Case Western Reserve Law Review

Volume 72 | Issue 2 Article 16

2021

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Recommended Citation

James Gordley, *Peter Gerhart on Good Faith: Following a Trail of Breadcrumbs*, 72 Case W. Res. L. Rsrv. 317 (2021)

Available at: https://scholarlycommons.law.case.edu/caselrev/vol72/iss2/16

Peter Gerhart on Good Faith: Following a Trail of Breadcrumbs

James Gordley†

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Introduction

Virtually every state recognizes that the parties to a contract are under a duty to act in good faith. According to the *Restatement (Second) of Contracts*: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[1] Scholars who have tried to explain that duty have become lost in a forest of difficulties. In Part II of this Article, we will see why. Peter Gerhart discussed the duty briefly in seven pages of *Contract Law and Social Morality*,[2] a book published shortly before his death. In Part I we will see how, if we follow the clues he left in these few pages, like the proverbial trail of breadcrumbs, they will lead us through the forest.

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1. Restatement (Second) of Conts. § 205 (Am. L. Inst. 1981).

2. Peter M. Gerhart, Contract Law and Social Morality 136–43 (2021) [hereinafter Gerhart, Contract Law].

I. Peter Gerhart's Approach

A. Preserving Equilibrium

In Gerhart's view, the duty to act in good faith followed from a larger principle: that of preserving the "ex ante equilibrium" of an exchange:

> It is hard to imagine the institution of contracting without a concept like good faith. When applied to performance obligations, the basic concept is straightforward: because contracts leave so many performance questions unaddressed, each party must interpret its performance obligations using a method of reasoning that appreciates the best way of maintaining the ex ante equilibrium position of the parties . . . . Both parties agree on, and thus maintain, the performance obligations that [the] ex ante equilibrium bargain maintained. The concept of good faith interpretation, as implemented here, tells the parties what they must do to align their interpretations with the equilibrium the parties achieved through bargaining.[3]

According to Gerhart, then: (1) there is an ex ante equilibrium in a contract of exchange, (2) which the parties achieved through bargaining and wish to preserve, (3) and a method of reasoning for deciding which terms will preserve it even though these terms were not expressly addressed in their contract.

I have defended propositions like these elsewhere. I believe my understanding of them may be, in relevant respects, like that of Gerhart. He said, at least, that he was following "the path suggested by James Gordley,"[4] which gives me too much credit. As he noted, "[t]he idea presented here has many ancestors."[5] Moreover, by extending the path, he showed how to explain the duty to act in good faith. As a first step in understanding his explanation, I will summarize how I understand the propositions on which it rests.

First, there is an ex ante equilibrium in a contract of exchange. This idea has many ancestors. As I have described elsewhere, the idea of equality in exchange can be traced from Aristotle through medieval philosophers, such as Thomas Aquinas, through the so-called "late scholastic jurists" of the 16th and 17th century, such as Domenico Soto, Luis de Molina, and Leonard Lessius, to the natural law writers of the 17th and 18th century, such as Hugo Grotius, Samuel Pufendorf, and

3. *Id.* at 137.

4. *Id.* at 6 n.9 (citing James Gordley, *Contract Law in the Aristotelian Tradition*, *in* The Theory of Contract Law: New Essays 265, 268 (Peter Benson ed., 2001)).

5. *Id.*

those they influenced, such as Robert Pothier.[6] It was only rejected confidently with the rise of the will theories of contract of the 19th century.[7] In speaking of "equilibrium," I believe that Gerhart endorsed a modern version of this traditional idea.

The traditional idea is that a fair exchange is one in which the performance that each party is to make is equivalent in economic value to the one that he is to receive.[8] Proponents of this idea understood that each party personally puts a higher value on what he is to receive than what he is to give in return. Otherwise, the parties would not exchange. Nevertheless, the economic value of each party's assets remained the same, and in that sense the value of the performances was equal. At the time of the transaction, neither party became richer or poorer. He would thereafter if the value of the goods or service he had exchanged rose or fell. But that risk was considered to be inherent in the decision to buy or sell, and it fell upon each of the parties. Soto said, "as the business of buying and selling is subject to fortuitous events of many kinds, merchants ought to bear risks at their own expense, and on the other hand, they may wait for good fortune."[9] According to Lessius, "as they may gain if they receive goods at small expense, so they may lose if the expense was disproportionate or extraordinary."[10] Each party was compensated for taking the risk that he would lose later on by the chance that he would gain.[11]

A corollary was that the other terms of the contract should preserve equality. If the seller does not warrant his goods against defects, the unwary buyer will pay a sound price for an unsound commodity. The seller can waive the warranty but only if he reduces the price to reflect the risk that the goods are defective.[12] The exchange is equal as long as each party is compensated for the risks that he assumed. In Gerhart's words, the contract is in equilibrium ex ante.[13] Ex post, there will be winners and losers. Ex ante, the contract is fair in the same sense as a fair bet.

6. *See, e.g.*, James Gordley, The Philosophical Origins of Modern Contract Doctrine 94–102 (1991).

7. *Id.* at 201–08.

