship" (an external approach).[132] Yet, what those transcendent norms should require as a matter of legal rules is problematic. For example, what behavior does a relational norm such as "solidarity" proscribe—or prescribe—at the level of legal rules?[133]

Alternatively, one could refer to the parties' relationship itself to determine the substantive content of the norms (an internal approach).[134] This approach, however, also presents difficulties.[135] Professor Schwartz, for example, critiques two possible internal approaches: first, viewing

731 (discussing limitations of promise-making). These obstacles affect promises in even the most discrete exchanges.

129. *See* Macneil, *Many Futures, supra* note 118, at 761-63; *see also* E. Allan Farnsworth, *Disputes over Omission in Contracts*, 68 Colum. L. Rev. 860, 868-73 (1968) (discussing gaps in contracts).

130. This type of gap may be the result of either a failure to foresee the foreseeable (human error) or the result of the occurrence of an event unforeseeable at the time of contracting (fate). *See* Farnsworth, *supra* note 129, at 871; *see also* Schwartz, *supra* note 116, at 278-80 (incompleteness resulting from oversight or imperfectly knowable future).

131. *See, e.g.*, Ayres & Gertner, *supra* note 127, at 92 n.29 (discussing gap arising when "parties' duties are fully specified, but the contracts are incomplete because those specified duties are not tailored to economically relevant future events"); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261, 267-72 (1985) (discussing formulation errors in contract drafting); Schwartz, *supra* note 116, at 272 (defining contracts that "partition[] future states or potential contracting partners 'too coarsely' " as incomplete).

132. Schwartz, *supra* note 116, at 275. Under this view, "judges should be guided by society's sense of what is fair, distributionally just, and adequately participatory." *Id.* Professor Schwartz coined the distinction between "external" and "internal" relational approaches. *See id.* at 275-76.

133. *See id.* at 275-76.

134. *See id.* at 275.

135. *See id.* at 275-77. Even relational contract writers concede the difficulties arising from relational interpretation in the courts. *See, e.g.*, Brown & Feinman, *supra* note 117, at 358 ("[R]elational analysis can be cumbersome and time consuming."); Hadfield, *supra* note 117, at 987 ("There are no hard-and-fast rules for [determining the scope of the relationship]. Relational interpretation is a fact-specific exercise of attention, insight and judgment.").

"contractual relationships as little societies in which values evolve over time" and, second, basing "decisional criteria on what parties probably expect of each other."[136] In Schwartz's view, the former approach suffers from the same problems as the external approach due to the impossibility of generating a set of rich, definable norms in otherwise thin commercial transactions.[137] Even if such norms could be generated,[138] because they are external to the parties' relationship, this internal approach becomes the functional equivalent of the external approach.[139] Because most contracting parties would prefer an efficient rule, the latter internal approach (what parties probably would expect of each other), according to Schwartz, collapses into the law-and-economics approach.[140]

Good faith, perhaps even over other contract doctrines, has been heralded by relational contract theorists as a potent doctrine through which courts may bring relational contract theory into practice.[141] How the relational potential of good faith is made manifest is, however, a matter of debate. First, it has been argued that good faith, "a circumstance-

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136. Schwartz, *supra* note 116, at 276.

137. *See id.*

138. For example, while the set "Commercial Relationships" may fail to yield norms that apply richly and predictably over a broad range of commercial relationships, narrowing the set to subsets of "Lending Relationships" or "Franchise Relationships" may in fact generate a richer set of norms applying to those relationships. *See id.*

139. *See id.*

140. *See id.* at 276-77. The "probable expectations" internal approach, though, does not necessarily collapse that easily into the law-and-economics approach. Professor Schwartz acknowledges that, if the parties contemplated that their relationship would be governed by norms other than those derived from efficiency, application of the law and economics approach would contravene the parties' probable expectations. *See id.* at 276 n.8. Presumably, therefore, if the parties have signalled their intent not to be governed by a rule derived from efficiency, a court could imply rules not derived from a norm of efficiency. For a discussion of the problems of signalling in the area of lender liability, see generally Gillette, *supra* note 10, at 565-74.

141. For discussions of the relational underpinnings of good faith, see Hadfield, *supra* note 117, at 984-86 ("The doctrinal tool necessary to bring the resolution of franchise contract disputes into line with the realities of the franchise relation is the covenant of good faith and fair dealing."); Peter Linzer, *Uncontracts, Context, Contorts and the Relational Approach*, 1988 Ann. Surv. Am. L. 139, 176-77; Macneil, *Adjustment of Long-Term Relations*, *supra* note 118, at 868-869; Macneil, *Presentiation*, *supra* note 118, at 604; Macneil, *supra* note 116, at 521-22; Reiter, *supra* note 24, at 725-29; Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & Com. 193, 201-02 (1982).

Two other theories of good faith discussed above are, in a sense, "relational" theories of contract. Professor Summers' excluder approach to good faith which imposes principles of contractual morality in the performance of the parties' agreement, *see supra* notes 75-88 and accompanying text, tracks an external relational approach to good faith. Similarly, Professor Patterson's deeply interpretivist approach to good faith which relies upon a broad interpretation of the parties' agreement and incorporates into the obligation of good faith community standards of decency, fairness, and reasonableness, *see supra* text accompanying notes 105-15, follows closely an internal relational approach to good faith. Although, unlike the excluder approach to good faith, the deeply interpretivist approach is grounded in a consent theory of contract, consent theories are not entirely irreconcilable with relational contract theory. *See* Barnett, *supra* note 34, at 1179.

bound concept that will, in many cases, be reducible to notions of fairness and reasonableness in the circumstances,"[142] is itself an independent common contract norm.[143]

In contrast, Ian Macneil rejects an independent role for good faith as a relational contract norm. He argues that "the essence of good faith in any society is adherence to the common contract norms."[144] Under this view, meeting the common contract norms would constitute good faith, whereas failing to meet the common contract norms would constitute bad faith.[145]

Yet, either of these relational perspectives on good faith evokes many of the concerns discussed above. Because the substantive content of the obligation of good faith is tied under each view to proper application of the norms of relational contract theory, the criticisms of relational contract theory in general apply equally to any relational application of the obligation of good faith.[146]

4. Law and Economics

An economic approach to good faith views the obligation as an implied term that prohibits opportunistic behavior by a party to a contract.[147] Opportunism occurs when a party uses "contractual terms as a pretense for extracting benefits for which [it has] not bargained."[148] Good faith thus serves efficiency goals by supplying a provision—"opportunistic behavior is prohibited"—that otherwise would require costly and extensive negotiations to draft specifically into the agreement.

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142. Reiter, *supra* note 24, at 707.

143. Reiter argues that:

> [Good faith] reminds us of the incompleteness of written or even oral records of contracts. The limits of human foresight, the costs and threat to solidarity of increased specificity, and the insurmountable barrier to complete communication attributable to our individuality ensure that no record of a contract can be complete and identically understood by all. Second, it entails "trust," an element in whose complete absence no contracting could occur. Third, it points out the participatory nature of contract. Contracts are never two-party affairs, but borrow heavily from various surrounding communities, from language for communication, through industry practice to the supra-contract, general social norms and finally good faith stresses the moral element present in even the most hard-nosed commercial agreement. Contract is a form of social behaviour infused with notions of doing right. Present throughout the other intermediate norms, this fact, without which contract could not exist, merits independent attention.

Id. at 727; *see also supra* notes 123-25 (discussion of norms in relational theory).

144. Macneil, *Values in Contract*, *supra* note 123, at 348 n.21; *see also* R. Macneil, *supra* note 117, at 378 & n.258 (discussing Reiter's and Ian Macneil's views on good faith as common contract norm).

145. *See* Macneil, *Values in Contract*, *supra* note 123, at 347-48 n.21.

146. The relational approach, therefore, is subject to many of the criticisms levied against the excluder approach. *See supra* note 88.

147. *See* Fischel, *supra* note 7, at 140-47; Goetz & Scott, *supra* note 116, at 1136-40; Muris, *supra* note 24.

148. Fischel, *supra* note 7, at 141.

Nonetheless, in the lender liability context the economic conceptualization of good faith concededly poses a threat of improper judicial intervention. Ordinarily, a borrower will grant a lender broad discretion or rights which decrease the chance of borrower misbehavior and allow the lender to monitor the borrower's business. This, in turn, results in a lower interest rate for the borrower.[149] The more absolute the power or discretion, the less risk assumed by the lender (which presumably the lender "paid for" by giving the borrower a reduced interest rate), but the greater incentive for opportunism.[150] Judicial intervention that expansively limits the lender's discretion or power dilutes the strength of the bond purchased by the lender, and, therefore, the bond's effectiveness in securing more favorable rates for borrowers.[151] Yet, judicial reluctance to interfere increases the potential for opportunistic behavior by the lender.[152]

Implementation of the economic approach to good faith and lender liability raises several difficulties. A court must determine whether the lender acted opportunistically. This assessment involves not only the difficult issue of distinguishing opportunistic behavior from non-opportunistic behavior but also the problem of proving that a lender in fact acted opportunistically.[153] In making this determination, a judge must find the right course between the Scylla of weakening the bargained-for bond and the Charybdis of protecting the borrower from opportunism.[154]

Thus, dissension and uncertainty begin at the initial questions of determining when the obligation of good faith applies in lending arrangements and, if so, what standard is to be used. Judicial applications of the Code's definitions erect more of a doctrinal labyrinth lacking in any uniform application rather than provide an effective, predictable guide for lender action. The friction intensifies when viewed from the more general contract law perspective. At one extreme, good faith might direct a lender to observe reasonable commercial standards, under the Code, or be faithful "to an agreed common purpose and consisten[t] with the justified expectations of the other party,"[155] as provided by the Restatement. Yet, at the other extreme, good faith may be merely innocuous, if not wholly inapplicable.

The dissensions at the doctrinal level have not been tempered by even

149. *See id.* at 141-42.

150. *See id.*

151. *See id.* at 142; *see also* Charny, *supra* note 10, at 458 ("If courts are willing to intervene to limit a bank's discretion, borrowers who rationally want to delegate discretion to the bank—for example, to signal their superior reliability or to induce the bank to accept arrangements that are riskier in other respects—may have difficulty doing so.").

152. *See* Fischel, *supra* note 7, at 147.

153. *See id.* at 141-42. A lender rarely will assert that it acted opportunistically. *See id.* For a discussion of the nature of opportunistic behavior, see Muris, *supra* note 24, at 522-26.

154. *See* Fischel, *supra* note 7, at 142.

155. Restatement (Second) of Contracts § 205 cmt. a.

a modicum of consensus at the theoretical level. The accepted view that good faith serves to enforce the "reasonable expectations of the parties" devolves into disparate conceptualizations of the obligation. Both the excluder conceptualization and the relational approach impose "extracontractual" duties upon the parties. Although agreement-based interpretivist theories shift the obligation conceptually from outside the agreement to within,[156] the methodologies which they advocate for dispute resolution also invite uncertainty.[157] Finally, the law and economics approach seeks to disengage the parties' agreement from the obligation of good faith, but hazards improper intervention.

A good indication of the viability of current theories on good faith is the courts. Even if judicial acceptance alone cannot be deemed dispositive, the growth in the last decades of lender liability litigation provides a corpus of judicial decisions to assess the extent to which the theoretical approaches to good faith have been integrated into the courts. Lender liability's uniqueness in offering a wealth of transactionally-focused data generated over the long term allows for subtle distinctions between the various general approaches to be drawn with greater specificity than in other areas of good faith law.[158]

II. JUDICIAL APPROACHES

At issue in the lender liability cases is the obligation of good faith's effect on a lender's exercise of express rights granted by the lending agreement. In spite of conventional perceptions that the obligation of

156. The interpretivist approaches are therefore more consistent with a notion of individual autonomy than the extracontractual approaches. The immutable rule nature of the obligation of good faith intensifies the appeal of an agreement-based theory of good faith from a standpoint of autonomy. *See* U.C.C. § 1-102(3) (1990) (obligation of good faith may not be disclaimed by agreement). Good faith is, more specifically, a hybrid immutable/default rule under the Code, because although the parties may not opt out of the general obligation they "may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable." *Id.* To the extent that the obligation of good faith is deemed to impose extracontractual principles of morality upon the parties, the obligation takes on the flavor of an immutable rule, hence posing a greater threat to party autonomy. For example, how could contracting parties draft around a standard that prohibits "evasion of the spirit of the bargain" or that enforces the " 'inner logic' of a deal"? *See supra* text accompanying notes 65 (Restatement criteria), 76-79 (excluder approach). In contrast, an agreement-based approach to good faith accentuates the default rule attributes of good faith by giving primacy (if only presumptively) to the parties' express terms, thereby facilitating the parties' ability to draft around an agreement-based standard for good faith. For a discussion of the relationship between contract background rules and party autonomy, see generally Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 Mich. L. Rev. 489 (1989).

157. By its own admission, the deeply interpretivist approach cannot yield predictable results. *See supra* notes 113-14 and accompanying text.

158. Many current theories claim to be descriptive of judicial behavior in the deciding good faith cases. *See, e.g.*, Andersen, *supra* note 24, at 331; Burton, *Article 2 Good Faith*, *supra* note 24, at 5-6; Patterson, *Easterbrook on Good Faith*, *supra* note 10, at 532; Summers, *"Good Faith" in General Contract Law*, *supra* note 24, at 262.

good faith has resulted in widespread judicial intervention,[159] no universal or clearly predominant methodology has in fact emerged from the decisions. Generally, judicial responses to claims of lender bad faith fall into three classes: interventionist,[160] interpretivist/relational,[161] and passive.[162] The approaches will be addressed in reverse order of frequency of appearance.

A. *Interventionist Approach*

Interventionist courts use the obligation of good faith to impose standards of appropriate conduct on a lender irrespective of the parties' agreement. Thus, the interventionist strategy adopts the "contractual morality" conceptualization of good faith—that good faith acts to impose an overlay of commercial morality onto the parties' agreement.[163] For example, a judicial interpretation of the Code's "honesty in fact" definition as requiring objective standards of commercially reasonable conduct[164] can imply an interventionist attitude[165] toward the obligation of good faith. Two 1991 decisions from the Ohio Court of Appeals best illustrate the interventionist strategy.

In the first decision, *Cardinal Federal Savings & Loan Ass'n v. Michaels Building Co.*,[166] Michaels Building Co. executed a promissory note in favor of Cardinal Federal Savings and Loan in the amount of $750,000.[167] The note was secured by an open-end mortgage on the debtor's shopping center in the amount of $1,240,000.[168] The bank's commitment letter indicated that the parties contemplated an additional

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159. *See supra* note 27.
160. *See infra* text accompanying notes 163-89.
161. *See infra* text accompanying notes 190-270.
162. *See infra* text accompanying notes 271-308. Two methodological points with respect to these classifications deserve mention. First, the identification of general classifications differs from the categories of theoretical approaches given above because, although certain courts may rely upon a particular theory to reach a certain result, many courts do not expressly do so. Second, an interpretivist might seek to claim that an interventionist decision is justified on interpretivist grounds, for example by asserting that the standard imposed by the court is consistent with the parties' agreement properly interpreted. The classifications set forth in this section are grounded in how the court perceived its role in applying the obligation of good faith rather than in whether the decision is consistent with other theoretical approaches to good faith. For example, some might claim that *K.M.C.*, discussed as a deeply interpretivist/relational case, *see infra* text accompanying notes 193-227, is an interventionist decision.
163. *See supra* text accompanying notes 75-88.
164. *See* cases cited *supra* note 50.
165. However, since courts rarely expose the underlying impetus for their holding, adoption of an objective standard for good faith alternatively may reflect a relational/deeply interpretive strategy toward good faith. *See infra* note 252.
166. No. 14521, 1991 Ohio App. LEXIS 2199 (Ohio Ct. App. May 8, 1991), *dismissed on joint application*, 585 N.E.2d 424 (Ohio 1992).
167. *See id.* at *4.
168. *See id.* Ohio law allows a mortgagor to file a mortgage that covers future advances and thereby receive priority with respect to those future advances over certain subsequent lienholders. *See* Ohio Rev. Code Ann. § 5301.232 (Baldwin 1990).

