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Contractual Good Faith: Variations on the Theme of Expectations

by C. Scott Pryor

Judges and lawyers are familiar with the principle that "a party's good faith cooperation is an implied condition precedent to performance of a contract."¹ The duty of good faith has had a sporadic history in Florida's common law tradition.² Since 1965 it has also been a statutorily implied term under the Uniform Commercial Code (Code).³ Good faith (or the lack of it) has been more frequently an issue in lender liability actions than any other category of claims.⁴ Nonetheless, astute counsel must consider this duty as either an affirmative defense or the basis of a claim in every contract action.

The concept of good faith is difficult to define apart from a set of facts to which it can be applied. Similar to Justice Potter Stewart's remark concerning pornography that "I know it when I see it," most attorneys and judges have an intuitive grasp of the parameters of good faith (or at least those situations that evidence bad faith). Although the Code defines good faith purely in subjective terms as "honesty in fact,"⁵ several decisions under the common law have adopted a broader definition.⁶ Recently, however, some opinions by various district courts of appeal have by implication narrowed the outer limits of the duty of good faith in both Code and common law contract cases.

The Early Days

An early discussion of obligations implied in a contract can be found in *Sharp v. Williams*, 192 So. 476 (Fla. 1939), in which the Florida Supreme Court affirmed a decision that breach of an implied contractual duty constituted actionable "bad faith." In *Sharp* a landlord sublet part of the leased premises to a subtenant with a provision that the sublease would be extended if the original lease were renewed. Rather than extending the original lease, how-

ever, the tenant/sublessor obtained a new lease and thereby eliminated the sublessee's right to extension. While the tenant's actions did not violate any provision of the sublease, the court noted, "A contract includes not only the things written, but also terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken."⁷

These implied terms include, among others, the promise to do nothing that would prevent the other party from creating or obtaining any benefit which could arise under the contract. Thus, the subtenant's expectation of an extension was a sufficient basis on which to base a claim for bad faith breach of contract.

The Uniform Commercial Code

Little came of the court's discussion of bad faith breaches of contract over the next 30 years. With the adoption of the Uniform Commercial Code in 1965, however, the duty of good faith became explicit. F.S. §671.203 recites that "[e]very contract or duty within this code imposes an obligation of good faith in its performance or enforcement." The Code narrowly defines its obligation: "Good faith means honesty in fact in the conduct or transaction concerned."⁸ Did the drafters intend that good faith under the Code prohibits only intentionally wrongful actions and otherwise permits enforcement "to the letter of the contract"? While their original intent is unclear, it would appear that at least today a narrow understanding of good faith under the Code is in order. In light of a series of cases from various jurisdictions holding parties liable in damages for breach of the Code's duty of good faith⁹ the Permanent Editorial Board issued an Official Commem-

tary in 1994 to the effect that

This section [UCC 1-203] does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section 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 or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith merely directs a court toward interpreting contracts within the commercial context in which they are created, performed and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.¹⁰

Good faith under the Code is thus more of an interpretive tool than an independent remedial source.

Common Law Good Faith

The narrow, subjective interpretation of good faith has not carried the day universally. In a non-Code case the Third District Court of Appeal expanded on the remedy afforded by the *Sharp* decision and held that a blanket lease provision prohibiting assignment by the tenant could not be enforced in an arbitrary or capricious manner. *Fernandez v. Vazquez*, 397 So. 2d 1171 (Fla. 3d DCA 1981). The owners of a bakery leased it for five years with a provision that the lessee could not assign the lease or sublet the premises without the written consent of the landlord. The tenants decided to get out of the bakery business and obtained a buyer who agreed to take an assignment of the lease. The landlord refused to consent but a month later offered to

lease the premises to the prospective buyer for an additional \$250 per month. The buyer rejected the offer and the sale of the business fell apart. The landlord immediately commenced an action to terminate the lease to which the tenants counterclaimed on the ground that it was the landlord who had breached the lease by refusing to consent to the proposed assignment.