8. James Gordley & Hao Jiang, *Contract as Voluntary Commutative Justice*, 2020 Mich. St. L. Rev. 725, 741 (2020).

9. Domenicus Soto, De iustitia et iure libri decem lib. 6 q. 2 a. 3 (1553).

10. Leonardus Lessius, De iustitia et iure, ceterisque virtutibus cardinalis libri quatuor lib. 2, cap. 21, dub. 4 (1628).

11. *See* James Gordley, *Equality in Exchange*, 69 Calif. L. Rev. 1587, 1610–11 (1981).

12. 3 Ludovicus Molina, De iustitia et iure tractatus III, disp. 353 (1614).

13. Gerhart, Contract Law, *supra* note 2, at 60–62.

The second proposition is that the parties arrive at this equilibrium through their own negotiations or bargaining. I understand this proposition to mean that they will do so even if neither of them gave a thought to fairness. Gerhart may not. He believes equilibrium is produced by "other-regarding or values-balancing reasoning" in which each party "appreciate[s] both parties' private projects but d[oes] not know which private project would be favored by the reconciliation of values."[14] "The other-regarding person does this by means of the thought process behind the veil of ignorance, a thought process that ensures that the appraisal of conflicting values is neutral . . . ."[15] "[T]he veil of ignorance [i]s the core concept that other-regarding persons will undertake when they have made promises."[16]

He took the idea of the veil of ignorance from John Rawls. In Rawls's theory of justice, a list of liberties to belong to each citizen is drawn up by their hypothetical representatives behind a "veil of ignorance," which prevents them from knowing what purposes the members that they represent wish to pursue.[17] I believe that Rawls's use of the "veil of ignorance" to explain justice is an illusion, but, nevertheless, Gerhart's use of it to explain equilibrium or equality in exchange is not. Rawls presupposes too much and too little of those who make decisions behind the veil of ignorance: too much, because he supposes that they represent people who have a "conception of the good"[18] without explaining what would make it "good" except that people in some way prefer it;[19] too little, because he supposes that they can make decisions about what form of government is best without regard to the context, culture, and characteristics of the people to be governed.[20] Even John Locke, who thought that government was formed by the people, believed that the people might choose to institute a monarchy, an aristocracy, or a democracy.[21]

If, however, we imagine the contracting parties making decisions behind a veil of ignorance, we arrive at much the same idea of equality in exchange as the one just described. Equality or equilibrium means that neither party can tell in advance whether he is more likely to win

14. *Id.* at 68.

15. *Id.*

16. *Id.* at 65.

17. John Rawls, Political Liberalism 24–25 n.27 (1993).

18. *Id.* at 18–19.

19. *See* James Gordley, *The Just Price: The Aristotelian Tradition and John Rawls*, 11 Eur. Rev. of Cont. L. 197, 215 (2015); James Gordley, The Eclipse of Classical Thought in China and the West, 309–19 (forthcoming 2022).

20. *See* Gordley, *supra* note 19, at 213; Gordley, *supra* note 19, at ch. 13.

21. John Locke, Two Treatises of Government 372 (Peter Laslett ed., Cambridge Univ. Press 1960).

or lose, much like gamblers who have made a fair bet. Gerhart recognized that "[p]arties implicitly bargain over the allocation of various risks. For any risk, we can presume that the parties allocate the risk to the low cost risk avoider . . . ."[22] Behind the veil of ignorance, presumably, the parties will agree that whichever party assumes that risk will be compensated for doing so. And so we arrive at the idea of equality in exchange presented earlier.

A difference, however, is that Gerhart, like Rawls, uses the metaphor of the veil of ignorance to determine what a person should do. That person's motivation for doing it, according to Rawls, is that he has "a capacity for a sense of justice,"[23] and for Gerhart, is that he is an "other-regarding person."[24] Actual contracts are made by parties who are not behind a veil of ignorance. Unless we assume that they are high-minded, they will pursue their private interests. If they arrive at a fair result, an "equilibrium," then we must explain how self-interested parties are able to do so. If they will not, then parties behind a veil of ignorance will be unable to supply terms that maintain an equilibrium that never was.

In my view, to quote Adam Smith: each person "intends only his own gain," and yet "he is . . . led by an invisible hand to promote an end which was no part of his intention."[25] The end of which I am speaking, however, might have surprised Adam Smith. It is to make a contract on terms that are fair to the other party.

We can see why if we consider how the traditional idea was once understood. Its proponents assumed that the exchange is made in a competitive market. Consequently, the terms on which each party contracts will be as good or better than the terms on which others are trading. The price that preserves equality will be the market price.[26] That price represents traders' estimate of what we would call the expected value of the goods exchanged. This understanding of equality is like that of proponents of the traditional idea. They called this estimate the "common judgement" or *communis aestimatio.*[27] The concept of expected value may seem modern, but proponents of the traditional idea invented it.[28]

22. Gerhart, Contract Law, *supra* note 2, at 173.

23. Rawls, *supra* note 17, at 19.

24. Gerhart, Contract Law, *supra* note 2, at 68.

25. 2 Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 258 (1776).

26. Gordley, *supra* note 6, at 97.

27. Gordley, *supra* note 6, at 97.

28. Molina, *supra* note 12, at disp. 736; James Franklin, The Science of Conjecture: Evidence and Probability Before Pascal 286–88 (2015) (citing Soto and Lessius on wagers and insurance).

