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Good Faith in Calling Demand Notes and in Refusing to Extend Additional Financing

WILLIAM H. LAWRENCE* AND
ROBERT D. WILSON**

Two recent cases have drawn considerable national attention to the issue of whether the standard of good faith governs a lender's decision to terminate financing under loans callable upon demand. *Centerre Bank of Kansas City v. Distributors, Inc.*¹ concerns the call of a demand note, while *K.M.C. Co. v. Irving Trust Co.*² addresses a lender's refusal to extend further credit under a loan obligation that could be called upon demand. Both cases involved awards of seven and one-half million dollars, thereby enhancing the attention directed toward them. In addition, the practicing bar is currently focusing extensively on several aspects of lender liability.³ The good faith standard is one of several theories lawyers advance with increasing frequency in litigation over the proper bounds of lender activity.⁴ The *Centerre* and *K.M.C.* cases have assumed paramount positions in that debate.

Several reasons suggest that a critical analysis of the role of good faith in this context should be undertaken. The two cases themselves reach different conclusions, and unfortunately, both courts commit serious errors. Despite these faulty analyses, other courts and commentators have demonstrated an uncritical willingness to reach similar results.⁵ These errors,

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1. *Centerre Bank of Kansas City v. Distributors, Inc.*, 705 S.W.2d 42 (Mo. Ct. App. 1985).

2. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985).

3. Current interest in lender liability is evidenced by the efforts of the Division for Professional Education of the American Bar Association. That organization has sponsored a number of national seminars on the topic and has published a three volume set of materials. See 1-3 AMERICAN BAR ASSOCIATION, EMERGING THEORIES OF LENDER LIABILITY (H. Chaitman ed. 1985). In addition to the issue of good faith, the scope of lender liability issues encompasses a wide variety of theories concerning lender control of debtors and the application of civil RICO to lender activities. See *id.*

4. See generally Warren, *Good Faith Under the Uniform Commercial Code*, in 1 AMERICAN BAR ASSOCIATION, EMERGING THEORIES OF LENDER LIABILITY 57 (H. Chaitman ed. 1985).

5. As is discussed below, *infra* notes 32-39 and accompanying text, the *Centerre* opinion is based in part upon the holding of a prior opinion, *Fulton Nat'l Bank v. Willis Denny Ford, Inc.*, 154 Ga. App. 846, 269 S.E.2d 916 (1980). See also *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank of Wash.*, 10 Wash. App. 530, 536 n.5, 518 P.2d 734, 738 n.5, *cert. denied.*, 419 U.S. 967 (1974). The *Centerre* case undoubtedly has received the most attention, however, because of the \$7.5 million award. For cases subsequent to these decisions, see *Reid v. Key Nat'l Bank of Southern Me., Inc.*, 821 F.2d 9 (1st Cir. 1987); *In re Red Cedar Constr. Co.*, 63 B.R. 228, 238 n.7 (Bankr. Mich. 1986) (*dicta*); *Flagship Nat'l Bank v. Gray Distribution Sys., Inc.*, 485 So. 2d 1336, 1340, 1341 (Fla. Ct. App. 1986); *Carrico v. Delp*, 490 N.E.2d

therefore, should be corrected. Critical analysis of these cases is all the more relevant since until recently applicability of good faith performance and enforcement has gone virtually unnoticed in the context of commercial paper and secured financing.⁶ The current interest in wholesale recodifications of commercial law in general⁷ and the recurring indications of displeasure with the codification of the good faith principle in particular increase the importance of assessing these cases.⁸

Section I of this Article addresses the applicability of the good faith standard to calls of demand instruments and to refusals of additional financing under loan obligations callable upon demand. This section analyzes extensively the *Centerre* court's error in holding that the good faith standard is inapplicable to the call of a demand note.⁹ Section II focuses on how the standard applies. It analyzes the approach codified in the Uniform Commercial Code (the Code) and suggests ways to break beyond some of the undesirable restraints of the codified scheme. The subjective standard drafted in the Code is excessively restrictive. The Article uses a combination of statutory construction techniques, argument by analogy, analysis of drafting objectives, and reasonable commercial practices to develop rationales by which to extend an objective standard of good faith to these cases.

I. DOES THE GOOD FAITH STANDARD APPLY?

Section 1-203 of the Uniform Commercial Code imposes a pervasive good faith standard on transactions that come within the scope of any of the

972 (Ill. App. 1986); *Shaughnessy v. Mark Twain State Bank*, 715 S.W.2d 944, 950, 953 (Mo. Ct. App. 1986) (dictum). For commentators, see 5 R. ANDERSON, UNIFORM COMMERCIAL CODE § 3-122:4, at 387, § 3-122:16, at 392 (3d ed. 1984); 2 BENDER'S UNIFORM COMMERCIAL CODE SERVICE § 5.02[2], at 5-8 to 5-9 & n.9 (F. Hart & W. Willier 1988) [hereinafter F. Hart & W. Willier]; Note, *Negotiable Promissory Notes Containing Time and Demand Provisions: The Need for Consistent Interpretation*, 19 GA. L. REV. 717, 722, 733-34, 738-39 (1985). See also McDONNELL, *Problems with Notes: Accrual, Acceleration, and Suretyship*, 18 U.C.C. L.J. 40, 41-42 (1985) (cites opinions but does not comment on them).

6. The focus has been on good faith as an element to achieve holder-in-due-course status and on good faith as an element in a bank's decision to pay an instrument. See *infra* notes 87-96 and accompanying text.

7. See MOONEY, *Introduction to the Uniform Commercial Code Annual Survey: Some Observations on the Past, Present, and Future of the U.C.C.*, 41 BUS. LAW. 1343, 1353-55 (1986).

8. See BURTON, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981); FARNSWORTH, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); HILLMAN, *Policing Contract Modifications Under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849 (1979); SUMMERS, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968). But see GILLETTE, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619.

9. *Centerre*, 705 S.W.2d 42.

articles of the Code. Section 1-203 provides that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."¹⁰ Since a negotiable promissory note falls within the scope of Article 3 on commercial paper,¹¹ and a lending agreement entered into pursuant to a security agreement comes within the scope of Article 9 on secured transactions,¹² all parties to these transactions are required to perform their contract obligations and duties in good faith. Further, they are permitted to enforce the contract obligations and duties of other parties only in good faith.

The Missouri appellate court in *Centerre Bank of Kansas City v. Distributors, Inc.*¹³ held that the obligation of good faith does not apply to a lender's decision to call a demand note.¹⁴ The court set aside a jury verdict in favor of the borrower on the grounds that, as a matter of law, the lack of good faith is not relevant to the call of a demand note.¹⁵ The court's ruling grossly misconstrues the Code on the question of applicability of the good faith standard.

Although the *Centerre* court recognized the codification of section 1-203, it ruled that this section was inapplicable because "[t]he imposition of a good faith defense to the call for payment of a demand note *transcends* the performance or enforcement of a contract"¹⁶ Without explaining its rationale as to why the call of a demand note does not relate to performance or enforcement, the court applied an unjustifiably restrictive construction to the codified terms. The court apparently did not appreciate the underlying policy of section 1-203.

The good faith standard in section 1-203 is limited to contract "performance or enforcement"¹⁷ in order to preclude its applicability to contract negotiations.¹⁸ The good faith obligation is imposed by law irrespective of

10. U.C.C. § 1-203 (1978). "This section sets forth a basic principle running throughout this Act." U.C.C. § 1-203 comment (1978).

11. U.C.C. § 3-104(1), (2)(d).

12. U.C.C. § 9-102(1)(a).

13. 705 S.W.2d 42 (Mo. Ct. App. 1985).

14. "Instruments payable on demand include those payable at sight or on presentation and those in which no time for payment is stated." U.C.C. § 3-108 (1978).

