

Winter 2008

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### Recommended Citation

Daniel B. Bogart, Good Faith and Fair Dealing in Commercial Leasing: The Right Doctrine in the Wrong Transaction, 41 J. Marshall L. Rev. 275 (2008)

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# GOOD FAITH AND FAIR DEALING IN COMMERCIAL LEASING: THE RIGHT DOCTRINE IN THE WRONG TRANSACTION

DANIEL B. BOGART\*

## I. INTRODUCTION<sup>1</sup>

The doctrine of good faith and fair dealing is the darling of contract law. It is not – and never has been – important in property law.<sup>2</sup> The deepest roots of American property law reside in England, in the world of feudal incidents, livery of seisin, and estates. English property law judges did not care a whit about *fairness*, but instead worried about *caste and category*. Everything and everyone had a proper place, and once a thing's or person's place was determined, the rules governing that thing or person followed.<sup>3</sup>

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1. This article was prepared in connection with a keynote lecture given by the author at the 2007 Kratovil Conference on Real Estate Law & Practice, held on October 19, 2007 at The John Marshall Law School, Center for Real Estate Law. I have expanded somewhat on my actual remarks, and provided footnotes, (by definition information that would distract or bore the listener). As a speech, it was not my goal to provide a treatise-like treatment of the subject, nor is it my goal to do so here.

The author thanks Professor Celeste Hammond for her gracious invitation to speak at the conference and commenting on an earlier draft. In addition, the author thanks Adjunct Professor Virginia Harding for helping to refine the hypotheticals that appear in Part III, as well as the editors and students of *The John Marshall Law Review*, and Eric Grote and Warren Morten, the author's research assistants. Using an earlier draft of this article as a jumping-off point for a directed research paper, Lisamarie Graham was helpful in providing comments and additional sources. Any errors are entirely my own.

2. Actually, like all good, strong statements, the suggestion that good faith has no property law antecedents is not entirely true. See Robert H. Kelley, *Any Reports of Death of the Property Law Paradigm for leases have been Greatly Exaggerated*, 41 WAYNE L. REV. 1563, 1597-98 (1995) (stating that are limited instances in which even property law courts might read "good faith" into a lease contract).

3. See *id.* at 1575-76 ("Under the traditional common law view, a lease was a conveyance (i.e. a sale by the landlord to the tenant of the right to have exclusive possession of the land in question)"). But, Professor Kelley notes that "as the transfer of the right to possess the land did entail promises

Therefore, if a landlord leased a farmhouse to his tenant on a large tract of land, and the farmhouse burned down, the tenant was still required to pay rent. Tenant had no frustration of purpose argument, and no assertion that performance was now impossible; these are contract law concepts. The tenant continued to owe his rent and, if it were necessary to rebuild the farmhouse at his own expense, the tenant would do so.

Property law suggested that landlord had given something valuable to tenant – the exclusive right of possession of the premises for the duration of the lease term. The landlord's later breach of a promise to tenant did not alter the basic conveyance. Absent Landlord's physical eviction of tenant from the premises, tenant had to endure a terrible array of problems and landlord failures, and still pay rent.

With respect to the farmhouse, property law posited two propositions, each disadvantageous to tenant: 1) landlord had no duty to repair the leased premises, and 2) independence of covenants (landlord's breach of a promise does not release tenant of its obligations to landlord). In fact, the latter proposition stands in direct opposition to contract law, in which breaching parties expend effort trying to show that the other "breached first" thus relieving it of liability for non-performance.

Modern American courts, with the encouragement of scholars and drafters of model acts, have thrown off much of the yoke of property law.<sup>4</sup> What is left of the ancient beast is frequently termed anachronistic, inefficient, and a poor second to contract law.<sup>5</sup>

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between landlord and tenant, the landlord-tenant relationship was also viewed as having some aspects of a bilateral contract." *Id.* (citing Michael Madison, *The Real Properties of Contract Law*, 82 B.U. L. REV. 405, 410-26 (2002)).

4. See generally, Madison, *supra* note 3, at 410-26. But see Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 OR. L. REV. 227, 227-28 (2005). Professor Dobbins argues that the doctrine has "been around for centuries," but recognizes that "it did not receive widespread acceptance in the United States until the mid-twentieth century." *Id.* (citing E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 669 (1963)).

5. In his article, Professor Madison argues, among other things, that "contract theory, along with some form of redaction of the Restatement of Property, is the reformism engine that is needed to shock antiquated property law out of its comatose state." Madison, *supra* note 3, at 409-10; see also Harold Dubroff, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, 80 ST. JOHN'S L. REV. 559, 560-61 (2006) ("Since the middle of the Twentieth Century it has attracted the attention of scholars and has become an increasingly familiar issue in commercial litigation."). Professor Dubroff does an especially nice job of tracing the history of the doctrine in American law, looking to the second half of the Nineteenth Century. *Id.* at 564. In these early cases, covenant was

Lease law is a component of property law, but it is perhaps in this area that contract law and property law have been most at odds. The rights of landlords and tenants – to enforce their agreements, to obtain damages, to maintain or obtain possession – have been clearly and historically set by property law. But a lease is also identifiably a contract, in which each party receives consideration, signs a document and has reasonable expectations about the behavior of the other.

In the residential sphere, the older concept of independence of covenants, a backbone of landlord/tenant law, has given way in some instances to dependence of covenants. Most notably, the tenant's obligation to landlord is, by virtue of the implied duty of good faith and fair dealing, dependant on landlord providing habitable premises. (This landlord obligation is otherwise known as the implied warranty of habitability, and carries tort law features as well as contract).

Lease law has been confronted with a continuing conflict between viewing a lease as a *transfer of an estate or as a contract*. For example, property law suggests that if a lease terminates at the will of one party, that right is implied to the other. This implication of a right to terminate arises even if the parties fully anticipated that the right would be unilateral only. By contrast, contract law looks to expectations of parties expressed in the document. Other examples abound.<sup>6</sup>

It is against this background that the doctrine of good faith and fair dealing has been injected into *commercial lease law*. Commercial lease transactions differ from residential leases in important respects.<sup>7</sup> Parties are often (although not always) represented by sophisticated counsel. The parties are savvy business people, or at least, we presume them to be. The money involved in a commercial lease transaction can be significant, and is usually far greater than the amounts involved in residential transactions.<sup>8</sup> Lease terms are usually longer. Office leases

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“applied to a variety of situations in which the express contract language, interpreted strictly, appeared to grant unbridled discretion to one of the parties and could reduce or eliminate the other party's contract benefits.” *Id.*

6. See Madison, *supra* note 3, at 410-11 (providing a series of leasing hypotheticals explicitly comparing the different results reached by property and contract law approaches). These include the problem of the holdover tenant, tenant's abandonment of the premises (and whether the landlord must relet), constructive eviction and commercial frustration (inability of the tenant to make the planned for use of the premises). *Id.* at 423.

7. See Susan E. Myster, *Protecting Landlord Control of Transfers: The Status of “Sole Discretion” Clauses in California Commercial Leases*, 35 SANTA CLARA L. REV. 835, 850-51 (1995). But see Gary Goldman, *Uniform Commercial Landlord and Tenant Act – A Proposal to Reform “Law Out of Context,”* 19 T.M. COOLEY L. REV. 175, 197-200 (2002) (arguing that the expectations of commercial and residential tenants are largely the same).

8. I have previously written:

typically run for five-year terms, and tenants may have options to renew or extend their terms. It is therefore not surprising that the idea of a lease as a *contract* is paramount in commercial lease transactions, and that the historical displacement of property law has been most noticeable in this arena.

Modern courts interpreting commercial leases today routinely answer the difficult questions by focusing on the contract law doctrine of the implied covenant of good faith and fair dealing. Unfortunately, these courts almost never look at the theoretical underpinnings of this doctrine. They should. The casual application of good faith and fair dealing to commercial lease transactions lessens the value of careful lawyering and protects sophisticated parties from the effects of foolish decisions. Ordinarily, courts presented with arguments that one party acted in bad faith parrot a basic truism – that bad faith occurs when one party acts in such a manner so as to deprive the other of the benefit of its bargain. As a result, there is little in the way of logic or consistency in many of the reported commercial leasing decisions and little basis for parties to anticipate how a court will rule. Transactional lawyers cannot plan for contingencies or draft to protect their clients if they do not know how a court will approach the lease document.

Sophisticated real estate attorneys chafe at the easy application of this doctrine to commercial leasing.<sup>9</sup> They argue that there are good reasons to enforce commercial lease agreements and maintain what might be described as a bias in favor of the landlord in commercial leasing transactions. In the heavily negotiated and fully represented world of commercial leasing, parties place virtually everything that matters to them in writing (dates for performance, methods of performance, obligations to one another, remedies, rights to pursue personal claims, etc.). All of these aspects of the lease transaction are

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Now imagine the dollars involved. In even a modest new office tower (one perhaps no greater than 15-20 stories tall) with an urban rental rate of \$25 a square foot, a five-year lease involves a lot of dollars. A 20,000 square foot lease at \$25 a square foot, with a term for five years, will generate 2.5 million dollars in revenues. Large businesses, law firms and accounting firms can lease well in excess of 100,000 square feet with options to expand their space and to renew the term. When these tenants sign on the dotted line for expensive and premium space in a new office tower, the dollar amount is staggering. These documents are therefore very thoroughly provisioned and heavily negotiated.

Daniel B. Bogart, *The Right Way to Teach Transactional Lawyers: Commercial Leasing and the Forgotten Dirt Lawyer*, 62 U. PITT. L. REV. 335, 342 (2000).

9. See, e.g., Eugene L. Grant, *The Implied Duty of Good Faith and Fair Dealing in Commercial Leases: Renewals, Extensions, Disclaimers, Exculpation, and Arbitration*, 3 THE COMMERCIAL PROPERTY LEASE, 133-42 (Patrick A. Randolph, ed., 1993).

negotiated (or negotiable). Resulting lease documents therefore represent the power and leverage of the parties to the transaction.

This article will do what courts have not done – explain the rationale for good faith and fair dealing as developed in academic literature *and apply this information to the commercial leasing context*.<sup>10</sup> This article will not argue that good faith and fair dealing should be excised from commercial leasing transactions. To the contrary, the commercial lease transaction is best understood as a contract. Rather, what good faith and fair dealing means in the context of commercial leasing is very different from what the term should mean in the residential scenario.<sup>11</sup>

To best understand the implied covenant of good faith and fair dealing in leasing, it is first important to examine the roots and rationale of the doctrine. Part II of this article touches on recent scholarship, particularly that of Professor Emily M.S. Houh.<sup>12</sup> Professor Houh identifies two possible explanations of (or approaches to) the Doctrine of Good Faith in contract law. One approach is economic in nature and suggests that parties to a contract forgo opportunities when they deal with one another and

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10. Perhaps because they must live with the consequences of court opinions, members of the practicing bar have looked at the application of the implied covenant of good faith in commercial leasing. Leasing lawyers face uncertainty in advising clients and have developed a real wariness of the value of the doctrine. For a good example, see Grant, *supra* note 9. Mr. Grant states up front that:

Over the last twenty years or so, the courts have increasingly imported this concept into commercial real estate leases, viewing them more as contracts for goods and services than as real estate conveyances. While this may sound like a reasonably benign legal concept, in practice it has created quite a ruckus in the law. The courts often seem to think this doctrine is a panacea for the harsh common law rule that silence means the landlord has the right to be arbitrary. But some cases have provided very surprising results. Some would say the results indicate we may have more of a Pandora's box than a panacea in this doctrine.

*Id.* at 133.

11. One commentator argues that we should start from ground up with commercial leases and incorporate contract law into a model law. See Goldman, *supra* note 7, at 178 (“The time has come to recognize that today’s commercial landlord-tenant law is ‘law out of context’ and needs a complete overhaul. Rather than try to fix the bleak house of landlord-tenant law made for another time and place, we should approach the law as Mr. Bumble would. The law is ‘a ass-a idiot,’ so replace it”). Professor Goldman suggests that states adopt a new act based on the 1972 Uniform Residential Landlord and Tenant Act (URLTA). He argues that, in most cases, the differences between residential and commercial tenants are not as significant as one might think. Professor Goldman argues that most commercial tenants take small spaces, are not major corporations, and do not actually employ expensive counsel. As the reader will note while reading this piece, I argue that even if commercial tenants are not all Wal-Mart sized, they are (or should be presumed to be) capable of hiring competent counsel.

12. Emily M.S. Houh, *The Doctrine of Good Faith in Contract Law: A (Nearly) Empty Vessel?*, 2005 UTAH L. REV. 1 (2005).

therefore impliedly expect a minimum level of acceptable behavior from the other. The second approach, “excluder-analysis,” essentially lists all instances of bad faith and, if behavior falls within this catalogue, invalidates it. The latter approach is best seen not as a *rationale* but rather as an *apparatus* for implementing commonly accepted business practices.<sup>13</sup>

The Restatement (Second) of Contracts adopts “excluder-analysis.” As we will see, this approach to defining the obligation of parties to deal in good faith with one another permits the court to add to an expanding, open-ended catalogue of bad faith behavior in contract performance. The Restatement’s implementation of good faith permits a court to look at the performance of parties in a contractual dispute, and “do justice.” In the residential leasing context, this makes eminent sense; nasty landlords behave dishonestly, and induce tenants to sign leases on the basis of promises that are left unfulfilled. However, we will see that many courts confronting allegations of bad faith performance in the commercial leasing scenario utilize the Restatement’s excluder-analysis (although they rarely note the theoretical underpinning of their holdings).

The “economic” approach to the doctrine puts into words a dynamic that commercial real estate lawyers see all the time and attempt to control, and where necessary litigate. On a regular basis, one party to a lease transaction will attempt to gain a “second bite at the apple,” – in other words, to obtain through opportunistic behavior a right not negotiated in the original lease document. This article will argue that in the commercial leasing sphere, it is not the job of the court to “do justice” in the broad sense, as the Restatement would suggest, but to limit this specific opportunistic behavior.

Professor Houh’s explanation of the underpinnings of the covenant of good faith is solid and clear. Nevertheless, this article does not conclude, as she does, that the doctrine is “a nearly empty vessel.”<sup>14</sup>

Part II will contrast the more general academic explanation of good faith and fair dealing with a more particular application of the doctrine in the area of commercial leasing. Very often, the doctrine is used to benefit tenants subject to landlord-oriented lease agreements. I should note at the outset, however, that landlord and tenant regularly allege that the other has acted in bad faith. Bad faith behavior is therefore not the sole province of landlords, by any means.

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13. *Id.* at 2-3.

14. *Id.* at 54; see also Dobbins, *supra* note 4, at 230 (arguing that courts should jettison the doctrine of good faith entirely, at least in a number of contract scenarios). Although Professor Dobbins’ piece is not limited to the leasing scenario, she touches upon it from time to time.