$150,000 advance to Michaels if certain conditions were met.[169] Michaels soon began defaulting in payment and Cardinal exercised its rights under the mortgage to receive rents and apply them to amounts due under the note.[170] After demanding payment under the note, Cardinal instituted an action seeking to collect the amounts due.[171] Michaels responded with claims of fraud, breach of contract, breach of the implied duty of good faith, slander of title, and unconscionability.[172] A jury found in favor of Michaels and awarded damages in the amount of $4,000,000.[173]

The appellate court refused to reverse the trial court's denial of directed verdict on the issue of good faith. In finding sufficient evidence for a finding of bad faith, the appellate court focused principally on the fact that Cardinal was oversecured, which precluded Michaels "from the full use and benefit of its property due to an unreasonable and unnecessary burden on the land."[174] Moreover, Michaels alleged that the bank acted in bad faith by misapplying the rents collected under the mortgage and by not providing "sufficient time to bring the loans current and to demand funds in excess of those due[175] . . . under the threat of immediate legal action."[176] In response to Cardinal's argument that it did no more than exercise rights permitted by the agreement, the court found that Michaels' claim lay "outside the border of the parties' contracts" and affirmed the finding of bad faith conduct by Cardinal.[177]

A similar approach to good faith was employed by a majority of the Ohio Court of Appeals in *Bank One, N.A. v. Grantham, Inc.*[178] The borrower, Grantham, Inc., had experienced severe financial difficulties and mismanagement from 1980-1984 and, after a series of attempts to renegotiate the loan and to seek new investors, the bank made demand under three demand notes executed by Grantham.[179] Because a term note executed by Grantham contained a cross-default clause providing that default in other indebtedness constituted a default under the term note, Bank One also accelerated the term note.[180] Bank One commenced foreclosure actions against Grantham, who had filed for bankruptcy protec-

169. *See Cardinal Federal*, 1991 Ohio App. LEXIS 2199, at *15-16. The borrower conceded that those conditions were never met. *See id.*

170. *See id.* at *5.

171. *See id.*

172. *See id.* at *6.

173. *See id.* at *8-*9.

174. *Id.* at *15.

175. The mortgage contained an ambiguity over whether a higher default rate of interest applied to the entire loan amount outstanding or merely the amounts currently in default. *See id.* at *4.

176. *Id.* at *17.

177. *Id.* at *18-*19.

178. Nos. 90-G-1555, 90-G-1556, 1991 Ohio App. LEXIS 4722 (Ohio Ct. App. Sept. 30, 1991), *vacated*, 588 N.E.2d 127 (Ohio 1992). This case was vacated and remanded by the Ohio Supreme Court without an opinion.

179. *See Grantham*, 1991 Ohio App. LEXIS 4722, at *3-*4.

180. *See id.* at *2-*4.

tion. Grantham responded with a counterclaim for breach of the implied covenant of good faith and fair dealing, breach of fiduciary duty, tortious interference with contractual relations, fraud, negligent and intentional infliction of emotional distress, and defamation.[181]

A majority of the Ohio Court of Appeals affirmed the jury verdict in favor of Grantham.[182] Although the court held that Bank One had no obligation of good faith in calling the demand notes,[183] the obligation did apply to Bank One's acceleration under the term note.[184] Turning to that issue, which was governed by the Code provisions on good faith,[185] the court utilized the Code's "honesty in fact" definition but articulated the scope of the obligation as precluding "commercially unjustifiable" behavior.[186] The court found sufficient evidence supporting the jury's conclusion that Bank One acted in a commercially unjustifiable manner. The court based its decision on the facts that: (1) the term loan was current at the time the bank exercised its right to accelerate under the cross-default provision; (2) the bank refused to execute a "standstill" agreement which would have facilitated new investors coming in; (3) the bank refused to remove its call letter, which hindered new investors from coming in; (4) the bank was adequately secured; (5) the bank refused to release collateral until the entire corporate debt had been paid; (6) the bank's complaints with current management would have been allayed if new investors had come in; (7) the company's financial difficulties seemed to be easing, with evidence of increasing sales; and (8) the company's financial difficulties had been ongoing for a long period of time.[187]

The *Grantham* decision was not without strong dissent. The dissenting judge strongly rebuked the majority for its interventionist methodology:

> [A]n expansive interpretation of honesty in fact, such as commercially unjustifiable, is undesirable because it will inevitably lead to violations of the basic principles of contract interpretation. Perhaps the most fundamental rule of contract law is that the express language of an agreement is always controlling. Stated differently, a court is always bound to enforce the explicit terms of the agreement, since those terms are the best indication of the intent of the parties. A court can only look beyond the four corners of the contract when the applicable language is ambiguous.
>
> When the majority's standard is applied to unambiguous language, such as that in a default acceleration clause, the foregoing rule is

181. *See id.* at *4.

182. *See id.* at *22.

183. However, because the demand notes contained insecurity and cross-default clauses, *see id.* at *2-*3, the court could have used a *Reid* analysis to find that the notes were functionally term notes to which the obligation applied. *See supra* note 57 and accompanying text.

184. *See Grantham*, 1991 Ohio App. LEXIS 4722, at *16-*17.

185. *See id.* at *11.

186. *See id.* at *20-*21; *see also supra* notes 48-51 and accompanying text.

187. *See Grantham*, 1991 Ohio App. LEXIS 4722, at *21-*22.

> clearly violated. An implied term would be added to the clause. To wit: a lender cannot exercise its right to accelerate whenever an event of default occurs, but can only do so when the action is commercially justifiable. Under these circumstances, the lender is essentially denied the benefit of its bargain, since it cannot exercise its right in the manner which is expressly stated in the contract.[188]

The different principles that underlie this dissent and the majority approach in *Grantham* and the court's approach in *Cardinal* are readily discernible. The court in *Cardinal* and the majority in *Grantham* view the obligation of good faith as superimposing a contractual obligation of "fair play" in the exercise of a bank's express rights. The question in *Cardinal* was not whether Cardinal was entitled by agreement to do what the agreement allowed it to do, but whether given its over-secured collateral position its behavior toward the borrower was hasty. Similarly, the *Grantham* majority does not dispute that Bank One had the contractual right to accelerate the loans. Rather, in the majority's view the bank ought to have refrained from exercising those rights to allow the borrower a more dignified exit from the transaction, particularly when, as was also the case in *Cardinal*, the bank was adequately secured.

Thus, the interventionist approach commands that lenders "do good" vis-à-vis their borrowers irrespective of their agreements. This approach, although not without some support in the courts, is visible only infrequently.[189]

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188. *Id.* at *44-*45 (Christley, J., dissenting). The dissent continued:

> In relation to this point, it is important to note that the general obligation of good faith under U.C.C. § 1-203 is distinct from the doctrine of unconscionability. The latter rule empowers a court to alter an unjust provision which was the result of unequal bargaining positions. In situations like the one in the instant case, involving a commercial loan between a bank and a small company, the doctrine of unconscionability simply does not apply. The loan agreement was clearly the result of arm's length negotiations, in which the bargaining positions of the respective parties were fairly equal. Again, under these circumstances, the unambiguous terms of the agreement should control. The duty of good faith should not be used to rewrite the agreement.

Id. at *45-*46 (Christley, J., dissenting) (citations omitted). The dissent, in terms of this Article, advocates a passive strategy toward resolution of good faith issue. *See infra* text accompanying notes 271-308. Although the Ohio Supreme Court, by a 4 to 2 majority, granted without opinion Bank One's motion to vacate and remanded the case, *see* 588 N.E.2d 127 (Ohio 1992), whether the Supreme Court did so in reliance upon the arguments raised in the dissent remains a mystery.

189. For other applications of the obligation of good faith and fair dealing which imply an interventionist bent, see Texas Refrigeration Supply, Inc. v. FDIC, 953 F.2d 975, 982 (5th Cir. 1992) (bank cannot take advantage of technical default to accelerate); Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846, 851 (3d Cir. 1964) (good faith is obligation of "fundamental integrity"); Desmond v. FDIC, 798 F. Supp. 829, 844 (D. Mass. 1992) (one may not injure other party's right to receive fruits of contract); Martin Specialty Vehicles, Inc. v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 766 (Bankr. D. Mass. 1988) (good faith prohibits "objectively oppressive and unfair" behavior and also "deceitful and downright dishonest" conduct), *rev'd on other grounds*, 97 B.R. 721 (D. Mass. 1989); Ricci v. Key Bancshares, Inc., 662 F. Supp. 1132, 1141 (D. Me. 1987) (good faith prohibits abrupt termination of "sustained, active and flexible

B. *Interpretivist/Relational Approaches*

In contrast to the interventionist strategy, the interpretivist and relational approaches to good faith have gained some acceptance in the courts, although in widely varying degrees. The perhaps most debated lender liability case, *K.M.C. Co. v. Irving Trust Co.*,[190] is considered the guiding star of the deeply interpretivist[191] and relational[192] theories and, therefore, merits extensive analysis. A discussion of alternative interpretive approaches to good faith follows.

1. Deeply Interpretive/Relational Applications: *K.M.C.* and Progeny

In *K.M.C.*, the borrower K.M.C. Company, Inc., a wholesale and retail grocery business, sued Irving Trust Company for breach of a financing agreement between K.M.C. and Irving.[193] Pursuant to the financing agreement, entered into in 1979, Irving agreed to extend to K.M.C. credit to a maximum of $3,000,000, increased later to $3,500,000.[194] The amounts outstanding under the line of credit were payable on demand.[195] The line of credit was secured by K.M.C.'s accounts receivable and inventory, and availability under the line of credit was determined by a borrowing base formula.[196] In addition, K.M.C. and Irving entered into

credit relationship"); Noonan v. First Bank, 740 P.2d 631, 634 (Mont. 1987) (good faith requires that bank not "unnecessarily deprive the [borrowers] of the benefits associated with the banking relationship between the parties"); Transcript at 11, First Fidelity Bank v. People Care, Inc., No. L-001554-90 (N.J. Super. Ct. Law Div. May 3, 1991) (denying motion for summary judgment) (holding that good faith "requires an honest effort to abide by the terms and spirit of the agreement"); Urdang v. Muse, 276 A.2d 397, 399 (Essex County Ct. 1971) ("An acceleration provision is not the law of the Medes and Persians, operating with iron rigidity under all circumstances."); Garrett v. BankWest, Inc., 459 N.W.2d 833, 845 (S.D. 1990) (adopting Summers and Restatement approach); Lane v. John Deere Co., 767 S.W.2d 138, 142 (Tenn. 1989) (bank cannot take "unconscientious advantage" of borrower when accelerating); Schaller v. Marine Nat'l Bank of Neenah, 388 N.W.2d 645, 651 (Wis. Ct. App. 1986) (in overdraft case, good faith means "an honest intention to abstain from taking unfair advantage of another, through technicalities of law, by failure to provide information . . . or by other activities which render the transaction unfair") (citation omitted); *see also supra* notes 50-51 (courts applying commercial reasonableness standard for U.C.C. obligation of good faith).

190. 757 F.2d 752 (6th Cir. 1985). For discussions of *K.M.C.*, see generally sources cited *supra* note 10.

191. *See generally* Patterson, Good Faith, *supra* note 105, at 125-55; Patterson, *Good Faith, Lender Liability*, *supra* note 10.

192. *See* Braucher, *supra* note 27, at 733-38; Linzer, *supra* note 141, at 176-78; Patterson, *Good Faith, Lender Liability*, *supra* note 10, at 184 & n.119.

193. *See K.M.C.*, 757 F.2d at 754.

194. *See id.*

195. *See id.* at 759.

196. *See id.* at 754. A "borrowing base" in secured lending refers to a formula which adds a certain percentage of inventory defined in the agreement as "eligible inventory" and a certain percentage of accounts receivable defined in the agreement as "eligible receivables." The sum establishes the maximum amount available under the line of credit. Although the definitions are commonly individually negotiated, inventory or receivables are generally "eligible" if the lender has a perfected security interest in the piece of inventory or in the receivable, as the case may be. In addition, the receivable's probability of

a cash management arrangement whereby all receipts of K.M.C. were deposited into a blocked account maintained with a participant bank.[197] K.M.C.'s only means of acquiring working capital was through borrowing under the line of credit.

On March 1, 1982, Irving Trust refused without notice to advance $800,000 as requested by K.M.C., even though the advance was available under the terms of the financing agreement.[198] The previous Friday, K.M.C. had unsuccessfully requested that Irving increase the line of credit to $4,000,000.[199] After refusing to make the advance, Irving dishonored numerous checks drawn by K.M.C. to K.M.C. suppliers.[200] Although Irving agreed three days later to advance K.M.C. $700,000,[201] K.M.C. ultimately collapsed. K.M.C. subsequently sued Irving, alleging that Irving's refusal to advance funds on March 1st constituted a breach of Irving's duty of good faith and fair dealing and that this breach resulted in K.M.C.'s demise. A jury found Irving liable and awarded K.M.C. damages in the amount of $7,500,000.[202]

The United States Court of Appeals for the Sixth Circuit affirmed the

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payment often affects its eligibility. The purpose behind the use of a borrowing base in revolving lines of credit is to ensure that the amounts borrowed under the line of credit correlate to the amount of quality inventory in which the lender has some assurance that it is perfected, and to the amount of receivables which are likely to be collected. *See generally* William C. Hillman, Commercial Loan Documentation 175-77 (3d ed. 1990).

197. *See id.* at 759, 761. Under this arrangement, also known as a "lockbox account," receipts from the borrower's receivables are sent directly to the bank where the account is maintained, and the amounts therein are used to pay the borrower's outstanding checks. To the extent that the amount in the account exceeds the checks drawn, the excess is applied to reduce the amount outstanding under the line of credit. Because the amounts outstanding under the line of credit are concomitantly reduced by the cash sweep, the borrower has increased availability under the line of credit. To the extent that the face amount of the checks drawn exceed the amounts in the account, the borrower borrows under the line of credit to cover the checks. At the time K.M.C.'s financing was cut off, K.M.C. had insufficient funds in the account to cover the checks that had been drawn and the requested draw under the line of credit was to cover those checks. *See* Brief for Defendant-Appellant at 9-11, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (No. 83-5563); Brief for Plaintiff-Appellee at 10-11, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (No. 83-5563).

198. *See K.M.C.*, 757 F.2d at 754. If Irving had granted this request, K.M.C.'s outstanding loan balance would have increased to just under the maximum $3.5 million limit under the line of credit. *See id.*

199. *See id.* at 762.

200. *See id.*; Brief for Plaintiff-Appellee at 8, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (No. 83-5563). The refused advance would have been used to cover the checks that Irving dishonored.

201. *See K.M.C.*, 757 F.2d at 762.

202. *See id.* at 752. Although the financing agreement contained a waiver of trial by jury, neither the trial court nor the court of appeals enforced the waiver clause. *See id.* at 755-58. The damage award was based on testimony as to K.M.C.'s going concern value immediately before March 1, 1982, and its value after that date. *See id.* at 763-66. One expert based his valuation of K.M.C.'s projected performance upon acquisition by a larger company, *see id.* at 764, while another expert compared K.M.C. to a similar wholesaler acquired on March 1, 1982, *see id.* at 765-76. For a criticism of the award of damages in *K.M.C.*, see Fischel, *supra* note 7, at 153-54.

jury's verdict.[203] The court held that, absent valid business reasons that prevented Irving from giving such notice, the requirement of good faith and fair dealing obligated Irving to give notice to K.M.C. prior to curtailing financing.[204] Crucial to the court's analysis was the fact that all of K.M.C.'s receipts were placed into the blocked account, depriving K.M.C. of any working capital while any portion of the line of credit was outstanding.[205] Under a "literal interpretation" of the credit agreement, K.M.C.'s ongoing existence was thus left "entirely at the whim or mercy of Irving, absent an obligation of good faith performance."[206] Notice to K.M.C. prior to Irving's termination of the line of credit would have allowed K.M.C. to seek alternative means of financing.[207] In addition, the court pointed out that Irving and K.M.C. had "a consistent and uninterrupted course of dealing . . . over an extended period of time."[208]

The court rejected Irving's argument that, because the amounts outstanding under the line of credit could be called on demand, Irving could refuse to lend without notice.[209] The court reasoned that the express demand provision in the financing agreement also was limited by an obligation of good faith.[210] Irving's right to demand, therefore, would

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203. *See K.M.C.*, 757 F.2d at 766.

204. *See id.* at 759.

205. *See id.*; *see also* Canterbury Realty & Equip. Corp. v. Poughkeepsie Sav. Bank, 524 N.Y.S.2d 531, 532-33 (N.Y. App. Div. 1988) (bank's refusal to honor checks and its retention of proceeds from receivables under "lock box" arrangement alleged to be "sudden, effective strangulation of [borrower's] economic lifeline caus[ing] it to cease operations").

206. *K.M.C.*, 757 F.2d at 759.

207. *See id.* The proceeds from the alternative financing would be used to pay off the outstanding indebtedness owed to Irving, in exchange for a release of Irving's security interest in K.M.C.'s receivables and inventory.

208. *Id.*

209. *See id.* at 760.

210. The court stated that

> just as Irving's discretion whether or not to advance funds is limited by an obligation of good faith performance, so too would be its power to demand repayment. The demand provision is a kind of acceleration clause, upon which the Uniform Commercial Code and the courts have imposed limitations of reasonableness and fairness.

Id. (citing U.C.C. § 1-208 (1990) and Brown v. AVEMCO Inv. Corp., 603 F.2d 1367, 1375-80 (9th Cir. 1979)).