15. *Centerre*, 705 S.W.2d at 48, 55.

16. *Id.* at 48 (emphasis added).

17. The Second Restatement of Contracts limits it similarly: "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 (1979). For commentary on the Restatement provision, see Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982).

18. *But see* Dugan, *Good Faith and the Enforceability of Standardized Terms*, 22 WM. & MARY L. REV. 1 (1980) (develops argument for application of contractual good faith constraints to standardized terms). Professor Summers has proposed amending the section to include negotiations. Summers, *supra* note 8, at 215 n.73, 218.

the contracting parties' actual intent.¹⁹ In our legal system the obligation arises from the contract itself. As a contractual obligation, however, it cannot apply before the contract is formed.²⁰ Other legal systems do extend good faith obligations to contract negotiations,²¹ but their extension as a basis for pre-contractual liability raises conceptual difficulties within our system.²² The codification of section 1-203 explicitly recognizes this limitation by precluding its applicability to contract negotiations.

The *Centerre* court's ruling that calling a demand note transcends performance and enforcement resembles the argument advanced in cases litigating dealership termination clauses. The franchisers have contended that the termination clause can be exercised without regard to good faith because its exercise is neither performance nor enforcement, but rather termination.²³ With only a few exceptions,²⁴ this argument generally, and properly, has not succeeded.²⁵ Although termination ends the basis to continue the contract

19. The obligation of good faith cannot be disclaimed by agreement between the parties. U.C.C. § 1-102(3) (1978).

20. The policing powers of the courts, invoked through doctrines such as fraud, duress, and capacity to contract, enable judges to invalidate contracts that may have been formed with one of the parties acting in bad faith. Those powers are very different, however, from the ability to determine that a party has breached an implied obligation of good faith and is therefore liable for the damages occasioned.

21. German law, for example, recognizes the doctrine of *culpa in contrahendo*, meaning fault in negotiating, which provides that "damages should be recoverable against the party whose blameworthy conduct during negotiations for a contract brought about its invalidity or prevented its perfection." Kessler & Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401, 402 (1964).

22. A few courts, particularly in franchise cases, have granted recovery based on the reliance interest against a negotiating party who has not extended an offer. *See, e.g., Hoffman v. Red Owl Stores*, 26 Wis. 2d 683, 133 N.W.2d 267 (1965). Most courts, however, have avoided imposing a contract duty to negotiate in good faith. Tort theory has provided more conceptually appropriate remedies in this area. For excellent discussions of the limits of contract theory in this context, see E. FARNSWORTH, *CONTRACTS* 187-92 (1982); Summers, *supra* note 8, at 220-32, 256-62. *But cf. Holmes, A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381 (1978) (principles of contract, tort, and equity combine in duty to disclose).

23. *See, e.g., Baker v. Ratzlaff*, 1 Kan. App. 2d 285, 564 P.2d 153 (1977).

24. *See, e.g., Division of Triple T Serv., Inc. v. Mobil Oil Corp.*, 60 Misc. 2d 720, 304 N.Y.S.2d 191 (1969). *See also* Summers, *supra* note 8, at 252 (suggesting that section 1-203 may be inapplicable because to terminate is neither to perform nor to enforce). Another commentator sees it as a borderline area that should be covered:

[W]hile the socially important goal of imposing good faith standards on all actors involved in transactions governed by the UCC indicates the desirability of treating the words "performance" and "enforcement" broadly, obviously, the formation and purchase aspects of contracts cannot logically be treated as matters of performance or enforcement. Nonetheless, the grey area that lies between those aspects and the "pure" performance . . . or enforcement . . . aspects of the contract [including termination of dealership contracts] should not be left without good faith protection.

1 W. HAWKLAND, *UNIFORM COMMERCIAL CODE SERIES* § 1-203:01, at 157 (1984).

25. *E.g., Baker*, 564 P.2d 153; *Atlantic Richfield Co. v. Razumic*, 480 Pa. 366, 378-81,

obligations, including the obligation of good faith, the contract remains in effect at the time the clause is exercised.²⁶ Exercise of the termination clause is a necessary incident to the enforcement of that substantive right of the contract²⁷ and as such is subject to the requirement of good faith.

Because calling a note is inseparable from enforcing the maker's duty to pay, the holder is constrained by the requirements of good faith in making a call. The maker of a note contractually "engages that he will pay the instrument according to its tenor at the time of his engagement"²⁸ As the *Centerre* court stresses,²⁹ a cause of action against a maker accrues on a demand note upon its date or, if no date is stated, on the date of issue.³⁰ The holder of a note in demand form thus has the discretion of

390 A.2d 736, 742-44 (1978). See generally 3 BENDER'S UNIFORM COMMERCIAL CODE SERVICE § 4.08[3], at 4-262 to 4-263 (R. Duesenberg & L. King 1988) ("It is doubtful that most courts would regard the concept of good faith to be inapplicable to the exercise of a termination clause"). Several courts have determined properly that the good faith obligation does not operate like the unconscionability provision of section 2-302 in allowing a court to override or strike express contract terms. See *Grand Light & Supply Co. v. Honeywell, Inc.*, 771 F.2d 672 (2d Cir. 1985); *Corenswet, Inc. v. Amana Refrigeration*, 594 F.2d 129 (5th Cir. 1979). Courts have had difficulties in applying the good faith standard, however. Although the refusal to limit termination "at will" cases to termination for good cause has been proper, see, e.g., *Smith v. Price's Creameries*, 98 N.M. 541, 650 P.2d 825 (1982), the courts go too far in suggesting that all motives in terminating are irrelevant, see, e.g., *Blalock Mach. & Equip. Co. v. Iowa Mfg. Co.*, 576 F. Supp. 774 (N.D. Ga. 1983); *Smith*, 650 P.2d 825. Terminations induced by dishonest motives would violate the good faith standard as codified. See *infra* notes 48-50 and accompanying text. For discussion of judicial application of the good faith standard to franchise agreements, see Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465; Hewitt, *Good Faith or Unconscionability—Franchise Remedies for Termination*, 29 BUS. LAW. 227 (1973).

26. This observation responds directly to the concern expressed by the court in *Division of Triple T Service*, 60 Misc. 2d 720, 304 N.Y.S.2d 191. The court denied the applicability of the Code good faith standard to the exercise of a termination clause on the grounds that the standard "merely relates to the honesty imposed upon the parties during the term of the contract" *Id.* at 201 (emphasis in original).

27. "Enforcement" in this context includes more than invoking the aid of the courts to compel observance or relief for breach. The exercise of the discretionary substantive right is enforced by invoking it to make it effective. The Uniform Commercial Code defines "action": " 'Action' in the sense of a judicial proceeding includes recoupment, counterclaim, set-off, suit in equity and any other proceedings in which rights are determined." U.C.C. § 1-201(1) (1978). Nothing in the statutory language or the Comment to section 1-203 limits the obligation of good faith enforcement to cases in which one of the parties brings an action. Additional illustrations of nonjudicial enforcement include a bank's right to set off and a secured lender's right to take possession of collateral following a default by the debtor.

28. U.C.C. § 3-413(1) (1978).

29. *Centerre*, 705 S.W.2d at 47.

30. An "action may be brought on a demand note immediately upon issue, without demand, since presentment is not required to charge the maker" U.C.C. § 3-122 comment 1 (1978). See also *Master Homecraft Co. v. Zimmerman*, 208 Pa. Super. 401, 222 A.2d 440 (1966); *Mandola v. Oggero*, 508 S.W.2d 861 (Tex. Civ. App. 1974). "The cause of action accrues on the date of the instrument rather than upon dishonor so as to deprive the holder of the ability to delay the running of the statute of limitations by delaying presentment of the instrument." 4 W. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 3-122:03 (W. Hawkland & L. Lawrence 1984).

determining when that payment must be made. What the *Centerre* court overlooks, however, is that the holder must either call the note or bring a cause of action in order to place the maker in default.³¹ The call of a demand instrument thus constitutes the lender's enforcement of the borrower's duty to pay, and it consequently is subject to the obligation of good faith.