The corollary, as we have seen, is that the other terms of the contract preserve equality. The seller can waive a warranty, but only if he reduces the price to reflect the risk that the goods are defective.[29] The exchange is equal as long as each party is compensated for the risks he is to bear. Again, there is no need to assume that a party will reduce his price because he is high-minded enough to be concerned about fairness. The other party will not contract with him unless he offers terms as good as those on which others are trading. If he does not offer a reduced price, the other party will contract with someone else.

Nevertheless, proponents of the traditional idea had little to say about why a party is deemed to warrant his goods against defects unless the contract provides otherwise, or why he might wish to waive the warranty and reduce the price. This brings us to the third proposition: there is a method of reasoning deciding which terms best preserve the ex ante equilibrium, even though they are not expressly mentioned in the contract. The method, according to Gerhart, is "values-balancing reasoning."[30] One must ask: do the "benefits" of such a term to one party "impose an unequal and therefore impermissible burden on the counterparty, given the benefits she has promised to deliver in the exchange?"[31] How do the "costs" that it saves by one party compare with the "burdens" it "would place on the counterparty's . . . interests"?[32]

I believe this approach is compatible with the one that Hao Jiang and I described in a recent article.[33] Equality is preserved when each party is compensated for the risks that he assumes. Economists explain that if the parties contemplate a risk in advance, they will assign it to the party who can bear it at the lowest cost and adjust the price to compensate him for doing so. They will not assign a risk to the party who can bear it at a higher cost and compensate him. Rather than do so, the party who can bear the risk at the lowest cost would choose to bear it himself. Economists conclude that this assignment of risk would be efficient ex ante.[34] As we have seen, it is also fair, although economists concern themselves with efficiency, not fairness.[35]

Economists also explain when one party can bear a risk at a lower cost than another. It depends on three factors. One is who can best

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29. *See* Molina, *supra* note 12, at disp. 353.

30. Gerhart, Contract Law, *supra* note 2, at 63.

31. *Id.* at 138.

32. *Id.*

33. Gordley & Jiang, *supra* note 8, at 725.

34. *Id.* at 738–39.

35. *See supra* text accompanying notes 8–11.

foresee the magnitude of the risk.[36] A risk is lower for the party who can best foresee it for roughly the same reason that the risk of playing poker is lower for someone who can peek at the other players' cards. Another factor is who can best control the risk.[37] If the party who can do so must bear the cost if the risk eventuates, then the further risk is eliminated that he may omit the precautions he ought to take to control it. A third factor is who can best spread the risk over similar transactions, whether by buying insurance or by self-insuring.[38] The risk of a house catching fire is less for an insurance company than for a homeowner because it can spread that risk over the many houses it insures. The risk of a streak of bad luck is less for a casino than for an individual gambler.

These factors explain why, if the parties contemplate a risk in advance, they will place it on the party who can bear it at the lowest cost and then compensate him. As we have seen, that result is fair in that it preserves equality in the values exchanged. These factors also explain why, if the parties did not contemplate a risk in advance, to place it on the party who can bear it most easily would best preserve equality in the values exchanged. Even if that party had not been compensated for bearing that risk, there will be less disruption of the equality of the exchange than if it is placed where it would cause a smaller loss. More importantly, the party who can bear the risk at the lowest cost would likely have been compensated for doing so by an adjustment in the contract price even if, when the contract was drafted, the parties did not have that specific risk in mind. The party who can best foresee the risk may have taken it into account along with all the other risks he could foresee in setting his prices, although he did not contemplate them all when the contract was drafted. If he incurs costs to control that risk, they will be reflected in the contract price along with all the other costs he incurs—although, again, when the contract is drafted he may not be thinking of any one of them. In the course of his business, a party may encounter the same risk repeatedly in other contracts. For that reason, he may, in effect, insure the other party against its consequences by raising his price and assuming the risk. He will do so when setting his prices for the entire range of contracts in which such a risk may arise. His contract with a single party may not contain a term that mentions that risk.

Consequently, when a risk is not expressly assigned by a contract, a court should place it on the party that can bear it at the lowest cost. To determine which party can do so, it might consider the factors just

36. Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. Legal Stud. 83, 91–92 (1977).

37. Guido Calabresi, The Costs of Accidents: A Legal and Economic Analysis 135 (1970).

38. Posner & Rosenfield, *supra* note 36, at 91.

mentioned and ask which party can best foresee and control the risk or will encounter it repeatedly in other transactions. A more reliable method is to see how the parties expressly assigned risks ex ante. The parties would have chosen to place these risks on the one who can bear them most cheaply. If the risk in question is like one that was expressly assigned, it should be placed on the same party.

B. Acting in Good Faith

Gerhart is right that the duty of good faith comes into play when "contracts leave . . . performance questions unaddressed."[39] Recognizing that duty, however, is different, in one respect, from most situations in which a court reads terms into a contract to resolve such questions. Usually, the parties could have addressed the question in advance and inserted a term in the contract to resolve it. In contrast, the most puzzling applications of the doctrine of good faith are in situations in which the parties could not have done so.