The *K.M.C.* court thus agreed with the view that demand notes are limited by an obligation of good faith irrespective of the comment to U.C.C. § 1-208. *See supra* note 56 and accompanying text. Debate has arisen over whether the court's discussion of good faith in demand notes, which is dicta because Irving did not demand payment from K.M.C. but rather merely refused to lend, has any precedential value. *Compare* West & Haggerty, *supra* note 9, at 101-02 (arguing that the demanding payment analogy by the court is only dicta) and Granoff, *supra* note 9, at 498 (same) *with* Patterson, *Good Faith, Lender Liability*, *supra* note 10, at 181 n.91 (refusal to lend is equivalent of demand, thus court's discussion is valid); *see also* Check Reporting Servs. v. Michigan Nat'l Bank, 478 N.W.2d 893, 899 (Mich. Ct. App. 1991) (*K.M.C.* court's statement on demand is dicta and not persuasive); Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 953 (Mo. Ct. App. 1986) ("When a bank calls a demand note, it is a more onerous burden on the debtor than when a bank refuses to disburse additional funds.").

equally have been subject to the court's notice requirement.

Examining the evidence presented at trial, the court found sufficient evidence that Irving's loan officer, Sarokin, did not have a valid business reason for refusing to lend without prior notice. The court first stated that Irving's conduct "to a certain extent . . . must be measured by objective standards."[211] However, after rejecting an entirely objective or entirely subjective standard for assessing the good faith of Irving's decision not to lend, the court applied a mixed subjective and objective test.[212] The court found ample evidence supporting the jury's determination that "no reasonable loan officer in the same situation would have refused to advance funds to K.M.C. without notice as Sarokin did on March 1, 1982."[213] Irving itself had no internal policy of terminating financing without notice.[214] There was testimony from an officer of a bank participating in the loan to K.M.C. that both the participant bank officer, as well as any reasonable banker examining the loan, would have believed that the loan was fully secured.[215] On March 1st, Sarokin himself told an attorney representing a wholesaler interested in acquiring K.M.C. that Irving would advance the requested funds in order to allow the potential acquiror to evaluate K.M.C. The next day, the attorney was informed that Sarokin "had changed his mind and decided to 'proceed with his game plan.' "[216] In sum, there was ample evidence for a jury to conclude that Irving did not have a valid business reason for refusing to advance the funds and, accordingly, prior notice was required.[217]

A full understanding of *K.M.C.* necessitates moving beyond the court's facial treatment of the subjective/objective standards for good faith and the issue of whether there is an obligation of good faith in demand notes. The case is inconsistent with several of the conceptualizations of good faith discussed above.[218] For example, ample precedent existed at the time to support a finding that good faith in fact does not require no-

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211. *K.M.C.*, 757 F.2d at 761.

212. *See id.* The court framed the test as follows:

> While it is not necessary that Sarokin have been correct in his understanding of the facts and circumstances pertinent to his decision not to advance funds for this court to find that he made a valid business judgment in doing so, there must at least be *some* objective basis upon which a reasonable loan officer in the exercise of his discretion would have acted in that manner.

Id.; *see supra* note 51 and accompanying text.

213. *K.M.C.*, 757 F.2d at 761.

214. *See id.*

215. *See id.* at 761-62. Although Irving conceded that the bank was adequately secured when it refused to advance funds, it argued that the important point was the debtor's capacity to repay the loan rather than the adequacy of security. *See id.* at 762. However, the court pointed out that Irving had quarterly audits and other information showing that the security would rapidly pay down the loan and that K.M.C.'s inventory position was strong. *See id.* This information undermined Sarokin's claim that K.M.C.'s payables and receivables position indicated that K.M.C. was near collapse. *See id.*

216. *Id.*

217. *See id.* at 763.

218. *See supra* text accompanying notes 73-154.

tice.[219] Hence, under the notion of "good faith law," the *K.M.C.* result appears unjustified and startling. No evidence was presented suggesting that Irving's discretionary right[220] to refuse to continue financing or its right to enforce the contract was exercised for improper purposes, or to recapture an opportunity foregone at the time of contracting.[221]

Thus, the case is best explained either by the court's use of a deeply interpretive process to determine what the parties' agreement "really meant"[222] or by a relational analysis of *K.M.C.* The exchange between K.M.C. and Irving involved prolonged interaction between the parties. The court expressed concern about the continuous past dealings between K.M.C. and Irving and the degree of leverage that Irving exercised over K.M.C. through the cash management arrangement. Thus, the court acknowledged the exchange's relational characteristics. The agreement was not a short-term, lump-sum disbursement of funds but rather was a long-term interactive relationship between the parties. The use of a borrowing base to calculate amounts available under the line of credit also increased Irving's leverage over the company's affairs through determination of eligibility of receivables and inventory. Although not discussed in the court's opinion, there were allegations that Sarokin demanded that K.M.C. "cut off" a long-time customer that was behind on its bills.[223] According to K.M.C., Irving exercised substantial control over the company's financial affairs, even at one time forcing it to change its pricing policy.[224] K.M.C. also asserted that "Sarokin believed the way to deal with clients of the bank was to put them under 'pressure.' "[225] K.M.C. was in a position of dependence upon Irving and Sarokin.

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219. *See* Jensen v. State Bank, 518 F.2d 1, 6 (8th Cir. 1975); Custom Panel Sys., Inc. v. Bank of Hampton, 239 S.E.2d 558, 559 (Ga. Ct. App. 1977); Van Bibber v. Norris, 419 N.E.2d 115, 122-23 (Ind. 1981); Cascade Steel Fabricators, Inc. v. Citizens Bank, 612 P.2d 332, 333 (Or. Ct. App. 1980); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 518 P.2d 734, 737 (Wash. Ct. App.), *cert. denied*, 419 U.S. 967 (1974). For cases subsequent to *K.M.C.* holding that no notice is required, see *infra* note 230.

220. This assumes that the lender's election to refuse to continue financing, as expressly provided for in the agreement, can be deemed "discretionary." *See supra* note 99; *cf.* Layne v. Fort Carson Nat'l Bank, 655 P.2d 856, 857 (Colo. Ct. App. 1982) (withholding of consent not contrary to good faith); Quintana v. First Interstate Bank, 737 P.2d 896, 898 (N.M. Ct. App. 1987) (mortgagee's consent not limited in any manner by good faith); Citizens Nat'l Bank v. Karsnak, No. CA 91-08-013, 1992 Ohio App. LEXIS 252, at *4-*5 (Ohio Ct. App. Jan. 27, 1992) (option to accelerate upon default not discretionary); State Nat'l Bank v. Academia, Inc., 802 S.W.2d 282, 294 (Tex. Ct. App. 1990) ("The Bank's rights under [the] agreements were clear and cannot subsequently be limited by labelling its decision to pursue collection efforts as discretionary.").

221. *See* Fischel, *supra* note 7, at 143-44.

222. *See* Patterson, *Good Faith, Lender Liability*, *supra* note 10, at 191-202; Patterson, *Easterbrook on Good Faith*, *supra* note 10, at 521-25.

223. *See* Brief for Plaintiff-Appellee at 9, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (No. 83-5563).

224. *See id.* at 8-10.

225. *Id.* at 9. Although not raised before the court, K.M.C. could have attempted to recover based on Irving's control over K.M.C. For a discussion of lender control liability, see generally Lawrence, *supra* note 71, at 1399-1403.

In the court's view, Irving's failure to give notice of its refusal to advance funds without a valid business reason constituted bad faith.[226] The notice provision, which would have allowed K.M.C. time to seek alternative financing, represents a careful balance by the court of several relational contract norms. Effectuation of planning and consent are served because Irving could terminate the financing after giving notice. The notice provision did not contravene any compelling planning interests of Irving, particularly when Irving was fully secured. Notice, however, furthers other, non-consensual norms. It maintains flexibility at no expense to Irving's interests. Notice also furthers contractual solidarity by allowing time for the parties to negotiate through the conflict. Additionally, notice ensures procedural fairness by preventing unfair surprise. In sum, the more relational norms were served by the notice requirement at no expense to planning, consent, and expectation. Accordingly, *K.M.C.* is a relational/deeply interpretive application of good faith.[227]

Given the outcry that emerged as a result of the *K.M.C.* decision,[228] the extent to which the *K.M.C.* interpretive/relational approach has been

226. The court stated that "[i]f Irving had given K.M.C. 30 days, 7 days, even 48 hours notice, we would be facing a different case." K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 763 (6th Cir. 1985). If K.M.C. within that notice period could have secured a commitment for financing from another lending institution which when completed would repay in full K.M.C.'s debt to Irving, the court indicated that Irving's termination at the end of the notice period prior to closing of the financing might be "arbitrary and capricious." *See id.* at 763 n.13.

Other courts have distinguished *K.M.C.* as solely requiring notice. *See* National Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 681 (S.D.N.Y. 1991), *aff'd sub nom.* Yaeger v. National Westminster, 962 F.2d 1 (2d Cir. 1992); *In re* William A. Smith Constr. Co., 86 B.R. 115, 119 (Bankr. N.D. Ohio 1988); *In re* Red Cedar Constr. Co., 63 B.R. 228, 237 (Bankr. W.D. Mich. 1986); Southwest Sav. & Loan Ass'n v. SunAmp Sys., Inc., 838 P.2d 1314, 1322-23 (Ariz. Ct. App. 1992).

227. For an interpretivist defense of *K.M.C.*, see generally Patterson, *Good Faith, Lender Liability*, *supra* note 10. To a great extent the relational and deeply interpretive approaches to good faith differ in application only as to the legal bounds of the parties' agreement. *See supra* note 141. A traditional relational thinker would adopt a narrow conception of agreement but would assess the parties' relation outside of the agreement in determining the breadth of the obligation of good faith. The deeply interpretive approach moves much of the "relation" into a broadly construed "agreement." The approaches differ at the theoretical level as to the initial scope of agreement—a distinction not lightly ignored. Many of the cases, however, can be justified on either relational or deeply interpretive grounds by asserting either that the court is really enforcing the extra-agreement relation or the intra-agreement relation. Courts rarely provide sufficient data to determine which of the two perspectives motivated the decision. For a non-lender good faith case recognizing the distinction between relational contract and agreement, see Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. CIV.A.12150, 1991 WL 277613, at *23 (Del. Ch. Dec. 30, 1991):

> Generally speaking, contracting parties are, to a large extent, entitled to act selfishly to promote their own interests under the contract. While in a relational contract it may be short-sighted and bad business to do so, they generally are entitled to push their claims of entitlement under a contract in an attempt to maximize their self-interest.

228. *Compare* Patterson, *Easterbrook on Good Faith*, *supra* note 10 (defending *K.M.C.*) *with* Fischel, *supra* note 7 (criticizing *K.M.C.*) and Snyderman, Comment, *supra* note 10 (same).

accepted by the courts is of critical importance. Surprisingly, and contrary to the assumption of some writers,[229] *K.M.C.* is a weak thread by which to hang a relational or deeply interpretive revolution in the courts. The case has been questioned by numerous courts.[230] Because courts have diverged on the Code's good faith doctrine,[231] and given the individualized nature of lending arrangements, it is nearly impossible to state precisely where other lender liability cases stand in relation to *K.M.C.* It appears, however, that courts are largely insensitive to factors in lending relationships that would justify a relational or deeply interpretive approach to good faith. Factors such as length of relations, a lender's control over the borrower, and communication between the borrower and lender support a more expansive view of good faith. Yet, in most cases these factors are not deemed significant.

a. *Length of Relations*

Unlike the *K.M.C.* court, most courts appear indifferent to the fact that the parties had a long-term, interactive relationship. For example, in *Terry A. Lambert Plumbing, Inc. v. Western Security Bank*,[232] a case very similar to *K.M.C.*, the court affirmed the lender's motion for summary judgment on the issue of good faith. In this case the lender and borrower "had a longstanding banking relationship" which included "loan transactions and the frequent exchange of advice and ideas."[233] The lender refused to make advances on a line of credit after the borrower defaulted on the loan agreement. Due to the refusal, the borrower suffered from both a lack of cash flow and a loss of its bonding.[234] Moreover, the lender exercised its rights under the security agreement to take possession of the borrower's collateral and liquidated the majority of the assets.[235] Regardless of the parties' relationship, the *Lambert Plumbing* court held that "[a]cting according to express terms of a contract is not a breach of good faith and fair dealing."[236]

Such disregard for long-term relations evokes objection, as seen in the

229. *See, e.g.*, Linzer, *supra* note 141, at 177-78 (courts use good faith relationally); Lawrence v. Farm Credit Sys. Capital Corp., 761 P.2d 640, 656 (Wyo. 1988) (Urbigkit, J., concurring in part and dissenting in part) (*K.M.C.* "may be considered as a premier case in persuasive authority").

230. *See supra* note 29 and accompanying text; *see also* Idaho First Nat'l Bank v. David Steed & Assocs., 825 P.2d 79, 83 (Idaho 1992) (no notification of intent not to renew credit line required); Diversified Foods, Inc. v. First Nat'l Bank, 605 A.2d 609, 613-14 (Me. 1992) (no notice required for demand instrument); Blome v. First Nat'l Bank, 776 P.2d 525, 529 (Mont. 1989) (no duty to give notice prior to termination of financing); Gillman v. Chase Manhattan Bank, N.A., 534 N.E.2d 824, 831 (N.Y. 1988) (no good faith obligation of notice).

231. *See supra* notes 45-60 and accompanying text.

232. 934 F.2d 976 (8th Cir. 1991).

233. *Id.* at 978.

234. *See id.* at 978-79.

235. *See id.* at 979.

236. *Id.* at 983.

dissenting opinion in *Lawrence v. Farm Credit System Capital Corp.*[237] In that case, a majority of the Wyoming Supreme Court examined the good faith issue and affirmed a directed verdict in favor of the lender.[238] In *Lawrence*, the borrower had fallen into financial difficulties after a spring blizzard caused major livestock losses at the borrower's ranch.[239] The losses undermined the borrower's ability to obtain alternative financing. Additionally, its current lenders sought foreclosure on their notes as the notes became due.[240] The *Lawrence* majority relied principally on an "effectiveness of express terms" approach to good faith in finding no issue of fact with respect to the lender's foreclosure on collateral.[241] In a harsh dissent, however, Justice Urbigkit urged that courts look beyond the "transactional arrangement of the parties" and instead examine the parties' "ongoing long-term understanding" and "years of mutual business association" in determining the lender's good faith.[242] These exhortations have apparently often been overlooked. While some courts mention the length of the parties' relationship, most do not appear to deem that fact legally relevant in assessing the lender's good faith.[243]

237. 761 P.2d 640, 654-56 (Wyo. 1988).

238. *See id.* at 651-52.

239. *See id.* at 649.

240. *See id.* at 651.

241. *See id.* The majority's "effectiveness of express terms" approach is discussed *infra* text accompanying notes 271-308.

242. My principal objection to the court's decision is it confines the course of business status of the business relationship, which occurred over years, to the particularized terms of the annualized loan security documents. Those documents were the result of the transactional arrangement of the parties and were not intended to create the ongoing long-term understanding between the parties. Obviously, if the borrower had known that [the lender] would jump ship with availability of capital in the event of a weather disaster, then many years earlier the borrower would have found an alternative source of financing in order to minimize the constancy of danger from a "pulled plug." The lending agreement between these parties was derived from understanding in express statements arising through the years of mutual business association as lender and borrower. Denial of a jury trial analysis is terribly unjustified.

Lawrence, 761 P.2d at 657 (Urbigkit, J., concurring in part and dissenting in part).

243. *See, e.g.*, Sanders v. First Nat'l Bank & Trust Co., 936 F.2d 273, 275 (6th Cir. 1991) (long standing customers); Whitney Nat'l Bank v. Stack, No. CIV.A.91-1320, 1991 U.S. Dist. LEXIS 16877, at *2 (E.D. La. Nov. 19, 1991) (25 year relationship); Resnick v. Resnick, No. 85 Civ. 9026, 1990 U.S. Dist. LEXIS 14206, at *31 (S.D.N.Y. Oct. 24, 1990) (20 year relationship); East Lansing State Bank v. Red Cedar Constr. Co. (*In re* Red Cedar Constr. Co.), 63 B.R. 228, 230 (Bankr. W.D. Mich. 1986) (long relationship); Smith v. Union State Bank, 452 N.E.2d 1059, 1064 (Ind. Ct. App. 1983) (over 12 year relationship); Mann Farms Inc. v. Traders State Bank, 801 P.2d 73, 74-75 (Mont. 1990) (nine year relationship); Shiplet v. First Sec. Bank, 762 P.2d 242, 243, 246 (Mont. 1988) (long-term relationship); Noonan v. First Bank Butte, 740 P.2d 631, 637 (Mont. 1987) (long relationship between bank and borrower) (Sheehy, J., dissenting); Central Bank v. Eystad, 710 P.2d 710, 711-12 (Mont. 1985) (19 year relationship); Cascade Steel Fabricators, Inc. v. Citizens Bank, 612 P.2d 332, 332-33 (Or. Ct. App. 1980) (12 year relationship). *But cf.* Ricci v. Key Bancshares of Me., Inc., 662 F. Supp. 1132, 1141 (D. Me. 1987) (lender acted in bad faith "by abruptly terminating their sustained, active and flexible credit relationship with [the borrower]"); Tri-Company Constr., Inc. v. Farmers & Merchants State Bank, No. 64,872, 1991 Kan. App. LEXIS 1, at *15-*16 (Kan. Ct.

b. *Control Over Cash Flow*

A brief survey of good faith cases ruling in favor of the borrower might first seem to indicate that the existence of a cash management arrangement, as in *K.M.C.*, could sway the court toward an expansive interpretation of the obligation of good faith.[244] As discussed earlier, the lockbox in *K.M.C.* placed the borrower at the mercy of the lender[245] and on relational or deeply interpretive grounds might give rise to an expectation of moderation by the lender. In fact, several courts have distinguished *K.M.C.* on the ground that the case involved a lockbox arrangement.[246] Nevertheless the existence of a lockbox arrangement does not necessarily lead to an expansive perspective on the obligation of good faith.[247]

c. *Communication*

One fact absent from *K.M.C.* was a sincere effort by the lender to communicate to the borrower any reasons for its behavior or to engage in an attempt to restructure the loan upon the borrower's financial downturn. Workout negotiations and a genuine attempt to save the deal rather than immediately to abandon it would facilitate more relational norms by forcing further communication and interaction between the parties. In a surprising number of good faith cases in which the court found in favor of the lender, the bank had attempted to work out the problematic loan before acting, or had otherwise waited for new financing to be put into

App. Jan. 4, 1991) (giving weight to twenty-year relationship); Production Credit Ass'n v. Halverson, 386 N.W.2d 905, 907, 910 (N.D. 1986) (reversing summary judgment in favor of lender where borrower alleged, inter alia, 13 year relationship with lender); Frank Lerner & Assocs., Inc. v. Merchants & Mechanics Fed. Sav. & Loan Ass'n, No. 90AP-1045, 1991 Ohio App. LEXIS 2938, at *9 (Ohio Ct. App. June 20, 1991) (noting commercial unreasonableness "especially given the long-standing relationship").