The *Centerre* court also relied upon and adopted the reasoning advanced by a Georgia appellate court in *Fulton National Bank v. Willis Denny Ford, Inc.*³² Both opinions take the position that the application of section 1-203 would add a term to the contract that the parties themselves had not included. Since the parties did not expressly include a good faith limitation, the courts professed an unwillingness to rewrite the agreements.³³

Both courts misunderstand the source of the good faith obligation. In construing section 1-203, they quote a commentator who suggests that the section "in effect states that what is not regulated by the contract should be done in such a way as to show good faith in the carrying out of what is expressed."³⁴ In reality, the good faith obligation is a basic principle reaching "the performance and enforcement of *all* agreements or duties."³⁵ The obligation arises by law in any contract within the scope of the U.C.C.,³⁶

31. "[I]t is clear that there is no default [on a note] until after demand by the holder" U.C.C. § 3-122 comment 2 (1978). As Hart and Willier point out:

As the term [demand instrument] applies to the maker of a note, it is somewhat anomalous since no demand need be made by the holder. . . . The holder usually does make demand, however, since it would be foolish for him to start a lawsuit if he is in fact going to be paid.

F. Hart & W. Willier, *supra* note 5, § 5.02[2], at 5-8 to 5-11. Furthermore, as McDonnell states, "The rules of Section 3-122 do not by their terms directly fix liability. They are in a sense secondary in that they have an impact on judgments only in combination with other doctrines." McDonnell, *supra* note 5, at 42.

32. 154 Ga. App. 846, 269 S.E.2d 916 (1980). The *Centerre* court also cited a Washington opinion for its conclusory statement that good faith under section 1-203 is not a factual issue in determining the bank's right to call a demand note. *See Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wash. App. 530, 536 n.5, 518 P.2d 734, 738 n.5, *cert. denied*, 419 U.S. 967 (1974).

33. *Centerre*, 705 S.W.2d at 48; *Fulton*, 269 S.E.2d at 918.

34. 1 R. ANDERSON, UNIFORM COMMERCIAL CODE § 1-203:3, at 378 (3d ed. 1984). *See also*

F. Hart & W. Willier, *supra* note 5, § 5.02[2], at 5-8 to 5-9 n.9.

35. U.C.C. § 1-203 comment (1978) (emphasis added).

36. U.C.C. § 1-203 (1978). As Professor Burton stated:

Good faith here [in the context of contract performance] functions to protect the contractual expectations of the parties to a contract when one of them exercises discretion in performance. It is a basis for the interpretation and implication of contract terms. Bad faith performance of a contract may give rise to liability for breach of contract.

Burton, *supra* note 8, at 20-21. *See also* Farnsworth, *supra* note 8, at 670, 672. (The significance of good faith under the Code is "in implying terms in the agreement . . . [T]he chief utility of the concept of good faith performance has always been . . . that of implying contract terms.").

and it cannot be disclaimed even by express agreement of the parties.³⁷ While it is true that good faith is not a bar to the enforcement of a party's legal rights even though enforcement may result in harshness to the other party,³⁸ the *Centerre Bank* and *Fulton* courts incorrectly assumed that good faith is reduced to governing only the gaps in an agreement.³⁹ Good faith governs the performance and enforcement of the express terms of the agreement as well.

The *Fulton* court finds additional alleged support for its position in part of the Comments to section 1-208.⁴⁰ This section governs the interpretation of contract terms that permit a party to accelerate payment "at will" or upon "deem[ing] himself insecure," and it requires that these words "shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired."⁴¹

37. U.C.C. § 1-102(3) (1978).

38. See 1 R. ANDERSON, UNIFORM COMMERCIAL CODE § 1-203:11, at 381 (3d ed. 1984). See, e.g., *American Exploration Co. v. Columbia Gas Transmission Corp.*, 779 F.2d 310 (6th Cir. 1985) (not breach of good faith to curtail gas purchases because of market conditions when contract allowed restricting flow or discontinuing purchases due to changed conditions); *Missouri Public Service Co. v. Peabody Coal Co.*, 583 S.W.2d 721, 725 (Mo. Ct. App. 1979), cert. denied, 444 U.S. 865 (1979) ("Where an enforceable, untainted contract exists, refusing modification of price and seeking specific performance of valid covenants does not constitute bad faith or breach of contract . . .").

39. *Contra* 1 R. ANDERSON, UNIFORM COMMERCIAL CODE § 1-203:17, at 385 (3d ed. 1984) ("The concept of good faith plays only a limited role in the field of commercial paper because of the basic principle that the enforcing of contract terms is not to be regarded as acting in bad faith . . ."). Professor Burton's analysis of good faith is a much more useful approach.

The courts generally have construed the good faith performance obligation as a limitation on discretion in performance. They generally use good faith in this context to mean that a discretion-exercising party rightfully may deprive the other of its anticipated benefits for any purpose that was within the reasonable contemplation of the parties at formation. The benefit perspective—focusing on whether the dependent party received the "fruits" of the contract—is inadequate because it fails to recognize that the discretion-exercising party may have withheld them *rightfully*. However, the courts have held that such a party breaches the contract by performing in bad faith when the facts indicate that discretion was used to recapture opportunities forgone upon contracting—that the discretion-exercising party refused to pay the expected costs of performance. Such behavior is wrongful because it necessarily harms the dependent party's contractual expectation interest.

Burton, *supra* note 8, at 5-6 (emphasis added). For his analysis in the common law context, see Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980). *But cf.* Summers, *supra* note 17, at 830-34 (criticism of Professor Burton's analysis).

40. For a critical analysis of section 1-208, see Note, *Standards for Insecurity Acceleration Under Section 1-208 of the Uniform Commercial Code: A Proposal for Reform*, 13 U. MICH. J.L. REF. 623 (1980).

41. Section 1-208 provides:

A term providing that one party or his successor in interest 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 power to do so only if he in good faith

The Comment properly states: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason."⁴² The *Fulton* court seizes upon this statement in the Comment to strip the constraint of good faith from the call of a demand note.⁴³

The *Fulton* court erred by applying the Comment out of context and by reading too much into it. Under section 1-208, an "at will" acceleration clause that is otherwise absolute on its face nevertheless can be exercised for only one reason—a good faith belief that the prospect for payment or performance is impaired.⁴⁴ The Comment accurately depicts the distinguishing features of demand instruments: payment does not have to be accelerated since demand instruments can be called at any time, and a holder's call of a demand instrument is not limited statutorily to any specific reasons. The statement in the Comment, however, does not legitimize bad faith calls of demand notes. A holder's right to call a demand instrument includes the section 1-203 obligation to do so only in good faith, and the Comment to section 1-208 does not provide otherwise.⁴⁵

Unlike the *Centerre* and *Fulton* opinions, the other leading case in this area avoids the error of denying applicability of the good faith standard to the call of a demand note. In *K.M.C. Co., Inc. v. Irving Trust Company*,⁴⁶ the Sixth Circuit Court of Appeals upheld a magistrate's jury instructions

believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

U.C.C. § 1-208 (1978).

42. U.C.C. § 1-208 comment (1978).

43. *Fulton*, 269 S.E.2d at 918-19. In *Reid v. Key Nat'l Bank of Southern Me., Inc.*, 821 F.2d 9 (1st Cir. 1987), the First Circuit Court of Appeals evaded the same issue that was presented to the *Fulton* court. The First Circuit examined the loan documentation and concluded that the inclusion of conditions and events relating to breach contradicted the alleged demand nature of the note. *Id.* at 13-14. The difficulty with the court's approach is that it inferentially suggests that the loan documents could be drafted in a way that would make the *Fulton* court's analysis appropriate.