Finally, Part II of this article will argue that, in order for there to be a *comparative advantage* to parties choosing the best lawyers, and then for following the advice of counsel, *courts must allow parties to live with the consequences of lawyer representation.*

The Restatement forwards a policy of “doing justice” for and to the parties. Although this is a noble goal generally in the law, perhaps there is a more appropriate and overriding objective for courts applying the duty of good faith in the context of commercial leasing. Courts should instead be concerned with “raising the bar” of competence in legal practice. Too often the implied covenant of good faith has been argued by parties, and used by courts, to save one party from a failure to protect itself adequately in the initial lease document.

Part III of this article will apply the approaches to the implied covenant of good faith to three hypothetical commercial leasing scenarios. Each hypothetical is based on a recent litigated case. The hypotheticals present increasingly difficult tests for the obligation of good faith and fair dealing. From the writer’s perspective, *none* of the hypotheticals involve a violation of the doctrine of good faith and fair dealing, as it should be understood in commercial leasing. (One should note, however, that each hypothetical is based on a case that was extensively litigated, and in at least one case, the court found a landlord to have acted in bad faith).

Disputes involving the doctrine of good faith and fair dealing arise most often where a contract does not adequately specify the obligations of the parties. In each of the hypotheticals, the reader should try to identify the “low cost” avoider of the lease dispute. Which party, landlord or tenant, should most reasonably insist upon and receive protective language in the commercial lease?

It is not possible to discuss all or even most of the instances in which a landlord or tenant argues that the other has acted in bad faith. An examination of the cases suggests that this is the first and often most emotional charge of the aggrieved party. But a brief review of some of the cases reinforces the basic idea that parties should be left with the fruits (sour or sweet) of their negotiations. An overly ambitious implication of good faith and fair dealing circumvents this result, and devalues effective lawyering.

## II. GOOD FAITH IN LEASING: RATIONALES AND THE RESTATEMENT

### A. *The Restatement of Contracts; Comments and Illustration.*

Restatements of the law are creations of the American Law Institute (the “ALI”), and are commonly (and rightly) believed to be drafted by the very best legal minds. Members of the ALI



include practicing lawyers, judges and professors. Originally, the Restatements were intended to put into words what the legal elite believed to be the best statement of the accepted common law. These documents were meant to “restate” what the law already provided, but in a manner more useable to judges and lawyers.

In time, revised Restatements became more aggressive in defining what the law *should be*, and not simply what the law *had been*. The more the Restatements drifted away from the extant judicial practice, the more these changes were met with resistance by judges and lawyers.<sup>15</sup> For example, the Restatement (Second) of Torts attempted a profound change in the law of private nuisance, one that would have deprived relatively poor parties from redress when harmed by larger, socially valuable entities.<sup>16</sup> The ALI was forced to revisit the subject and provide an alternative definition of “intentional private nuisance” to placate hesitant judges.<sup>17</sup>

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15. See David A. Thomas, *Restatements Relating to Property: Why Lawyers Don't Really Care*, 38 REAL PROP. PROB. & TR. J. 655 (2004) (providing a pessimistic view). Mr. Thomas argues that the entire *Restatement* endeavor is flawed, and attempts too often to introduce changes in the law that move too far from the expectations of judges and lawyers.

16. See Jeff L. Levin, *Compensated Injunctions and the Evolution of Nuisance Law*, 71 IOWA L. REV. 775 (1986) (providing a wonderful discussion of the Restatement (Second) of Torts' treatment of nuisance doctrine). As Professor Levin explains, the ALI initially adopted a balance of utilities to determine whether private, intentional behavior would be deemed “unreasonable,” and therefore a nuisance. Behavior will be deemed unreasonable if the “gravity of the harm outweighs the utility of the actor's conduct.” *Id.* at 782-83 (citing RESTATEMENT (SECOND) OF TORTS § 826(a) (1977)). For example, a small chicken farm would be damaged by a large manufacturing plant that moves next door (second in time), but the utility of the defendant manufacturing plant's conduct would outweigh that harm. Under this rubric, the defendant's behavior is reasonable, and therefore not a nuisance.

17. See Levin, *supra* note 16, at 782-83 n.37 (noting that while the ALI was clinging to the balance of utilities doctrine, the highest courts of three more states rejected that approach in late 1969 or early 1970, holding that plaintiffs would be entitled to damages without regard to the utility of the defendant's enterprise). Ultimately, the ALI adopted a second definition of unreasonable conduct that permitted redress, even where the defendant's conduct was more valuable than the harm it caused. Under the new test, behavior was deemed unreasonable if “the harm caused by the conduct is serious and the financial burden of compensating for the harm caused by this and similar harm to others would not make the continuation of the conduct not feasible.” RESTATEMENT (SECOND) OF TORTS § 826(b) (1977). This very lawyerly double negative language essentially means that a defendant's behavior will be unreasonable if it causes some real harm to the plaintiff, and if defendant can afford to pay damages without going out of business. In the example of a small first-in-time chicken farm that finds itself harmed by the noise and odors emitted by a large second-in-time manufacturing facility, it is likely that the defendant will not be put out of business by paying damages. Its behavior would therefore be deemed unreasonable, and a nuisance. Note that the very language of the second definition of unreasonable behavior limits the

And yet, changes suggested by a revised Restatement can sometimes have a fast and profound impact. The Restatement (Third) of Property suggested significant changes to the law of easements. One such change would allow the owner of a tract of land burdened by an easement to relocate the location of an easement without permission of the owner of the easement, if certain conditions are met.<sup>18</sup> This change is controversial,<sup>19</sup> but it

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plaintiff's remedy to damages.

18. RESTATEMENT (THIRD) OF PROP., SERVITUDES § 4.8 (2000). That Section reads as follows:

§ 4.8 Location, Relocation, and Dimensions of a Servitude

Except where the location and dimensions are determined by the instrument or circumstances surrounding creation of a servitude, they are determined as follows:

- (1) The owner of the servient estate has the right within a reasonable time to specify a location that is reasonably suited to carry out the purpose of the servitude.
- (2) The dimensions are those reasonably necessary for enjoyment of the servitude.
- (3) Unless expressly denied by the terms of an easement, as defined in § 1.2, the owner of the servient estate is entitled to make reasonable changes in the location or dimensions of an easement, at the servient owner's expense, to permit normal use or development of the servient estate, but only if the changes do not
  - (a) significantly lessen the utility of the easement,
  - (b) increase the burdens on the owner of the easement in its use and enjoyment, or
  - (c) frustrate the purpose for which the easement was created.

*Id.*

The common law rule denied the owner of the servient tract the right to make changes to the location or dimensions of the easement. The general assumption was that the easement holder paid value for the easement (including the location of the easement). "Changing the location of the easement may reduce its utility to the holder of the easement and deprive the easement holder of the bargained-for benefit. Uncertainty about possible reduction in utility of the easement can decrease the value of the dominant estate." Susan F. French, *Relocating Easements: Restatement (Third), Servitudes § 4.8(3)*, 38 REAL PROP. PROB. & TR. J. 1, 1 n.1 (2003). Professor French was the Reporter for Restatement on Servitudes, and explains the rationale for the move to the new rule. She states:

The traditional rule puts the landowner at the mercy of the easement holder. The Restatement rule does not put the easement holder at the mercy of the landowner. Under the Restatement rule, the servient owner can relocate only if the easement holder suffers no damage. Under the traditional rule, the easement holder can torpedo a proposed relocation even though there is no damage. Under the traditional rule, the easement holder can demand and, in theory, expect to get almost all the surplus value created by any relocation. If the development made possible by relocation of the easement increases the value of the servient estate, the servient owner will be better off by the amount of that increase. Theoretically, the servient owner should be willing to part with as much of that increase as necessary to obtain the right to relocate so long as sufficient surplus remains to make the time and trouble of the redevelopment worthwhile. Of course, receipt of any payment from the

has already been incorporated into the common law of several states in recent case opinions.<sup>20</sup>

The Restatement is not law adopted by legislatures. Rather, it is a set of principled and thoughtful suggestions. If the suggestions have the weight of common sense and good policy behind them, so the argument goes, courts will adopt them.<sup>21</sup> In practice, this may mean overruling decades, and perhaps centuries, of common law.

For the purposes of commercial lease law and the implied obligation of good faith, it is the Restatement (Second) of Contracts (hereinafter, the "Restatement") that matters. Section 205 of the Restatement provides "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."<sup>22</sup> Good faith and fair dealing issues arise in two aspects of the relations between parties to a transaction – negotiation of the deal at its inception, and performance of the obligations created by the deal between the parties. However, the Restatement expressly refers to "performance" of contracts. The Restatement's implied obligation of good faith is therefore limited to *performance* of the contract, and does not cover *negotiations* leading up to the contract.<sup>23</sup> The landlord/tenant disputes that are

servient owner will make the easement holder better off so the easement holder may settle for less. Because the surplus value is due entirely to the investment made by the servient owner and the easement holder suffers no harm, any payment to the easement holder seems unwarranted, unless the easement holder or his or her predecessor actually bought that right as part of the easement. However, as explained above, knowing purchase of the right is unlikely unless the easement was negotiated by sophisticated real estate players.

*Id.*

19. See, e.g., John V. Orth, *The Burden of an Easement*, 40 REAL PROP. PROB. & TR. J. 639 (2006) (arguing that the Restatement's approach of allowing the servient estate holder to relocate the easement, in essence, "overburden[s] the servient estate").

20. See, e.g., M.P.M. Builders, LLC v. Dwyer, 809 N.E.2d 1053 (Mass. 2004) (expressly adopting Restatement § 4.8(3); developer obtained right to relocate easement to enable development of subdivision); Roaring Fork Club, L.P. v. St. Jude's Co., 36 P.3d 299 (Colo. 2001) (permitting development of a club so long as development does not reduce value of the easement); R & S Investments v. Auto Auctions, Ltd., 725 N.W.2d 871 (Neb. Ct. App. 2006) (allowing owner of property burdened by sanitary sewer easement to relocate a sewer lagoon).

21. The problem is that the drafters of the Restatement may be seen to stray so far from the comfort zone of lawyers and judges that the drafters' work may sometimes be ignored. See Thomas, *supra* note 15.

22. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

23. See Mark A. Senn, *The Covenant of Good Faith and Fair Dealing: Tenant's Implied Covenant of Continuous Operation*, COMMERCIAL REAL ESTATE LEASES: SELECTED ISSUES IN DRAFTING AND NEGOTIATING IN CURRENT MARKETS, SK010 ALI-ABA 723 (ALI-ABA Course of Study, June 2-3 2005) (noting the Restatement's good faith doctrine applies only to performance of the lease agreement, and not to negotiation of the document).

at issue in this article involve only questions of good or bad faith in the *performance* of obligations of the lease.<sup>24</sup>

According to comment a to Restatement Section 205, “good faith” requires “honesty in fact in the conduct of the transaction concerned.”<sup>25</sup> Mere honesty is not enough to insulate a party from the charge that it acted in bad faith. Comment d to Section 205 of the Restatement further explains that:

Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasions of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.<sup>26</sup>

Several aspects of these comments to Section 205 are initially striking. First, the Restatement defines good faith by describing what it is not. In other words, the Restatement defines bad faith behavior, and then explains that good faith is the opposite.<sup>27</sup>

Furthermore, a careful reading of the Restatement indicates that the good faith performance obligation has both subjective and objective components, and presumably, this would be true of any good faith obligation implied into a lease contract. Subjectively, *deliberate* failures to cooperate with an opposing party's attempt to meet the obligations of the lease will constitute acts of bad faith. (For example, one party's deliberately slow response to requests required under the lease that results in the other party missing a deadline might be deemed bad faith). There is also a clear objective component to the notion of good faith.<sup>28</sup> Honest behavior

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24. Commercial landlords and tenants typically formalize their understanding of the transaction, prior to signing the actual lease contract, in the form of a Letter of Intent (“LOI”). Occasionally, courts will imply an obligation of good faith and fair dealing on the parties from and after the moment they enter the LOI. This is a source of significant dispute and is beyond the scope of this article. For an extended discussion of the role and enforceability of Letters of Intent in commercial lease transactions, see generally DANIEL B. BOGART & CELESTE HAMMOND, *COMMERCIAL LEASING, A TRANSACTIONAL PRIMER* 3-10 (2007).

25. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1979) (quoting UNIFORM COMMERCIAL CODE § 1-209(19)).

26. *Id.*

27. See *infra* notes 35-39 and accompanying text for a discussion of “excluder-analysis.”

28. Professor Dubroff suggests that the separation between the subjective and objective elements of the Restatement approach is not so cleanly found. See Dubroff, *supra* note 5, at 572 (“Restatement Second and the U.C.C. have by no means abandoned objectivity in contract interpretation and gap filling,

by the parties, (or derivatively, by their attorneys) may not suffice to meet the obligation of good faith. It is not enough for a landlord or tenant to actually believe that it is acting properly. Indeed, the Restatement suggests that in some circumstances, honest answers may not relieve a party for violating the duty of good faith.

The question really becomes whether a third person in the aggrieved party's shoes would reasonably believe that the breaching party acted in bad faith.

Regular users of the Restatement (and this would be true of any of the Restatement projects) look for clues to the correct application of the language of the Restatement in the series of "Illustrations" that follow each section. Comment d to Section 205 is followed by seven illustrations. Illustration 2 explicitly treats a commercial leasing scenario. It reads:

A, owner of a shopping center, leases part of it to B, giving B the exclusive right to conduct a supermarket, the rent to be a percentage of B's gross receipts. During the term of the lease A acquires adjoining land, expands the shopping center, and leases part of the adjoining land to C for a competing supermarket. Unless such action was contemplated or is otherwise justified, there is a breach of contract by A.<sup>29</sup>

The scenario described in the illustration is certainly not foreign to commercial leasing lawyers. The supermarket was granted an exclusive use right, and now the owner of the supermarket feels cheated. This fact pattern has almost certainly cropped up in actual practice, and will occur again in the future.

In order to obtain the exclusive right, the grocery store owner, "B," either paid a higher rental or traded some other right away during negotiations. Having presumably traded a right of substance for the exclusive right to operate a grocery store, we can understand B's dismay when it discovers another grocery store in a now expanded shopping center. On the other hand, it is very easy to see the strong incentive created for the landlord, "A," to locate a second grocery store. Shopping center owners regularly expand in light of demographics and spending patterns.<sup>30</sup> A has

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but an objective determination of the meaning of contract terms is made upon an examination of the context of the bargain, permitting exploration into the subjective intent of the parties and the circumstances attendant to the particular contract issue").