244. *See, e.g.*, Reid v. Key Bank, Inc., 821 F.2d 9, 11 (1st Cir. 1987) (without notice bank offset debt with borrower's accounts receivable); Spencer Cos. v. Chase Manhattan Bank, N.A., 81 B.R. 194, 203 (Bankr. D. Mass. 1987) (borrower maintained accounts at bank); First Nat'l Bank v. Sylvester, 554 N.E.2d 1063, 1066 (Ill. App. Ct. 1990) (borrower moved accounts to bank); Canterbury Realty & Equip. Corp. v. Poughkeepsie Sav. Bank, 524 N.Y.S.2d 531, 532 (App. Div. 1988) (lock box arrangement).

245. *See supra* text accompanying notes 205-06.

246. *See* Fasolino Foods Co. v. Banca Nazionale del Lavoro, 961 F.2d 1052, 1057-58 (2d Cir. 1992); Check Reporting Servs., Inc. v. Michigan Nat'l Bank, 478 N.W.2d 893, 899 (Mich. Ct. App. 1991); Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 953 (Mo. Ct. App. 1986); Schaller v. Marine Nat'l Bank, 388 N.W.2d 645, 651 (Wis. Ct. App. 1986).

247. *See, e.g.*, Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336, 1341-42 (Fla. Dist. Ct. App. 1986) (rejecting *K.M.C.* and finding in favor of bank where lock-box arrangement existed); Gillman v. Chase Manhattan Bank, N.A., 534 N.E.2d 824, 831 (N.Y. 1988) (finding no bad faith when bank, without notice, segregated borrower's working capital account and dishonored checks drawn thereunder); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 518 P.2d 734, 736 n.2, 738 n.5 (Wash. Ct. App.) (abrupt termination of line of credit not bad faith even where borrower "was completely dependent upon defendant bank for its financial operation"), *cert. denied*, 419 U.S. 967 (1974); *cf.* Mid-State Fertilizer Co. v. Exchange Nat'l Bank, 877 F.2d 1333, 1337-39 (7th Cir. 1989) (Easterbrook, J.) (rejecting testimony regarding lock-box arrangements).

place.[248] Similarly, in affirming a finding of bad faith by the lender, some courts have noted that the lender refused to give reasons to the borrower for its behavior.[249] Yet when directly confronted with the proposition that good faith imposes a legal duty to attempt workout negotiations prior to enforcing express rights,[250] courts nearly unanimously reject it.[251]

248. *See* Micronesian Yachts Co. v. Bank of Guam, No. 90-16663, 1992 U.S. App. LEXIS 865, at *3-*4 (9th Cir. Jan. 15, 1992); Mirax Chem. Prods. Corp. v. First Interstate Commercial Corp., 950 F.2d 566, 568 (8th Cir. 1991); Sanders v. First Nat'l Bank & Trust Co., 936 F.2d 273, 276 (6th Cir. 1991); C.H. Betterton v. First Interstate Bank, N.A., 800 F.2d 732, 733-34 (8th Cir. 1986); Bank of Md. v. Kule, No. 91 Civ. 6490, 1992 U.S. Dist. LEXIS 8947, at *2 (S.D.N.Y. June 17, 1992); Bankers Trust Co. v. F.D. Rich Co., No. 90 Civ. 4827, 1991 U.S. Dist. LEXIS 14682, at *2 (S.D.N.Y. Oct. 11, 1991); Price v. Wells Fargo Bank, 261 Cal. Rptr. 735, 737 (Cal. Ct. App. 1989); *Flagship Nat'l Bank*, 485 So. 2d at 1338-39; Fulton Nat'l Bank v. Willis Denney Ford, Inc., 269 S.E.2d 916, 917 (Ga. Ct. App. 1980); Idaho First Nat'l Bank v. Bliss Valley Foods, Inc., 824 P.2d 841, 847 (Idaho 1991); Wooden v. First Sec. Bank, 822 P.2d 995, 996-97 (Idaho 1991); Smith v. Union State Bank, 452 N.E.2d 1059, 1064 (Ind. Ct. App. 1983); Farmers Coop. Elevator, Inc. v. State Bank, 236 N.W.2d 674, 675 (Iowa 1975); Check Reporting Servs. v. Michigan Nat'l Bank, 478 N.W.2d 893, 896-97 (Mich. Ct. App. 1991); First Sec. Bank & Trust v. VZ Ranch, 807 P.2d 1341, 1344 (Mont. 1991); Lachenmaier v. First Bank Sys., Inc., 803 P.2d 614, 616 (Mont. 1990); Mann Farms Inc. v. Traders State Bank, 801 P.2d 73, 74-75 (Mont. 1990) (extensive efforts at refinancing); Coles Dep't Store v. First Bank (N.A.)—Billings, 783 P.2d 932, 933 (Mont. 1989); Shiplet v. First Sec. Bank, 762 P.2d 242, 244 (Mont. 1988); Noonan v. First Bank, 740 P.2d 631, 633 (Mont. 1987); Central Bank v. Eystad, 710 P.2d 710, 711 (Mont. 1985); Garrett v. BankWest, Inc., 459 N.W.2d 833, 836 (S.D. 1990).

249. *See* Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 946 (Mo. Ct. App. 1986); Clayton v. Crossroads Equip. Co., 655 P.2d 1125, 1130 (Utah 1982). *But cf.* Affiliated Capital Corp. v. Commercial Fed. Bank, 834 S.W.2d 521, 527-28 (Tex. Ct. App. 1992) (giving reasons for exercising right irrelevant).

250. Support for such a duty derives from *K.M.C.* Borrower's counsel have argued unsuccessfully that K.M.C. requires a good faith obligation to engage in post-default workouts. *See* Halliburton Co. v. William A. Smith Constr. Co. (*In re* William A. Smith Constr. Co.), 86 B.R. 115, 119 (Bankr. N.D. Ohio 1988). *K.M.C.* also has been cited as authority for a legal obligation to provide "adequate notice and a reasonable opportunity to find alternative financing." Quality Automotive Co. v. Signet Bank/Md., No. 92-1619, 1993 U.S. App. LEXIS 901, at *4 (4th Cir. Jan. 15, 1993). *See* Connecticut Nat'l Bank v. Chern, No. 90 Civ. 7459, 1992 U.S. Dist. LEXIS 11364, at *8 (S.D.N.Y. July 30, 1992); Quality Automotive Co. v. Signet Bank/Md., 775 F. Supp. 849, 851 (D. Md. 1991); Southwest Sav. & Loan Ass'n v. SunAmp Sys., Inc., 838 P.2d 1314, 1320-23 (Ariz. Ct. App. 1992); *see also* Fasolino Foods Co. v. Banca Nazionale del Lavoro, 961 F.2d 1052, 1057-58 (2d Cir. 1992) (limiting any obligation to give notice to cases of blocked accounts); Connecticut Nat'l Bank v. Douglas, 606 A.2d 684, 686 n.2 (Conn. 1992) (trial allowed to determine whether refusal to cooperate in workouts constituted bad faith; jury found for bank); Lawrence v. Farm Credit Sys. Capital Corp., 761 P.2d 640, 657 (Wyo. 1988) (Urbigkit, J., concurring in part and dissenting in part) ("The obdurate and unexpected rejection of continued financing responsibility by the [lender] was exasperated [sic] . . . in failure to even cooperate with the borrower so that substitute credit might be acquired. This lender was not to be a port in any storm but rather an abyss when turbulence was encountered.").

251. *See* Micronesian Yachts Co. v. Bank of Guam, No. 90-16663, 1992 U.S. App. LEXIS 865, at *11-*12 (9th Cir. Jan. 15, 1992) (no duty to assist or renegotiate); Resolution Trust Corp. v. Lesal Assocs., 91 Civ. 2025, 1992 U.S. Dist. LEXIS 6620, at *16-*17 (S.D.N.Y. May 6, 1992) (refusal to negotiate not bad faith); Bohm v. Commerce Union Bank, 794 F. Supp. 158, 163 (W.D. Pa. 1992) (no duty to assist); Bank of Md. v. Kule,

Thus, the expansive relational and interpretive principles that could have stemmed from the *K.M.C.* decision have been significantly undercut by other courts. *K.M.C.*'s precedential force is nominal, if not nil in some jurisdictions. Although not without exception,[252] the deeply inter-

No. 91 Civ. 6490, 1992 U.S. Dist. LEXIS 8947, at *8 (S.D.N.Y. June 17, 1992) (refusal to negotiate not bad faith); Bank of New York v. Sasson, 786 F. Supp. 349, 354 (S.D.N.Y. 1992) (no good faith obligation "to take actions contrary to [the lender's] own economic interest such as extending, or even negotiating the possible extension of, a risky loan"); Barclays Business Credit, Inc. v. Inter Urban Broadcasting, Inc., No. 90 Civ. 2272, 1991 U.S. Dist. LEXIS 17473, at *18-*20 (S.D.N.Y. Nov. 25, 1991) (refusal to renegotiate terms not bad faith); Savers Fed. Sav. & Loan Ass'n v. Home Fed. Sav. & Loan Ass'n, 721 F. Supp. 940, 946 (W.D. Tenn. 1989) (failure to respond not bad faith); *Halliburton Co.*, 86 B.R. at 119 (refusal to engage in post-default workout not bad faith); Mendel v. Production Credit Ass'n, 656 F. Supp. 1212, 1217 (D.S.D. 1987) (failure to forbear not bad faith), *aff'd in part, rev'd in part*, 862 F.2d 180 (8th Cir. 1988); Crissey v. Alaska USA Fed. Credit Union, 811 P.2d 1057, 1060 n.2 (Alaska 1991) (refusal to renegotiate not bad faith); Montana Bank of Circle, N.A. v. Ralph Meyers & Son, Inc., 769 P.2d 1208, 1213 (Mont. 1989) (no legal duty to renegotiate); Citizens Nat'l Bank, Inc. v. Karsnak, No. CA91-08-013, 1992 Ohio App. LEXIS 252, at *4 (Ohio Ct. App. Jan. 27, 1992) (failure to make an effort "to work out alternate financial programs" or "to establish forbearance strategies" not bad faith); Cascade Steel Fabricators, Inc. v. Citizens Bank, 612 P.2d 332, 333 (Or. Ct. App. 1980) (failure to grant additional financing not bad faith); Creeger Brick & Bldg. Supply Inc. v. Mid-State Bank & Trust Co., SEDA, 560 A.2d 151, 154 (Pa. Super. Ct. 1989) (no duty to assist borrower in obtaining additional loans); Badgett v. Security State Bank, 807 P.2d 356, 361-62 (Wash. 1991) (no legal obligation to "consider proposals"); Lawrence v. Farm Credit Sys. Capital Corp., 761 P.2d 640, 651 (Wyo. 1988) (failure to sign nondisturbance agreement enabling borrowers to obtain alternative financing not bad faith).

252. *See, e.g.*, American Sec. Bank, N.A. v. York, No. CIV.A.91-1212, 1992 U.S. Dist. LEXIS 14309, at *12 (D.D.C. Sept. 1, 1992) (focusing on alleged oral agreement); Glad v. Thomas County Nat'l Bank, No. 87-1299-C, 1991 U.S. Dist. LEXIS 14161, at *5-*9 (D. Kan. Sept. 10, 1991) (discussing course of dealing), *aff'd sub nom.* Glad v. Thomas County Bankshares, Inc., 978 F.2d 1267 (10th Cir. 1992); Quality Automotive Co. v. Signet Bank/Md., 775 F. Supp. 849, 851-52 (D. Md. 1991) (adopting *K.M.C.* approach); Fleet Bank, N.A. v. Winthrop Partners, No. CV92-0065008, 1992 WL 369681, at *7 (Conn. Super. Ct. Nov. 25, 1992) (examining bank's "course of conduct"); American Fed. Sav. & Loan Ass'n v. Buckland, 777 P.2d 1289, 1291-93 (Mont. 1989) (engaging in deep factual inquiry); Gilbert Cent. Corp. v. Overland Nat'l Bank, 442 N.W.2d 372, 377-78 (Neb. 1989) (holding that refusal to lend must be reasonable); Yankton Prod. Credit Ass'n v. Larsen, 365 N.W.2d 430, 434 (Neb. 1985) (focusing on "express or implied contemplation of the parties"); Components Direct, Inc. v. European Am. Bank & Trust Co., 572 N.Y.S.2d 359, 361 (App. Div. 1991) (adopting *K.M.C.* approach); Ford Motor Co. v. Lyons, 405 N.W.2d 354, 372 (Wis. Ct. App. 1987) (finding bad faith even where lender's actions were expressly authorized). In addition, a relational/deeply interpretivist inclination may be reflected in a court's finding that good faith under the Code includes "reasonable commercial standards." *See* cases cited *supra* note 50.

General judicial restraint to the incorporation of relational contract norms into the positive law of good faith would not undermine the viability of relational contract theory under the view that the intertwined, relational nature of exchanges ought not necessarily predominate over the need for enhancing discreteness in exchange relations. *See supra* note 126 (Macneil's views on relational contract law). However, the emerging passive judicial strategy toward good faith issues, *see infra* text accompanying notes 271-308, is problematic for relational contract theory. To the extent that relational contract theory envisions a relational contract law which advances the need for discreteness within the realm of relations, the express rejection by some passive courts of the relational characteristics of exchange, *see, e.g.*, *infra* note 295 and accompanying text, represents a judicial pretive and relational strategies toward the obligation of good faith and fair dealing have yet to emerge perceptibly in the courts.

2. Other Interpretivist Applications

In contrast to the deeply interpretivist and relational approaches, the agreement-based interpretive approach which focuses upon reasons available for acting, has made substantial inroads in the courts, as evidenced by the recent Arizona case of *Southwest Savings & Loan Ass'n v. SunAmp Systems, Inc.*[253] At issue in *SunAmp Systems* was the review of a jury finding that the lender, Southwest Savings and Loan Association breached the implied covenant of good faith and fair dealing when it froze, without notice, SunAmp System's line of credit. The lender then directed SunAmp to cease using a letter of credit that had previously been issued, and finally terminated the line of credit.[254] Southwest asserted that it froze the line because (1) subsequent to entering into the line of credit, it discovered that a key guaranty of the line might be invalid,[255] (2) SunAmp failed to provide monthly financial statements required as a condition to lending,[256] and (3) SunAmp had exceeded the borrowing base as set forth in the credit agreement.[257]

Southwest contended that because it was acting according to the express terms of the agreement, the jury's finding of bad faith had no valid basis.[258] SunAmp responded that Southwest was using its contractual powers only as a pretext and that Southwest "wielded its contractual authority unfairly,"[259] thus providing sufficient evidence supporting the jury's finding.[260] In addressing the interrelationship between the obligation of good faith and the express terms of a contract, the Arizona Court of Appeals noted several cases that adopted an "effectiveness of express

tendency to focus upon discreteness for the sake of discreteness rather than upon the need for discreteness within relations.

253. 838 P.2d 1314 (Ariz. Ct. App. 1992).

254. *See id.* at 1316-18. The jury awarded SunAmp, who had filed for bankruptcy protection, damages of $774,141, which were offset against the amounts owed to Southwest under the line of credit. *See id.* at 1318.

255. *See id.* at 1317, 1318-19. The guaranty had not been signed by the principal guarantor's wife, thus rendering the guaranty subject to attack under Arizona community property law. *See id.* at 1315-16.