44. One court has applied section 1-208 to an acceleration based on a specific default clause rather than the generalized insecurity acceleration clause. *Brown v. Avemco Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979). The acceleration was based on a "due-on-lease" clause in a security agreement covering an airplane. The court's application of section 1-208 was inappropriate and not in accord with other court opinions. *See Bowen v. Muse*, 114 N.J. Super. 372, 276 A.2d 397 (1971). Even default accelerations are subject to a good faith standard through section 1-203. The imposition of section 1-208, however, would limit the opportunity to accelerate following breach of the default provision to circumstances in which the debtor honestly believes that the default impairs the prospects for payment or performance by the debtor.

45. Although it is made in the context of acceleration under a specific default clause, the following observation is equally pertinent in the context discussed in the text. "The implication that simply because Section 1-208 is inapplicable good faith is immaterial, should be resisted." *McDonnell*, *supra* note 5, at 58.

46. 757 F.2d 752 (6th Cir. 1985).

that the decision on whether to advance additional funds under a financing agreement was limited by the obligation of good faith performance.⁴⁷ The court also held that the demand feature of the financing agreement did not alter the requirement because the power to demand repayment also is constrained by the same good faith obligation.⁴⁸

Unfortunately, the *K.M.C.* court failed to rely upon section 1-203 for its holding. Instead, the court cited section 1-208 and stated that “[t]he demand provision is a kind of acceleration clause”⁴⁹ The *K.M.C.* court thus reached the correct result concerning application of the good faith standard, but it used an incorrect Code provision.⁵⁰

II. WHAT DOES THE GOOD FAITH STANDARD REQUIRE?

Once a court decides that the good faith standard applies, the court must still determine what that standard includes. The term “good faith” is defined in the Code to mean “honesty in fact in the conduct or transaction concerned.”⁵¹ This definition creates a purely subjective standard that is not affected by objective concerns about what a reasonable person would do under similar circumstances. Without question, the Code definition is overly restrictive because it precludes using the good faith requirement to strike down many offensive, but not dishonest actions.⁵² In addition, the purely subjective standard does not invoke the standards of fairness and commercial reasonableness that should surround many of the transactions arising under the Uniform Commercial Code.⁵³

47. *Id.* at 759.

48. *Id.* at 760.

49. *Id.* The Comment to section 1-208, discussed *supra* notes 42-45 and accompanying text, should preclude precisely this type of erroneous conclusion. *But see* Comment, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?*, 40 VAND. L. REV. 1197, 1223 (1987) (The *K.M.C.* court appeared to apply a “two-tiered analysis” using sections 1-203 and 1-208.).

50. The First Circuit correctly relied upon section 1-203 in holding that the good faith applies to a lender’s decision to terminate its secured credit arrangement with its debtors. *Reid v. Key Nat’l Bank of Southern Me., Inc.*, 821 F.2d 9, 12-13 (1st Cir. 1987). The court also relied upon the *K.M.C.* holding. *Id.* at 13. An appellate court in Illinois correctly implied a good faith standard to a lender’s unilateral decision to terminate further financing under a line-of-credit security agreement despite a clause in the loan documents that further loans were “at bank discretion.” *Carrico v. Delp*, 490 N.E.2d 972, 976 (Ill. App. 1986). Unfortunately, the court did not refer to the U.C.C. at all, let alone section 1-203.

51. U.C.C. § 1-201(19) (1978).

52. Professor Summers analyzes seven separate classes of cases. *Summers, supra* note 8, at 210-12. According to Professor Summers, “[t]he Code’s definitions restrictively distort the doctrine of good faith.” *Id.* at 215.

53. “Good faith performance properly requires some objective standard tied to commercial reasonableness.” Farnsworth, *supra* note 8, at 671. Professor Farnsworth also states that “[b]oth common sense and tradition dictate an objective standard for good faith performance.” *Id.* at 672. *See also id.* at 674 (limiting the definition of good faith to honesty in fact left the concept “enfeebled”).

The Code does include an additional definition of good faith. Article 2 provides that with respect to a merchant, "good faith" means both honesty in fact and "the observance of reasonable commercial standards of fair dealing in the trade."⁵⁴ This additional definition, however, is expressly restricted to transactions within Article 2 involving sales of goods.⁵⁵ Therefore, even though lenders could satisfy the definitional requirements of "merchants,"⁵⁶ the good faith definition would not apply.⁵⁷ The additional objective component of the definition of good faith in Article 2 is not applicable on its face to transactions under Articles 3 or 9, and thus does not govern the cases under discussion here.

Lenders would be well advised, however, not to depend upon courts using only a subjective standard when called upon to determine the lender's good faith obligation in the performance and enforcement of loan agreements payable on demand. The line between subjective and objective standards can be difficult to determine under some facts,⁵⁸ and a court might be inclined to bend that line against a lender. Also, a court might simply ignore the applicable statutory definition and apply an objective standard.⁵⁹ The temptation to bend or ignore the statutory standard might be particularly inviting in a situation involving the call of a demand loan because the borrower is particularly vulnerable to the lender's unfettered discretion. Therefore, a lender might find itself bound to an objective measure of good faith either because the court completely disregards the statutory framework, or because the court justifies its approach through an argument based upon analogy or supplementary principles of law.

The next subsection of this Article discusses the application of the subjective standard of good faith to the facts of the *K.M.C.*, *Centerre* and *Fulton* opinions. This subsection focuses on the standard as it is codified in the U.C.C. The final subsection addresses the desirability of an objective element of good faith in this context, how it might be achieved legitimately,

54. U.C.C. § 2-103(1)(b) (1978).

55. The preface provision of the section 2-103 definitions begins with the words "[i]n this Article."

56. Article 2 defines "merchant" to mean "a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill." U.C.C. § 2-104(1) (1978) (emphasis added).

57. The index of definitions provision indicates that the listed definitions, including "merchant" and "between merchants," apply to "this Article or to specified Parts thereof" U.C.C. § 2-103(2) (1978).

58. "Under a subjective test of good faith it is always open to the trier of the facts to evaluate the credibility of a claim of 'honesty in fact,' and in doing so to take account of the reasonableness or unreasonableness of the claim." Farnsworth, *supra* note 8, at 672.

59. This approach is precisely the one followed by the court in *K.M.C. v. Irving Trust Co.* See *infra* notes 60-63 and accompanying text.

and what it portends for the future of both lender liability and commercial law.

A. *The Codified Approach*

The *K.M.C.* court erred in the way that it rejected the subjective standard as the appropriate measure of good faith. Spurning dishonesty as the relevant standard, the court concluded that abuse of discretion is the proper criterion by which to review a refusal to extend additional credit under a financing agreement in which the loan balance is payable upon demand.⁶⁰ The *K.M.C.* court required "reasonableness" and "valid business judgment."⁶¹ It concluded that, due to the significant impact that withdrawing financing would have upon the borrower, "[l]ogically, . . . this obligation to act in good faith would require a period of notice to *K.M.C.* to allow it a reasonable opportunity to seek alternate financing, absent valid business reasons precluding [the lender] from doing so."⁶² The court flatly stated its reliance upon the objective criterion: "[T]here 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."⁶³

In addition to embracing an objective standard for good faith without establishing any legal support, the court misunderstood how to apply the subjective standard. The court suggested that the evidence presented might

60. *K.M.C.*, 757 F.2d at 760.

61. *Id.* at 761.