In one situation, as Gerhart observed, the duty to act in good faith "accommodates the need for . . . flexibility . . . ."[40] It may be better not to prescribe everything a party must do or not do in advance. Sometimes the parties can achieve flexibility in a way that does not raise issues of good faith. For example, they provide that a term of their agreement, such as an increase in price, depends on a standard that can be applied mechanically, such as the Consumer Price Index. Instead, they might entrust the decision as to what a term will be to the discretion of one of the parties. That discretion must be exercised in good faith.

In another situation, the duty to act in good faith is needed to promote cooperation by the parties after the contract is made so that each party can receive the benefits for which he contracted. It may be impossible to set out in advance all the things that each party should or should not do.

Neither problem could be solved even if drafting a contract were costless and drafters more astute. It is sometimes thought, as Robert Scott has noted, that "[i]n a world where Coasian assumptions of zero transactions costs hold, the choice among gap-filling default rules is irrelevant because parties can and will negotiate around suboptimal legal rules."[41] It may not be so for the two reasons just described.

Gerhart gave two examples of how to determine whether a party is acting in good faith. They both concern the first situation: in order to make the contract more flexible, discretion is given to one of the

39. Gerhart, Contract Law, *supra* note 2, at 137.

40. *Id.* at 137–38.

41. Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. Rev. 847, 850 (2000).

parties.[42] We will consider his examples and their implications for similar cases. We will then see how his approach can be extended to the second situation: the parties need to cooperate in good faith so that each may obtain the benefits for which he contracted.

1. Providing Flexibility

There are two ways to make a commitment more flexible by conferring discretion on one of the parties. That party might be required to use his discretion according to a standard which is not to be applied mechanically but according to his best judgment. An example is an output or requirements contract in which one party is to buy or sell what the other party supplies or orders. The standard is that the amount supplied or ordered is to be the amount that the party produces or needs. That is Gerhart's first example of a duty to act in good faith.[43]

Alternatively, the contract may allow a party to use his discretion without regard to any such standard. An example is an option, which a party is free to exercise or not. That is Gerhart's second example.[44] He implicitly recognized that there is a difference between these two situations.

a. Discretion to Be Exercised According to a Standard

We will follow the trail that Gerhart laid out in these examples. Appropriately enough, it begins with a case about breadcrumbs. In *Feld v. Henry S. Levy & Sons, Inc.*,[45] the defendant agreed to sell all the breadcrumbs it produced.[46] The contract could be terminated on six months' notice.[47] When the seller found it "uneconomical" to produce breadcrumbs and the buyer refused to pay a penny per pound more than the contract price, the seller shut down production and sold the raw material to an animal feed producer.[48] Gerhart said, correctly, that to decide whether the seller acted in good faith, we must "determine the plausibility of any assertion that the seller lowered the price of the breadcrumbs in order to buy the freedom to terminate the contract without notice."[49]

That assertion is not plausible. In the sale of a definite quantity of goods yet to be produced at a fixed price, the seller assumes two risks. One is that he could have sold the goods to someone else if he had

42. Gerhart, Contract Law, *supra* note 2, at 139–43.

43. *Id.* at 139.

44. *Id.* at 141.

45. 335 N.E.2d 320 (N.Y. 1975).

46. *Id.* at 321.

47. *Id.*

48. *Id.*

49. Gerhart, Contract Law, *supra* note 2, at 141.

waited. The other is that the goods will cost him more to produce than he estimated. If he did not wish to assume the second of these risks, he would contract to be paid cost-plus rather than at a fixed price. In return, the buyer assumes the corresponding risks: that had he waited he could have bought the goods for less from someone else, and if he contracted for the goods cost-plus, the cost of producing them would have been lower than estimated. In *Feld*, the seller tried to escape the risk that a party normally assumes when he sells at a fixed price, a risk which the seller had been compensated to bear. The court held that whether the seller acted in good faith was a factual question to be resolved at trial.[50] According to Gerhart, the seller could escape liability if he can show that he lowered his price "in order to buy the freedom to terminate the contract without notice."[51] Certainly, but for the reason just explained, it is unlikely that he did. If so, Gerhart said, "the seller is likely to have evidence to that effect available."[52] That evidence would have to be convincing indeed.

In an output or requirements contract, unlike an option, the seller or buyer must exercise his discretion according to a standard. That requirement predates the Uniform Commercial Code.[53] According to the UCC, the quantity supplied or ordered must be "such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded."[54]

In an output or requirements contract, however, all that is necessary is that there be a standard. A party may be acting in good faith even if the amount he supplies or orders is not proportionate to a stated estimate or to his normal output or requirements.

In *Feld*, the defendant agreed to sell all the breadcrumbs it produced.[55] As the court noted, breadcrumbs are "a manufactured item, starting with stale or imperfectly appearing loaves and followed by removal of labels, processing through two grinders, the second of which effects a finer granulation, insertion into a drum in an oven for toasting and, finally, bagging of the finished product."[56] Consequently, the standard was not the seller's "normal or . . . prior output" but the number of stale and imperfect loaves available to produce them.

50. 335 N.E.2d at 323.

51. Gerhart, Contract Law, *supra* note 2, at 141.

52. *Id.*

53. *See, e.g.*, Brawley v. United States, 96 U.S. 168, 172 (1877); N.Y. Cent. Ironworks Co. v. U.S. Radiator Co., 66 N.E. 967, 968 (N.Y. 1903).