256. *See id.* at 1316 & n.2.

257. *See id.* at 1316-17 & n.1. For a discussion of the use of a borrowing base in secured lending, see *supra* note 196. Although Southwest had made prior advances to SunAmp in excess of amounts available under the borrowing base, the court appears to have found that SunAmp had retained its right to insist upon compliance with the borrowing base provisions. *See SunAmp Systems*, 838 P.2d at 1320.

258. *See SunAmp Systems*, 838 P.2d at 1318-19. Although the agreement was secured and no doubt involved a security agreement governed by Article 9 of the Code, the court based its decision on the common-law obligation of good faith. *See id.* at 1319-20.

259. *SunAmp Systems*, 838 P.2d at 1319.

260. *See id.*

terms" approach to good faith,[261] but then continued:

> If contracting parties cannot profitably use their contractual powers without fear that a jury will second-guess them under a vague standard of good faith, the law will impair the predictability that an orderly commerce requires. Yet contracting parties, hard as they may try, cannot reduce every understanding to a stated term. Instances inevitably arise where one party exercises discretion retained or unforeclosed under a contract in such a way as to deny the other a reasonably expected benefit of the bargain.
>
> . . . .
>
> In this case, therefore, inquiry does not end with recognition that Southwest had contractual authority to freeze, and ultimately terminate, SunAmp's credit line. The question is whether the jury might reasonably have found that Southwest wrongfully exercised this power "for a reason beyond the risks" that SunAmp assumed in its loan agreement or for a reason inconsistent with SunAmp's "justified expectations."[262]

Turning to SunAmp's "justified expectations," the court found that Southwest had exercised its authority to freeze the line of credit for a purpose preserved at the time of contracting, namely, to be able "to withhold financing pending proof of adequate security"[263]—the allegedly defective guaranty.[264] Similarly, Southwest's subsequent suspension of SunAmp's right to use the letter of credit was justified for the same reason.[265] Finally, Southwest's ultimate termination of the entire line of credit, being based not only on the defective guaranty but also on information of SunAmp's deteriorating financial condition and Southwest's prior attempts to remedy the guaranty problem, was not beyond SunAmp's justifiable expectations and thus not bad faith.[266] Accordingly, the Arizona Court of Appeals reversed the jury's finding of bad faith.[267]

The *SunAmp Systems* court's interpretive approach is subtly distinguishable from the relational and deeply interpretive approaches dis-

261. *See id.* at 1319 & n.4. For a discussion of the approach, see *infra* text accompanying notes 271-308.

262. *SunAmp Systems*, 838 P.2d at 1319-20 (citations omitted) (citing and quoting Burton, *Common Law Good Faith*, *supra* note 24, and Restatement (Second) of Contracts § 205 cmt. a (1981)).

263. *Id.* at 1321.

264. *See id.* at 1320-22. In resolving this issue, the court examined evidence which indicated that both SunAmp and Southwest, prior to executing the agreement, considered the guaranty to be a crucial condition of the loan. *See id.*

265. *See id.* at 1323.

266. *See id.* at 1323-24. SunAmp also argued that Southwest's failure to give notice prior to freezing the line of credit constituted bad faith, citing *K.M.C.* as support. However, the *SunAmp Systems* court declined to rule on whether to adopt *K.M.C.* because, unlike in *K.M.C.*, SunAmp was not in a critical financial condition, Southwest had no knowledge that SunAmp might collapse, and Southwest was not adequately secured due to the defective guaranty. *See id.* at 1322-23.

267. *See id.* at 1324.

cussed above. While the latter approaches advocate a deep, factual inquiry into the totality of the parties' relation or agreement, the *SunAmp Systems* methodology only looks to the purposes for which an express term was invoked and, concomitantly, to purposes within the parties' justifiable expectations at the time of contracting.[268] As a result, it recognizes only a narrow range of inquiry beyond the parties' express terms—the purpose and context at the time of contracting—and no further. And, while the relational and deeply interpretive approaches arise only relatively rarely as a judicial strategy,[269] the interpretive approach used in *SunAmp Systems* has received fairly substantial acceptance in some courts.[270]

268. Although *SunAmp Systems* does not draw the distinction between enforcement terms and performance terms as this approach advocates, *see supra* text accompanying notes 91-104, the court's treatment of the issues, if only intuitively, seems consistent with the distinction. While the court's analysis with respect to Southwest's failure to lend (arguably a discretion in performance issue, *see supra* note 99 and accompanying text) focuses merely upon Southwest's reasons for acting, the discussion of Southwest's termination of the line of credit (arguably an enforcement term, *see supra* note 104 and accompanying text) focuses not only on Southwest's reasons for acting but also on Southwest's prior attempts to remedy the situation—an allusion to mitigation. *See SunAmp Systems*, 838 P.2d at 1323-24.

269. *See supra* note 252.

270. *See, e.g.*, Reid v. Key Bank, Inc., 821 F.2d 9, 11 (1st Cir. 1987) (acting for discriminatory reasons); Ford v. Manufacturers Hanover Mortgage Corp., 831 F.2d 1520, 1521 (9th Cir. 1987) (discretionary use of insurance proceeds); Brown v. AVEMCO Inv. Corp., 603 F.2d 1367 (9th Cir. 1979) (acceleration depends upon proper purpose); National Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 679-81 (S.D.N.Y. 1991) (focusing on discretion), *aff'd sub nom.* Yaeger v. National Westminster, 962 F.2d 1 (2d Cir. 1992); East Bay Ltd. Partnership v. American Gen. Life & Accident Ins. Co., 744 F. Supp. 1118, 1122-23 (M.D. Fla. 1990) (implying that there are limitations on consent), *aff'd*, 937 F.2d 619 (11th Cir. 1991); Heller Fin., Inc. v. Finch-Bayless Equip. Co., No. 90 C 1672, 1990 U.S. Dist. LEXIS 6523, at *7-*9 (N.D. Ill. May 30, 1990) (limitations on discretion); Spencer Cos. v. Chase Manhattan Bank, N.A., 81 B.R. 194, 203 (D. Mass. 1987) (bank's discretion was not "unfettered"); Autoparts Fin. Co. v. Grier Auto Parts, Inc., 462 F. Supp. 198, 200 (E.D. Mo. 1978) (discussing whether default was minor); Seay v. Davis, 438 S.W.2d 479, 480-81 (Ark. 1969) (improper acceleration); Schoolcraft v. Ross, 146 Cal. Rptr. 57, 59-60 (Cal. Ct. App. 1978) (limitations on retention of insurance proceeds); Milstein v. Security Pac. Nat'l Bank, 103 Cal. Rptr. 16, 18-19 (Cal. Ct. App. 1972) (same); Bartlett Bank & Trust Co. v. McJunkins, 497 N.E.2d 398, 404 (Ill. App. Ct. 1986) (limitations on discretion); Carrico v. Delp, 490 N.E.2d 972, 976-77 (Ill. App. Ct. 1986) (same); Diversified Foods, Inc. v. First Nat'l Bank, 605 A.2d 609, 614 (Me. 1992) (looking to reasons for acting); Black v. Peoples Bank & Trust Co., 437 So. 2d 26, 29-30 (Miss. 1983) (discussing discretion); Richland Nat'l Bank & Trust v. Swenson, 816 P.2d 1045, 1052 (Mont. 1991) (limitations on bank's discretion to lend); Lachenmaier v. First Bank Sys., Inc., 803 P.2d 614, 617 (Mont. 1990) (same); Mann Farms Inc. v. Traders State Bank, 801 P.2d 73, 76 (Mont. 1990) (same); Frank Lerner & Assocs. v. Merchants & Mechanics Fed. Savs. & Loan Ass'n, No. 90AP-1045, 1991 Ohio App. LEXIS 2938 (Ohio Ct. App. June 20, 1991) (consistent with enforcement test); Siegner v. Interstate Prod. Credit Ass'n, 820 P.2d 20 (Or. Ct. App. 1991) (focusing on discretion and purposes); Fuqua v. Springfield Prod. Credit Ass'n, No. 86-280-II (Tenn. Ct. App. Feb. 27, 1987) (LEXIS, States library, Tenn. file) (*K.M.C.* precludes "abuse of discretion"); American Bank v. Waco Airmotive, Inc., 818 S.W.2d 163, 171-73 (Tex. Ct. App. 1991) (considering circumstances surrounding acceleration); Clayton v. Crossroads Equip. Co., 655 P.2d 1125, 1128-29 (Utah 1982) (focusing on failure to provide reasons).

C. *Passive/"Effectiveness of Express Terms" Approach*

The final judicial approach to lender bad faith issues—the passive strategy—stands in contradistinction to the strategies discussed above in two principal respects. First, the passive strategy rejects any notion that good faith provides a vehicle for superimposing standards of contractual morality over or onto the parties' agreement. Second, and perhaps more importantly, the passive strategy adopts a non-interpretivist approach toward that agreement. In this regard, the passive strategy adopts an "effectiveness of express terms" approach to good faith in its refusal to examine more deeply the contextual basis of the parties' contract in an attempt to ascertain precisely the parties' true "agreement."

From a statutory perspective, judicial implementation of a subjective standard for the Code definition of good faith[271] reflects an underlying passive strategy toward good faith.[272] The recent Seventh Circuit case of *Kham & Nate's Shoes No. 2, Inc. v. First Bank*[273] best exemplifies the passive judicial strategy in lender liability litigation while levying the most vehement (if not hostile) criticism of *K.M.C.* to date. *Kham & Nate's* involved an appeal from a bankruptcy court order subordinating creditor First Bank of Whiting's secured claim to unsecured status because of the bank's bad faith conduct.[274] Whiting had extended credit to Kham & Nate's Shoes, a retail shoe store operation, since July 1981.[275] After Kham & Nate's filed a petition under Chapter 11 of the Bankruptcy Code, the bankruptcy court issued a January 1984 order approving a loan agreement between Whiting and Kham & Nate's that established in Kham & Nate's favor a $300,000 line of credit.[276] The agreement granted to Whiting a lien on most of the debtor's post-petition assets.[277] Because Whiting advanced funds under the post-petition line of credit to repay unsecured advances made prior to the debtor's Chapter 11 petition, Whiting thus effectively converted an unsecured claim into a secured claim.[278]

Approximately two weeks after entering into the post-petition loan agreement Whiting decided to terminate the line of credit, although it

271. *See supra* notes 48-49 and accompanying text. Similarly, albeit a point of speculation, judicial refusal to impose an obligation of good faith in certain transactions, *see supra* notes 55, 68 and accompanying text, may also be grounded in a passive proclivity toward good faith.

272. For an analysis of judicial passivity in other areas of contract law, see generally Schwartz, *supra* note 116.

273. 908 F.2d 1351 (7th Cir. 1990).

274. *See* Kham & Nate's Shoes No. 2, Inc. v. First Bank (*In re* Kham & Nate's Shoes No. 2, Inc.), 97 B.R. 420, 427 (Bankr. N.D. Ill. 1989). The Bankruptcy Code allows the bankruptcy court to subordinate a creditor's debt upon equitable grounds. *See* 11 U.S.C. § 510(c) (1988).

275. *See Kham & Nate's*, 908 F.2d at 1353.

276. *See Kham & Nate's*, 97 B.R. at 422.

277. *See* 11 U.S.C. § 364(c)(2) (1988) (providing for post-petition lien); *Kham & Nate's*, 97 B.R. at 422.

278. *See Kham & Nate's*, 97 B.R. at 422.

did not notify the debtor of the decision until two weeks after the decision was made.[279] The bankruptcy court order approving the agreement provided that the agreement could be terminated by either party on five day's written and telephonic notice.[280] Although Whiting gave timely written notice, no telephonic notice was given.[281] The bankruptcy court found that Whiting's abrupt termination of the line of credit constituted a breach of the obligation of good faith and fair dealing and subordinated Whiting's lien.[282]

The Seventh Circuit disagreed and reversed the bankruptcy court order subordinating Whiting's lien. In an opinion by Judge Easterbrook, the court articulated its view on contract interpretation:

> We do not doubt the force of the proverb that the letter killeth, while the spirit giveth life. Literal implementation of unadorned language may destroy the essence of the venture. Few people pass out of childhood without learning fables about genies, whose wickedly literal interpretation of their "masters' " wishes always leads to calamity. Yet knowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of "kindness" in performance, or of judicial oversight into whether a party had "good cause" to act as it did.[283]

"Demand," in other words, means "demand" and "[f]irms 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.' "[284] Good faith, according to the court, only precluded opportunistic behavior by one party in the face of a "gap" in the contract and could not block the effectiveness of express terms in the contract.[285] Since the loan agreement provided for termination upon notice, and there was no evidence of opportunism by Whiting, good faith in no way limited Whiting's right to terminate.[286] Turning to *K.M.C.*, the

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279. *See id.* at 422-23. The reasons for the decision, made by Whiting's loan committee, were that the bank did not like the nature of the credit with a Chapter 11 debtor or the location of Kham & Nate's stores, and that it did not think it should be doing business on the South Side of Chicago, since Whiting was located in Indiana. *See id.* at 425.

280. *See id.*

281. *See id.* at 423.

282. *See id.* at 427.

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

284. *Id.*

285. *See id.*; *see also supra* text accompanying notes 147-54 (law and economics approach to good faith). Judge Easterbrook's view that good faith acts as a gap-filler which does not block the effectiveness of express terms in the contract is delineated further in Continental Bank, N.A. v. Everett, 964 F.2d 701, 705 (7th Cir.), *cert. denied*, 113 S. Ct. 816 (1992).

286. *See Kham & Nate's*, 908 F.2d at 1357-58. The court found that Whiting's failure to give five days' telephonic notice was a "trivial" offense and an "inconsequential breach[]" not justifying subordination of Whiting's lien. *Id.* at 1359. Thus, although Whiting's right to insist upon the express terms of the agreement was absolute, Kham & Nate's was not.

court stated that to the extent that *K.M.C.* "holds that a bank must loan more money or give more advance notice of termination than its contract requires, we respectfully disagree . . . . It need not throw good money after bad, even if other persons would catch the lucre."[287]

As with the *K.M.C.* approach, the "effectiveness of express terms" approach of *Kham & Nate's* is inconsistent with many conceptualizations of the obligation of good faith. For example, evading the "spirit of the deal" may act to override the express terms of the contract under a contractual morality perspective on good faith.[288] Whiting's abrupt and immediate termination of the line of credit after having its unsecured claim transposed into a post-petition secured claim quite conceivably could fall into this category of bad faith behavior. Assuming that invocation of an express term constitutes a discretionary or enforcement event, the effectiveness of express terms approach places no constraint on that discretion, as some interpretivists would hold. Moreover, the approach fails to acknowledge as probative any alleged deeper interpretive gloss on the literal terms of the parties' agreement.[289] *Kham & Nate's* and *K.M.C.* thus squarely set the battle lines of good faith in lending arrangements.

Given those lines, the *Kham & Nate's* side appears to be winning. A substantial number of courts, consistent with *Kham & Nate's*, *Lambert Plumbing*,[290] the majority in *Lawrence*,[291] and the dissent in the appellate decision in *Grantham*[292] adopt the "effectiveness of express terms" approach under which good faith plays no moderating role in the performance or enforcement of express duties and rights.[293] Moreover, some

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287. *Id.* at 1358. Although *K.M.C.* did not technically hold "that a bank must loan more money . . . than its contract require[d]," *id.*, clearly Irving's only option in *K.M.C.* was to have lent the requested funds, because Irving had an obligation to provide reasonable notice and K.M.C. had drawn checks on the funds requested. *See supra* note 200.

288. *See* Summers, *"Good Faith" in General Contract Law*, *supra* note 24, at 234-35.

289. *See supra* text accompanying notes 91-115. *See generally* Patterson, *Easterbrook on Good Faith*, *supra* note 10 (criticizing this approach). *Kham & Nate's* contradicts the interpretivist view that good faith excludes acting for reasons forgone at the time of contracting. Not liking a bankrupt debtor or the location of the debtor, *see supra* note 279, clearly would be impermissible reasons for action under a credit agreement executed after the debtor filed for Chapter 11 protection with the lender's full knowledge of the debtor's location.

290. *See supra* text accompanying notes 232-36.

291. *See supra* text accompanying notes 237-41.

292. *See supra* text accompanying note 188.