62. *Id.* at 759. In another case involving a lender's decision to terminate its secured line of credit, the trial court initially instructed the jurors with both subjective and objective standards of good faith, but upon a request for clarified instructions, formulated a purely subjective standard. *Reid v. Key Nat'l Bank of Southern Me., Inc.*, 821 F.2d 9, 14-15 (1st Cir. 1987). In ruling that the evidence was sufficient to support a jury verdict against the lender, the First Circuit nevertheless applied the same criteria as the *K.M.C.* court. The First Circuit wrote:

In sum, the jury could have reasonably found that the bank acted in bad faith in precipitously and without warning halting further advances on which it knew Reid's business depended, in failing to make a sufficient effort to negotiate alternative solutions to any problems it perceived in its relationship with Reid, and in failing to give notice that it intended to terminate the relationship entirely.

Id. at 16. The court held that even if the jury did not believe the plaintiffs' allegations of racial prejudice, it still could have found that "the bank was motivated by ulterior considerations, not a good faith concern for its financial security." *Id.* at 15, 16. However, the court never identified what those ulterior considerations might be.

63. *Id.* at 761 (emphasis in original). Another court, without any attempt to apply the U.C.C. to the transaction, applied a purely objective standard to a lender's unilateral decision to terminate further loans under a line-of-credit security agreement.

Good faith between contracting parties requires the party vested with contractual discretion to exercise it reasonably, and he may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties. We conclude the agreement gave the bank reasonable, not absolute, discretion.

Carrico v. Delp, 490 N.E.2d 972, 976 (Ill. App. 1986) (citations omitted).

not have been sufficient to sustain a verdict for the plaintiff-borrower under a purely subjective standard.⁶⁴ As is discussed below, however, even under the codified subjective approach, the facts of *K.M.C.* suggest a strong case of violation of the good faith obligation.

K.M.C. and Irving Trust Co. entered into a financing agreement whereby Irving ultimately extended a line of credit for \$3.5 million dollars that was payable on demand. Irving received a security interest in all of *K.M.C.*'s inventory and accounts receivable, and all of *K.M.C.*'s receipts were deposited into a "blocked account" to which Irving alone had access. Without continued and regular financing, *K.M.C.* would be left without operating capital and could not continue its operation.⁶⁵ On March 1, 1982, Irving, without prior notice, refused a request to advance additional funds that would have been within the established limit. *K.M.C.* alleged that this refusal breached the implied obligation of good faith performance, and ultimately resulted in its collapse as a going concern.

The record included several facts that would constitute sufficient evidence to justify a conclusion that Irving had not acted honestly in refusing the additional credit, thereby breaching its obligation of good faith. Most importantly, the court referred to competent evidence that a personality conflict had developed between the loan officer for Irving and the president of *K.M.C.* The evidence that the loan decision was motivated by a personal vendetta supports the inference that it was not made honestly. The honesty-in-fact standard of good faith precludes a lender from invoking a contract right merely to avenge ill-feelings toward the borrower.

The court referred to additional evidence in the record that would support the inference that the lender acted upon a dishonest motive. It showed that the loan officer was aware that terminating additional financing would destroy *K.M.C.* The loan officer also testified that on March 1 the lender "was faced with a sudden crisis of unprecedented proportions."⁶⁶ The statement may have been an exaggeration, however, because the court found that "there was ample evidence in the record from which the jury could have concluded that March 1 simply was not that unusual a day in the history of the relationship between Irving and *K.M.C.*"⁶⁷ Further, the evidence reported by the court showed that Irving knowingly violated its own policy of providing advance notice before it terminates financing when adequately secured.⁶⁸ The evidence thus showed that the loan officer proceeded in actions adverse to *K.M.C.* knowing that the lender's interests were fully protected, knowing that the refusal to extend an additional loan

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

65. *K.M.C.* was a medium-sized company in the wholesale grocery business.

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

67. *Id.*

68. *Id.* at 761, 763.

violated Irving's own policies, and knowing that his actions would destroy the borrower as an operating entity. This evidence, coupled with the lender's dislike of the borrower's president, supports an inference that the additional loan was refused for the sole dishonest motive of injuring K.M.C. Even under the more restrictive subjective standard, the evidence supports a finding that the refusal to extend additional credit was a breach of the obligation of good faith.

The facts in the *Centerre* opinion show some interesting parallels to the *K.M.C.* case. In 1979, Centerre Bank extended a line of credit to Distributors, Inc. in exchange for a \$900,000 demand note, a security interest in inventory and accounts receivable, and the personal guaranty of the owner and sole shareholder. By 1981, the owner had sold twenty percent of Distributors' stock to the general manager, Dan Brown, and was considering selling the remaining eighty percent. Brown and other members of his family were interested in acquiring the remaining stock but were concerned about whether the bank would continue to extend financing if the purchase went through. The record shows that the loan officer of the bank assured Brown that financing would continue as long as the current owner continued on his personal guaranty.

Subsequent to the purchase of the remaining stock by the Browns, the loan officer of the bank informed them that their personal guaranties would be required in addition to that of the previous owner. Brown testified that assurances were given that financing would continue if the guaranties were produced. He admitted, however, that he was told the loan would have to be run through the bank's committee for final approval. On August 18, 1981, Brown delivered the guaranties to the bank. Three days later, the bank gave notice that it was calling the demand note in sixty days. Despite this notification, between August 19, 1981 and December 15, 1981, the date of the final call, the bank continued to extend almost \$635,000 in credit to Distributors. During this time the bank also received substantial payments on the loan, and made several unsuccessful attempts to assist Distributors in securing other financing. On December 24, 1981, Brown surrendered all of the assets of Distributors to the bank.

The similarities to the *K.M.C.* case concern allegations that the president of the bank did not like Brown, that the president did not think that Brown was a good manager, and that the bank knew that calling the note would effectively put Distributors out of business. If provable, these facts could have been utilized to support a breach of the good faith obligation under the codified subjective standard of good faith. The court did indicate, however, that "[i]t is highly questionable that the evidence showed that the bank intended to cause injury to Distributors,"⁶⁹ which, if correct, would

69. *Centerre*, 705 S.W.2d at 54.

preclude using the codified subjective standard as a basis for proving breach of good faith. Interestingly, however, the court reports that Distributors submitted these allegations in support of its claim against the bank under a prima facie tort theory, and not on behalf of the breach of good faith theory.

The court's report of the allegations under the good faith theory suggest that perhaps the allegations were not pleaded specifically enough to relate to a purely subjective standard. This observation, of course, is purely academic in relationship to its effect on the outcome of the case, because the appellate court ruled incorrectly that the good faith obligation was inapplicable to the call of the demand note.⁷⁰ Nevertheless, the limitations under the subjective standard of good faith can be illustrated well through this case.

Rather than focusing on the alleged ill-feelings between the bank president and Brown, Distributors claimed that:

various loan officers of the Bank thought the Distributors loan was a bankable one, the Bank failed to disclose it was concerned about the loan and that [its president] believed the loan was the largest risk exposure in the Bank, [the loan officer] led the Browns to believe the Bank approved of their buying the Distributors' stock while [the president] was preparing to call the loan, and the loan was called only three days after the Browns delivered their personal guaranties even though the financial situation of Distributors was improving after the Browns purchased all of the stock.⁷¹

These allegations are relevant to prove a breach of the subjective standard of good faith only to the extent that they show that the bank was acting dishonestly.

Combined with a showing of alleged ill-feelings between the bank's president and Brown, these facts could have provided the cornerstone for a case of dishonest enforcement of the loan by the bank. The appellate court did shield the bank from liability on the count of misrepresentation based upon the loan officer's assurances of continued bank approval. This holding clearly was appropriate since the Browns knew that loan approval had to come from a loan committee, thus establishing the lack of legitimate reliance. The preclusion of the claim of misrepresentation is not necessarily conclusive on an attempt to show subjective bad faith, however, because the plaintiffs still might have been able to demonstrate an inference of the bank's false pretenses.