54. U.C.C. § 2-306(1) (Am. L. Inst. & Unif. L. Comm'n 2020).

55. 335 N.E.2d at 321.

56. *Id.*

In *New York Central Ironworks Co. v. United States Radiator Co.*,[57] the court upheld the contract even though the most the buyer had ever required before was "48,000 feet of radiation," and it now required 100,000 feet.[58] "After the execution of the contract there was a large advance" in the price of radiation.[59] There was no evidence, however, that the buyer increased the quantity he purchased, not because his needs increased, but to take advantage of the rise in prices.[60] That was so, even though the buyer may have needed more because the price of his own product had risen and so it became advantageous to him to produce more.[61] He profited from a change in the market price, but he was not ordering more simply because the market price had changed.[62]

Moreover, a party may act in good faith even though his output or needs are disproportionate to a "stated estimate."[63] In the early case of *Brawley v. United States*,[64] the plaintiff agreed to supply Fort Pembina in Dakota Territory with 880 cords of oak wood "more or less, as shall be determined to be necessary, by the post-commander."[65] The post-commander determined that only 40 cords were needed.[66] The court held that as 880 was "only . . . an estimate of the probable amount," the army could take only 40.[67] "[S]o long as [it] act[ed] in good faith," in both making the estimate and in determining how many cords were needed, the buyer could take only what it needed.[68]

In output and requirements contracts, the parties leave the quantity term open. They may do so with the price term. A party may be allowed to decide on the price according to some standard which, again, cannot be applied mechanically. As before, a party acts in bad faith if he deviates from that standard. As before, to determine if he has done so, one must identify the risks the parties wished to allocate when they gave him this discretion.

57. 66 N.E. 967 (N.Y. 1903).

58. *Id.* at 967–68.

59. *Id.* at 968.

60. *Id.* at 967–68.

61. *Id.* at 968.

62. *Id.* at 967–68.

63. U.C.C. § 2-306 (Am. L. Inst. & Nat'l Conf. of Comm'rs on Unif. State L. 2020).

64. 96 U.S. 168 (1878).

65. *Id.* at 169.

66. *Id.*

67. *Id.* at 171.

68. *Id.* at 172.

Neither the standard nor the duty needs to be set out in the contract. In *Best v. United States National Bank of Oregon*,[69] depositor claimed that a bank had abused its authority to set fees for checks drawn on nonsufficient funds (NSF fees) by charging far more than its costs plus a reasonable profit.[70] According to the court, the Bank did not act in good faith if the depositors "reasonably expected that the Bank's NSF fees would be priced . . . to cover the Bank's NSF check processing costs plus an allowance for overhead costs plus the Bank's ordinary profit margin on checking account services."[71]

There is an ongoing controversy as to whether the duty to act in good faith can be violated only by one who acts dishonestly.[72] As Summers said, "[m]any theorists have been tempted to try to conceptualize . . . bad faith, partly in terms of some necessary or singular 'mental element,' such as a 'bad motive.'"[73] When discretion must be exercised according to a standard, that element should not be necessary, as some courts have recognized. Using the expression more loosely, they have held that a party does not act in "good faith" if he deviates from this standard whether he was dishonest or not.

An example is *Best*. What mattered was that the bank charged higher fees than it was entitled to under the standard the depositors expected. The court said:

> It is . . . not necessarily sufficient, as the Bank contends, that the Bank acted honestly in setting its NSF fees . . . . Undoubtedly, parties to a contract always expect that the other party will perform the contract honestly and, where the performance of a commercial enterprise is at issue, ordinarily expect that it will do so in a commercially reasonable manner.

69. 739 P.2d 554 (Or. 1987).

70. *Id.* at 555.

71. *Id.* at 559.

72. *E.g.*, Thomas A. Diamond & Howard Foss, *Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery*, 47 Hastings L.J. 585, 602, 614 (1996) (distinguishing two types of bad faith: "commercial unreasonableness" which does not require dishonesty, and "dishonesty" or "causing contractual injury through deceptive or disingenuous means"); Teri J. Dobbins, *Losing Faith: Extracting the Implied Covenant of Good Faith from (Some) Contracts*, 84 Or. L. Rev. 227, 270 (2005) (arguing that "motive should be irrelevant"); Restatement (Second) of Conts. § 205 cmt. d (Am. L. Inst. 1981) ("Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified.").

73. Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 Cornell L. Rev. 810, 820 (1982).