293. *See In re* Nantahala Village, Inc., 976 F.2d 876, 881-82 (4th Cir. 1992); Travelers Ins. Co. v. Corporex Properties, Inc., 798 F. Supp. 423, 425 (E.D. Ky. 1992); Westinghouse Credit Corp. v. Hall, 144 B.R. 568, 576 (S.D. Ga. 1992); Bohm v. Commerce Union Bank, 794 F. Supp. 158, 163 (W.D. Pa. 1992); Temp-Way Corp. v. Continental Bank, 139 B.R. 299, 319-20 (E.D. Pa.), *aff'd*, 981 F.2d 1248 (3rd Cir. 1992); Van Arnem Co. v. Manufacturers Hanover Leasing Corp., 776 F. Supp. 1220, 1223 (E.D. Mich. 1991); Barclays Business Credit, Inc. v. Inter Urban Broadcasting, Inc., No. 90 Civ. 2272, 1991 U.S. Dist. LEXIS 17473, at *19-*20 (S.D.N.Y. Nov. 27, 1991); Southern Fed. Sav. & Loan Ass'n v. 21-26 E. 105th St. Assocs., 145 B.R. 375, 384 (S.D.N.Y. 1991), *aff'd*, 978 F.2d 706 (2d Cir. 1992); Government Street Lumber Co. v. AmSouth Bank, N.A., 553 So. 2d 68, 75 (Ala. 1989); Villegas v. Transamerica Fin. Servs., 708 P.2d 781, 784 (Ariz. Ct. App. 1985); Price v. Wells Fargo Bank, 261 Cal. Rptr. 735, 742 (Cal. Ct.

courts are openly and vocally reluctant to find that good faith restrains a lender who acts with no motive or bad motives[294] or encompasses some general legal obligation of fairness or decency toward the borrower.[295]

App. 1989); Layne v. Fort Carson Nat'l Bank, 655 P.2d 856, 857 (Colo. Ct. App. 1982); Riedel v. NCNB Nat'l Bank 591 So. 2d 1038, 1040-41 (Fla. Dist. Ct. App. 1991); Idaho First Nat'l Bank v. David Steed & Assocs., 825 P.2d 79, 83 (Idaho 1992); Idaho First Nat'l Bank v. Bliss Valley Foods, Inc., 824 P.2d 841, 862-64 (Idaho 1992); Wooden v. First Sec. Bank, N.A., 822 P.2d 995, 998 (Idaho 1991); Centerre Bank, N.A. v. Distributors, Inc., 705 S.W.2d 42, 48 (Mo. Ct. App. 1985); Simon v. New Hampshire Sav. Bank, 296 A.2d 913, 915 (N.H. 1972); Bank of N.M. v. Sholer, 695 P.2d 832, 833 (N.M. Ct. App. 1985); Capri Jewelry, Inc. v. Chayavi, 503 N.Y.S.2d 370, 373 (App. Div. 1986); First Fed. Sav. & Loan Ass'n v. Cheton & Rabe, 567 N.E.2d 298, 304 (Ohio Ct. App.), *dismissed*, 538 N.E.2d 124 (Ohio 1989); Creeger Brick & Bldg. Supply Inc. v. Mid-State Bank & Trust Co., 560 A.2d 151, 154 (Pa. Super. Ct. 1989); Bank of Crockett v. Cullipher, 752 S.W.2d 84, 91-92 (Tenn. Ct. App. 1988); Affiliated Capital Corp. v. Commercial Fed. Bank, 834 S.W.2d 521, 527-28 (Tex. Ct. App. 1992); State Nat'l Bank v. Academia, Inc., 802 S.W.2d 282, 294 (Tex. Ct. App. 1990); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 518 P.2d 734, 738 n.5 (Wash. Ct. App.), *cert. denied*, 419 U.S. 967 (1974); Valley Bank-Menomonie v. Computerized Business Servs., 485 N.W.2d 840 (table case), No. 91-2245, 1992 WL 126790, at *3 (Wis. Ct. App. March 10, 1992) (per curiam).

294. *See, e.g.*, Quail Ridge Assocs. v. Chemical Bank, 586 N.Y.S.2d 155, 157 (App. Div. 1992) ("[W]e do not view [the bank's] motivation . . . as relevant."); United States Nat'l Bank v. Boge, 814 P.2d 1082, 1092 (Or. 1991) (having bad motive not breach of obligation of good faith); *Affiliated Capital Corp.*, 834 S.W.2d at 527-28 (no reasons required in exercising absolute right). *But see* Martin Specialty Vehicles, Inc. v. Bank of Boston (*In re* Martin Specialty Vehicles, Inc.), 87 B.R. 752, 766-67 (Bankr. D. Mass. 1988) (assessing bank's ulterior motives), *rev'd on other grounds*, 97 B.R. 721 (D. Mass 1989); Alaska Statebank v. Fairco, 674 P.2d 288, 297 (Alaska 1983) (focusing on bank "specifically acting for the purpose of setting an example and putting [borrowers] under duress to coerce them to agree to terms to which the plaintiffs were not obligated to agree"); Quest v. Barnett Bank, 397 So. 2d 1020, 1022 (Fla. Dist. Ct. App. 1981) ("ulterior motive" relevant).

295. *See, e.g.*, Fasolino Foods Co. v. Banca Nazionale del Lavoro, 961 F.2d 1052, 1057 (2d Cir. 1992) (no duty of altruism); Jensen v. State Bank, 518 F.2d 1, 6 (8th Cir. 1975) (lower court's finding that "heavy-handed treatment" not bad faith even if it "is cause for dismay" was not clearly erroneous); Bank of New York v. Sasson, 786 F. Supp. 349, 354 (S.D.N.Y. 1992) (bank not required to act against its own economic interests); Resolution Trust Corp. v. Lesal Assocs., No. 91 Civ. 2025, 1992 U.S. Dist. LEXIS 6620, at *17 (S.D.N.Y. May 7, 1992) (lender not required to act against economic interest); Van Arnem Co. v. Manufacturers Hanover Leasing Corp., 776 F. Supp. 1220, 1223 (E.D. Mich. 1991) ("[A] lender remains entitled to advance its own interests by enforcement of contract terms, and is not required to forego enforcement of contract terms to put the borrower's interests ahead of its own."); Southern Fed. Sav. & Loan Ass'n v. 21-26 E. 105th St. Assocs., No. 90 Civ. 6959, 1991 U.S. Dist. LEXIS 16649, at *22-*23 (S.D.N.Y. Nov. 18, 1991) ("The fact that there was a limit to the Bank's generosity cannot be construed as bad faith."); Savers Fed. Sav. & Loan Ass'n v. Home Fed. Sav. & Loan Ass'n, 721 F. Supp. 940, 946 (W.D. Tenn. 1989) ("Courts . . . must distinguish between moral obligations between the parties and legal obligations that are dispositive of the duties one party owes the other.") (citation omitted); *Villegas*, 708 P.2d at 784 ("Courts have no right to remake contracts to comport with some unspecified notion of fairness nor to refuse enforcement on that ground."); *Price*, 261 Cal. Rptr. at 742 (good faith "does not impose an affirmative duty of moderation in the enforcement of legal rights" or preclude lender from taking "hard line" in renegotiations); Wagner v. Benson, 161 Cal. Rptr. 516, 521 (Cal. Ct. App. 1980) (bank does not have to disregard own interests); Hais v. Smith, 547 A.2d 986, 987 (D.C. 1988) (distinguishing good faith from "good

The opinion of the Iowa Supreme Court in *Tolander v. Farmers National Bank*[296] best embodies this attitude of restraint. In *Tolander*, the bank accelerated upon deeming itself insecure and used a $16,992.40 check delivered to the bank, but addressed to Tolander, to offset the amounts due.[297] The debtor, a financially strapped farmer, alleged that the bank acted in bad faith in accelerating and in offsetting a check addressed solely to the debtor.[298] A former Iowa superintendent of banking testified on behalf of Tolander, stating that the bank's behavior was "a malicious act," and that he was "appalled" by the bank's actions.[299] Nonetheless, the Iowa Supreme Court found that the bank had acted in good faith.[300] Although it "strongly condemn[ed] aspects of the bank's conduct"[301] and "[a]lthough the bank obviously collects no plaudits [,] it remains that Tolander has not shown that the bank acquired anything to which it was not entitled. Notwithstanding its insensitivity to Tolander the bank was fully justified in considering itself insecure."[302]

In sum, the passive judicial strategy toward good faith in lender liability cases is beginning to achieve substantial acceptance in the courts. True, a predisposition toward passivity must be viewed in the shadow of the reality that, when faced with a case suggesting a clear lack of bad faith on the lender's part, the case often efficiently can be disposed of under the guise of "effectiveness of express terms."[303] Yet the sheer volume of cases adopting the approach and, more importantly, the existence of cases in which vigorous debate over the passive strategy occurs between majority and dissent[304] block this easy exit. The emergence of the passive strategy thus bears significantly upon the debate between the ap-

judgment or a kind heart"); Tolander v. Farmers Nat'l Bank, 452 N.W.2d 422, 426 (Iowa 1990) ("insensitivity" not bad faith); Parker v. Columbia Bank, 604 A.2d 521, 531 (Md. Ct. Spec. App. 1992) (no good faith obligation of affirmative action); Shiplet v. First Sec. Bank, Inc., 762 P.2d 242, 246 (Mont. 1988) (not being "always strictly forthright" not bad faith); *Cheton & Rabe*, 567 N.E.2d at 304 (merely being callous not bad faith); *Creeger Brick & Bldg. Supply*, 560 A.2d at 154 (failing to assist not bad faith); Garrett v. BankWest, Inc., 459 N.W.2d 833, 847 (S.D. 1990) (bank not required to "disregard its own interest"); *Academia*, 802 S.W.2d at 294 ("Vague notions of fairness limiting [express] rights based on the overall relationship between the parties would impermissibly extend the covenant [of good faith and fair dealing] beyond mere definition or modification of the terms of the . . . agreement.").

296. 452 N.W.2d 422 (Iowa 1990).

297. *See id.* at 424.

298. *See id.* at 425.

299. *Id.*

300. *See id.* at 426.

301. *Id.* at 422.

302. *Id.* at 426; *see also* Jensen v. State Bank, 518 F.2d 1, 6 (8th Cir. 1975) (although demand without notice "cause for dismay," finding of good faith not clearly erroneous).

303. *See* Andersen, *supra* note 24, at 329-30. A notable exception is the *SunAmp Systems* case, discussed *supra* text accompanying notes 253-67, which expressly refused to adopt the effectiveness of express terms approach even though that would have handily disposed of the issue.

304. *See, e.g.*, *supra* text accompanying notes 178-88 (*Grantham* case); *supra* text accompanying notes 237-42 (*Lawrence* case).

propriate conceptualization of the obligation of good faith. Irrespective of any perceived social repugnancy of a lender's behavior, a number of courts are unwilling to imbue the obligation of good faith with the shimmer of "contractual morality," undermining the strength of any assertion that that conceptualization reigns in the courts. Moreover, the effectiveness of express terms approach hints at a reluctance of a substantial number of courts to assume an interpretive role in determining a lender's good faith *vel non*.

Finally, and perhaps most importantly, the timing of the emergence of the passive strategy cannot be ignored. The number of courts employing the passive strategy appears, although maybe coincidentally, to be increasing since "lender liability" became the buzzword of the 1980s. Related thereto, the number of decisions in favor of the borrower has decreased significantly since 1990.[305] While this shift, both in the theoretical conceptualization of the obligation of good faith and in the statistical results of good faith lending cases, may possibly be attributable to other factors,[306] the shift leads to some speculation. That the shift in judicial philosophy may be generated out of the twin concerns of a liability explosion[307] and an institutionally burdensome litigation explosion[308] cannot be ignored. Prior to addressing the propriety of the passive strategy, however, a brief excursus needs to be made into the doctrinal implications of the interventionist, interpretivist, relational, and passive strategies.

III. DOCTRINAL IMPLICATIONS

> "Whether the decision of the Washington Court of Appeals adversely impacts the public interest because it diminishes freedom of contract, is inconsistent with the objective theory of contract law and threatens commercial certainty for borrowers, lenders and other con-

305. *See infra* app. A.

306. For example, borrowers may be bringing more claims that are either spurious or that seek to expand the obligation far beyond the point at which a court may feel safe to go under existing precedent. Moreover, lenders may be settling more claims because precedent clearly defines bad faith behavior, thus altering the ratio of decisions.

307. To that extent, the liability fear is unjustified. *See infra* app. A; *see also supra* note 12 and accompanying text (rejecting idea of liability explosion).

308. The litigation fear may perhaps be justified. *See infra* app. A (number of cases by year); *see also* William E. Nelson, *Contract Litigation and the Elite Bar in New York City, 1960-1980*, 39 Emory L.J. 413, 415-17 (1990) (discussing possible causes of increase in federal court filings through 1986). The current economic climate in particular may be one alternative explanation for the growth in litigation. *See supra* note 8 and accompanying text. In addition, the growth in the number of cases accessible to practitioners also may be partially attributable to the increased availability of cases on computer databases that until recently were unreported. Although a recent rise in the number of federal cases, *see infra* app. B., coupled with the fact that federal courts decided many of the well-known pro-borrower cases, *see supra* note 6 and accompanying text, could be evidence of forum shopping, federal courts do not seem significantly more predisposed toward one party than state courts, *see infra* app. C.

tracting parties."[309]

"You used to be good people and now you are second class citizens."[310]

"This action is based on an alleged breach of a written financing agreement entered into between two business corporations represented by independent counsel under circumstances where neither party was under any kind of duress."[311]

"If 'you destroy [a wholesale grocery company's] credit, you destroy the company.' "[312]

The divergent theoretical conceptualizations of the obligation of good faith and the numerous judicial strategies delineated in the previous sections illustrate why disputes such as the one in *Micronesian Yachts*, with which this Article began,[313] are incapable at this time of extra-judicial settlement. The law in the area of contractual good faith has yet to provide any consistent positive rules of conduct upon which lenders may rely or which borrowers legitimately may claim were contravened by their lender. A case study of the litigation in *Badgett v. Security State Bank*,[314] exemplifies the indeterminacy which both lenders and borrowers currently face in the name of "good faith."

At issue in *Badgett* was a loan from Security State Bank to Raymond and Audrey Badgett, who were in the dairy business. In 1981 they borrowed $476,000 from Security, of which $336,000 was a term loan.[315] In 1984, the Badgetts decided to quit the dairy business.[316] They asked that Security assist in restructuring the loan in order to facilitate liquidation of their assets and participation in a government termination program.[317] After negotiations, Security agreed to modify the loan agreement.[318] In

309. Petition for Review at 1, Badgett v. Security State Bank, 807 P.2d 356 (Wash. 1991) (No. 11965-0-II) (bank's statement of "Issues Presented for Review").

310. Brief for Appellants at 12, Badgett v. Security State Bank, 807 P.2d 356 (Wash. 1991) (No. 54834-0) (from affidavit of borrower quoting bank officer's statement to borrower).

311. Brief for Defendant-Appellant at 13, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (No. 83-5563) (bank's statement of "[t]he Essence of this Case").

312. Brief for Plaintiff-Appellee at 2, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (No. 83-5563) (quoting statement of bank vice president).

313. *See supra* text accompanying notes 14-23.

314. 807 P.2d 356 (Wash. 1991) (en banc).

315. *See id.* at 358. In addition to the term loan, the remaining $140,000 was for operating expenses. *See id.* The Court of Appeals remarked that the loan was used to pay off the Badgett's loan from their previous bank. *See* Badgett v. Security State Bank, 786 P.2d 302, 303 (Wash. Ct. App. 1990), *rev'd*, 807 P.2d 356 (Wash. 1991). The term loan facility provided for a one year call and maturity date, but was amortized over five to ten years. *See Badgett*, 807 P.2d at 358. Badgett's first loan officer at Security stated that this structure was common in agriculture loans, because it allowed the loans to be reexamined each year to assess the bank's "collateral position, update financial statements, and to make projections for the upcoming year." *Id.*

316. *See Badgett*, 807 P.2d at 358.