Further inferences of false pretenses might stem from a showing that the bank purposely delayed its decision to call the loan until it first secured the personal guaranties of the Browns. The defendants would have had to

70. See *supra* notes 13-39 and accompanying text.

71. *Centerre*, 705 S.W.2d at 47.

establish that the loan officer knew the loan was classified as a problem loan. Alternatively, they would have had to show that the bank was not prepared to continue with the financing but rather was poised to call the loan upon receiving the guaranties. Under these circumstances the loan officer would have been pretending to believe facts that he actually knew to be otherwise. Another possibility is that the loan officer's conduct could still satisfy the subjective standard even in the absence of such actual knowledge if he wilfully refrained from investigating the bank's real view of the loan. On the other hand, a negligent failure to ascertain this information would not constitute subjective bad faith. Several months elapsed between the initial inquiries by Brown and the delivery of the additional guaranties. Since the loan officer indicated that the guaranties would be required, one would assume that he would have acquired some basis of information concerning the bank's position. Negligence in determining the accuracy of its position, or breakdowns in communications within the bank, would fall outside the scope of a purely subjective standard of good faith.

The reporting of the *Centerre* case, and the failure even to apply the good faith standard to the facts, make it impossible to ascertain whether a pure honesty-in-fact standard was possible or even attempted. The *Centerre* case nevertheless demonstrates that the limited subjective standard can make violations of the good faith obligation in the call of a demand instrument very difficult to prove. Plaintiffs must base their cases not only upon events that occur exclusively within the internal structure of the lender, but also upon the mental motivations affecting those events. Even skillful use of discovery will not be adequate in many instances to develop this latter type of evidence. Lenders will stress objective factors of the transaction that appear to legitimize their decision, as the Centerre Bank did⁷² and as Irving Trust feebly attempted to do.⁷³ Furthermore, prudent lending institutions will assume a more professional posture than Irving Trust and Centerre Bank did by guarding against any overt manifestations of personality conflicts with personnel of the borrower.

Although the *Fulton* case is criticized along with the *Centerre* opinion in the first part of this Article because it did not recognize the applicability of the good faith obligation,⁷⁴ the reported facts of *Fulton* do not suggest any plausible grounds for a violation of the good faith obligation. The automobile dealer that had borrowed the money, giving demand notes pursuant to a floor planning arrangement, was "out of trust" in excess of \$180,000 from having failed to remit the proceeds of fifty-six sales of

72. *Id.* at 49-50, 54.

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

74. *See supra* notes 32-45 and accompanying text.

automobiles subject to the agreement. The bank's subsequent examination of the dealer's books and records revealed several additional reasons for legitimate concern: "improper record entries, questionable tax deductions, use of corporate funds for personal expenses, payment of salaries deemed 'excessive' to [the dealer's] relatives who were employed by [the dealership], and a significant drop in car sales from November 1973 to February 1974."⁷⁵ The dealer then refused to agree to proposed changes to avoid another "out of trust" situation. Despite the bank's refusal to extend any additional financing for new cars, it did agree to extensions on payment of all of the outstanding notes until the dealer was able to establish a floor planning arrangement through Ford Motor Credit Company.

The bank in *Fulton* thus appears to have proceeded for completely legitimate reasons, without any indications of false pretenses or ulterior motives. On the other hand, the court does not report what facts concerning alleged bad faith were presented by the plaintiff-dealer in opposition to the bank's motion for summary judgment. It is impossible, therefore, to ascertain whether the plaintiff presented a claim even relevant to the subjective standard. To decide the case properly, the court should have held first that the good faith obligation applied to the call of the demand notes. Then, depending upon the evidence presented, the court should have found either that the plaintiff did not allege adequate material facts to raise a genuine issue of good faith to preclude granting the motion for summary judgment, or that the allegations were sufficient to cause the case to be remanded for trial on that issue.

B. Beyond the Codified Approach

The *K.M.C.* case vividly demonstrates that some courts, despite the limitations of the codified definition of good faith, are prepared to inject an objective component into the lender's good faith obligation in a financing decision on loans with a demand feature. Extending the good faith requirement into the objective sphere seems appropriate in this context.⁷⁶ Unlike the approach in *K.M.C.*, however, courts addressing these lending decisions

75. *Fulton*, 269 S.E.2d at 917.

76. As one commentator has stated:

Nor should we neglect the fact that the Code elevates into overriding principles such concepts as good faith, unconscionability, and commercial reasonableness. . . . Karl Llewellyn's best legacy to us may have been that, against powerful opposition, he succeeded in keeping his Code open-ended. Good faith and the like are words to conjure with, whenever we feel like conjuring.

Gilmore, *The Good Faith Purchase Idea and the Uniform Commercial Code: Confessions of a Repentant Draftsman*, 51 GA. L. REV. 605, 629 (1981). A contrary position is indicated in Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775, 798 (1986) ("[T]he actionable theory of good faith and fair dealing is too broad and inconcrete to serve as a basis of lender liability, as no workable limits to liability exist.").

in the future should develop a suitable analogy or statutory construction to justify their decisions.

One desirable approach would be to apply by analogy the objective standard of good faith performance of sales contracts by merchants. The words "argument by analogy" cannot magically dispense with the statutory language that limits the objective standard of good faith to Article 2 transactions involving merchants.⁷⁷ Proponents of analogies must formulate a rationale to demonstrate the appropriateness of the proposed analogy. In this case, the formulation is even more difficult because, rather than justifying the application of a Code concept to a transaction outside the scope of the Code, it applies a Code definition beyond its codified scope. Nevertheless, combined principles of analogy and statutory construction create persuasive arguments in this area.

A lender's performance and enforcement of a loan agreement subject to the lender's discretion to call is sufficiently analogous to a merchant's performance and enforcement of a sales contract to support the integration of the objective standard to the lender's good faith obligation. The commercial settings of the two types of transactions are similar. The reason for limiting the objective requirement of good faith to merchants is obvious: since the standard requires "the observance of reasonable commercial standards of fair dealing within the trade,"⁷⁸ it applies only within a trade context in which reasonable commercial standards exist. Similar reasons, however, do not justify restricting this requirement only to merchants engaged in sales transactions. Lending and financing institutions also hold themselves out as professionals in commercial transactions.⁷⁹ The proposition that they should not be held to observe reasonable commercial standards of fair dealing within the lending and financing trade is untenable. To the extent that such standards exist within the requisite trade, the same policies that support their required observance by merchants apply with equal force to lenders and other financing enterprises.

The three cases discussed in this Article provide insights into the commercial standards lenders follow in exercising their discretion to call demand obligations.⁸⁰ The *K.M.C.* opinion states that both the manager of secured lending activities of Irving Trust, and the president of another bank participating with Irving Trust in the financing agreement, testified that a bank owes its clients a duty of good faith. Furthermore, they both testified that the duty would be violated by terminating the financing without prior notice

77. U.C.C. § 2-103(1)(b) (1978).

78. U.C.C. § 2-103(1)(b) (1978).

79. Even the definition of "merchant" is broad enough to encompass lending and financial institutions: "a person who . . . by his occupation holds himself out as having knowledge or skill peculiar to the practices . . . involved in the transaction . . ." U.C.C. § 2-104(1) (1978).

80. See also *In re Red Cedar Constr. Co.*, 63 Bankr. 228, 238 (W.D. Mich. 1986).

or by terminating under any circumstances when the bank is fully secured.⁸¹ The bank in *Centerre* in fact did provide an advance notice period of several months, during which time it loaned additional funds and sought alternative financing for the borrower.⁸² Similarly, the bank in *Fulton* gave prior notice and extended the outstanding loans during the interim period.⁸³

The banks in each of these cases thus recognized the existence of a commercial standard to at least provide advance notice before calling a demand note or refusing additional credit under a security agreement callable upon demand. The call feature in these transactions between lenders and borrowers is a power granted to the lender under the terms of the lending agreement. The discretion granted to the lender should not include the opportunity to abuse that power. In this sense, the *K.M.C.* court is right in concluding that the abuse of discretion standard is the "correct" one to apply in this instance.⁸⁴ The court, however, ignored the legal support for its position. That support can be found in the analogous principle of holding merchants in sales transactions to an objective component of good faith.