29. RESTATEMENT (SECOND) OF CONTRACTS, § 205 cmt. d, illus. 2 (1979).

30. I can think of one shopping center in my hometown of Atlanta that has grown and morphed over the years ("Toco Hills Shopping Center"). It is a huge hodgepodge of stores, and now contains two very large supermarkets. There are even mini strip centers on out parcels, and a bewildering array of entrances and exits to the parking lot. Was there a time when the first grocery store in the shopping center had an exclusive use? If so, did the shopping center owner believe that by adding land and expanding, it could avoid the use restriction? The author has no idea of either answer.

already received its “consideration” in the form of a concession of one kind or another in the original lease form.

Standing in the shoes of B’s lawyers, how would one field the client’s angry call? Technically, the argument can be made that A did not violate the contract. The exclusive use granted by the landlord covered certain property – the shopping center existing at the time the lease was signed. The new supermarket occupies space in what A almost certainly will call “the equivalent of a new shopping center.”

The Restatement suggests that, even if A (the shopping center landlord) believes its actions to be justified, it nevertheless breached the contract in this case (the objective component). A may honestly believe and explain its viewpoint to B. But the Restatement suggests that a reasonable party in the shoes of the tenant would have thought any addition to the shopping center property would be subject to the exclusive use. This may also be an instance in which the landlord has subjective bad intent (although proving it will be difficult).

The Restatement helps the court evaluating the dispute between A and B by permitting the court to add to an open catalogue of scenarios in which bad faith is essentially presumed (“[a] complete catalogue of types of bad faith is impossible . . .”). Exclusive use provisions in shopping center leases have proved an especially fertile ground for misunderstanding and opportunism, on both the parts of landlords and tenants.<sup>31</sup> The Restatement allows the court to do justice among the parties. The common indicators of bad faith mentioned by the comment include dishonesty, dawdling, and “evasions of the spirit of the bargain.” This last phrase has particular application to the Illustration. It is possible that the new grocery store tenant in A’s expanded shopping center will *technically* not occupy a portion of the “shopping center” described in B’s exclusive right. But B will argue that permitting a second grocery store violates the “spirit of a bargain” between A and B.

I will come back to the Restatement’s leasing Illustration later in this article. For now, it is enough to ask whether B might have circumvented its own misery by insisting on a more protective and better drafted exclusive right. If the answer is “yes,” what are the implications for the implied covenant of good faith and fair dealing in the commercial leasing context?

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31. Exclusive use provisions in shopping center leases generate litigation that results in case opinions. One party or the other will routinely argue that the allegedly breaching party violated the implied duty of good faith in performance. See *generally*, Horton v. Uptown Partners, L.P., No. 05-0982, 2006 WL 1279044, at \*3 (Iowa Ct. App. May 10, 2006). This case is discussed *infra*, note 32, 46 and accompanying text.

### B. Recent "Good Faith" Scholarship

Unfortunately, the Restatement sheds little remaining light on the commercial leasing scenario, at least as it interacts with the implied obligation to perform a lease obligation in good faith. Taking a cue from the Restatement, courts agree that the doctrine applies to commercial leases. However, courts rarely describe the underlying rationale for the doctrine. At best, a court will mouth the most basic explanation that each party has the right to receive the benefit of its bargain.<sup>32</sup> Without a thoughtful rationale, it is hard to know when the doctrine is correctly applied in a given scenario.

Not surprisingly, however, scholars have stepped into the breach. Their purpose, to a large extent, has been to explain the Restatement, and to provide the policy justifications and analyses that the Restatement does not itself provide.

Professor Emily M.S. Houh of the University of Cincinnati College of Law has recently added a much-needed academic analysis of the doctrine of good faith in contract law. Although this article will ultimately disagree with some of Professor Houh's conclusions about the substance of the doctrine of good faith, it nonetheless draws heavily from her work. Rather than focus on areas of disagreement, perhaps it would be more accurate to say that Professor Houh's views of the doctrine of good faith do not apply perfectly to the particular scenario of commercial leasing.<sup>33</sup>

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32. *Horton* is a good example. The court states "our courts imply a covenant of good faith and fair dealing in every contract . . . and we have no doubt that this covenant is likewise operative in a commercial real estate setting." *Id.* (citing RESTATEMENT (SECOND) OF CONTRACTS § 205). The court then justifies the implied doctrine by quoting 13 RICHARD A. LORD, WILLISTON ON CONTRACTS § 38:15 (4th ed., 1999): "The underlying principle is that there is an implied covenant that neither party [to a contract] will do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract." *Id.* at 437. "In fact, looking at how courts have employed good faith analyses in breach of contract cases, it appears that the scholarly debates about good faith . . . have mattered very little to courts." Houh, *supra* note 12, at 13.

33. Professor Dobbins' article, *Losing Faith*, *supra* note 4, is also a significant addition to the literature on the covenant of good faith. Like Professor Houh, Professor Dobbins suggests that the doctrine is of much less use than believed typically by courts. Professor Dobbins states:

[I]n many contracts, the implied covenant of good faith is not capable or worthy of being saved from the chaos that currently surrounds it. The inability to define good faith leaves contracting parties with no clear understanding of their obligations. For this reason alone, courts should be wary of including the implied covenant of good faith in every contract.

Dobbins, *supra* note 4, at 230. Professor Harold Dubroff has also authored an excellent article on the subject of good faith and, as do Professors Houh and Dobbins, takes a distinctly critical view. See Dubroff, *supra* note 5, at 616. He states:

According to Professor Houh, two primary analyses of good faith have heretofore been offered. She terms the first, reflected in Section 205 of the Restatement, “excluder-analysis.” The chief proponent of this approach is Professor Robert S. Summers.<sup>34</sup> Under excluder-analysis, good faith has no real core meaning. Instead, the phrase “good faith,” although described as a “doctrine,” is employed instead to “exclude a wide range of heterogeneous forms of bad faith.”<sup>35</sup> Professor Summers argues that some forms of behavior depart so wildly from the norm that parties to an existing contractual relationship reasonably anticipated from one another that this behavior should simply be deemed violations of the doctrine of good faith. The open-ended catalogue of bad faith includes garden-variety misbehavior that reasonable persons accept as outside the scope of conventional behavior.<sup>36</sup>

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[T]he addition of the covenant to the law of contracts has not, by and large, been helpful. One reason for this is that imposing an unbargained for covenant of good faith and fair dealing on contracting does not necessarily mesh with the principle of individual autonomy. . . . Another reason why the covenant has not been as helpful is its potential to confuse and sometimes misdirect contract disputes that should be resolved by familiar principles of interpretation and gap-filling.

*Id.*

34. Robert S. Summers, *The General Duty of Good Faith – Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982); Robert S. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968). Professor Houh cites and discusses Professor Summers’ groundbreaking work in detail throughout her article. In addition, she lists a number of articles on the nature of the doctrine of good faith. See Houh, *supra* note 12, at n.2.

35. Houh, *supra* note 12, at 5 (quoting Summers, *supra* note 34, at 201); see also Dobbins, *supra* note 4, at 271-72.

36. See Dobbins, *supra* note 4, at 271-72.

Unfortunately, more than thirty-five years later, courts have failed to live up to Professor Summers’ aspiration.

Some of the fault may lie with the examples listed in Professor Summers’ article and Comment d to the Restatement (Second) of Contracts section 205, since those examples can be more confusing than enlightening. Some of the alleged examples of bad faith, such as willful rendering of imperfect performance, lack of diligence, and slacking off, may constitute a breach of contract.

...  
The Restatement’s definition of] “evasion of the spirit of the bargain” as bad faith is troubling because it assumes that the “spirit” of an agreement can be discerned, and because it ignores the fact that the parties negotiate or agree to terms, not a general concept or “spirit.”

...  
Other examples of “bad faith,” such as interference with or failure to cooperate in the other party’s performance, can be dealt with by



As such, it is impossible to list fully bad faith scenarios that might arise. They are as varied and unanticipated in nature as the parties who sign contracts. At best, one might create a non-exclusive set of possible categories of bad faith, recognizing that human nature would in time add to the list further forms of pernicious behavior that would cross the line.

As Professor Houh notes, the Summers' good faith rationale serves three purposes. First, good faith (at least according to Professor Summers) creates a basis for an independent action under the contract. Second, it works to "limit and quantify specific legal rules and contract terms."<sup>37</sup> Third and finally, the doctrine furthers a basic social good: it permits judges "to do justice and do it according to the law."<sup>38</sup>

Professor Summers' view of the implied covenant of good faith is squarely represented in Restatement Section 205. As noted above, Section 205 defines good faith in the negative. It states that behavior that is not "bad faith" is "good faith," and provides a non-exclusive list of bad faith performance scenarios. It does so first in the language of the Section itself, and then in the comments fleshing the Section out.

The second approach to the implied covenant of good faith is premised in economic analysis. Where Professor Summers' definition of bad faith (and therefore of good faith) has the unmistakable characteristic of "I know it when I see it," the approach based in economic analysis is defined by external markers. Professor Steven J. Burton is the primary author of this economic analysis that defines the doctrine of good faith in terms of "opportunities forgone upon entering a particular contract."<sup>39</sup>

other contract law doctrines or can exist separately as independently defined and recognized duties.

*Id.* Part III of this article presents three hypothetical commercial leasing scenarios, and applies both Professor Burton's and Professor Summers' approaches to good faith. In doing so, the somewhat unmanageable nature of Professor Summers' catalogue of bad faith becomes apparent.

37. Houh, *supra* note 12, at 7 (quoting Summers, *supra* note 34, at 265).

38. *Id.*

39. Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 372 (1980). Professor Burton's article is also cited throughout Professor Houh's piece and provides in relevant part:

The core of his analysis is that a party in these circumstances [in which the contract explicitly grants it discretion or there is an ambiguity in the contract providing it discretion] who exercises discretion so as to recapture opportunities forgone in the contract is performing in bad faith; on the other hand a party who exercises discretion to capture opportunities preserved (or not forgone) in the contract is acting in good faith.

Dubroff, *supra* note 5, at 603-09.

Professor Dubroff argues that the lost opportunities analysis has its weaknesses, however. He states:

The economic analysis suggests that parties who violate the duty of good faith are doing nothing more than attempting to “recapture opportunities” that were not negotiated in the initial contractual agreement.<sup>40</sup>

Real estate lawyers see this conduct all the time, and Professor Burton’s explanation of bad faith (and therefore of good faith) strikes a sympathetic chord. In the jargon of leasing lawyers specifically, and transactional lawyers generally, a party acting in bad faith is doing so in order to take “a second bite at the apple.” The problem, according to Professor Burton, is that usually one party has greater discretionary power in the performance of the contract than the other.<sup>41</sup>

In the context of commercial leasing, discretionary power may be in the hands of one party as to one aspect of performance of the contract, and in the hands of the other party as to some other aspect of performance of the contract. However, on the whole, discretionary authority is largely in the hands of the landlord. Initial lease forms are drafted by landlord and not tenant. Consider the typical office lease in a major urban area. Assume that a law firm is in negotiation for a suite a quarter of a floor. This is a good tenant and one that will obtain concessions in the ultimate lease document. That said, the initial form of the lease contract is *pro-landlord* in *myriad respects*. At best, law firm

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It is hard to argue with Professor Burton’s view that the good faith doctrine is superfluous if it serves only as a justification for requiring contract performance that is within the justifiable expectations of the parties. But it is also hard to argue that his forgone opportunity analysis is necessary, or even helpful, in analyzing whether a party has exercised discretion in a manner permitted by the contract. Clearly, parties who enter into contracts forgo their opportunities to act in specified and unspecified ways . . . . But forgone opportunities will be revealed in the same way reasonably expected benefits will be revealed – by determining the agreement of the parties based on principles of interpretation and gap-filling. Until the agreement is so determined the forgone opportunities will be known but will be of no consequence in determining the rights and obligations of the parties – these have already been determined by the process of interpretation and gap-filling.

*Id.* at 605.

This article argues, notwithstanding the foregoing, that Professor Burton’s analysis is helpful in the commercial leasing scenario (and in the broader context of real estate transactions). Forgone opportunities may be revealed during litigation sometimes in a very precise manner, as parties dredge up iteration after iteration of lease document negotiated by the parties, leading to the final document. Furthermore, trained real estate lease lawyers do have a general understanding of what types of concessions a tenant in a particular market might obtain, and through reverse engineering, it is often possible to discern the rights that one party has traded away.

40. Houh, *supra* note 12, at 8.

41. Burton, *supra* note 40, at 373. Professor Houh discusses Professor Burton’s approach, including this aspect of his analysis, in Houh, *supra* note 12, at 8-9.

tenant will extract perhaps half of its requested changes to the document, (and very likely less than half). The tenant's lawyer will advise tenant which rights to forgo and which changes to the lease it should push hard to obtain. It is a game of high-stakes chicken in which tenant will say that without certain changes to the document it will walk away from the table. Neither landlord nor tenant wants the deal to crater, but in most cases, tenant will give more than it gets.

To the extent that one party is not attempting to obtain this second bite, it cannot be said that it is acting in bad faith. Professor Burton's approach is more specific and grounded than the approach of Professor Summers. In fact, it is this characteristic that Professor Burton touted.<sup>42</sup>

Professor Burton does not burden himself with issues of fairness and justice. Instead, he inquires narrowly whether one party acted opportunistically. One implication of his analysis, (and not of Summers', which is concerned with justice in a broad sense) is that a party cannot be said to act in bad faith if that party is merely pursuing an express right granted under the contract. Indeed, parties should be able to bargain out of the obligation of good faith. If one side is willing to forgo its right to accuse the other of bad faith, and receives consideration (perhaps in the form of a lower rental), then following Burton's approach, this is a valid and enforceable trade-off.<sup>43</sup>

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42. As Professor Houh notes, Professor Burton disapproved of Professor Summers' and the Restatement's approach. Professor Burton suggested that the latter was dependent on an "amorphous totality of the circumstances at the time of formation." Burton, *supra* note 40, at 387. Professor Houh suggested that Burton disapproved of the Restatement's "open-ended and far-reaching factual inquiry it may require to discern" the reasonable intentions of the parties to the contract. Houh, *supra* note 12, at 9.