The trial court granted summary judgment against the tenants but the court of appeal reversed, holding that "[a] withholding of consent to assign a lease, which fails the tests for good faith and commercial reasonableness, constitutes a breach of the lease agreement."¹¹ Unlike the comment of the Permanent Editorial Board, the Third District concluded that breach of the duty of good faith produced an affirmative claim for relief and was to be measured by objective criteria, not the subjective state of mind of the landlord.¹²

In most circuits, the effect of the *Fernandez* decision has largely been limited to situations involving similar facts (i.e., assignments of commercial leases).¹³ The Third District extended the reach of *Fernandez*, however, in *L.V. McClendon Kennels, Inc. v. Investment Corp. of South Florida*, 490 So. 2d 1374 (Fla. 3d DCA 1986), by applying it to a greyhound booking contract. The contract between the kennel and the track was silent about the kennel's right of assignment, but the court of appeal read that silence as an authorization

to assign subject only to the track's right to evaluate the proposed assignee's qualifications and fitness.¹⁴ The same court also applied the broad notion of good faith in the interpretation of a disputed provision of an easement in *Green Companies, Inc. of Florida v. Kendall Racquetball Investments, Ltd.*, 560 So. 2d 1208 (Fla. 3d DCA 1990).¹⁵ Good faith under the common law can thus be an independent source of a right or an affirmative defense.

Code Decisions

Another line of cases, primarily arising under the Code, has continued to apply the obligation of good faith in narrower, subjective terms. In one of the first lender liability cases in Florida a borrower brought an action against its bank for accelerating an installment note in bad faith. *Quest v. Barnett Bank of Pensacola*, 397 So. 2d 1020 (Fla. 1st DCA 1981). Installment or term notes¹⁶ generally contain a provision that allows the lender to accelerate the obligation if the lender feels "insecure." The Code provides that a lender may deem itself "insecure" only if the lender "in good faith believes that the prospect of payment or performance is impaired."¹⁷ Of particular importance is the Code's allocation of the burden of proof of lack of good faith to the borrower.¹⁸ This burden was too much for the borrower in *Quest* to overcome, especially where the evidence showed that the borrower was overdrawn by

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\$6,500 with two more drafts of \$6,000 and \$14,000 due to be presented shortly. Unlike the common law definition of good faith, the court held that under the Code "the test of good faith . . . is a wholly subjective one of honesty."¹⁹

Quest's strongest argument to overcome the high burden of establishing that the bank had not acted in good faith was that a prior course of conduct (i.e., payment of overdrafts) established a standard from which the bank could not deviate without prior notice.²⁰ Unfortunately for Quest, the court in effect deemed such notice to have been given in a redocumented loan agreement executed after the most recent previous overdraft. In short, the terms of the written agreement governed, not some objective extra-contractual principles.

Two subsequent cases reiterated the sanctity of written contracts in the face of challenges to a bank's good faith under the Code. In *Flagship Nat'l Bank v. Gray Distribution Systems, Inc.*, 485 So. 2d 1336 (Fla. 3d DCA 1986), a borrower and its guarantor both sued a bank for failing to extend additional credit after having done so in the past. Unlike the situation in *Quest*, Gray had not executed new documents after previous additional extensions of credit. Nonetheless, the appellate court reversed the trial court's decision that the bank had violated its duty of good faith. The note at issue in *Flagship* was a demand instrument that is normally unencumbered by notions of good faith. In what could be considered as *dicta*, the court considered F.S. §671.205 and held that the express language of the contract would prevail even over a prior inconsistent course of dealing:

[W]hen a course of dealings and the express terms of an agreement appear to conflict, the practice of the parties and the agreement must be construed, wherever reasonable, as consistent with each other. . . . If no reasonable consistent construction can be drawn, the express terms of the agreement control.²¹

The next year the Second District Court of Appeal weighed in with a similar conclusion in *Brighton Dev. Corp. v. Barnett Bank*, 513 So. 2d

1103 (Fla. 2d DCA 1987). Brighton had paid a \$171,000 commitment fee to the bank but failed to complete all the required loan documents by the deadline specified in the commitment letter. The bank refused Brighton's request for an extension of time and kept the fee. Brighton sued, arguing the bank's refusal constituted bad faith. The court of appeal affirmed the dismissal of Brighton's complaint holding that "the bad faith claim had no merit since Barnett was under no contractual obligation to grant an extension of time."²² Of course, neither the landlord in *Fernandez* nor the track owner in *McClendon Kennels* had been under a contractual obligation to consent to the requested assignments in their cases, either.