An obvious objection to the proposed technique of applying the Article 2 concepts of "merchant" and "good faith" beyond the confines of that single article is that it conflicts with the apparent intention of the drafters. The codification scheme of the U.C.C. appears to present a carefully bifurcated drafting of the good faith concept, which arguably demonstrates an intent to restrict the objective element of good faith only to transactions within the scope of Article 2. These appearances are deceiving, however. An analysis of the codification history leading to the current definitional scheme simply does not support such an inference.⁸⁵

81. *K.M.C.*, 757 F.2d. at 761-62. The president of another bank found liable for terminating the secured financing of its customer testified in a similar vein. "The bank's president testified that it was customary before cutting off a customer's line of credit to send notices in advance and call the customer to the bank for discussion." *Reid v. Key Nat'l Bank of Southern Me., Inc.*, 821 F.2d 9, 15 (1st Cir. 1987).

82. *Centerre*, 705 S.W.2d at 46.

83. *Fulton*, 269 S.E.2d at 917. The testimony of bank officials and their actions in these lender liability cases, *supra* notes 81-82, provide a strong refutation to the following position: [T]he duty of good faith, by its very nature, provides no objectively identifiable guidelines concerning the bounds of legally permissible conduct. The duty of good faith and fair dealing simply instructs the lender that "it is right to do right." Yet, in commercial affairs such a mandate is, without further delineation, formless and inconsistent with the basic notion of fairness that notice be given as to what activities are legally permitted or prohibited.

Ebke & Griffin, *supra* note 68, at 798. The refutation applies also to the student commentator who contends that an advance notice obligation was never contemplated between the parties in *K.M.C.* See Comment, *Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 EMORY L.J. 917, 933, 966-67 (1987).

84. *K.M.C.*, 757 F.2d at 760.

85. See generally Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798 (1958).

Originally the Code had only a general definition of good faith, and it included an objective as well as a subjective element.⁸⁶ The drafters focused foremost on good faith in purchase contexts, particularly the purchase of negotiable instruments.⁸⁷ The "subjective vs. objective" controversy had raged for decades in the purchaser context,⁸⁸ and the drafters continued within that perspective.

The ABA Section objected to the inclusion of the objective test on the grounds that it did not accord with precedent,⁸⁹ and it might tend to freeze commercial practices.⁹⁰ In a spirit of compromise, the Code drafters limited the general definition to its current "honesty in fact" language and added objective tests in several specific provisions of the Code. The latter provisions included section 2-103 and section 3-302. Section 2-103 defined good faith for merchants as including the observance of reasonable commercial standards.⁹¹ Section 3-302 required that in order to attain the status of holder in due course of commercial paper, the holder must take "in good faith

86. A draft of the good faith provision stated:

"Good faith" means honesty in fact in the conduct or transaction concerned. Good faith includes good faith toward all prior parties and observance by a person of the reasonable commercial standards of any business or trade in which he is engaged.

U.C.C. § 1-201(16) (May 1949 Draft).

87. Summers, *supra* note 8, at 208. As Professor Summers stated:

In the early drafts, Karl N. Llewellyn, the chief draftsman of the Code, had the purchase context very much at the forefront of his mind in drafting good faith definitions. *See, e.g.*, U.C.C. § 10, Comment (1948 Draft). No doubt many other scholars of commercial law were, at this time, thinking in the same vein. For example, one author stated: "In its customary setting in problems of *bona fide* purchase, a concept such as 'good faith' is necessary, and reasonably workable." Honnold, *Buyer's Right of Rejection*, 97 U. PA. L. REV. 457, 475 (1949).

Id. at 208 n.53. Professor Summers continued and stated:

Of course, the draftsmen doubtless recognized that this definition controlled the meaning of good faith not only in sections of article 3 on holders in due course, but also in section 1-203, imposing a general Code obligation of good faith, and in other specific sections of article 2 using these words. But what will suffice in the purchase context should suffice in others as well. Good faith is good faith, or so the draftsmen seem to have thought.

Id. at 208.

88. *Id.* at 208 (collecting authorities).

89. This attention to good faith purchase, to the exclusion of good faith performance, seems to have led to two general misconceptions: First, that good faith referred only to purchase; and second, that the proper test of good faith was always subjective. The uniform acts that preceded the Code contain upwards of fifty references to good faith, and not once is that term used in the sense of good faith performance. A subjective test of "honesty in fact" is used consistently throughout the uniform acts.

Farnsworth, *supra* note 8, at 670-71.

90. Malcolm, *The Proposed Commercial Code*, 6 BUS. LAW. 113, 128 (1951) (report by the Chairman of the Committee on the Proposed Commercial Code of the Section on Corporation, Banking and Business Law of the American Bar Association).

91. Uniform Commercial Code, Text and Comments Edition § 2-103(1)(b) (Official Draft 1952).

including observance of the reasonable commercial standards of any business in which the holder may be engaged."⁹²

Debate before the influential New York Law Revision Commission led to further changes. Once again, the primary focus appears to have been directed toward good faith in the purchaser context of commercial paper.⁹³ The reference to reasonable commercial standards was deleted,⁹⁴ with approval of the New York Commission,⁹⁵ from the definition of holder in due course.⁹⁶

Arguably, the ultimate intent of the drafters was to exclude the objective element of good faith from the purchaser context and to limit its application in performance and enforcement contexts to trade settings with recognized reasonable commercial practices.⁹⁷ The drafters' excessive focus on the purchaser context unfortunately led to a drafting approach that is inadequate to implement these intentions fully.⁹⁸ Nonetheless, the codification history certainly does not support the conclusion that the drafters intended to preclude an objective standard of good faith to the enforcement of professional lending transactions even when these lenders acknowledge established reasonable commercial standards of fair dealing. Recognizing the single-minded purpose leading the drafters to modify the definitional approach to good faith, and lacking indications that the drafters intended to free

92. *Id.* § 3-302(1)(b).

93. "The provision as to holders in due course was perhaps the item most vigorously discussed in the New York hearing." Braucher, *supra* note 76, at 813 (citing 1954 N.Y. REPORT 203-06, 213-40, 241-43, 424-26).

[G]ood faith purchase rather than good faith performance continued to hold the spotlight. The emasculating of the general obligation of good faith occasioned far less controversy than did the insertion of some of the discarded language in Article 3 on Commercial Paper.

Farnsworth, *supra* note 8, at 674.

94. Uniform Commercial Code, 1953 Official Draft of Text and Comments (Supp. No. 1, 1955). See also *id.* § 7-501(4).

95. 1956 N.Y. LAW REVISION COMM'N REP. 17, 29.

96. On good faith purchase, see Gilmore, *The Commercial Doctrine of Good Faith Purchaser*, 63 YALE L.J. 1057 (1954).

97. "[N]egotiable instruments-minded lawyers could be expected to assume that the sole effect of lopping off the reasonableness half of the 1949 definition was merely to 'make negligence irrelevant to good faith.'" Summers, *supra* note 8, at 211. For support, Professor Summers cites the following statement by Professor Braucher: "Section 1-201(19) defines 'good faith' as 'honesty in fact,' and thus follows a number of the uniform commercial acts in making negligence irrelevant to good faith." *Id.* (citing Braucher, *supra* note 85, at 812). Professor Summers argues persuasively that the cases in one major category seem to have "escaped the notice of nearly everyone." Summers, *supra* note 8, at 211. The class of cases involves "forms of bad faith that do not involve dishonesty, let alone negligence—for example, openly abusing the power to break off negotiations, openly taking unfair advantage of bargaining power, openly acting capriciously or openly undercutting another's performance." *Id.* at 210.