43. Assignment and sublease provisions of commercial leases are a good example. Courts today often read an obligation of good faith and fair dealing into these provisions. If the tenant is required to obtain the landlord's consent to an assignment of the lease, then a growing trend suggests that landlord is not permitted to withhold the consent in bad faith. *See generally*, Kathleen Hopkins & Cynthia Thomas, *Overview of Assignment and Subleasing Issues, THE SUBLEASE AND ASSIGNMENT DESKBOOK, LEGAL ISSUES, FORMS, AND DRAFTING TECHNIQUES FOR COMMERCIAL LEASE TRANSFERS* 11-12 (Brent C. Shaffer ed., 2006). If the lease is written to allow Landlord to withhold its consent "for any reason or for no reason," this language will be enforced. *See* MILTON R. FRIEDMAN & PATRICK A. RANDOLPH, *FRIEDMAN ON LEASES* § 7:3.4 (5th ed., 2007) (hereinafter "FRIEDMAN ON LEASES, (RANDOLPH ED.)") ("It may be concluded that the rule in this country is still that a clear anti-assignment clause, with no reference to 'consent,' will be enforced."). FRIEDMAN ON LEASES, (RANDOLPH ED.) cites a number of cases, many of which are old. However, as the treatise notes, the basic premise has been validated in recent cases. 21 *Merchs. Row Corp. v. Merchs. Row Inc.*, 587 N.E.2d 788 (Mass. 1992); *F&L Ctr. Co. v. Cunningham Drug Stores Inc.*, 482 N.E.2d 1296 (Ohio Ct. App. 1984). FRIEDMAN ON LEASES, (RANDOLPH ED.) is considered the

Of course, there are instances in which the *tenant* has significant discretionary authority and may use it. Very often, these scenarios result in gray area cases that Professor Burton's analysis does not seem to resolve. For example, in the retail sphere, the tenant may be required to pay as rent a percentage of tenant's gross revenues. These percentage rent leases always require the tenant to pay a minimum base rent. Some tenants have taken the extreme course of continuing to pay base rent while closing up shop in that location and turning out the lights (this is known as "going dark"). The language of the lease may not on its face preclude the tenant from going dark. Both the tenant and the landlord could have insisted on language in the lease agreement that would clarify the right of tenant to go dark, or not to go dark.<sup>44</sup>

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"Bible" of lease law, and for good reason. It is a thoughtful and comprehensive review of the history of lease law, the state of the law today and trends in the law, as well as a succinct examination of the practice area. FRIEDMAN ON LEASES, (RANDOLPH ED.) goes on to say that courts might be tempted, under the right circumstances, to invalidate even a flat anti-assignment clause (one that does not condition assignment upon tenant obtaining landlord's consent) if the circumstances of the case make the landlord look especially unsympathetic. *Id.* § 7:3.4. FRIEDMAN ON LEASES, (RANDOLPH ED.) notes one "extreme" case, in which "the tenant vacated the premises and sought permission to sublet to the government for a post office. The court upheld the landlord's right to forbid the subletting and gave landlord judgment for about \$20,000 for rent accruing after tenant's vacation." *Id.* § 7:3.4 n.152 (citing *Gruman v. Investors Diversified Servs., Inc.*, 78 N.W.2d 377 (Minn. 1956)); see also BOGART & HAMMOND, *supra* note 24, at 160 ("Landlord may include in its lease form the most brusque and air-tight language indicating that Landlord has the 'right, for any reason, or no reason' to withhold its consent."). Letters of Intent, *infra* notes 56-58, and accompanying text, sometimes include language permitting the parties to negotiate in bad faith. Obviously, this is a different context than that facing landlord and tenant once the leasehold commences and one party is miffed about the failure of the other to perform.

44. No doubt gray area cases pose a problem for Professor Burton's test. In practice, "[f]ew courts appear to rely expressly and exclusively upon Professor Burton's conceptualization of good faith, which holds that a party breaches the implied covenant when it uses its discretion 'to recapture forgone opportunities.'" Dobbins, *supra* note 4, at 272-73 (quoting Burton, *supra* note 40, at 378). According to Professor Dobbins, "[c]ourts may be reluctant to rely on this conceptualization because it requires them to determine what opportunities a party gave up when entering into a contract. This undertaking seems even more difficult than identifying the parties' reasonable expectations." *Id.* at 378. Professor Dobbins insight into the hesitance of courts to adopt Burton's approach has a strong resonance in commercial leasing. Given the significant complexity of commercial leases – the many drafts that change hands and the range of communications and negotiations, not to mention the sophisticated financial background necessary for the lawyers and clients to confront the transactions – courts may find it hard on occasion to determine what right was given up in exchange for another. On the other hand, sometimes the exchange between landlord and prospective tenant is explicit. A tenant may hold out for a broad right to assign, and be forced to give up other specific concessions.

The tenant could have negotiated the right to “go dark” in the initial lease agreement. However, if tenant had attempted to do so, this might have caused landlord to doubt the selection of the tenant and perhaps back out of the deal altogether.

Landlord could just have easily negotiated an express provision requiring tenant to *operate continuously* in the location. Is the inclusion of a percentage rent provision in the lease agreement the same as an express obligation for tenant to continuously operate in a location? Some courts have answered in the affirmative, and have based their decision on the tenant’s implied covenant to act in good faith.

Professor Houh asks the critical question, and it is a question that is central to a discussion of good faith in the context of commercial leasing. She asks, “[w]hat does compliance with the good faith obligation require of contracting parties, beyond compliance with abstract notions of fairness?”<sup>45</sup> When a court interpreting a commercial lease explains the duty of good faith by stating that it denies each party from doing anything “which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract,”<sup>46</sup> that court has done nothing more than reflect on abstract notions. The problem, according to Professor Houh, comes in translating these abstractions. In other words, the difficult matter is resolving “the positive question of what the good faith doctrine *does* require and the normative question of what it *should* require.”<sup>47</sup>

Indeed, Professor Houh refers to the doctrine of good faith, as it is presently applied and more importantly explained in the case law, as a “nearly empty vessel.”<sup>48</sup> This view has some merit. She notes that, in practice, courts regularly reflect on one party’s breach of the implied duty to act in good faith. But very rarely do courts employ a *substantive framework* for explaining why one form of behavior may be aggressive but permissible, and the other actionable bad faith. Instead, according to Professor Houh, “courts have come to apply good faith not as a substantive implied obligation, but as a rhetorical proxy for underlying material breach analyses.”<sup>49</sup> In other words, courts allege that one party to a contract has breached the duty of good faith when in fact they are really employing the language of the doctrine to determine that the party is in material breach. As a result, most commonly

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45. Houh, *supra* note 12, at 2.

46. *Horton*, 2006 WL 1279044, at \*3.

47. Houh, *supra* note 12, at 2.

48. *Id.* at 54.

49. *Id.*

applied, the doctrine is more correctly identified as “a subduty relating to material breach and constructive conditions.”<sup>50</sup>

As Professor Houh explains, Section 241 of the Restatement, defining material breaches of a contract, lists breach of the good faith obligation as among several triggers.<sup>51</sup> This is significant. One of the most basic tenets of contract law is that once one party to a contract breaches, the other may cease its performance under the contract. Therefore, when one party breaches its duty of good faith, the other is released from its performance obligation.

Commercial lease law presents opportunities to test this idea. If a tenant views the landlord’s behavior as somehow “bad faith,” presumably that would be enough to constitute a material breach, and excuse the tenant’s performance. In the give and take of a real landlord tenant relationship, one wonders how often *a tenant actually ceases performance* – which mainly is constituted of the rental obligation – on those occasions the tenant claims landlord violates the implied obligation to act in good faith.

Nevertheless, in her careful examination of cases drawn from a variety of fact patterns, (one involving commercial leasing), Professor Houh decides that the doctrine of good faith has its uses, empty of content though it may be. She explains that the doctrine of good faith in contract performance and enforcement eliminates the need for parties to draft a provision to cover every contingency at the contract formation stage of the relationship. In other words, good faith is a gap-filler, taking the place of some details that might have delayed execution of the contract. From an economic perspective, she points out that negotiating too many provisions at the outset of a contractual relationship would so raise the transaction costs associated with the contract as to make its creation unlikely.<sup>52</sup> Finally, she argues that too hard nosed a negotiation process at the outset of a transaction may introduce distrust among parties that will have to deal with, or in some sense, live with one another over a number of years. Poisoning the relationship of parties to the contract at the outset of the relationship would lead to breaches and socially undesirable results.<sup>53</sup>

In the end, Professor Houh would resuscitate the implied covenant of good faith in two ways. First, she would refocus the doctrine on contract negotiation (of which letters of intent play a crucial role in the leasing context). Second, she would utilize the doctrine in the specific arena of employment law. Employment law is fraught with issues of discrimination. She states that the doctrine should be used in contract law “to prohibit improper

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50. *Id.*

51. *Id.* at 52 (citing RESTATEMENT (SECOND) CONTRACTS § 241).

52. *Id.* at 18.

53. *Id.*

considerations of race, gender, and sexuality in contract performance and [that courts] should recognize the doctrine as a device for eliminating racial and sexual subordination that can function beyond the scope of conventional civil rights jurisprudence.<sup>54</sup>

The idea that the doctrine of good faith has a place in contract formation in commercial leasing – at the stage of letters of intent and preliminary descriptions of lease agreements – is certainly one that will interest commercial leasing attorneys. This article is focused on performance, but contract formation issues are relevant and difficult. Leasing attorneys regularly use Letters of Intent (“LOI”).<sup>55</sup> Whether these letters are binding on the parties is a hot-button topic.<sup>56</sup> The Restatement does not impose a duty of good faith on parties during the negotiation phase of a contract. However, in some jurisdictions, the execution of an LOI denotes a moment at which courts expect the parties to begin acting in good

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54. *Id.* at 56. Professor Dobbins would limit the implied covenant of good faith in contracts to a few limited spheres.

The implied covenant of good faith may be appropriate in certain categories of contract where the duty can be defined with a reasonable degree of clarity, thus putting parties on notice of their obligations at the time of contracting. For instance, the covenant may be implied to address situations unforeseen at the time of contracting or to interpret ambiguous or incomplete contracts. Moreover, the duty of good faith in the Uniform Commercial Code (UCC) should be preserved.

Dobbins, *supra* note 4, at 231.

55. See Donald S. Horvath, *Letters of Intent and Drafting Decisions that Affect the Profitability of and Management of the Building*, 2 NEGOTIATING COMMERCIAL LEASES: HOW OWNERS AND CORPORATE OCCUPANTS CAN AVOID COSTLY ERRORS 449-50 (PLI Real Estate Law and Practice Course, Handbook Series No. 522, 2005).

56. Generally, courts characterize a Letter of Intent in one of three ways on the question of its binding effect. In some jurisdictions, courts hold that the Letter of Intent is a binding contract requiring the consummation of the particular lease whose terms are included. Other courts have held that a Letter of Intent is of no binding effect, at least where the document expressly states that the parties will not be bound to complete the transaction by the terms of the preliminary agreement and where the agreement contains no express duty to continue to negotiate. The third possibility is that a court will not view a Letter of Intent as a binding contract but as nonetheless imposing an enforceable duty on the parties to negotiate the terms that remain open in good faith. BOGART & HAMMOND, *supra* note 24, at 5-6 (internal citations omitted). If the parties to the LOI understand the default rules of their jurisdiction, then they will be able to draft around the rules. In other words, the parties may by, careful drafting, disable any jurisdictional rule enforcing the LOI as a binding contract. Similarly, the parties may create the LOI so that some or all of the terms of the document are binding on the parties. Horvath, *supra* note 56, at 450-45; BOGART & HAMMOND, *supra* note 24, at 5-10.

faith. This may mean, in essence, that the parties must continue to negotiate in good faith to the execution of a lease agreement.<sup>57</sup>

As to Professor Houh's second use for the doctrine of good faith, (broadly, to prevent discrimination), this is not central to the commercial leasing world. No doubt, discrimination against prospective tenants does occur in the rental of commercial office space. But the problem is controlled to a large degree by the "Ivan Boesky" effect.<sup>58</sup> In a competitive (buyer's) market for office space, a tenant may be a law firm composed of persons of color. The landlord's lender will still demand a mortgage payment at the end of the month. If a tenant is capable of paying rent, that tenant will suit landlord's primary need.

To summarize, two distinct well-recognized views of good faith have emerged in academic literature. The first defines good faith by what it is not (bad faith) and seeks to further social goals of justice and fairness. The second seeks to control opportunism and invalidates behavior that could have been bargained for at the outset of the contract.

### C. *Commercial v. Residential; A Look at the Implied Warranty of Habitability*

To truly understand what the implied covenant of good faith should mean in the context of commercial leasing, it is necessary to spend some time with residential landlord/tenant relationship. Certain expectations of the parties to the transaction, and the resulting scholarly and judicial impulses, are specific to the residential market. The particular reading of good faith in residential leasing is seen in relief in the Implied Warranty of Habitability. There are good reasons for the warranty in the residential sphere, but little good reason to transpose it to the commercial arena.

At common law, lease covenants were independent. Tenant was excused from his rent payments only if the landlord physically interfered with tenant's quiet enjoyment of the property (making quiet enjoyment the only "dependent" covenant). Leases were understood as devices that transferred an estate, rather than as agreements governed by contract law.<sup>59</sup>

Although harsh, the common law rules largely reflected the expectations of the parties: that landlord would transfer a *right* to

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57. *Id.* at 8-10.

58. Ivan Boesky was a Wall Street financier who famously stated "I think that greed is healthy." He was later convicted of securities related crimes. His activities, as well as those of other insider traders, are famously chronicled in JAMES B. STEWART, *DEN OF THIEVES* (1991).

59. See generally, Fred William Bopp, *The Unwarranted Implication of a Warranty of Fitness in Commercial Leases - An Alternative Approach*, 41 VAND. L. REV. 1057, 1059-60 (1988).



possession (but not to put tenant into *actual physical* possession); that tenant would maintain the property and make it suitable for tenant's use; that tenant would inspect the property prior to taking the lease and that tenant had the knowledge to evaluate the property [keep in mind the agrarian nature of most early leases]; that tenant did not want or need the involvement of landlord in tenant's day-to-day use of the property; and that tenant invariably had meager bargaining power but that this was an accepted aspect of life at the time.<sup>60</sup> Certainly, it would be uncommon at early common law for tenant to be represented by a lawyer.

Over time, courts recognized that acts of a landlord, short of a true physical eviction, might make the tenant so miserable in its use of the leased property that the tenant was all but physically removed. If landlord constructively evicted tenant, tenant would have a defense to an action for rents. In order to make use of the defense, the tenant ordinarily had to show that he vacated the premises immediately, or as soon as possible, following the events or actions that rendered the premises *untenantable*. Furthermore, the tenant would show that the defect in the premises that caused tenant's departure resulted from some failure of the landlord to keep a promise made in the lease. To put it another way, landlord could not constructively evict tenant for failing to provide a service or make a repair that landlord had not promised in the first place.

The expectations of residential tenants and landlords are radically different from those held at early common law. As at common law, lawyers are normally absent from the typical residential lease transaction. But unlike agrarian tenants of early common law, present day residential tenants do not have the ability or knowledge to make repairs to the premises. Indeed, their leases may forbid tenants from making physical repairs. The typical tenant in a garden-style apartment expects the rental unit to meet a minimum standard of quality and to be reasonably free from defects. The defense of constructive eviction is inadequate, because it does not reflect expectations of parties to the contract. It is also inappropriate because it forces a tenant to quickly decide whether to ditch its leased property, and then hope that a court

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60. Professor Goldman states:

To comprehend the law it is helpful to envision the tenant leaning on a fence at twilight, watching his fields and awaiting the call to dinner. It is against this simple background that landlord and tenant law took the shape it has essentially retained to this day. With this background as a starting point, the crudities and eccentricities of landlord-tenant law become at least understandable. Still more important, it focuses our attention on not only where things started to go wrong in this body of law but also on the reason why.