The application of a purely subjective measure of good faith and a corresponding emphasis on the written contract terms in Code cases has continued unabated. See, e.g., *Riedel v. NCNB Nat'l Bank of Florida*, 591 So. 2d 1038, 1040 (Fla. 1st DCA

1991) ("The UCC duty of good faith may not be imposed to override the express terms of a contract."); and *Indian Harbor Citrus, Inc. v. Poppel*, 658 So. 2d 605 (Fla. 4th DCA 1995) ("We hold that when the contract is clear and unambiguous, the contract terms may not be varied by resort to those concepts [of good faith, custom and usage or course of dealing].")²³ The Florida Code decisions track the Official Commentary of the Permanent Editorial Board and eliminate good faith as an independent basis of a claim.

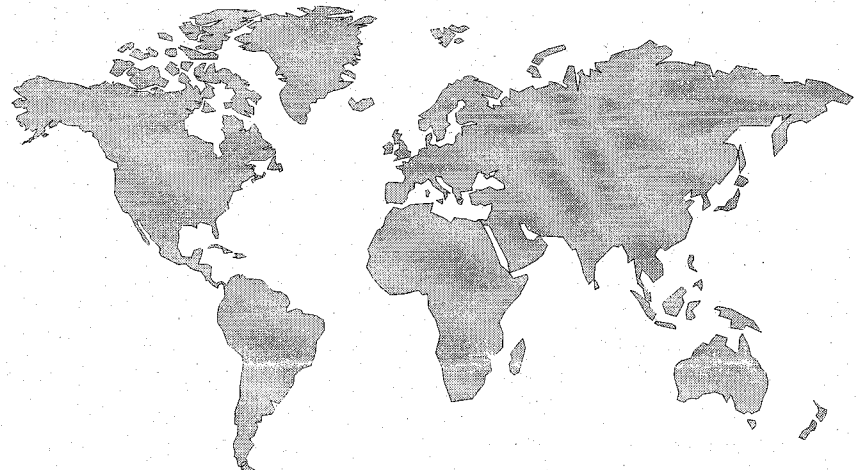
Two Standards or One?

The apparent bifurcation of the nature and standards of the obligation of good faith under the common law and the Code is not as contradictory as might first appear. F.S. §671.103 provides that:

Unless displaced by the particular provisions of this code, 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, coer-

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cion, mistake, bankruptcy, or other validating or invalidating causes shall supplement its provisions.

The federal District Court for the Northern District of Florida made use of this section to allow a surety to be subrogated to payments due under a construction contract, notwithstanding its failure to perfect a security interest under Article 9 of the Code. *McAtee v. United States Fidelity & Guaranty Co.*, 401 F. Supp. 11 (N.D. Fla. 1975). Courts in other jurisdictions have specifically grounded the propriety of importing an expansive definition of the common law duty of good faith into a Code case under this provision.²⁴ There is, thus, no inherent inconsistency between two lines of good faith depending on the context of a case (Code or non-Code).

What is making matters unclear, however, are several federal and state court decisions applying the narrow Code understanding of good faith in non-Code cases. These decisions are particularly puzzling because they fail to articulate any rationale for doing so. In *East Bay Ltd. Partnership v. American General Life & Accident Insurance Co.*, 744 F. Supp. 1118 (M.D. Fla. 1990), the court granted summary judgment to a lender who had refused to consent to its borrower's sale of a shopping center. The lender had concluded that the prospective buyer lacked sufficient management experience to operate the mall. Such consideration probably met the objective good faith criteria of *Fernandez* and its progeny. Nonetheless, the court cited *Brighton*, a Code decision, in support of its conclusion.