98. As Professor Burton stated: "They [the Code definitions of good faith] may play an important role in the good faith purchase cases for which they were designed, but seem irrelevant to good faith performance for all practical purposes." Burton, *supra* note 8, at 18.

professional lenders from established standards of fair dealing within their trade,⁹⁹ courts today might very well be convinced to apply an objective component to the good faith obligation of lenders.

Additional techniques could be utilized by a court to justify extending the objective good faith standard into contract performance and enforcement under Articles 3 and 9. A direct method would be to avoid the restrictive definition of good faith through the language that prefaces it. The general Code definitions apply "unless the context otherwise requires."¹⁰⁰ The existence of recognized commercial standards governing the exercise of discretion to call demand instruments¹⁰¹ might persuade a court that it has an appropriate context for deviation from the general definition.¹⁰² The position might be bolstered with reference to the provision in the Comment to the general obligation of good faith that indicates that the obligation is "further implemented by Section 1-205 on course of dealing and usage of trade."¹⁰³ Arguably, the context requires the additional inclusion of an objective component, rather than just the overly-restrictive general definition of good faith, when usage of trade has established reasonable commercial standards of fair dealing.¹⁰⁴

Alternatively, a court might rely on section 1-103 which allows judges to utilize supplementary general principles of law and equity.¹⁰⁵ Examples of bad faith can be found in a number of different case-law contexts. An innovative court might be willing to extend into the lender context any of a number of these types of bad faith, including evasion of the spirit of the deal, abuse of power to specify contract terms, conjuring up a dispute,

99. *But cf.* Van Bibber v. Norris, 419 N.E.2d 115, 122 (Ind. 1981). In *Van Bibber*, the court stated:

We note, however, that the absence of a similar burden of observing "reasonable commercial standards" on a secured party reflects the code drafters' recognition that sales transactions are more amenable to establishment of "reasonable commercial standards" than are the relations between secured parties and debtors.

Id.

100. U.C.C. § 1-201 (1978) (preamble language).

101. *See supra* notes 81-83 and accompanying text.

102. Courts can be reluctant to invoke the "unless the context otherwise requires" language since it easily could be used so frequently as to itself become the rule rather than the exception. *See Summers, supra* note 8, at 213-15.

103. U.C.C. § 1-203 comment (1978).

104. *But cf.* Farnsworth, *supra* note 8, at 676-77 ("Where the general obligation of good faith requires only 'honesty in fact' it is difficult to see how it could be meaningfully 'implemented' by course of dealing or usage of trade . . .").

105. Section 1-103 provides:

Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions.

U.C.C. § 1-103.

taking advantage of another to get a favorable readjustment, and abuse of a power to terminate.¹⁰⁶ Application of supplementary principles is inappropriate when they have been displaced by particular provisions of the Code.¹⁰⁷ However, the legislative history showing that the drafters did not focus on good faith performance and enforcement in this context¹⁰⁸ can be used to argue that these basic principles have not been displaced by Code provisions.

Courts desiring to apply an objective element to the good faith requirement as it applies to lenders calling demand instruments thus have a variety of alternative rationales available. One hopes that courts embracing the objective element will make the effort to justify their approaches through these techniques of analogy and statutory construction.¹⁰⁹ The benefits will extend beyond the improvement of individual decisions in this area. These cases raise the issue of application of the good faith standard to Articles 3 and 9 in an enforcement, rather than a purchaser context. They have the potential to serve as a catalyst to draw even greater attention to the proper role of good faith performance and enforcement outside of Article 2.¹¹⁰

CONCLUSION

Problems with the good faith standard in the Uniform Commercial Code were recognized soon after its codification. One commentator even referred to good faith performance as "one of the major casualties during the drafting of the Code."¹¹¹ However, courts and commentators have only recently begun to address on any extensive scale the concept of good faith performance and enforcement for Code sections beyond the scope of Article 2. The same codification problems plague these applications.

106. The identification and discussion of these categories, among others, are provided in Summers, *supra* note 8, at 234-52. See also RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."). The comment to the section emphasizes that the duty invokes an objective as well as a subjective standard. One of the specific violations of good faith in enforcement noted in the Comment is "abuse of a power to determine compliance or to terminate the contract." *Id.* comment e.

107. U.C.C. § 1-103 (1978).

108. See *supra* notes 86-99 and accompanying text.

109. For a contrary position, see Note, *K.M.C. Co. v. Irving Trust Co.: Discretionary Financing and the Implied Duty of Good Faith*, 81 Nw. U. L. Rev. 539, 563-67 (1987) (courts should apply only the subjective standard to reflect statutory language and intent of the drafters).

110. The courts have been called upon to decide increasing challenges of bad faith action in the lending area. See, e.g., 999 Corp. v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985) (unilateral addition of prepayment penalty to financing agreement); *United States v. Cain*, 736 F.2d 1195 (7th Cir. 1984) (release of collateral without notice to guarantor); *Layne v. Fort Carson Nat'l Bank*, 655 P.2d 856 (Colo. App. 1982) (acceleration following default); *Van Bibber v. Norris*, 419 N.E.2d 115 (Ind. 1981) (repossession of collateral without prior notice); *Todsen v. Runge*, 211 Neb. 226, 318 N.W.2d 88 (1982) (taking security interest while aware of prior unperfected security interest in the same collateral).

111. Farnsworth, *supra* note 8, at 673.

Recent litigation concerning good faith in the call of demand notes and the refusal to extend additional financing under a demand loan amply demonstrates the difficulties. Several courts have failed even to recognize the applicability of the good faith obligation to these cases. The few courts that have applied the standard have done so outside of the codified scheme of the concept without any attempts to establish a justifiable basis for their approaches. This litigation record suggests fundamental needs both to develop understanding concerning the scope of good faith performance and enforcement within the Code and to utilize principles of analogy and statutory construction to break beyond the restrictive bonds of the codified definition of good faith.

These codification problems and their current impact on issues of lender liability also provide some timely lessons for the emerging efforts to recodify commercial law. A committee of the Permanent Editorial Board of the Uniform Commercial Code already is preparing revisions for Articles 3 and 4,¹¹² and interest in revising Article 2 is mounting.¹¹³ One hopes that the recent litigation involving lender liability issues premised on the good faith obligation will draw the committee's attention to the role of good faith in Article 3, particularly in the areas of performance and enforcement as well as the purchaser contexts. Each committee seeking to recodify individual articles of the Code also should admonish itself to guard against focusing only on single contexts of pervasive concepts. The good faith obligation cuts across the lines of individual sections and articles, and the failure of the drafting committee to appreciate that pervasiveness inevitably will lead to inadequate codification efforts. Perpetuation of the known drafting errors of the past would be inexcusable.

112. The project is directed toward modernizing revisions of Articles 3 and 4 and the addition of specific types of electronic funds transfer payment systems. Mooney, *supra* note 7, at 1354. For the background leading to this project, see Brandel, *Payment Systems Law Moves in New Directions*, THE BUS. LAW. UPDATE, July-Aug. 1985, at 5, col. 1.

113. "The Subcommittee on General Provisions, Sales, Bulk Transfers and Documents of Title, Committee on Uniform Commercial Code, is now thoroughly reviewing U.C.C. art. 2 and nonuniform amendments to it." Mooney, *supra* note 7, at 1355 n.73. In somewhat related activities, a proposed final draft for Article 2A, covering leases of personal property, has been promulgated. American Law Institute, Article 2A Leases (proposed final draft) (Apr. 6, 1987). A drafting committee also is revising Article 6 on bulk sales. Mooney, *supra* note 7, at 1354.