> But the reasonable expectations of the parties need not be so limited.[74]

In *Best*, the defendant was liable for deviating from the proper standard intentionally but not dishonestly. A defendant may also be liable when the deviation is not intentional but negligent. In *Miller v. Othello Packers, Inc.*,[75] one party was to plant and grow a crop of lima beans, and the other was to harvest the crop and process it by freezing.[76] "Payment was to be made on the basis of the tonnage and grading as determined by the processor as the beans went through its plant."[77] The trial court found that the processor's sampling, grading, and record keeping was done so negligently that its figures could not be used to determine the compensation due to the grower.[78] It awarded the market value of the crop at the time of harvesting.[79] The Washington Supreme Court, in upholding this result, said that the processor had violated the implied covenant of good faith and fair dealing.[80]

Similarly, it does not matter if a party acted dishonestly if the contract contains an "objective" condition of satisfaction, and he professes himself dissatisfied. An "objective" condition is met if the party's dissatisfaction is unreasonable even if it is sincere. For example, a contract may entitle a builder to payment only if his client is satisfied that the work was completed according to the specifications of the contract. If the builder can prove that it was, the condition is met.[81] What matters is that the standard met was the standard on which the client's satisfaction was to depend.[82] In contrast, a "subjective" condition of satisfaction is not met as long as a party is genuinely dissatisfied.[83] A common example is a contract to paint a portrait in which the client must pay only if he is satisfied. There is no standard except whether the client likes the painting or not. If he does not, he need not pay.[84]

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74. 739 P.2d at 558.

75. 410 P.2d 33 (Wash. 1966).

76. *Id.* at 33.

77. *Id.*

78. *Id.* at 34.

79. *Id.*

80. *See id.*

81. *See* E. Allan Farnsworth, Contracts § 8.4, at 520–21 (4th ed. 2004).

82. *Id.*

83. *Id.*

84. *Cf.* Kohler v. Leslie Hindman, Inc., 80 F.3d 1181, 1183–84, 1187 (7th Cir. 1996) (holding that where a consignment agreement permitted an auction house to rescind an artwork's sale in the house's "sole discretion," that discretion was bound only by "good faith").

b. Discretion That is Not Subject to a Standard

Sometimes there is no standard or criteria by which a party's discretion is to be exercised. Gerhart recognized that whether a party acts in good faith depends on whether he exercised it in accordance with the purpose for which it was conferred on him by the contract.[85]

Gerhart's example is an option, which is his second illustration of the duty to act in good faith. In *Market Street Associates v. Frey*,[86] the purpose of the option was to allocate various risks concerning the future value of property and the financing of improvements.[87] Judge Posner held correctly that the option could not be used to take advantage of the other party's momentary inattention to the terms of the contract.[88] J.C. Penney Company had sold property to General Electric Pension Trust, which leased it back to J.C. Penney with an option to repurchase for twice the purchase price.[89] J.C. Penney could exercise the option only if, after it requested that the Trust consider refinancing improvements on the premises, the parties failed to reach agreement.[90] J.C. Penney assigned the lease to Market Street Associates.[91] The general partner of Market Street Associates contacted the Trust about financing improvements on the property.[92] He did not mention the option, and when the Trust indicated that it was not interested, he tried to exercise it.[93] According to Posner, Market Street Associates took "deliberate advantage of an oversight by [its] contract partner concerning [its] rights under the contract."[94] As Gerhart recognized, what mattered was the purpose of the option. Its "function was to put a cost on the lessor's failure to negotiate in good faith," not on "remembering that the forfeiture provision was there."[95]

As noted earlier, another situation in which a party is given discretion without a standard according to which it must be exercised is when a contract provides a "subjective" condition of satisfaction.[96] As long as a party's dissatisfaction is genuine, he has acted in good

85. *See* Gerhart, Contract Law, *supra* note 2, at 141.

86. 941 F.2d 588 (7th Cir. 1991).

87. *Id.* at 591.

88. *Id.* at 597–98.

89. *Id.* at 591–92.

90. *Id.*

91. *Id.* at 591.

92. *Id.*

93. *Id.* at 591–92.

94. *Id.* at 594.

95. Gerhart, Contract Law, *supra* note 2, at 142.

96. *See* Farnsworth, *supra* note 81, § 8.4, at 520.

faith. Such conditions are common when the condition concerns aesthetics or business judgment. A party may agree to buy a portrait but only if, when the portrait is painted, he is satisfied with it.[97] In *Mattei v. Hopper*,[98] a developer agreed to buy a parcel of land for a shopping center but only if he was satisfied with the leases that he could enter into with third parties.[99] In *Western Hills v. Pfau*,[100] a purchaser agreed to buy land subject to his ability "to negotiate with City of McMinnville as to a planned development satisfactory" to both parties.[101]

In these cases, the standard is the party's own satisfaction, not whether a reasonable person would have been satisfied. Yet the standard is not whether the contract will serve his own interests. If it were, he would have an option. He may not back out, for example, if he has decided to patronize a different artist or found a less expensive but equally suitable piece of land. Again, the discretion must be exercised according to the purpose for which it is conferred by the contract.

A condition that a party must be genuinely satisfied need not be explicit. In *Locke v. Warner Brothers., Inc.*,[102] Warner had a right of first refusal on Locke's proposals for film productions and the discretion to accept or reject them.[103] The plaintiff claimed that "the development deal was a sham, that Warner never intended to make any films with her, and that Warner's sole motivation in entering into the agreement" was to do a favor for the star, Clint Eastwood, by helping him to settle litigation with Locke.[104] The court held that although Warner had the "right to make a subjective creative decision, which is not reviewable for reasonableness," its "dissatisfaction [must] be bona fide or genuine."[105] Teri Dobbins Baxter criticized the court for "read[ing] into the contract a 'satisfaction' requirement that was not included in the language of the contract itself."[106] The question, however, should have been whether Warner used its discretion for the purpose for which it was given. Doubtless, Locke ran the risk that her proposals would be turned down, but the provision would have been pointless if Warner did not need to consider them.