More recently, the Florida Fourth District Court of Appeal explicitly relied on a series of Code cases to reverse a decision of the trial court in favor of a party to a non-Code contract. *City of Riviera Beach v. John's Towing*, 691 So. 2d 519 (Fla. 4th DCA 1997). The court held that "[a]lthough *Indian Harbor* was a case decided under the Uniform Commercial Code's implied obligation of good faith, we find no difference when the implied term attempts to vary the express terms of

a contract not under the UCC."²⁵

Nonetheless, there may be a unifying rationale under the common law good faith cases after all. In *First Texas Savings Assoc. v. Comprop Investment Properties Ltd.*, 752 F. Supp. 1568 (M.D. Fla. 1990), a construction lender sought to foreclose a mortgage and to obtain a money judgment on the underlying note as well as personal guaranties. The borrower and guarantors counterclaimed on several grounds including breach of duty of good faith. Rather than simply applying the appropriate rule, the district court analyzed the purpose of the requirement of good faith and concluded that

[I]n determining the nature and extent of the covenant of good faith and fair dealing between the parties, courts generally use a measure of the justifiable expectations of the parties. As a result, where one party acts arbitrarily, capriciously or unreasonably, that conduct exceeds the justifiable expectations of the second party and consequently, the second party should be compensated for its damages and/or excused from performance.²⁶

Given the fact-based focus on the parties' "justifiable expectations," the court denied the lender's motion for summary judgment. The district court in *Burger King Corp. v. Weaver*, 798 F. Supp. 684 (S.D. Fla. 1992), applied the same reasoning to deny Burger King's motion for summary judgment on a counterclaim brought by a franchisee for allowing another restaurant to open in close proximity to it. The franchise agreement at issue specifically negated any expectation of the franchisee that it had acquired an "exclusive" territory. Yet the court concluded that

[T]he express denial of an exclusive territorial right to the franchisee "does not necessarily imply a wholly different right to Burger King—the right to open other proximate franchises at will regardless of their effect on the [defendant's] operations." . . . [A] franchisee is entitled to expect that the franchisor "will not act to destroy the right of the franchisee to enjoy the fruits of the contract."²⁷

Both the Code and common law doctrines of good faith focus on expectations. Their respective range of relevant expectations, however, differs substantially. Under the Code, it is

only those of the defending party. By contrast, the common law looks at the expectations of both parties.

Litigation Considerations

At least in non-Code cases, the court must define the expectations of the parties to the agreement. Of first importance in this process of definition is the contract itself. In other words, the mutual intention of the parties at the time of the original contract is of primary significance. Where a contract expressly deals with an issue neither party should be heard to complain of the other's lack of good faith when enforcing with it. If the written agreement provides that the party alleged to have breached the duty of good faith can take a particular action, it cannot be a breach of the duty of good faith when it does so.

However, when the contract does not deal explicitly with a particular action, the court must look to the agreement's overarching purpose to determine if the act is consistent with the expectations that would normally accompany that purpose. There is thus a breach of good faith where the mutually anticipated result (whether express or implied) is intentionally frustrated by the performance (or lack thereof) of the other party. Each of the non-Code decisions arguably falls within the ambit of the "mutual expectations" of the parties even though the opinions were not articulated in that fashion. Instead of pronouncing certain bright line objective standards of good faith, the courts could have allowed each of the parties to develop evidence of their expectations at the trial level. It would then be up to the trier of fact to determine if the aggrieved party's expectations were indeed "mutual."

Summary judgment would still be appropriate in cases in which the alleged breach of the duty of good faith does not conflict with the purpose of the contract. In cases in which the evidence of the purpose of the contract is in conflict and a jury has been empaneled, a special verdict should be submitted to determine the scope of the mutual expectations

of the parties at the time of contracting. If the jury concludes that the aggrieved party's expectations were shared by the other party, then it would go on to decide whether the other party's actions violated the duty of good faith.

The Code's definition of good faith remains subjective. It is not the parties' mutual expectations that determine the scope of obligations to which the duty of good faith applies. Rather, it is only the terms of the contract and the understanding of the party alleged to have breached to which the duty of good faith is relevant. Counsel for the aggrieved party, therefore, has the more difficult burden to demonstrate an actionable understanding from the defending party's own testimony or internal documents.

The contractual duty of good faith remains of great significance in Florida. While the bases for the duty vary with whether the contract is subject to the Code, counsel for either party must consider the existence of the duty and take steps to ensure its factual development in discovery and at trial. □

¹ *Fernandez v. Vazquez*, 397 So. 2d 1171, 1174 (Fla. 3d D.C.A. 1981); see also *Champagne-Webber, Inc. v. City of Fort Lauderdale*, 519 So. 2d 696 (Fla. 4th D.C.A. 1988).