Goldman, *supra* note 7, at 177.

after the fact agrees with the tenant that it had been constructively evicted.

The problem is compounded if the tenant is truly poor and at the landlord's mercy. Landlord may hold tenant's deposit, and without this deposit money tenant is unable to rent new quarters. If the tenant is held to be without the defense, then even if the landlord mitigates damages, the tenant will find itself paying the equivalent of two rent payments. In slum housing, the next landlord may be no better than the landlord presently making the tenant's life miserable. Constructive eviction is inadequate to protect the most vulnerable residential tenants.

Enter the Implied Warranty of Habitability (the "IWH"). The IWH supplants the defense of constructive eviction.<sup>61</sup> The IWH requires the landlord to provide minimally habitable premises throughout the term of the lease. It does not matter whether the tenant knows of the defect on the date she signs, and the tenant may not waive the warranty. Most importantly, the tenant does not have to vacate the premises in order to take advantage of the warranty. It may be used as an affirmative cause of action for recovery of damages. Courts vary on specifically what benchmarks should be used to determine whether residential housing violates the IWH. Typically, courts look to local health and safety standards.<sup>62</sup>

The IWH derives from both contract law and tort law. It takes most its substance from contract because the tenant expects the landlord to act in good faith and deal fairly. But there is a tort element as well. Landlord can reasonably foresee certain harms from its behavior. The tort aspect of the IWH presents the tenant with the opportunity to obtain punitive damages from the landlord.

One can see how Professor Summers' Excluder-Analysis, reflected in the Restatement, finds voice in the IWH. This approach creates an open catalogue of behavior that courts accept as "bad faith."

Residential housing has become, in some sense, almost a fungible commodity, similar to personal property that an individual might own.<sup>63</sup> (A widget is a widget is a widget). This is

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61. Actually, the two actions may exist side-by-side, like Neanderthals living in Europe at the time as Cro Magnon man.

62. See generally, WILLIAM B. STOEBOCK & DALE A. WHITMAN, *THE LAW OF PROPERTY* § 6.38 (3d ed. 2000) (calling the IWH "a revolution in landlord-tenant law" and "the most dramatic and sudden change in that area of the law in modern times"); BOGART & HAMMOND, *supra* note 24, at 134-35; Bopp, *supra* note 60, at 1064-67.

63. Good faith is contract law. It has been incorporated into the law most successfully in the Restatement Section 205. However, the Restatement does not cover real property. Some commentators find this odd. Professor Robert H. Kelley exclaims:

a departure from the usual truism, often stated, that land is unique. No doubt that to a prospective residential tenant, one garden-style apartment may seem nearly identical to the next. Presumably, a rational individual will choose the least expensive residential apartment that fits comfortably within his budget, that otherwise meets that person's reasonable needs.<sup>64</sup>

In this world of leased premises as "widgets," specific, nasty landlord behaviors recur over and over, particularly where the widget involved is low-cost housing. It is precisely because the list is open-ended that courts may look at the facts of each case and tailor the IWH to "do justice" for the tenant. Looking back at the comment to the restatement, the drafters explained that "evasions of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance" constitute bad faith.<sup>65</sup> Failing to fix toilets, remedy mold problems, and delay in addressing security concerns in common areas, all fit within the parameters of the Restatement's view of bad faith.

By contrast, the open-ended catalogue of bad faith at the heart of the Restatement makes little sense in the commercial context. Commercial leases are negotiated by specialized attorneys and involve larger sums of money than are the norm in

Resulting anomaly is that if a person enters into a contract to sell or lease a \$79.00 toaster, he must act reasonably and in good faith. However, if the same person is a landlord under a lease that requires the tenant to pay a monthly rent of \$790.00, the landlord act unreasonably, arbitrarily, and in bad faith so long as the landlord does not commit fraud.

Kelley, *supra* note 2, at 1597.

Professor Kelley is exasperated that a transaction involving the conveyance of real property does not treat the subject matter of the transfer – and the obligations of good faith that each party to the contract has to the other – the same as if the transfer had involved a household appliance. Yet, real property lawyers might view the same scenario entirely differently. There are real and significant reasons to view leases as something more than the contracts for goods and services that are governed by the U.C.C. One sophisticated lawyer writes that it is not blind tradition that maintains a pro-landlord bias in landlord tenant relations, and militates against finding a breach of the duty of good faith under every rock. Instead, "there are factors unique to real estate leasing transactions, as opposed to contracts in general that support the traditional bias in favor of the landlord." Grant, *supra* note 9, at 133.

64. People are not always rational, of course. Sometimes tenants choose to rent premises "above their means," or below it. And no doubt, for all of us, other considerations come into play as we assess the utility of a particular rental unit: how much do we value amenities such as a swimming pool, what are the aesthetics of the property, what is its location and proximity to work, etc.

65. Grant, *supra* note 9, at 133.

residential practice. (Indeed, a substantial urban office lease may call for rentals over the term in the millions of dollars). The clients are sophisticated. There is a wealth of information to educate both lawyer and client alike on the impact of different lease provisions and on the business implications of decisions that parties make.

In many cases, tenants come to the table with real leverage. The document that is ultimately produced may vary significantly from the initial form presented to tenant by landlord.<sup>66</sup> This is very different from the reality of residential leases, in which tenants are presented with form documents that they do not substantively negotiate. Some commercial landlords, in hot markets, may assume a take-it-or-leave-it attitude. But the important point is that, typically, the commercial tenant really can leave it and look elsewhere. If there is any environment in which the negotiated decision of the parties should hold, it is this one.<sup>67</sup> Real property lawyers need a more general recognition that the duty of good faith means something *different* in the context of commercial leasing.<sup>68</sup>

As noted above, a modern trend is to sometimes view real property as fungible, in the same sense that personal property is fungible. This may be an accurate representation of some commercially leased property. To commercial tenants taking undistinguished and utilitarian office space, the primary concern may merely be the dollar cost per useable square foot of space.

However, most commercial tenants focus heavily on location; it is *not* true that commercially leased property is simply another "widget." A small law firm may try to signal its capability by stretching to afford offices in a prestigious location. That same tenant may choose to pay, or forgo paying for prime space in a

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66. In some cases, the lease document will be so exhaustive and vary so significantly from the initial form that either or both sets of attorneys will create "lease summaries" for their clients.

67. See Bopp, *supra* note 60, at 1087 (arguing that the differences between residential and commercial tenancies "dictate confining the broadest remedy, an implied warranty of habitability, to the residential sphere," and relying instead on the doctrine of dependence of mutual covenants to govern landlord/tenant behavior).

68. *Id.* at 138-41. Gene Grant's goal seems not to be elimination of the doctrine, but to rein in its abuse. For example, he chastises the Third Circuit Court of Appeals for its opinion in *J.C. Penny Company, Inc., v. Giant Eagle, Inc.*, 85 F.3d 120 (3d Cir. 1996) in which the court held that an exclusive right granted to a retail tenant in the original lease would be impliedly incorporated into a new lease between the parties. Grant, *supra* note 9, at 136-37.

According to Mr. Grant, the lease in *J.C. Penney* was new, and the tenant did not negotiate exclusives in new lease document. It may be that this defeated plans tenant had for the space. But it is equally clear, says Mr. Grant, that the tenant should have made certain that its needs were met in the finished document. *Id.*

building that provides optimum views from offices and conference room windows.<sup>69</sup> One building is not the same as another. In fact, the exact location on a floor, and whether a tenant occupies floor 5 as opposed to floor 55, will matter to a commercial tenant paying rent in the many thousands of dollars. The tenant may view nearly identical property as being different because of the location of competitors, or general movement of other businesses to or away from the location. This property is not fungible.

The unique nature of real property also makes it difficult if not impossible for a judge having little or no experience with the complexities of real estate operations to easily resolve disputes among commercial landlords and tenants. This is quite different from the residential sphere; a good judge, whether or not she has had transactional experience, will identify behavior that falls within the "catalogue." By contrast, that judge may not have the background or savvy to fairly say what can and should be done in response to a commercial tenant's request for consent to assignment of the lease or the decision of the retail tenant to abandon the premises while continuing to pay annual base rent."<sup>70</sup>

Attorney Mark A. Senn is an authority on commercial leasing. He notes an outer limit on the implied duty of good faith. He suggests that the implied covenant does not (or at least, should not) "be used to vary the express terms of the agreement."<sup>71</sup>

From my perspective, good faith should be used in a manner consistent with the test proposed by Professor Burton. Courts

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69. *Id.*

70. *Id.* at 134.

71. *Id.* I say "should not" because, as Mr. Senn notes, courts have in fact varied the terms of sophisticated and well-negotiated agreements, citing the doctrine of good faith. Mr. Senn cites *Grenfell v. Anderson*, 56 P.3d 326 (Mont. 2002); see also Dobbins, *supra* note 4, at 265-66 (quoting RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981)) (noting the usual basis for arguing that a party breaches the covenant of good faith is "by exercising an express contractual right is justified by the argument that the duty of good faith enforces 'community standards of decency, fairness or reasonableness.'"). Professor Dobbins agrees with Mr. Senn. She states:

A party can only reasonably or justifiably expect conduct in addition or contrary to the contract terms if the contract has been modified, the contract or certain terms are unconscionable or violate a statute, the other party's conduct constitutes a waiver of a contractual right or obligation, the other party's conduct gives rise to an estoppel claim, or if the conduct involves taking opportunistic advantage in a way that could not have been contemplated by the parties when they entered into the agreement. While this will certainly leave some parties disappointed and wishing that they had been more careful in drafting their contracts, the certainty and predictability of this approach make it the more prudent option. This is especially true in light of the fact that the law does not require that contracts (or contracting parties) be objectively "fair" or "equitable."

*Id.* at 269.

evaluating lease contracts entered into by sophisticated parties who had the benefit of counsel should look for and punish opportunistic behavior. Behavior intended to grant one party a “second bite at the apple” – in other words, rights that could have been negotiated in the original lease but were not – is bad faith. Absent fraud, anything short of such behavior should be deemed good faith, even if it is not very nice.

One will recall that Professor Emily M.S. Houh expressed the view that the doctrine of good faith, as it is often applied, is nearly empty of content. As useful as her dissection of the doctrine of good faith may be, however, it cannot be transposed to the commercial leasing scenario with a one-to-one correspondence.

For example, Professor Houh explains that the doctrine is useful because it permits the parties to avoid negotiating every contingency that may arise once the deal is struck. Instead, the parties can proceed with their negotiation, and leave some issues raised in the initial documents untouched, because the parties know that they will be forced to perform in good faith after the fact. This is true, *but not as true in the commercial leasing context as it may be in the residential context*. Real estate lawyers, and particularly those whose practices involve leasing, and who have been in practice for more than seven or eight years, will have survived both booms and collapses in the office building market. In the latter periods, tenants come to the negotiating table with tremendous leverage. It is common for a landlord’s lawyer to receive a call from the landlord (or perhaps the landlord’s in-house leasing agent) informing the lawyer that landlord has a strong prospect of leasing a suite, “but that we had better move quickly before some other building owner makes a more attractive offer to tenant.” Landlords will offer generous improvement allowances and monetary incentives to sign the tenant in this market.

In fact, landlords will agree (perhaps reluctantly) to make significant changes to the basic lease document. Where previously they might only have agreed to mostly minor changes, *in significantly down markets* landlords may be forced to provide tenant rental abatement provisions for failures to provide building services, termination rights, rights to review the landlord’s books to determine if the statement of operating expenses is accurate, and so on. The negotiations are intense, and the landlord’s lawyers will ultimately produce an amendment to the basic lease form that is very long and detailed. In some cases, where the tenant takes over one or more floors, landlord’s and tenant’s lawyers will find it useful and necessary to create summaries and “executive summaries” of the finished lease agreements for their clients, so that in later years, if a dispute arises between the parties, the attorneys can quickly identify just where, how and to what extent the model lease contract was changed. These

summaries are necessary because the finished contractual product will vary in profound ways from the original model lease form.

Therefore, although Landlord and tenant and their respective lawyers may not attempt to anticipate *every* contingency in the commercial lease agreement, it is clear that in heavily negotiated lease agreements where the tenant has leverage, the lawyers come *darn close* to doing so. The implied covenant of good faith therefore does not have the effect of saving as much in the way of transaction costs as might be true in other settings.

What is more, Professor Houh's concern that the initial hard bargaining on multitudinous details of the agreement will poison the relationship between the parties after a contract is signed is simply not correct in most commercial leasing arrangements. In both the office and retail markets, landlords often own and control more than one building, and deal with many, many tenants. Landlords rely on in-house and in-building management personnel to interact with tenants after the lease term begins. These in-house management personnel may have little involvement with the initial lease negotiation. Leasing agents, even in-house leasing agents, may be in separate offices and face different pressures from day-to-day building management personnel. It is unlikely that the relationship between the management of the building – the people whose responsibility it is to keep and prepare operating expense statements and make the elevators run on time – will be poisoned because the attorneys for tenant pushed hard at the time of contract formation.

The Restatement's excluder-analysis is valuable in the sense that it allows real property lawyers to develop a consensus (or better yet, a "conventional wisdom") of behavior that is in bad faith and that which is not.<sup>72</sup> However, this approach to the

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72. A Landlord's "double-dipping" expenses would likely fall into the category of behavior that real property lawyers collectively agree to be in bad faith. Double-dipping occurs when the landlord has a specific right to charge the tenant for a discrete expense in the lease, and then charges for that expense in the primary operating expense provision. For example, some commercial leases contain an "HVAC" provision, entitling landlord to charge tenant for tenant's share of heating and cooling common areas of a building. This is usually determined in accordance with a set formula based on the sizes of the tenant's leased premises. The same lease will also contain an operating expense pass-through provision. This allows the landlord to charge, as "additional rent," tenant's share of the costs of maintaining a slew of common expenses. The dishonest landlord may choose to pass-through expenses it has already charged in the specific HVAC fee provision. In fact, most landlord attorneys will modify a lease agreement to eliminate the ability of the landlord to double bill as soon as the tenant lawyer objects in the negotiation. This is true even of small tenants who have otherwise little leverage. This is probably because there is a collective understanding among real estate lawyers that double-dipping will not hold up in court, because it is patently unfair and a breach of good faith.

implied duty of good faith and fair dealing does not help a court, or the parties and their lawyers, decide whether behavior of one party crosses the line when the behavior arises in a *new or unusual scenario*. Professor Burton's test, by contrast, helps resolve those cases that are not garden-variety.