97. *See supra* notes 81–84 and accompanying text.

98. 330 P.2d 625 (Cal. 1958).

99. *Id.* at 625–26.

100. 508 P.2d 201 (Or. 1973).

101. *Id.* at 202.

102. 66 Cal. Rptr. 2d 921 (Cal. App. 1997).

103. *See id.* at 922.

104. *Id.*

105. *Id.* at 925.

106. Dobbins, *supra* note 72, at 248.

In another situation, a contract gives a party the discretion to determine the price without prescribing a standard that he must follow in doing so. The question again is whether this discretion was exercised in accordance with the purpose for which it was conferred. In *Wilson v. Amerada Hess Corp.*,[107] Hess marketed gasoline through independent franchise dealers and through Hess-run cooperative dealers.[108] The prices at which it sold were to be "determined by Hess."[109] Plaintiffs, three independent dealers, alleged "that Hess knowingly sets its . . . prices at a level that will not allow the dealers to cover operating expenses and achieve profit."[110] It did so, they alleged, in order to drive out independent dealers so that Hess could replace them with its own cooperative stations.[111] If so, Hess acted in bad faith, as the court correctly held.[112] The purpose of giving Hess discretion to determine the price was not so that it could drive the independent dealers out of business. They were not compensated for assuming the risk that it would do so.

In *Amoco Oil Co. v. Ervin*,[113] the contract allowed Amoco to set the prices and rent it charged dealer-lessees according to a formula, which it was to devise.[114] Its formula for rent charged twice for the value of service bays.[115] The court held that Amoco acted in bad faith.[116] "The dealers were justified in expecting that . . . Amoco would not charge double for any one element of the calculation," and "they presumably would not have signed the agreements had they known" that it would.[117]

A recurring situation is a clause allowing a party to terminate a contract at will. Again, whether a party acted in good faith depends on whether he used that right in accordance with the purpose for which it was conferred.

107. 773 A.2d 1121 (N.J. 2001).

108. *Id.* at 1124.

109. *Id.*

110. *Id.* at 1125.

111. *Id.*

112. *Id.* at 1132.

113. 908 P.2d 493 (Colo. 1995).

114. *See id.* at 495.

115. *Id.* at 496.

116. *See id.* at 499 (determining that evidence supported the jury's conclusion).

117. *Id.*

In an employment contract, it has been held to be bad faith for a company to terminate a contract with an employee[118] or other agent[119] to avoid paying him a commission or letting him purchase stock which he would otherwise be entitled to buy under a stock option.[120] As the *Restatement (Second) of Agency* provides:

> An agent to whom the principal has made a revocable offer of compensation if he accomplishes a specified result is entitled to the promised amount if the principal, in order to avoid payment of it, revokes the offer and thereafter the result is accomplished as the result of the agent's prior efforts.[121]

That rule is correct. In such a situation, the employer uses his discretion to deprive a party of part of his compensation: the extra amount he was supposed to be paid if he was successful. The employee surely did not assume the risk that if he were successful, the employer would exercise his discretion to take it away.

Similarly, a franchisor, licensor, or wholesale distributor cannot use a termination clause to appropriate an increase in the value of the business in which the other party is engaged. This principle is sometimes applied without being acknowledged. Some courts reach the right result but claim that they do so because of the language of the parties' contract. In *Atlantic Richfield Co. v. Razumic*,[122] the franchisor refused to renew a franchise, presumably because it wished to replace the franchisee with someone else.[123] If it were able to do so, it could appropriate the value of the franchise.[124] The Pennsylvania Supreme Court held that it could not.[125] In *Amoco Oil Co. v. Burns*,[126] the franchisor wished to terminate the franchise and sell off the property that it had leased to the franchisee.[127] It was not appropriating the franchisee's business, but cutting its losses.[128] The same court held that

118. *See* Fortune v. Nat'l Cash Reg. Co., 364 N.E.2d 1251, 1257–58 (Mass. 1977) (citing Restatement (Second) of Agency § 454 (Am. L. Inst. 1958)).

119. RLM Assocs. v. Carter Mfg. Corp., 248 N.E.2d 646, 646 (Mass. 1969).

120. Lemmon v. Cedar Point, Inc., 406 F.2d 94, 95–97 (6th Cir. 1969).

121. Restatement (Second) of Agency § 454 (Am. L. Inst. 1958).

122. 390 A.2d 736 (Pa. 1978).

123. *Id.* at 737–38.

124. *Id.* at 742.

125. *Id.* at 743.

126. 437 A.2d 381 (Pa. 1981).

127. *Id.* at 382.

128. *Id.*

it could terminate.[129] The reason for the difference in result, according to the court, was that, "unlike *Razumic*, the right to terminate the relationship without cause [in *Burns*] was reserved by the parties in their written agreement."[130] The result should not turn on the presence or absence of such a provision. If the contract in *Razumic* had expressly allowed the franchisor to terminate the relationship without cause, the purpose of that provision could not have been to allow it to appropriate the value of the franchisee's business. If the contract in *Burns* had contained no such provision, termination by Amoco to cut its losses would be consistent with good faith.