² See, e.g., the early discussion of "bad faith" hinderance of performance in *Sharp v. Williams*, 192 So. 476 (Fla. 1939).

³ FLA. STAT. §671.203 (1995).

⁴ See, e.g., *Flagship National Bank v. Gray Distribution Systems, Inc.*, 485 So. 2d 1336 (Fla. 3d D.C.A. 1986); and *Quest v. Barnett Bank of Pensacola*, 397 So. 2d 1020 (Fla. 1st D.C.A. 1981).

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⁵ FLA. STAT. §671.210(19) (1995). This article specifically excludes consideration of a merchant's obligation of good faith under Article 2 of the Code (FLA. STAT. §672.103(1)(b)) or the good faith required of a holder in due course under Article 3 (FLA. STAT. §673.1031(1)(d)).

⁶ *Fernandez*, 397 So. 2d at 1173-74.

⁷ *Sharp*, 192 So. 480; see also *Department of Insurance v. Teachers Insurance Co.*, 404 So. 2d 735 (Fla. 1981).

⁸ FLA. STAT. §671.201(19).

⁹ See, e.g., *Duffield v. First Interstate Bank of Denver, N.A.*, 13 F.3d 1403 (10th Cir. 1993); *Conoco, Inc. v. Inman Oil Co.*, 774 F.2d 895 (8th Cir. 1985); *Reid v. Key Bank of Southern Maine*, 821 F.2d 9 (1st Cir. 1987); and *First Nat'l Bank in Libby v. Twombly*, 689 P.2d 1226 (Mont. 1984).

¹⁰ Perm. Ed. Bd., Commentary no. 10, 1-203 (Feb. 10, 1994).

¹¹ *Fernandez*, 397 So. 2d at 1174.

¹² In the case of commercial leases, those criteria include the "(a) financial responsibility of the proposed subtenant, (b) the 'identity' or 'business character' of the subtenant, i.e., suitability for the particular building, (c) the need for alteration of the premises, (d) the legality of the proposed use, and (e) the nature of the occupancy, i.e., office, factory, clinic, etc." *Id.*

¹³ See, e.g., *Petrou v. Wilder*, 557 So. 2d 617 (Fla. 4th D.C.A. 1990); *Ludal Dev. Co. v. Farm Stores, Inc.*, 458 So. 2d 781 (Fla. 3d D.C.A. 1984).

¹⁴ "Its refusal may not be arbitrary and unreasonable." *McClendon*, 490 So. 2d at

1377 (citing *Fernandez*). In *McClendon* the track owner undercut whatever subjective good faith it may have claimed by entering into a separate booking contract with the proposed assignees after they had purchased another kennel.

¹⁵ The *Green* case is also significant because it cites §205 of the Restatement (Second) of Contracts which contains a very expansive definition of good faith. 560 So. 2d at 1210. Accord, *First Nationwide Bank v. Florida Software Services, Inc.*, 770 F. Supp. 1537 (M.D. Fla. 1991) (applying *Fernandez* rationale to assignment of computer software licensing agreement).

¹⁶ Demand notes, however, may be called at any time "with or without reason." *Quest*, 397 So. 2d at 1021.

¹⁷ FLA. STAT. §671.208 (emphasis added).

¹⁸ *Id.*

¹⁹ *Quest*, 397 So. 2d at 1022 (quoting *Farmers Co-Op Elevator, Inc. v. State Bank*, 236 N.W.2d 674, 678 (Iowa 1975)).

²⁰ FLA. STAT. §671.205(1).

²¹ *Flagship*, 485 So. 2d at 1340.

²² *Brighton*, 513 So. 2d at 1104.

²³ See also *Crawford v. Goldkist, Inc.*, 614 F. Supp. 682 (M.D. Fla. 1985).

²⁴ See, e.g., *United States National Bank of Oregon v. Boge*, 102 Or.App. 262 (1990).

²⁵ *City of Riviera Beach*, 691 So. 2d at 521.

²⁶ *First Texas*, 753 F. Supp. 1574.

²⁷ *Burger King*, 798 F. Supp. 689 (quoting *Scheck v. Burger King Corp.*, 756 F. Supp. 543, 549 (S.D. Fla. 1991)).

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