For example, think back to the commercial leasing Illustration to Section 205 of the Restatement. In that scenario, a retail landlord granted a grocery store tenant an exclusive right to that use in landlord's shopping center. The landlord then acquired additional, adjoining land, and leases some of this space to a competing grocery store. Landlord will proffer a very technical reading of the lease, and say that it did not violate the exclusivity provision. Here is its basic argument: It is possible, even likely, that the "shopping center" in which the tenant has an exclusive right is *specifically defined* in the lease. If so, the shopping center will be *only that property which comprised the facility when tenant leased its space, and not as expanded*. Therefore, landlord may argue that it has not given any other party a grocery store lease in the area covered by the exclusive use provision.

Nevertheless, the Restatement concludes that the landlord breached its implied obligation to act in good faith by leasing to the second grocery store tenant. This is true despite the fact that a very technical reading of the tenant's lease would probably save the landlord.

The Restatement's excluder-analysis says essentially that anything that is done in bad faith is not good faith. And bad faith is defined loosely by reference to behavior that is dishonest, or dilatory, or defeats the benefit of the bargain. As such, bad faith behavior is recognized as part of an open catalogue of behavior by the parties and their lawyers. This reasoning is facile. The problem is that the behavior described in the Illustration is not so easily placed in the catalogue. Although it surely must happen, it is by no means garden-variety. Landlords expand shopping centers all the time, and both landlords and tenants reasonably expect that this can happen.

A court would be correct to inquire whether the landlord in the Illustration acted in bad faith. However, Professor Burton's approach suits the Illustration better than that adopted by the drafters of the Restatement. For the purposes of this commercial leasing scenario, the court should ask whether the landlord's behavior – acquiring adjoining property and leasing a portion of the property to a competing grocery store – opportunistically allowed the landlord to achieve a right it could have acquired in the original lease but failed to do so. If the question is phrased this way, the answer is less clear.

The Illustration does not give us enough facts to truly resolve the problem. How obvious was the possibility that landlord would



expand? Is the shopping center in which the original grocery store tenant leased the premises a *discrete parcel*, or has landlord basically tacked on additional land, *physically extending the shopping center building itself*? (Imagine a strip shopping center that had the original grocery store tenant as anchor at one end, and now has a new grocery store in the same, now expanded shopping center at the other). In the latter case, it really does look as if the landlord has taken a second bite at the apple. With these additional facts, it is clear that landlord's goal is to steal a right that it could have obtained initially but failed to do so.

*D. One More Reason to View the Doctrine Narrowly in Commercial Leasing; Raising the Bar for Good Legal Practice*

There is an underlying question raised by the Restatement's commercial leasing Illustration of the implied covenant of good faith and fair dealing: should the tenant's lawyer in that scenario have the burden of insisting on more protective language in the initial lease document, or should the law infer a general doctrine to protect the tenant in the absence of such language? *The tenant could have insisted on a radius clause giving it exclusive rights to operate a grocery store in property owned by landlord within some radius of the original leased premises.* With a wide enough radius, the tenant would be protected from the competing store.

We should therefore ask: is this a case in which a capable tenant's lawyer should anticipate the problem and demand the radius clause? If so, using the implied covenant of good faith to solve the dispute *eliminates* the value of good lawyering.

Let me therefore propose one further view of the doctrine of good faith that does not displace it from the commercial leasing sphere, but helps put it in its proper place. This practice-based view of the doctrine bolsters a strict understanding of the doctrine of good faith and fair dealing when applied to commercial leasing, and suggests more concretely that Professor Burton's approach works best in this environment.

Lawyers are legion. Real property lawyers doing lease work practice in every jurisdiction and at almost every law firm of size doing transactional work. Lawyers may develop expertise in lease practice not merely by doing it, but by attending seminars, educational events, conferences and the like. For example, the Practising Law Institute puts on an annual two day commercial lease law program that brings together the most adept lawyers in the business. Law libraries often buy these materials for their general collections.

Courts employing good faith doctrine as a means of substituting or redefining the relationship between landlord and tenant ultimately do a disservice to the quality of the practice of

law, and therefore to clients for legal services generally.<sup>73</sup> Why should lawyers spend time and money in additional and difficult training if a less experienced attorney will receive the benefit of judicial protection of his or her educational laziness? And why should a party to a transaction go to the trouble to seek out recommendations for experienced lawyers, to fire incompetent attorneys, or to locate organizations that train and validate the special skills of expert lawyers, if a lawyer's mistake in judgment will be corrected by judges after the fact?<sup>74</sup>

This is especially true of lease law. The American College of Real Estate Lawyers ("ACREL") is a premier organization for real property lawyers. It is a working group and it has, as part of its mission, the goal of improving the quality of real property practice. One party to a lease transaction may seek out ACREL members for legal representation, while the other party may not. The final, negotiated document will reflect the advice and counsel of each party's attorney, and thus the comparative advantage gained by the party having chosen the better lawyer.<sup>75</sup>

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73. Mark Senn suggests that courts employing the doctrine routinely "recognize the contractual nature of leases" and that therefore the courts purport to enforce these expectations. Senn, *supra* note 23. "However, the ease of [a court's expression of the doctrine] contrasts starkly with the difficulty of its application. Since the landlord's and tenant's expectations may not be stated in the lease, this duty invites a judge or jury to infer extraneous matters that were meant to be expressed fully in the lease." *Id.*

74. Although not explicitly addressed, this seems to be an underlying theme in Gene Grant's article arguing for a restricted understanding of the covenant of good faith in commercial leasing. Grant, *supra* note 9. Mr. Grant is a practitioner with many years of lease negotiation (representing both landlords and tenants) under his belt.

75. The "comparative advantage" that flows to the party with the best lawyer is described in ROBIN PAUL MALLOY & JAMES CHARLES SMITH, *REAL ESTATE TRANSACTIONS* 6 (3d ed., 2007). Professors Malloy and Smith state:

As real estate lawyers, we are often called on to determine the legal reliability and completeness of essential information underlying the client's judgments and expectations. We are also engaged to structure transactions so as to protect the value of the client's plans. To do this we must truly understand the market choices and preferences that shape the client's market outlook and transactional motivation. In this context, the *value* of the lawyer rests in her ability to facilitate the client's investment expectations. The lawyer is selling an expertise, or *comparative market advantage*, in understanding the legal rules and infrastructure necessary to protect the client's expectations and to complete the desired transaction. The client is treating law and the legal system as a commodity. The law is a product that forms a necessary part of a successful real estate transaction, and the lawyer is hired to provide a level of skill and confidence in the delivery of the product that exceeds the performance of nonlawyers. This added level of skill is the lawyer's comparative advantage in facilitating the transaction and it is generally thought that these skills increase with time and experience. Thus, more senior lawyers and lawyers with a specialized practice gain more expertise, and advantage over others, and

*The implied duty of good faith must not be interpreted to do damage to a system that rewards clients for finding and trusting better lawyers.* Further legal education and the exchange of knowledge are incentivized by a process that requires parties to live with the consequences of their choices.

This is much less a consideration in the residential leasing arena. Owners of large apartment communities are particularly unwilling to negotiate changes to pre-prepared form lease agreements. The landlords have significant leverage, and deal with unrepresented tenants. Most people sign these lease agreements without understanding the basic terms, or because other landlords of similar apartment communities use the same if not identical forms. There is therefore little value in trying to negotiate a change. Landlords are loathe to accept changes also because a large scale apartment community may have hundreds of apartments. Routine changes to the lease agreements would create a nightmare for the landlord. Although the author is a strong proponent for the use of lawyers (otherwise why make a living training them?), for the vast number of residential tenants the cost of hiring a lawyer for a lease negotiation would be prohibitive.<sup>76</sup>

It makes considerable sense therefore to interpret good faith broadly in the residential context. If there are no lawyers in the residential lease negotiation, it makes no sense to speak of "comparative advantage" or "incentivising the use of good lawyers by the parties." (Indeed, even the landlord is typically not represented by counsel in the residential scenario. A lawyer drafts the initial lease form, and this is the extent of the lawyer's involvement).

Notice again that the good faith of which this article speaks is good faith in *performance* and not *negotiation*. The goal is to encourage (incentivize) a businessperson's search for and the use of *good* lawyers in commercial lease negotiation. If parties are forced to live with their decisions regarding the hiring of lawyers,

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consequently command higher fees for their services.

*Id.*

One assumes that the process of meeting stringent selection criteria required for membership in ACREL results in an organization composed of truly expert members. Thus, a client choosing an ACREL lawyer would obtain a comparative advantage, at least in transactions in which opposing counsel are non-ACREL lawyers. The value to the lawyer is that membership serves as a very powerful signal that the lawyer really is an expert and choosing the lawyer will lead to the client's success. Membership in this type of organization indicates a lawyer's capabilities, but it does not guarantee a particular client's outcome.

76. Indeed, if the leasing personnel made more than the most minor changes to the standard apartment lease agreements, they would run afoul of rules prohibiting the practice of law without a license.

and the consequences of failing to heed the advice of counsel, then these same parties are presumed to have addressed important issues in the lease document. This reduces the need for courts after the fact to employ the doctrine of good faith to alleviate the suffering of one party to the contract who alleges that the other party is in breach.

### III. SOME INTERESTING HYPOTHETICALS

The preceding Part of this article attempted to synthesize some of the academic material explaining the content and purpose of the doctrine of the implied covenant of good faith. Part II addressed the lease transaction generally. This Part will set out several brief commercial leasing hypotheticals. In each case, either landlord or tenant will make the argument that the other party has breached its obligation of good faith implicit in the lease agreement. A careful analysis of each hypothetical reveals that the argument should only rarely succeed.<sup>77</sup>

Obviously, this approach to fleshing out a correct application of good faith in the commercial scenario has its weaknesses. The most significant is that of biased selection. One might present scenarios in which it would never be possible to find the doctrine applicable, and just as easily, one might construct hypotheticals in which landlord's or tenant's arguments that the other acted in bad faith are always valid. The author is sensitive to the problem. Each scenario is drawn from the facts of recent case opinions in which either landlord or tenant has attempted to stretch the envelope of the good faith doctrine.

Initially, consider the following two hypotheticals:

#### *Hypothetical #1:*

Landlord owns One Stop Shopping Center in a well-trafficked part of town. The stores in One Stop Shopping Center are successful. One of Landlord's tenants is Grocery Store. Grocery Store's lease is dated January 1, 2000. It has a lease term of ten years, with a single ten-year renewal period. Absent notice given by Landlord to Grocery Store, the lease will automatically renew on December 31, 2010. Prior to the expiration of the initial ten-year term, Grocery Store requests Landlord's consent to Grocery

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77. The interested reader might supplement this triad of hypotheticals by reading Gene Grant's article on good faith in commercial leasing. Rather than present a series of hypotheticals, Mr. Grant collects cases that involve specific scenarios: lease renewals, lease extensions, disclaimers of the covenant, exculpation clauses, and arbitration provisions. Grant, *supra* note 9. Throughout his exposition, Mr. Grant demonstrates the limitations of the covenant of good faith, and more importantly, how the doctrine should operate in a limited manner in the context of commercial leasing. Mr. Grant's article was authored in 1993. *Id.*

Store's sublease to Food Mart. Food Mart operates a chain of grocery stores similar to Grocery Store and otherwise meets the use requirements of the lease. Landlord approves the sublease. The sublease grants Food Mart the right to extend its term for two successive 5-year periods, upon no less than 180 days written notice to Grocery Store prior to the expiration of its initial sublease term. The sublease will expire (if not otherwise extended) on April 31, 2010.

On April 1, 2009, real estate agents of Grocery Store and Food Mart converse regarding the Food Mart sublease. The agent for Grocery Store asks whether Food Mart will continue to operate in the One Stop Shopping Center location. The Food Mart agent responds: "This is Food Mart's most successful location. I cannot imagine that Food Mart will let it go. I am sure Food Mart intends to exercise its right to extend its lease term." Third party witnesses confirm the conversation.

The market value of space in One Stop Shopping Center has increased since the execution of the sublease, and market rental values for the Food Mart space exceed what Food Mart will pay in the event it exercises it right.

Food Mart sends written notice exercising its right to extend the term 165 days prior to the expiration of its sublease term. Grocery Store responds that Food Mart forfeited its right to timely extend the term of its sublease.

Although Food Mart does not deny that it missed the deadline, it argues that Grocery Store's unwillingness to treat the term as extended is in "bad faith," and violates the implied covenant of good faith and fair dealing.<sup>78</sup>

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Each of the hypotheticals presented in this Part can be approached using the traditional Restatement/excluder-analysis, the Burton/lost opportunity cost analysis, and by addressing the impact that using good faith doctrine in the particular hypothetical might have for incentivising "good practices" for real estate lawyers and their clients.

Hypothetical #1 is an easy one, or at least it should be. Tenant is a savvy and represented business party. Its failure is probably due more to sloppy internal practices than poor lawyering. There is no indication in the facts that tenant's lawyer was even involved in the failure to provide notice.

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78. This hypothetical is based loosely on *Kings Super Markets, Inc. v. Stop & Shop Supermarket Company, LLC*, 2006 WL 1449339 (N.J. Super. App. Div. May 26, 2006).

This hypothetical tests the conventional wisdom that tenants and landlords should meet time deadlines set out in written contracts, especially those provided in sophisticated, negotiated commercial lease agreements. To that end, one should point out that the conversation among the real estate agents in the hypothetical is hardly the stuff of a binding contract. As pointed out earlier in this article, steps leading to the formation of a contract are not normally enforceable, and in any event, the Restatement does not concern itself with contract formation,<sup>79</sup> only contract performance.

The landlord's behavior was certainly mercenary, but it was reasonably expected. There is no requirement in the law that landlords be "nice." The open catalogue of bad faith behavior that is used to define "good faith" under the Restatement should not include a requirement of "niceness." Conventional lawyer thinking probably suggests that the oral statements of a party's intent attributed to real estate agents are *not* reliable sources of authority and are not binding on parties. After all, a real estate agent's interest is the commission. He would work hard to preserve all possible avenues of earning the commission, including overstating the likelihood that tenant would seek to keep the space. Therefore, even the open-catalogue approach of the Restatement probably suggests that it is acceptable to hold the tenant to the deadline and this landlord's behavior is not typical bad faith.

Still, tenant might argue that landlord knew *unequivocally* of tenant's desire to extend the term, that it was clearly in tenant's financial interest to extend and that therefore tenant's failure to do so was more akin to clerical error than error in judgment. Furthermore, tenant will assert that landlord was not in any sense harmed by a late notification (after all, if extended, the lease would provide landlord with a stream of rental income it agreed to initially), and that landlord did not take even minimal steps to remind tenant of the deadline. If this issue arose in the residential context, a court might well be tempted to "do justice" among the parties and permit the tenant to give slightly late notice, and thereby allow the tenant to retain his lease.