317. *See id.*

318. *See id.*

1985, the Badgetts decided to re-enter the dairy business.[319] Security indicated that it would require a new loan agreement.[320] In September 1985, after negotiations, the parties entered into a new agreement providing for a loan of $1,050,000. The debt was secured by the "livestock, equipment, feed inventories, and junior liens on all real estate."[321]

In early 1986, several months after entering into the new loan agreement, the Badgetts again decided to quit the dairy business, and again considered participating in a federal termination program under which participants bid to keep their facilities out of production for five years.[322] Based on their proposed bid, the Badgetts expected to receive $1,600,000 for their participation in the program if that bid was accepted.[323] After deducting costs for other loans and expenses incurred in maintaining the dairy facilities until they could be sold at the end of the program, the Badgetts could not pay off the entire debt owed to Security with the proceeds from the program.[324] Accordingly, the Badgetts met with their loan officer at Security, Joe Cooke, and initially proposed that Security accept $1,300,000 in satisfaction of the $1,500,000 debt owed to Security and forgive the remaining $200,000.[325]

Cooke did not accept this proposal. Discussions ensued as to a possible auction sale of the business' cattle and the possibility of deferring payment on the $200,000 after a release by Security of its lien on the existing collateral in exchange for a lien on certain unspecified real estate.[326] No agreement was reached at the meeting and the parties understood that Cooke needed to meet with Security's loan committee.[327] As in *K.M.C.*, there was some evidence of hostility in the relationship between Cooke and the Badgetts.[328] Cooke presented only the Badgett's proposal for a twenty percent forgiveness of the loan to the loan committee and allegedly characterized it as a "take-it-or-leave-it" non-negotiable proposition by the Badgetts, which the loan committee opted to leave rather than take.[329]

The Badgetts subsequently submitted a higher bid to the federal termination program in order to receive proceeds sufficient to pay off the Se-

319. *See id.*
320. *See id.*
321. *Id.*
322. *See id.*
323. *See id.*
324. *See* Badgett v. Security State Bank, 786 P.2d 302, 304 (Wash. Ct. App. 1990), *rev'd*, 807 P.2d 356 (Wash. 1991). The Badgett's debt to Security was over $1,500,000, comprised of the $1,050,000 loan in 1985 and the restructured $476,000 loan in 1981. *See Badgett*, 807 P.2d at 358.
325. *See Badgett*, 807 P.2d at 358.
326. *See id.*
327. *See id.*
328. *See* Badgett v. Security State Bank, 786 P.2d 302, 306 (Wash. Ct. App. 1990), *rev'd*, 807 P.2d 356 (Wash. 1991).
329. *See Badgett*, 807 P.2d at 358-59.

curity debt, but the bid was rejected.[330] After stopping payments on the loan in April 1986, the Badgetts and Security entered into an agreement under which certain collateral was auctioned for $374,447.85.[331] In September 1986, the Badgetts filed a complaint against Security, alleging that Security's failure to cooperate in the Badgett's proposed participation in the federal termination plan constituted a breach of the implied covenant of good faith and fair dealing.[332] Although they acknowledged that there was no express term in the loan agreement requiring Security to consider their proposal and that Security had no obligation to modify the agreement, the Badgetts contended that Security "was obligated by the duty of good faith implicit in every contract to affirmatively cooperate with them in their efforts to participate in the [federal termination program] and restructure their loan."[333]

After the trial court granted summary judgment for Security, the court of appeals reversed, finding that there was a material issue of fact as to Security's duty to the Badgetts.[334] The appellate court noted that while the obligation of good faith[335] would not require Security to accept a material change in the terms of the loan agreement, Security's course of dealing arguably created a good faith obligation to "consider" the Badgetts' proposal.[336] The Washington Supreme Court, en banc, reversed the court of appeals and reinstated the trial court's dismissal of

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330. *See id.*

331. *See id.* at 359.

332. *See id.*

333. *Id.* at 359-60.

334. *See* Badgett v. Security State Bank, 786 P.2d 302, 303 (Wash. Ct. App. 1990), *rev'd*, 807 P.2d 356 (Wash. 1991).

335. Because the loan was secured in part by certain personal property, and therefore within the scope of Article 9 of the Code, the appellate court based its analysis of good faith on U.C.C. § 1-203. *See id.* at 304; *see also supra* notes 45-60 and accompanying text (discussion of Code definition of good faith). However, the application of § 1-203 was problematic since the loan was also partially secured by real property, a lien not governed by the Code. The appellate court nonetheless applied the Code, if only by analogy. *See Badgett*, 786 P.2d at 304 ("[B]ecause the UCC reflects many principles of contract law which are also applicable to the making and performance of agreements governed by other laws, the Code has often been used as an analogy to situations that are not explicitly covered by its provisions."). The concurring opinion on appeal questioned whether the Code applied, but determined that the result reached by the majority would be the same under Washington common law. *See id.* at 306 (Reed, J., concurring).

336. *See Badgett*, 786 P.2d at 305-06. As evidence supporting the course of dealing that gave rise to this obligation, the appellate court stated that there was evidence that the Bank anticipated changes in its clients' situation and routinely restructured agricultural loans to meet the requirements of these changing circumstances. There was evidence that this had been the pattern of the bank's relationship with the Badgetts for six years, even resulting in the Bank's agreement to a similar liquidation proposal in 1984. "The final loan agreement, itself, indicated the possibility of amendments." *Id.* at 305. The 1985 agreement provided that, although additional advances or increased commitments were not contemplated, if such advances or commitments were made while the agreement was in effect such advances or commitments were subject to the terms and conditions of the agreement as amended. *See id.* at 305 n.3.

the Badgetts' claim.[337]

According to the supreme court, the duty of good faith was not as broad as either the Badgetts or the court of appeals suggested. Although the duty obligated the parties "to cooperate with each other so that each may obtain the full benefit of performance," the duty only arose in connection with terms agreed to by the parties and did not " 'inject substantive terms into the parties' contract.' "[338] Unlike the court of appeals, the supreme court refused to consider any evidence of a prior course of dealing, because the express terms of the agreement would "prevail over any inference based on a course of dealing."[339] Further, the court continued that although Security could choose to renegotiate the loan agreement with the Badgetts, it had no implied good faith duty to do so apart from the terms of the contract.[340] The court noted the open-ended effect that a duty to consider proposals might have. Such a duty, in the court's view, might lead to a duty to negotiate, increasing the transactions costs for the parties.[341] Additionally, a duty to negotiate could result in an action for failure to negotiate in good faith.[342] If accepted, the Badgetts' claim of affirmative cooperation, would, in the court's view, hinder rather than facilitate the certainty of transactions.

The arguments made before the *Badgett* court severely undermine any

337. *See* Badgett v. Security State Bank, 807 P.2d 356, 357-58 (Wash. 1991).

338. *Id.* at 360. (quoting Barrett v. Weyerhaeuser Co. Severance Pay Plan, 700 P.2d 338 (Wash. Ct. App. 1985)).

339. *Id.* at 362 n.4. "As a matter of law, there cannot be a breach of the duty of good faith when a party simply stands on its rights to require performance of a contract according to its terms." *Id.* at 360; *see also* Seattle-First Nat'l Bank v. Westwood Lumber, Inc., 829 P.2d 1152, 1158 (Wash. Ct. App. 1992) (discussing and applying *Badgett* approach to course of dealing).

340. *See Badgett*, 807 P.2d at 361. The court refused to decide whether a good faith duty to renegotiate or "consider proposals" arose in connection with express contract terms. *See id.* at 362. In an earlier non-lender case the Washington Supreme Court had indicated that the implied duty of good faith and the derivative duty of cooperation may impose an implicit obligation on a party to consider proposals for modification. *See* Metropolitan Park Dist. v. Griffith, 723 P.2d 1093 (Wash. 1986) (en banc).

Metropolitan Park involved a concession agreement entered into by a restaurant owner and the city of Tacoma, Washington granting to the owner an exclusive right to operate concession stands in municipal parks. *See id.* at 1095. The owner subsequently made proposals to the Park Board to permit consumption of alcohol and to allow a sit-down restaurant in a city park. *See id.* at 1096. The court held that the Park Board may have had a good faith duty to consider the proposals because the parties contemplated some sort of development in the concessions at the time the agreement was executed. *See id.* at 1100. However, the supreme court's decision in *Badgett* clearly calls into question the interpretation of good faith set forth in *Metropolitan Park*.

341. *See Badgett*, 807 P.2d at 361 n.3.

342. *See id. Compare* Speidel, *Price Adjustments*, *supra* note 117, at 404-10 (advocating legal duty to negotiate price adjustments in long-term contracts with action for bad faith refusal to adjust) *with* Clayton P. Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 Minn. L. Rev. 521, 524 (1985) (no duty to adjust). *Badgett* follows the generally accepted view that a lender has no legal obligation to renegotiate or otherwise work-out the problem loan. *See supra* note 251 and accompanying text.

assertion that the result in the case was brought about by some vague, intuitive judicial process rather than by conscious deliberation and choice. Rather, the briefs reflect a deeper theoretical disagreement between the parties on the appropriate legal scope of the obligation of good faith. The court's opinion relied on arguments advanced by the Washington Bankers Association and the American Bankers Association.[343] In an amicus brief, those institutions urged upon the court an efficiency-based conceptualization of good faith:

> The effect of frustrating expectation interests is to raise transaction costs. The cost of making a contract is increased by anticipated expenses resulting from greater likelihood of litigation over alleged breach of the duty to bargain. To lessen the risks of litigation, business firms will take costly preventive measures, not only to ensure compliance with their duty to bargain, but also to build a record enabling them to prove in court that they have complied. The greatest cost of a duty to bargain is that of uncertainty. In loan contracts, for example, the prospects of timely repayment will be less certain. Every loan becomes more risky. (Query if now is the time to adopt rules that increase risks to financial institutions.)[344]

Counsel for the Badgetts responded to the bank associations' arguments with a highly relational view of good faith. Counsel argued:

> 4. The Associations' comments on economic policy and economic efficiency would turn the clock back to 1861 (the publication date of Ancient Law,[345] cited by the Associations). Their view that "the common law is best understood as a system for maximizing the wealth of society," is at best a narrow vision of society's larger goals.
> 5. The Associations' discussion of "reasonable expectations" is also narrow. It fails to consider the fundamental maxim that "the law fulfills reasonable expectations." The Badgetts' reasonable expectations were that their loan officer would keep his promise.
> 6. Finally, the Associations' view that the [appellate court] opinion is "bad jurisprudence" proceeds from a faulty premise. The Associations charge the Court of Appeals with having created "an overriding implied obligation" out of thin air. On the contrary, the duty of good faith is well established. It is not created out of thin air, but is a term of every contract. As such, it does not create a new contractual obligation . . . .
>
> On the *Badgett* facts, it would be "bad jurisprudence" to reject the ancient concept of good faith. Good jurisprudence demands a remedy.[346]

343. *See Badgett*, 807 P.2d at 361 n.3.

344. Brief for Amici Curiae Washington Bankers Association and American Bankers Association at 15-16, Badgett v. Security State Bank, 807 P.2d 356 (Wash. 1991) (No. 56993-2) (citation omitted).

345. Sir Henry S. Maine, Ancient Law (1861).

346. Answer of Appellants to Brief for Amici Curiae at 11-13, Badgett v. Security State Bank, 807 P.2d 356 (Wash. 1991) (No. 56993-2) (footnote omitted). The relational

Given these arguments, the friction underlying the decisions of the Washington Court of Appeals and the Washington Supreme Court in *Badgett* takes on a new perspective. The court of appeals decision is consistent with the relational/deeply interpretive approach taken in *K.M.C.* The parties' long, interactive relationship and a tense situation between the bank officer and the borrower necessitated an expansive interpretation of good faith and fair dealing. Preserving the relationship and fairness toward the borrower outweighed enforcing the literal terms of the original agreement—status conquered contract. In contrast, the supreme court decision sets forth the passive approach advanced by the banking associations. In limiting the obligation of good faith to the terms of agreement, the court viewed the loan agreement as evidencing a discrete exchange existing independently from all other dealings between the contractual parties and adequately expressing the intentions of the parties throughout the duration of the relationship.

Yet, the arguments before the court in *Badgett* also explain why cases such as *Micronesian Yachts* must inevitably end up in court. Every dispute between lender and borrower is necessarily a lawsuit. Transactors cannot, as provided by the time-honored trope, "bargain in the shadow of the law."[347] Good faith may require notice prior to demand,[348] or it may not,[349] or it may in certain circumstances.[350] A failure by the lender to renegotiate the terms of a loan may lead to claims of bad faith[351] but so may the lender's attempt to renegotiate.[352] A lender may have a good

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underpinnings of this argument become plain when read in connection with Charles Fried's depiction of relational contract:

> [Under a relational] view, contractual relations establish ties of community between parties, and such ties generate their own moral imperatives, quite apart from the limited obligations the parties may have assumed in creating the relation. This view is (and is intended to be) a deliberate rejection and reversal of Henry Sumner Maine's classic thesis in *Ancient Law* that modern law has moved away from status relations to relations founded on promise, that is, relations defined by the will of the parties.

Charles Fried, Contract as Promise 76 (1981); *see also* Matthew P. Bergman, *Status, Contract, and History: A Dialectical View*, 13 Cardozo L. Rev. 171, 180 (1991) ("Macneil's insight suggests that the law . . . has returned to status"); Linzer, *supra* note 141, at 143 (move away from consent "reflects a move away from the Victorian idealization of bargained contract (and with it consent and agreement) as the centerpiece of private legal relations, expressed most famously in Sir Henry Maine's axiom that 'the movement of the progressive societies has hitherto been a movement from Status to Contract' "). *But see* Macneil, *Values in Contract*, *supra* note 123, at 390-91 n.162 (rejecting Fried's characterization).

347. For an attempt to provide a methodology for parties to contract around good faith decisions, see Note, *"Contracting Around" the Good Faith Covenant to Avoid Lender Liability*, 1991 Colum. Bus. L. Rev. 359.

348. *See supra* note 226.

349. *See supra* notes 219, 230.

350. *See* sources cited *supra* note 250.

351. *See id.*

352. *See id.*; *see also supra* text accompanying notes 16-20 (*Micronesian Yachts* restructuring), 317-29 (*Badgett* restructuring).

faith obligation to allow the borrower to seek alternative financing,[353] or it may not.[354] If the lender allows the borrower to seek alternative financing, however, as the lender did in *Micronesian Yachts*, it may expose itself to claims of bad faith.[355] The law in the area of lender good faith is simply too grounded in inherently irreconcilable theoretical conceptualizations of the obligation to provide any consistent rules to bargain around. As *Badgett* indicates, the conflict in the courts is one of deliberate choice rather than of accident, fortuity, or inattention. This Article now turns to the preferable conceptualization—the "effectiveness of express terms" approach.

IV. "Effectiveness of Express Terms": The Preferable Approach

It is perhaps disheartening that years of lender liability litigation have yet to resolve debates over the obligation of good faith such as the one that occurred in *Badgett*. Perhaps the doctrine of good faith and the competing conceptualizations which drive it are simply not amenable to any one articulation satisfactory to all. Regardless of the theoretical perspective held, the doctrine of good faith has failed when applied to the area of lending relationships. Disparate views over the proper interpretation and application of the obligation of good faith in lending has generated a corpus of case law that instills uncertainty rather than predictability. Transactors desiring to conform their actions to the dictates of the law have benefited little from the, at best, nominal positive rules of conduct that such a period of extensive and costly litigation has generated.

The lender liability experience, however, discredits concerns that the obligation of good faith licenses judges to superimpose extracontractual obligations upon the parties.[356] The interventionist and relational approaches appear the least employed. Generally, courts have been sensitive to the parties' contract and agreement. Moreover, the failure of the cases to generate the body of "good faith law" necessary to provide certainty and consistency exemplifies the limitations of those approaches in providing workable standards for the obligation of good faith. The plane of debate in the courts, rather, lies in differences over the amount of sensitivity which courts should have to the parties' agreement. Hence, the choice devolves to one between the interpretivist and passive approaches to good faith. In the lending context, the "effectiveness of express terms" approach, as set out in *Kham & Nate's*, is the preferable methodology to use in enforcing the parties' agreement.

In addition to being supported by strong precedent,[357] the "effective-

353. *See* sources cited *supra* note 250.
354. *See supra* note 251 and accompanying text.
355. *See supra* note 22.
356. *See supra* note 27.
357. *See supra* notes 293-95 and accompanying text. As discussed earlier, courts' con-

ness of express terms" approach is further strengthened by persuasive policy considerations. First, as pointed out in detail in the *Grantham* dissent[358] the approach enforces the basic principle of contract interpretation that express terms control over implied terms.[359] When a lending agreement asserts that amounts due thereunder are payable upon demand or upon acceleration by the lender upon a specified event of default, or that a lender may discontinue financing as provided by the agreement, any interpretation otherwise necessarily contravenes this principle. To the extent that the interventionist, interpretivist, or relational approaches impose requirements of fair play in demanding payment,[360] of restraint in accelerating under the agreement,[361] or of notice prior to discontinuation of financing,[362] those requirements inexorably lead to the conclusion that demand does not mean demand, acceleration does not mean acceleration, or a right to discontinue does not mean a right to discontinue. Just because the borrower blindly hoped the lender would not exercise those rights does not create an interpretive event.

Second, the interpretive methods mandate judicial intervention in, and review of, every lender decision in order to determine the broadly construed "agreement" of the parties. Regardless of whether that effort could lead to determinable results, it conflicts with other principles bearing upon the enforcement of contracts beyond those of promoting autonomy or enforcing expectations in the particular case before the court. The interpretivist approaches increase the cost of contracting through invocation of the judicial dispute resolution mechanism in every case. Further, the interpretivist approaches rely upon transaction-specific facts which generate little information upon which transactors may rely in structuring their own affairs, and, by interjecting the state into every dispute, threaten to alter the social relationship between lender and borrower.[363]

scious rejection of other theories, *see supra* text accompanying notes 303-04, 343-46, renders unpersuasive any assertion that this precedent should be given less weight on the grounds that the "effectiveness of express terms" approach was not deliberately adopted.

358. *See supra* text accompanying note 188.

359. *See, e.g.*, U.C.C. § 1-205(4) (1990) (express terms control over course of dealing and usage of trade). Advocation of the effectiveness of express terms approach should not be read as a wholesale rejection of the interpretive value of course of dealing and usage of trade. Rather, the approach takes a narrower reading (a reading borne out in numerous courts) that in the context of claims brought by borrowers, which generally involve the rights of the lender to collect its debt as provided in the contract, anything other than enforcement of express terms would contravene § 1-205(4). One may attempt to place those contract provisions, which are not boilerplate but rather the essential terms of a loan, in as deep a commercial context as one desires and, nonetheless, the express terms should control. The interpretive approaches to good faith merely allow judicial error and jury sympathies to override this obvious conclusion.