By contrast, Professor Burton asks the reader to evaluate whether the landlord was opportunistically seeking, by its behavior, to defeat the terms of the contract and obtain a right not originally negotiated. In this case, one might argue that landlord is attempting a second bite of the apple. After all, by refusing to grant extension of the term after the stated lease deadline, landlord obtains higher rental than initially agreed in the

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79. See *supra* notes 22-24 and accompanying text.

previously negotiated escalation provision of sublease. Upon reflection, however, this is not a “second bite” at all.

The landlord and tenant were both aware at the time the parties executed the lease agreement that it called for a 180-day notice period. Either the tenant did not believe it needed a shorter period (say – 165 days) or in the give-and-take of negotiations tenant accepted a half-year notice period because this led to a more agreeable lease in other respects. Landlord always has the right and should in fact try to find the tenant who will pay highest rent for space when the present tenant’s lease term expires. In this case, the lease term will expire because the tenant failed to properly exercise its extension right. The landlord in hypothetical #1 merely enforced a right it had properly obtained in its initial negotiation of the lease.

Would a court’s use of the implied covenant of good faith in this scenario to require landlord to accept late notice of extension of the lease undermine the overall quality of real estate practice? In this case, the initial answer is “no.” The obvious reason is that, under the facts as presented, no lawyer was involved with the contract performance error that resulted in the tenant’s downfall. Undoubtedly, a lawyer drafted the initial lease form requiring tenant to give notice of its decision to exercise the extension option. That language is standard and there is nothing to suggest that the tenant’s lawyer somehow failed to incorporate language that would protect its client.

However, upon reflection, the answer is not so clear. Using the doctrine to save the tenant in the first hypothetical might well reduce the value of good lawyering.

Both landlord and tenant profit from having their lawyers train and inform employees of their clients of the requirements of the leases they sign, and of the need to abide by deadlines. In fact, law firms often provide this kind of training, formally and informally. This close working relationship between a party and its counsel can help the party avoid errors. The fact is that at some point lawyers leave the playing field and clients are left to their own devices. *Good lawyers will make sure that their clients understand the documents they sign, and real estate practice would be improved if these relationships are encouraged.* Assuming that lawyers were uninvolved in the tenant’s actual failure to give notice on time, there is no reason to use the implied doctrine of good faith to save the tenant. The court in *Kings Super Markets v. Stop & Shop Supermarket Company, LLC*,<sup>80</sup> the case on which the hypothetical is based, correctly held for the landlord.

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80. *Kings Super Markets*, 2006 WL 1449339, at \*6.

*Hypothetical #2:*

Landlord is the owner of a Big Box Store Location. Tenant is a national chain retailer with a 20-year lease. The lease is executed on January 1, 2000. The lease permits Tenant to construct a warehouse store, and Tenant does so at a cost in the millions of dollars.

The lease further provides for an automatic 20-year extension, unless *“Tenant, by prior written notice to Landlord, said notice to be not less than six (6) months prior the expiration of the Term, notifies Landlord of Tenant’s intention to terminate this Lease . . . .”*

In the alternative, the lease provides Tenant with the option of entering into a new 99-year lease with Landlord. Given the popularity of Big Box Stores and changing demographics, the financial terms of the 99-year lease described in the option are favorable to Tenant.

The lease provides that: *“[t]enant may exercise its option to enter into a 99-year lease for the Premises by 1) informing Landlord by written notice and 2) providing a one-time payment to Landlord of \$200,000 as a fee for the exercise of said option; provided, however, that both Tenant’s prior written notice of its intention to exercise its option and the payment of said \$200,000 fee shall occur no later than 180 days prior to the expiration of the original lease term.”*

Tenant informs Landlord in writing of its intention to exercise the option to enter into the 99-year lease more than a year prior to the end of the original lease term. Tenant does so formally in a letter dated December 1, 2018 and in subsequent conversations between Tenant and Landlord representatives. At no time does Landlord confirm (in writing or verbally) Tenant’s exercise of the option to extend the lease for 99 years.

Concerned with the Landlord’s failure to respond, Tenant’s attorney attempts to extract Landlord’s acknowledgment that Tenant had validly exercised its option. Landlord’s employees refuse to provide such assurance. In the few instances that Tenant’s phone calls are even returned by Landlord, the individuals returning the calls are lower level employees of Landlord with no real authority to speak or bind Landlord.

In a letter to Landlord dated February 1, 2019, Tenant’s attorney notes that he will need to obtain a title search for the property prior to closing. In the same letter, Tenant’s attorney inquires which of Tenant’s lawyer or Landlord’s lawyer will draft the new lease agreement.

On March 1, 2019, the leasing agent for Landlord informs Tenant’s lawyer in writing that “we will be forwarding your letter to our attorneys and will be back in touch within 2 weeks.”



Four weeks later, on April 1, 2019, Landlord's attorney writes a letter to Tenant's lawyer soliciting a phone conversation regarding the option right.

After two weeks of trying to reach the Landlord's attorney by phone, Tenant's lawyer writes another letter requesting a time to discuss the "serious issues and necessary steps to concluding the exercise of my client's option to a 99-year ground lease. Tenant is required to tender payment of the option fee at time of closing of the 99-year ground lease. The fee is significant in size, and my client needs to know the date of closing and wire transfer information to assure that it can meet the requirements of the option."

On August 1, 2019, Landlord's attorney lowers the boom, and sends a letter to Tenant and Tenant's lawyer stating the following:

"The lease agreement between Landlord and Tenant for the Big Box Location will terminate according to its terms on December 31, 2019. Tenant has failed to validly exercise its option right to a 99-year lease as required by the original lease contract. Said lease contract requires both prior written notice to Landlord and payment of the \$200,000 fee to Landlord no later than 180 days prior to expiration of the term. Tenant failed to timely tender said \$200,000 payment as required by the lease."

Tenant argues that, although it failed to timely tender the payment, Landlord violated its obligation of good faith and fair dealing in performance of Landlord's lease obligations.

\* \* \* \* \*

In many respects hypothetical #2 is similar to hypothetical #1. In both cases, the tenant failed to meet a deadline specifically referenced in the lease agreement. Yet, in the latter scenario, a court might be tempted to find the landlord in breach of its implied obligation to act in good faith. (In fact, in *Brunswick Hills Racquet Club, Inc. v. Route 18 Shopping Center Associates*,<sup>81</sup> the court confronting the case on which this hypothetical is based determined that the landlord breached its implied good faith obligation).<sup>82</sup> Clearly, the attorney for tenant overlooked a critical element of the option right – the fact that tenant was required to tender payment of the option fee within 180 days of expiration of the term. The tenant and tenant's lawyer were both operating under the misapprehension that the option fee was due at closing of the lease transaction.

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81. 864 A.2d 387 (N.J. 2005).

82. In *Brunswick Hills*, the New Jersey Supreme Court held that the landlord had in fact violated its obligation of good faith and fair dealing. *Id.*

The Restatement determines whether the landlord met its good faith obligation by asking whether the landlord's actions are contained within an open catalogue of bad faith behavior. To answer this question, courts applying the Restatement's good faith doctrine begin by repeating the truism: a party acts in bad faith when it acts to deprive others of the benefit of the bargain.<sup>83</sup> The catalogue of bad faith, although applied by courts, is in essence a reduction of the "conventional wisdom" of real estate lawyers.

The landlord's behavior in hypothetical #2 seems to parallel behavior deemed bad faith in comment d to Section 205 of the Restatement.<sup>84</sup> The comment states that good faith behavior requires something "more than honesty," and bad faith may be shown by, among other things, "evasions of the spirit of the bargain, lack of diligence and slacking off."<sup>85</sup> In the hypothetical, landlord delayed or evaded tenant's request for information and communication with the landlord, and the landlord engaged in a pattern of stringing tenant along in the very hope that tenant would fail to meet its deadline. This may not be *fraudulent* behavior (after all, the lease clearly spelled out the deadline and requirements), but landlord is taking advantage of tenant's obvious misunderstanding.

In hypothetical #2, the tenant had in fact sent *written* notice to the landlord as required by the lease to convert the lease to a 99-year term. This is a significantly more concrete manifestation of the tenant's intention than tenant's reliance on the conversation of two real estate agents in hypothetical #1. Indeed, the tenant in hypothetical #2 had taken one of the two *formal* steps towards exercising its right by sending written notice of its intention.

The problem with the conclusion of the court in *Brunswick Hills Racquet Club*, on which hypothetical #2 is based, is not that it fails to apply good faith doctrine as developed by the Restatement, *but that it does so*. The landlord's behavior is mercenary, and the attorney's behavior is unprofessional, but this should *not* be the dividing line for good faith in the commercial context.

Under Professor Burton's lost opportunity cost analysis, the landlord should not be held to have acted in bad faith. The landlord negotiated to receive its \$200,000 fee at least 180 days in advance of the expiration of the lease. This is *not* a minor detail. There are very good reasons that the landlord would want to have the fee paid at the time of written notice. The requirement demonstrates that tenant is serious about closing the new 99-year lease, has the requisite financial wherewithal, and is not wasting landlord's time. *Therefore, the landlord did not obtain in its post*

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83. See *supra* note 32 and accompanying text.

84. See *supra* note 26.

85. *Id.*

execution performance a right from tenant that the landlord failed to negotiate in the initial lease agreement. The facts tell us the opposite – that the landlord negotiated to receive a large sum well in advance of termination of the lease, and that the tenant failed to tender this amount in time.

Most likely, the landlord's goal is not to absolutely kick tenant out of the property. Instead, if the lease terminates without exercise of the option, the tenant is forced into a very weak negotiating posture for the Big Box Store Location. The costs to tenant of closing its store at the Big Box Location would be significant, and no doubt the landlord understands this reality of tenant's business. Landlord is acting to obtain higher market rental value for the property. In the abstract, this is exactly the behavior we expect of any property owner when a lease *legitimately* expires. It is common for lawyers and their parties to wait for a deadline to pass, and there is no general requirement to practice law for the benefit of an opposing party, especially where the other party is well represented.

What is grating about the landlord's behavior in hypothetical #2 is that, arguably, Landlord "lulled" tenant into a false sense that it was not late in the tender of the \$200,000 fee.<sup>86</sup> Landlord's behavior seems designed to delay the tenant until the magic moment that the landlord can announce the option is extinguished. In other words, the tenant's premise is that the landlord induced tenant to rely to its detriment on the landlord's statements and behavior.

This idea may seem persuasive to courts routinely addressing *residential* leasing transactions. However, it is not persuasive in the *commercial* context. In the commercial leasing scenario

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86. The court's decision to find a violation of the landlord's duty of good faith in *Brunswick Hills* might be read very broadly. After all, the lease explicitly described the steps necessary to exercise the option in that case. Does this mean that each party (and most likely landlord in most cases) has a duty to make sure that the opposing party takes steps in a timely way to protect its rights? The answer, according to the court, is no. The court states:

In concluding that defendant violated the covenant, we do not establish a new duty for commercial landlords to act as calendar clerks for their tenants. We do not propose that attorneys must keep watch over and protect their adversaries from the mishaps and missteps that occur routinely in the practice of law. The breach of the covenant of good faith and fair dealing in this case was not a landlord's failure to cure a tenant's lapse. Instead, the breach was a demonstrable course of conduct, a series of evasions and delays, that lulled plaintiff into believing it had exercised the lease option properly. Defendant acted in total disregard of the harm caused to plaintiff, unjustly enriching itself with a windfall increase in rent at plaintiff's expense. In the circumstances of this case, defendant's conduct amounted to a clear breach of the implied covenant of good faith and fair dealing.

*Brunswick Hills*, 864 A.2d at 399.

described in hypothetical #2, any reliance by tenant and its lawyer on the behavior of landlord was unjustified. This article argues that the implied doctrine of good faith in commercial leasing *should not be interpreted to validate ineffective lawyering*. In the case of the hypothetical #2, finding a breach of the duty of good faith does just that. The deadline was an *obvious* detail that an *experienced* real estate lawyer should have discovered as soon as he or she is told that the client wishes to exercise its right. Should we save that lawyer for failing to notice this requirement and read the lease document carefully? The reader should ask himself or herself: might tenant's lawyer be subject to a suit for malpractice for failing to inform his client that the option fee was due at the same time as the written notice?

The third and last hypothetical in Part III involves an unusual case of turn-about. Courts often say that there are a "myriad" of cases involving the implied covenant of good faith in contractual relations.<sup>87</sup> Courts are correct.

Whether a tenant in a retail lease has the right to "go-dark" – in other words, bug-out and leave space vacant paying only minimum base rent – has been and remains a controversial topic for commercial leasing lawyers.<sup>88</sup> There is little dispute if landlord includes a provision in the tenant's lease expressly requiring the tenant to continuously operate in the leased location. Tenant's decision to vacate is a breach of the lease entitling landlord to damages. Landlord lawyers now routinely include continuous operation provisions in these leases, which will likely reduce litigation in the future. However, many older leases continue in force and do not contain a tenant's covenant to continuously operate. (Retail leases can run for a significant number of years with options to extend and renew terms; some landlord/tenant relationships are decades old). How should these leases be treated?

The problem arises *only* where landlord *fails* to include such a provision. Landlord is left with an argument based in the doctrine of good faith: landlord will argue that, because it only receives the "benefit of its bargain" from percentage rents, tenant and landlord must reasonably have expected that tenant would operate its business until the end of the term.

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87. "We cannot catalogue the myriad forms of conduct that may constitute a violation of the covenant of good faith and fair dealing. Each case is fact-sensitive." *Id.* at 396.

88. *Id.* These cases are collected and ably discussed in Senn, *supra* note 23; see also Patrick A. Randolph, Jr., *Going Dark Aggressively*, 10 REAL PROP. PROB. & TR. J. 6 (1996) (discussing relevant case law).