360. *See supra* text accompanying notes 188-89.

361. *See supra* note 104 and text accompanying notes 248-51.

362. *See supra* note 226 and accompanying text.

363. *See, e.g.*, Scott, *supra* note 116, at 2054 (discussing effects of legal intervention on social norms).

For example, current interpretivist approaches fail to accommodate the proposition that parties may have intended to leave their dispute to non-legal enforcement.[364] Reliance upon reputational failures to mandate such broad, sweeping judicial control over contracting behavior rests on two interrelated factual issues: (1) whether the risk of dishonorable behavior by lenders is palpable, and (2) if so, whether the magnitude of that risk, given reputational constraints, justifies imposition of an immensely costly mechanism of judicial intervention to police such behavior in every instance. Surely the time-honored convention of "banker-bashing" that perceives lenders as arbitrary and interested only in advancing their economic self-interest at any cost cannot support advocating judicial policing of such behavior.[365] One must assume bankers to be responsible actors even in the face of such perceptions.[366] Nonetheless, some lender liability cases do indicate some socially undesirable behavior on the part of lenders.[367] Absent evidence that market constraints are failing to police such behavior, or evidence that borrowers have inadequate or unaffordable access to information about the integrity of their potential lenders,[368] however, it does not follow that a broad interpretive standard for good faith is necessary. Thus, any reputational justification for an interpretive standard for good faith is speculative.

Finally, the interpretive approaches place upon the lender insurmountable and costly burdens in attempting to draft an agreement that adequately will convey to the borrower the "meaning" of that agreement. For example, consider the following loan covenant: "The Borrower shall not sell any collateral without the Lender's advance written consent." Is it less costly from a drafting perspective for the lender to hypothesize and articulate the alternative opportunities of which it might wish to take advantage than to require the borrower to articulate under which cir-

364. For a discussion of extra-legal enforcement, see generally Charny, *supra* note 10.

365. Bankers even from ancient times have been the target of abuse. Consider the following passage from the Minoponeros ("The Hater of Rogues"), a lost comedy of Antiphanes, on the relative disagreeability of certain classes in ancient Athenian society:

> A. And are not the Scythians wise indeed? For as soon as their children are born, they give them the milk of mares and cows to drink.
> B. And, by Zeus, they don't bring in to look after them malignant nurses or, later on, pedagogues; there could be no greater pests.
> A. Excepting midwives, by Zeus, because they are in a class by themselves.
> B. And excepting the begging priests of Cybele; for they are by far the foulest breed of all.
> A. Unless, by Zeus, you want to call fishmongers the foulest.
> B. But only after bankers (trapezitai): there is no more pestilential tribe than theirs.

Paul Millett, Lending and Borrowing in Ancient Athens 197 (1991).

366. For a thoughtful and persuasive defense of bankers' individual recognition of "moral duty, social responsibility, and the commercial value of an untarnished public image," see Ebke & Griffin, *Conceptual Framework*, *supra* note 10, at 807-08.

367. *See, e.g.*, cases cited *supra* note 96; *see also* Fischel, *supra* note 7, at 138-39 (discussing failures of reputational constraints).

368. *See, e.g.*, Charny, *supra* note 10, at 459.

cumstances it might wish to sell collateral over which it has control? That the lender is in any better position is not obvious. Similarly, consider the following acceleration provision:

> The sale of any collateral by the Borrower shall constitute an event of default hereunder upon the occurrence of which event of default the Lender shall have the right, without notice to the Borrower, to declare all or any portion of the outstanding principal amounts hereunder to be due and payable, whereupon such amounts so declared due and payable shall be and become immediately due and payable.

Again, it does not evidently follow that the costs incurred by the lender in hypothesizing and articulating the possibility of an uncertain future in which invocation of the acceleration clause might advance any ethereal purposes for which the term was included in the agreement outweigh those incurred by the borrower in formulating its future plans to dispose of, or business requirements which might necessitate disposal of, collateral within its control and to articulate those plans or requirements to the lender. Simply put, the borrower most often is in the best position to have put the issue on the table.

The interpretive approaches raise two other minor issues bearing upon the costs of contracting and the negotiating process. First, an interpretive approach places the lender in a unique bargaining position: the proposed interpretive standards peculiarly require the lender ex ante affirmatively to bring to the bargaining table all the reasons for which—or circumstances under which—it may wish to back out or all of its perceived purposes for the agreement. The borrower need only evaluate such reasons or purposes and is not affirmatively required to articulate the circumstances under which it is willing to repay the loan which the lender is interested in making. The lender must adopt a negotiating strategy of affirmatively protecting its right to back out of the loan—a strategy certain to alienate borrowers and hardly facilitative of a nonconfrontational bargaining process.

Related thereto, an interpretive approach impedes one of the functions of covenants in loan contract negotiation. Terms introduced into negotiation are ordinarily understood by most transactors to perform an information-forcing function in the contract negotiation stage. For example, the borrower, upon seeing a default term such as the one set forth above might communicate valuable information to the lender about the borrower's business (for example, that the borrower intends to sell a subsidiary). This exchange performs a "due diligence" function in evaluating the borrower and in structuring a credit facility that, to the best extent possible, most meets the borrower's needs. To the extent that legal rules impede this exchange of information, both banks and borrowers potentially suffer. Banks may make riskier loans and borrowers may receive a financial product not individually tailored to their needs.

Thus, unless the position is that the legal system should protect the broadly interpreted agreement of the parties at all costs, an interpretive role for the courts in lender liability cases remains questionable. The grave social, institutional, and economic toll of implementation of the interpretivist approaches is unjustified. The "effectiveness of express terms" judicial strategy, undergirded by the law and economics approach to good faith prohibits opportunism by the lender and most adequately advances the interests of both lender and borrower. Although the determination of whether particular acts are opportunistic is indeed a difficult one,[369] the disengagement of the obligation of good faith from the notion of "agreement" minimizes the shortcomings of the interpretivist approaches raised above. Parties no longer would be hamstrung throughout their relationship by the enormous threat of unpredictable post hoc guesswork by judges and juries.

Claims that widespread implementation of the effectiveness of express terms approach, in conjunction with a prohibition on opportunistic behavior, will destroy any viability of the obligation of good faith as a check on egregious lender behavior can be allayed by an examination of the dispute in *First Fidelity Bank v. People Care, Inc.*[370] In *People Care*, First Fidelity Bank (Fidelity) provided a $2,000,000 line of credit, payable upon demand, to People Care, Inc. (People Care), a provider of home health care services.[371] A year after entering into the agreement, Fidelity demanded a payment of principal under the note. Soon thereafter, Fidelity demanded that the loan be restructured and threatened to engage in "dramatic or precipitous action": using its ability to demand under the note and thereby force People Care to go under if it failed to accede to Fidelity's demands.[372] Although People Care's financial condition steadily improved,[373] Fidelity's threats continued. As a result, People Care executed a forbearance agreement which included a higher interest rate and a balloon payment of principal that was contrary to the bank's internal policies.[374] Subsequent to the forbearance agreement, Fidelity repeatedly assured People Care that, as long as People Care made payments pursuant to the agreement, it would make extensions of the forbearance agreement.[375] Instead, without warning, Fidelity instituted an action to collect upon the note.[376] The trial court, on these facts, denied Fidelity's motion for summary judgment and allowed the matter to go to trial.[377]

369. *See supra* text accompanying note 153. However, the current disarray of lender liability litigation may be one source of the difficulty in determining opportunistic behavior. Refocusing the analysis may generate predictable rules.

370. No. L-001554-90 (N.J. Super. Ct. Law Div. May 3, 1991) (order denying motion for summary judgment).

371. *See id.*; Transcript of Proceedings, *People Care*, at 4-6. The amount available was subsequently increased to $2,300,000. *See id.* at 7.

372. *See* Transcript of Proceedings, *People Care*, at 7-8.

373. *See id.* at 8, 10.

374. *See id.* at 8-9.

375. *See id.* at 10.

376. *See id.*

377. *See id.* at 12-15; First Fidelity Bank v. People Care, Inc., No. L-001554-90 (N.J.

Fidelity's handling of its loan to People Care was indisputably shocking and, under any theory of good faith, the trial court's decision is justified. A contractual moralist would assert that good faith and principles of contractual morality precluded Fidelity's abuse of its power over People Care. Interpretivists would look deeply into the parties' agreement and the term "demand" to assess whether Fidelity's behavior contravened that agreement and the parties' reasonable expectations thereunder. Relationists would examine the parties' relationship as it extended through the course of the arrangement to determine the normative framework governing the relationship. Yet, the law and economics approach focuses on issues that more concisely identify where Fidelity went wrong, thus providing guidance to subsequent transactors: a reasonable jury could find that Fidelity acted opportunistically when it exercised its leverage over People Care to extract a better deal than it initially bargained for.[378] In sum, the effectiveness of express terms approach to good faith, which gives terms in lending agreements their commonly understood meaning and prohibits only opportunistic behavior, protects borrowers from egregious lender behavior while also providing standards which lenders can conform their actions. Beyond that, other legal protections to parties in lending agreements ought to be furnished by traditional contract law doctrines such as modification, estoppel, waiver, and unconscionability rather than by a noble, yet unworkable, concept of good faith.

CONCLUSION

One significant concern raised in the debates over introduction of the obligation of good faith and fair dealing in the Restatement focused on the obligation's potential to invoke widespread "judicial remaking of contracts."[379] A comprehensive analysis of the history of lender liability litigation indicates that, for the most part, United States courts are resisting that temptation. Although not entirely unprecedented, judicial activism which uses the obligation of good faith to impose standards of conduct irrespective of the parties' agreement is rare. The recent shift in some courts to a vocally passive strategy toward good faith issues in lend-

Super. Ct. Law Div. filed May 3, 1991) (order denying motion for summary judgment). After denial of summary judgment, the case was settled. *See* First Fidelity Bank v. People Care, Inc., No. L-001554-90 (N.J. Super. Ct. Law Div. Dec. 19, 1991) (order dismissing complaint and counterclaims with prejudice and without costs).

378. *See, e.g.*, Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990) ("Bank did not break a promise at a time Debtor was especially vulnerable, then use the costs and delay of obtaining legal enforcement of the contract as levers to a better deal."); *In re* Red Cedar Constr. Co., 63 B.R. 228, 238 (Bankr. W.D. Mich. 1986) (lenders should not "be able to refuse financing at the last minute in an attempt to secure concessions from its customers more favorable to the lender"); Fischel, *supra* note 7, at 138 ("[W]henever a lender attempts to renegotiate with the borrower for better terms when there is no basis for doing so, the lender is behaving opportunistically.").

379. 47 ALI Proceedings 490-91 (1970).

ing reaffirms that the initial concerns over the introduction of the obligation of good faith ought not be a source of extreme apprehension. Accordingly, lenders may rest a little easier knowing that they are winning in the courts and their agreements generally will be enforced.

Despite the absence of a liability crisis for lenders, the existing litigation crisis points to the crucial need for a consistent judicial strategy in determining good faith conduct in lending agreements. The divergent conceptualizations of good faith and the numerous judicial strategies which have failed to generate consistent, positive rules of conduct to which lenders may safely conform have placed lenders, such as the Bank of Guam in *Micronesian Yachts*, in a position where they are forced into long and costly litigation of often spurious claims.

The "effectiveness of express terms" approach to good faith lending retains a role for the judiciary in policing lenders' opportunistic behavior while minimizing the potential for spurious claims of bad faith. This approach best balances the interests of both borrower and lender. Absent widespread judicial adoption of the "effectiveness of express terms" approach, the current business climate in which lenders must deem every loan a lawsuit, every borrower a plaintiff, and every act actionable will continue. This prospect calls for a deeper consideration of abolishing the contractual obligation of good faith as it applies to lending agreements.

APPENDIX A
Lender/Borrower Results

	Total for Year	Borrower's Favor	Lender's Favor
1964	2	1 (50.00%)	1 (50.00%)
1965	-	-	-
1966	-	-	-
1967	-	-	-
1968	1	-	1 (100%)
1969	4	1 (25.00%)	3 (75.00%)
1970	-	-	-
1971	1	1 (100%)	-
1972	3	1 (33.33%)	2 (66.67%)
1973	-	-	-
1974	1	-	1 (100%)
1975	4	-	4 (100%)
1976	3	1 (33.33%)	2 (66.67%)
1977	2	-	2 (100%)
1978	4	3 (75.00%)	1 (25.00%)
1979	5	2 (40.00%)	3 (60.00%)
1980	7	1 (14.29%)	6 (85.71%)
1981	5	1 (20.00%)	4 (80.00%)
1982	4	1 (25.00%)	3 (75.00%)
1983	5	2 (40.00%)	3 (60.00%)
1984	6	5 (83.33%)	1 (16.67%)
1985	9	2 (22.22%)	7 (77.78%)
1986	13	4 (30.77%)	9 (69.23%)
1987	12	7 (58.33%)	5 (41.67%)
1988	17	4 (23.53%)	13 (76.47%)
1989	19	3 (15.79%)	16 (84.21%)
1990	19	2 (10.53%)	17 (89.47%)
1991	39	9 (23.08%)	30 (76.92%)
1992	38	6 (15.79%)	32 (84.21%)
TOTAL	223	57 (25.56%)	166 (74.43%)

APPENDIX B
FEDERAL/STATE ALLOCATION

	Total for Year	State	Federal
1964	2	1 (50.00%)	1 (50.00%)
1965	-	-	-
1966	-	-	-
1967	-	-	-
1968	1	1 (100%)	-
1969	4	3 (75.00%)	1 (25.00%)
1970	-	-	-
1971	1	1 (100%)	-
1972	3	3 (100%)	-
1973	-	-	-
1974	1	1 (100%)	-
1975	4	3 (75.00%)	1 (25.00%)
1976	3	3 (100%)	-
1977	2	2 (100%)	-
1978	4	3 (75.00%)	1 (25.00%)
1979	5	4 (80.00%)	1 (20.00%)
1980	7	6 (85.71%)	1 (14.29%)
1981	5	5 (100%)	-
1982	4	4 (100%)	-
1983	5	5 (100%)	-
1984	6	5 (83.33%)	1 (16.67%)
1985	9	8 (88.89%)	1 (11.11%)
1986	13	11 (84.62%)	2 (15.38%)
1987	12	6 (50.00%)	6 (50.00%)
1988	17	11 (64.70%)	6 (35.30%)
1989	19	16 (84.21%)	3 (15.79%)
1990	19	15 (78.95%)	4 (21.05%)
1991	39	24 (61.54%)	15 (38.46%)
1992	38	17 (44.74%)	21 (55.26%)
TOTAL	223	158 (70.85%)	65 (29.15%)

APPENDIX C
FEDERAL/STATE RESULTS

	State			Federal		
	Total for year	Borrower	Lender	Total for year	Borrower	Lender
1964	1	-	1 (100%)	1	1 (100%)	-
1965	-	-	-	-	-	-
1966	-	-	-	-	-	-
1967	-	-	-	-	-	-
1968	1	-	1 (100%)	-	-	-
1969	3	1 (33.33%)	2 (66.67%)	1	-	1 (100%)
1970	-	-	-	-	-	-
1971	1	1 (100%)	-	-	-	-
1972	3	1 (33.33%)	2 (66.67%)	-	-	-
1973	-	-	-	-	-	-
1974	1	-	1 (100%)	-	-	-
1975	3	-	3 (100%)	1	-	1 (100%)
1976	3	1 (33.33%)	2 (66.67%)	-	-	-
1977	2	-	2 (100%)	-	-	-
1978	3	3 (100%)	-	1	-	1 (100%)
1979	4	1 (25.00%)	3 (75.00%)	1	1 (100%)	-
1980	6	1 (16.67%)	5 (83.33%)	1	-	1 (100%)
1981	5	1 (20.00%)	4 (80.00%)	-	-	-
1982	4	1 (25.00%)	3 (75.00%)	-	-	-
1983	5	2 (40.00%)	3 (60.00%)	-	-	-
1984	5	4 (80.00%)	1 (20.00%)	1	1 (100%)	-
1985	8	1 (12.50%)	7 (87.50%)	1	1 (100%)	-
1986	11	4 (36.36%)	7 (63.64%)	2	-	2 (100%)
1987	6	4 (66.67%)	2 (33.33%)	6	3 (50.00%)	3 (50.00%)
1988	11	3 (27.27%)	8 (72.73%)	6	1 (16.67%)	5 (83.33%)
1989	16	3 (18.75%)	13 (81.25%)	3	-	3 (100%)
1990	15	2 (13.33%)	13 (86.67%)	4	-	4 (100%)
1991	24	7 (29.17%)	17 (70.83%)	15	2 (13.33%)	13 (86.67%)
1992	17	1 (5.88%)	16 (94.12%)	21	5 (23.81%)	16 (76.19%)
TOTAL	158	42 (26.58%)	116 (73.42%)	65	15 (23.08%)	50 (76.92%)