The cases are divided.<sup>89</sup> Perhaps this is because the Restatement analysis, which essentially relies on an *accepted conventional wisdom of sophisticated lawyers*, falls apart here. Lawyers who represent mall landlords may see the existence of percentage rent provisions as self-evident proof of the tenant's good faith obligation to continue in operation. Lawyers who represent tenants ask why landlord, the drafter of the lease

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89. See *Slater v. Pearle Vision Center, Inc.*, 546 A.2d 676 (Pa. Super. Ct. 1988) (implying a covenant of continuous operation in a retail lease); *Rothe v. Revco D.S., Inc.*, 976 F. Supp 784 (S.D. Ind. 1997) (refusing to find a covenant of continuous operation in a retail lease). See generally, Senn, *supra* note 23. There are always fact patterns that depart from the norm. See, e.g., *Oakwood Village LLC v. Albertsons, Inc.*, 104 P.3d 1226 (Utah 2004). This is the odd case in which the tenant, a large grocery chain, obtained an extraordinarily pro-tenant lease. The only exclusive rights in the lease were granted to tenant (tenant had the exclusive right to operate a grocery store in the shopping center). Tenant was not subject to restrictive use provisions. Tenant was permitted under the lease to assign or sublease without obtaining landlord's consent. The tenant built the store structure, but the lease did not contain any provision limiting the tenant from razing the store altogether. Most oddly, the lease did not contain a percentage lease provision. As is typical of such leases (at least the ones that result in litigation) there was no provision requiring tenant to continuously operate. Tenant ceased operations in landlord's location and paid only the minimal base rent. The opinion reflects some wonderful evidence that tenant opened a new location near the old vacant location with the avowed intent of hurting the old shopping center and to therefore restrict competition with tenant's new store.

Was tenant's behavior bad faith? The court agreed that the tenant's behavior was "not nice." But the failure to act nicely is not the same as bad faith. The parties knew how to draft exclusive uses and presumably, landlord could have insisted on a protective provision. It failed to do so and the court held the landlord to its bargain. Under any of the approaches described in this article, the court is correct. The Restatement's open catalogue of bad faith behavior should not include the tenant's behavior. As best as one can tell from the facts of the case, tenant simply drove a hard bargain. One goal of the Restatement approach to the covenant of good faith is to assure that parties receive the benefits of the bargain. Under the Burton/opportunity cost approach, it would be inappropriate to read the tenant's behavior as bad faith. Doing so would give landlord a clear second bite at the apple. No one held a gun to landlord's head to force it to agree to such a pro-tenant agreement (unless it is shown that Tony Soprano had an interest in tenant). The overall effect of the lease agreement benefits tenant. Landlord must have had its reasons for agreeing to these terms, although it is hard to fathom these reasons from the pages of the opinion. Finally, the goal of improving the practice of real estate law and rewarding clients who rely on better lawyers would absolutely not be served saving landlord. This is not to say that landlord's lawyers were wrong or ineffective. They may well have informed landlord of the risk associated with executing this agreement. But to inform the landlord fully, landlord's lawyers should have explained to landlord that the absence of percentage rent, and the inclusion of pro-tenant provisions, would make it possible for tenant to shut its doors and kill the shopping center.

document, and a party with access to the best legal counsel, could not have included the express provision.<sup>90</sup>

It is against this backdrop that we should confront the third hypothetical. In a sense, this final hypothetical is a *mirror image* to the going-dark scenario.

*Hypothetical #3:*

Landlord owns Civic Center Mall. Civic Center Mall is a converted urban civic center. The conversion from civic center to mall took place in 1990. Following conversion, Landlord signs many smaller chain and boutique retailers as tenants.

Civic Center Mall is located near sporting venues, and much of the traffic for the mall comes on game days. As a result, the tenants are particularly interdependent. Restaurants and general and specialty stores depend on one another to a great extent to bring in traffic.

Although there is space allocated in Civic Center Mall for an anchor tenant, Landlord never finds or signs such a tenant. In order to avoid the appearance that Civic Center Mall is a losing proposition, Landlord takes the unusual step of creating and running its own department store to take the anchor tenant space. However, Landlord is out of its depth and has no experience as a retailer; the department store operates in the red.

One of the Civic Center Mall's tenants is Cigar Heaven. Cigar Heaven is a cigar shop. Cigar Heaven is one of Landlord's original tenants. Cigar Heaven's lease provides rights to extend its term. It is a "boutique" establishment in every sense of the word.

Cigar Heaven's lease requires it to pay \$50.00 per month to a mall promotional fund. Other tenants are similarly required to pay into the fund in proportion to the amount of space in the mall each tenant leases.

Cigar Heaven's lease requires Landlord "*to contribute to the Civic Center Mall Promotional Fund not less than twenty-five (25%) percent of the total amount of funds paid by the tenants of Civic Center Mall pursuant to their lease agreements with Landlord. However, Landlord, at its option may elect to contribute all or part of the services of a promotion director and/or secretary or to provide reasonable office space and equipment in lieu of the cash contributions.*"

The lease does not contain an express provision requiring Landlord to spend the money collected on direct promotional activity. For the first several years of operation of the mall,

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90. And since good lawyers often represent both retail landlords and tenants, these lawyers experience an odd professional bipolar and compartmentalized approach to the world of negotiation.

Landlord contributes well in excess of the 25% promotional matching funds.

During this same time period, the downtown area in which Civic Center Mall is located faces increasing unemployment, and businesses close down. One of the local sporting teams moves to another city.

Because it is losing money at a very fast pace, Landlord prefers to find a buyer for Civic Center Mall. Landlord believes that a buyer of the facility might find a different and more profitable use (something other than a shopping mall).

To further this goal, Landlord begins to sign short-term leases with new tenants, to make easier any such sale. Landlord informs tenants of Civic Center Mall that Landlord will not hold tenants in default of their leases for failure to pay into the promotional fund. However, many tenants continue to pay into the fund, as does Cigar Heaven.

In fiscal year 1998, Landlord collects \$80,470.00 in tenant contributions to the Civic Center Mall promotional fund and spends \$66,700.00 for direct advertising and promotion of the Civic Center Mall. For fiscal year 1999, the tenants contribute \$29,179.00 and Landlord spends less than \$12,000.00 in direct promotion.

Ultimately, Landlord ceases to promote Civic Center Mall, and pulls all advertising of any kind. Landlord limits its capital expenditures to safety measures and maintaining the physical integrity of the mall. Finally, Landlord closes its money-losing department store. The anchor tenant space is therefore vacant.

Cigar Heaven is especially upset because, at the time that Landlord ceases promotional work for the mall and closes the anchor store, the cigar business is booming. Cigar Heaven brings a suit alleging that Landlord has violated its obligation of good faith by failing to promote Civic Center Mall.<sup>91</sup>

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The landlord's duty to promote is, in a sense, an echo of the tenant's duty to operate continuously (to not "go dark"). The landlord and tenant each rely on the other to obtain the benefit of its bargain.

In a retail lease, the benefit that Landlord seeks is a slice of tenant's profits (via percentage rents), and the hope that these profits will exceed minimum base rent. When tenant ceases to operate in a location and pays only base rent, it deprives landlord

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91. This case is drawn from *De La Concha of Hartford, Inc. v. Aetna Life Ins. Co.*, No. CV9800580129, 2002 WL 31170495 (Conn. Super. Ct. Aug. 23, 2002).

of this benefit.<sup>92</sup> (The landlord controls the drafting of the lease and the failure to include a protective provision speaks to the ability of landlord's counsel as much as to the leverage of the parties).

Similarly, the benefit that tenant seeks from the landlord when leasing space in a shopping mall, and in hypothetical #3, is a *successful* location. The higher the sales numbers tenant earns at the property, the more profits it earns. The humidor and cigar shop finds itself in a business at just the right time, but in just the wrong location. Landlord's failure to promote the mall and to keep the mall in good health reduces the Cigar Heaven's profit. Is this a breach of Landlord's implied covenant of good faith?

The Restatement begins by asking whether the Landlord's activities fall into the open category of bad faith behavior. This case is a good example of just how diverse bad faith cases can be, and would be a case of first impression in many jurisdictions. Landlord in fact attempted to promote the dying mall for many years, and took the unusual step of opening a department store in an effort to keep the mall afloat. This is not behavior that falls neatly into some accepted catalogue of bad faith behavior. Reasonable minds can differ on the question of whether Landlord took appropriate steps to save the mall and met the normal expectations of reasonable parties.

Landlord's agreement to collect promotional fees from all the tenants of the Civic Center Mall creates similar expectations to tenant's agreement to pay percentage rents in the going dark cases. After all, why would any tenant sign a lease in which promotional money is collected if not intended by the parties to be used? Cigar Heaven might have attempted to negotiate an express landlord obligation to promote the mall. However, it is unlikely that Landlord would agree to this promise. Cigar Heaven was a boutique store with very limited negotiating power. When negotiating the lease, the provisions upon which the tenant would most likely focus are those that directly affect its pocketbook. To Cigar Heaven, and perhaps to its lawyer, the odds that Landlord would simply lose interest in the Civic Center Mall may have seemed remote.

On the other hand, Landlord will argue that calling the Landlord's failure to promote the mall bad faith opens the door to an overly broad implied covenant. Is Landlord required to take out expensive newspaper ads to promote the mall? Is Landlord required to hire an expensive public relations firm? If Landlord is required, as a matter of good faith, to promote the mall, just what is "reasonable" promotion?

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92. *Supra* notes 89-92 and accompanying text.



Cigar Heaven will respond that, at the very least, Landlord should spend the money that it actually collects for promotion. Furthermore, Cigar Heaven might argue that the landlord should engage in promotional activities comparable to the owners of similar malls and shopping centers in the same region.

The scenario simply does not meet some conventional wisdom of what constitutes bad faith, and as a result, it does not make sense to speak of “doing justice” to the parties in the context of this transaction. Yes, Cigar Heaven was financially harmed by the failure of Landlord to *ultimately* promote the mall. But this financial harm occurred despite Landlord’s very aggressive steps over many years to keep the mall afloat.

Professor Burton would ask whether Landlord in hypothetical #3 is seeking a second bite at the contractual apple. Although this is not an easy case, the correct result is that Landlord did *not* obtain a right by opportunistic failure to perform that it could have achieved initially in negotiation of the lease. Under Professor Burton’s approach, Landlord should be deemed to have acted in good faith.

Reading its own lease, and making reasonable suppositions about the other tenant leases, Cigar Heaven, the tenant, knew or should have known that Landlord collected money from *all* of the tenants to promote and market Civic Center Mall. Cigar Heaven will argue that it reasonably expected that Landlord would collect promotional money and put it to good use. But, similar (in a mirror-image way) to the going dark cases, *Cigar Heaven did not negotiate a promise of continuous promotion, and Landlord would have extracted a cost for granting this right.*

Finally, we should ask whether implying a covenant to act in good faith on Landlord to affirmatively promote the shopping mall in Hypothetical #3 would detract from the best practice of law, and in the long run, disadvantage all parties engaging in commercial lease transactions. The eventual maturation and possible death of shopping malls should be *absolutely* on the radar of both the landlords’ and tenants’ attorneys when negotiating retail leases. Going-dark cases are important precisely because, on a regular basis, demographic changes cause affluent shoppers to move from one mall to the next. Tenants find it in their interest to move to the new malls.

Landlords’ and tenants’ counsel therefore should (or at least we presume them to) negotiate with this eventuality in mind. In hypothetical #3, the tenant’s lawyer did not insist on the inclusion of an affirmative obligation for the landlord to promote. Instead, the lease only created the right of Landlord to collect promotional

funds, a right that Landlord waived when it was clear that Civic Center Mall was at death's door.<sup>93</sup>

The language in the lease in hypothetical #3 could have been revised to protect Cigar Heaven. Assume that the provision in the lease requiring tenants to pay a promotional fee to Landlord concluded as follows: "Landlord agrees to use funds collected for the purposes of promoting and marketing the mall for actual promotion and marketing."

The court hearing the case on which hypothetical #3 was based rightly decided that the promotion requirement was not unlimited. The court noted that the landlord did initially promote the mall and spent a lot of money doing so.<sup>94</sup>

#### IV. CONCLUSION

Courts and lawyers often rely on gap-filler arguments. However, this indicates that the party using the gap-filler has a weaker position rather than a stronger one.<sup>95</sup> The use of the implied covenant of good faith is the legal equivalent to a Hail-Mary pass in the fourth quarter and 60 yards out from the touchdown.

The Restatement's position that contract law implies good faith and fair dealing into every agreement is now well-settled doctrine. But the regularity with which commercial landlords and tenants resort to this argument suggests something other than a thoughtful attempt to incorporate an important development in contract law. Instead, the constant refrain that one party acted in bad faith suggests that the aggrieved party poorly negotiated the initial lease agreement.

The Restatement's excluder-analysis is useful and appropriate in the commercial lease context only to a limited extent. Certain oft-spotted landlord and tenant behaviors are

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93. Given the small amount of money given by tenants to the Mall Promotional Fund in its last year, it is likely that Landlord would have happily returned the tenant's money to be done with the case. No doubt the attorneys' fees in the case exceeded the money contributed by the tenants that was not spent on actual promotion.

94. *De La Concha*, 2002 WL 31170495, at \*4. Perhaps this is an example of a case in which one litigator (not a real estate lawyer) did his job really well. He told the mall landlord's story effectively. One can see, however, why the tenant would feel a bit robbed.

95. In this context, one might compare the implied covenant of fair dealing to Section 105 of the Bankruptcy Code, which provides that the bankruptcy court may take actions "necessary or appropriate to carry out the provisions of this title." 11 U.S.C. § 105(a) (2000). See Daniel B. Bogart, *Resisting the Expansion of Bankruptcy Court Power under Section 105(a) of the Bankruptcy Code: The All Writs Act and an Admonition from Chief Justice Marshall*, 35 ARIZ. ST. L. J. 793 (2003) (discussing how Section 105(a) has been used in a host of ways that do not on their face seem to further specific provisions of the Code).

typically believed by real property lawyers to be bad faith. The Restatement therefore provides a short-cut and allows quick identification of bad faith behavior. The problem, of course, is that the most interesting and nasty behavior of parties is not garden-variety, and may even present issues of first impression. By definition, the Restatement is much less helpful in these scenarios.

Furthermore, the Restatement is concerned chiefly with creating a list of traditionally accepted (if ever expanding) bad behaviors to enable courts the flexibility of doing justice to and for the parties. A residential tenant who signs a lease and incorrectly believes (or is tricked into believing) that the landlord will repair a particular defect in the property may be faced with bad faith behavior. The Restatement allows a court to do justice for the tenant. A commercial tenant may not have the negotiating power of the landlord, but the tenant is nevertheless reasonably presumed to have access to counsel and the ability to understand the document signed. Furthermore, there is much less of a sense in the commercial context that a lease is a contract of adhesion.

Professor Burton's second-bite-at-the-apple approach is the better fit for the commercial context. It describes a dynamic that real estate lawyers confront daily – that of one party trying to obtain, after the fact, a right that it failed to negotiate in the original lease document. It is this behavior that should be deemed bad faith.

In calculating whether one party to a commercial lease (either the landlord or the tenant) has breached its implied obligation of good faith, the nature of the transaction weighs heavily against a finding of bad faith. The parties are presumed to be sophisticated, and are (or could be) represented by counsel. For this reason, courts should ask whether determining that one party to a commercial lease violated its implied covenant to act in good faith will save lawyers from sloppy legal practice, and clients from failing to heed their lawyer's advice.