The same principle limits a landlord's right to refuse his consent to an assignment or sublease. The modern rule is that, in the words of the California Supreme Court, the landlord cannot refuse without "a good faith reasonable objection."[131] According to the *Restatement (Second) of Property*:

> A restraint on alienation without the consent of the landlord of the tenant's interest in the leased property is valid, but the landlord's consent to an alienation by the tenant cannot be withheld unreasonably, unless a freely negotiated provision in the lease gives the landlord an absolute right to withhold consent.[132]

As the Supreme Court of California said, to refuse consent, "in order . . . [to] charge a higher rent than originally contracted for . . . fail[s] the tests of good faith and reasonableness . . . ."[133]

Again, the question is the purpose for which the landlord was given the right to consent. Normally, a lease is like a sale: the lessor avoids the risk that if he waits or leases for a shorter term, the market value of the leasehold may fall, and the lessee avoids the risk that it may rise. If the lessee wished to move out before the end of the term, for example, because someone else can operate a business there more profitably, he would continue to pay the rent for which he originally contracted if the rental value of the property had fallen. To allow the lessor to appropriate part of the increase if the value has risen would be to allow him to renege on a bet he has lost.

129. *Id.* at 384.

130. *Id.* at 383.

131. Kendall v. Ernest Pestana, Inc., 709 P.2d 837, 842 (Cal. 1985), (quoting Cohen v. Ratinoff, 147 Cal. App. 3d 321, 330 (Cal. Ct. App. 1983)).

132. Restatement (Second) of Prop. § 15.2(2) (Am. L. Inst. 1977).

133. *Kendall*, 709 P.2d at 842 (quoting Schweiso v. Williams, 150 Cal. App. 3d. 883, 886 (Cal. Ct. App. 1984)).

2. Promoting Cooperation

Gerhart's examples concern situations in which the issue of good faith arises because, to achieve flexibility, the contract confers discretion on one party. In other situations, the issue arises because the parties must cooperate in ways that cannot easily be specified in advance.

Daniel Markovits had such situations in mind when he said that "good faith becomes particularly important" when it is "impracticable or even impossible for the parties to regulate . . . advantage taking directly and expressly, because prior agreements cannot effectively reach them."[134] "For imperfect planners, who cannot plan clearly for every contingency but whose plans inevitably involve haziness and have gaps, good faith is required to make joint planning possible."[135]

Markovits believed, however, that in these situations there is no way to draw a line between avoiding fraud, at one end of the spectrum, and observing a "fiduciary loyalty," at the other.[136] One cannot do so by asking about the reasonable expectations of the parties: "good faith is required precisely because the contractual intentions of the parties, and hence also their reasonable expectations, are not complete or clear."[137] Consequently, "[a]n understanding of good faith thus does not so much help to decide cases as to understand what has been decided."[138]

Here, as before, what should matter is whether a party who fails to cooperate is imposing a risk on the other party, which that party was not compensated to assume. He does so if his failure deprives the other party of a benefit that induced that party to contract so long as cooperation does not impose a burden on him that he was not compensated to bear. As Gerhart said, sometimes "contracting parties will accept some burdens on behalf of the counterparty in order to provide that counterparty with the rewards that the counterparty bargained for. . . . [I]t is part of the obligation that maintains the ex ante equilibrium . . . ."[139]

According to Markovits, similar considerations should guide parties who are attempting to act in good faith. "[G]ood faith supports the parties' contractual settlement . . . . It is thus, fundamentally, an attitude of respect for the contract relation, and the measure of good

134. Daniel Markovits, *Good Faith as Contract's Core Value*, *in* Philosophical Foundations of Contract Law, 272, 274 (Gregory Klass, George Letsas, & Prince Saprai eds., 2014).

135. *Id.* at 293.

136. *Id.* at 279.

137. *Id.* at 278.

138. *Id.* at 280.

139. Gerhart, Contract Law, *supra* note 2, at 139.

faith is the contract itself."[140] Each party has a duty "to adjust, in good faith, to new contingencies, in order not to deprive the other party of the benefits that the contract was intended to secure."[141]

It is true, as Markovits observed, that in these situations, deciding whether a party acted in good faith is not like "implying terms in the agreement."[142] One can often tell what terms the parties would have agreed upon had they considered a problem at the time they entered into a contract. In these situations, one cannot. The issue of good faith arises because the parties must cooperate in ways that cannot easily be specified in advance. It may not be possible to say what a party acting in good faith should do. It may still be possible to see when his act or failure to act "deprive[s] the other party of the benefits that the contract was intended to secure."[143]

a. Positive Duties of Cooperation

Sometimes cooperation requires a positive act without which the other party's performance cannot be made[144] or without which a condition cannot be fulfilled.[145] If an owner must empty his cabinets before a contractor can remodel his kitchen, or if he must seek a permit before the contractor can build on his land, then the court will imply that he must make a good faith effort.

A good faith effort is not necessarily the same as "best efforts." In *Beraha v. Baxter Health Care Corp.*,[146] the court held that the licensee of the rights to a biopsy needle did not have a duty to use best efforts to develop a market for it even though the licensor was to be paid a percentage that depended on the success of his efforts.[147] "Especially . . . when an inventor grants a license to patented technology, the application of which is unknown, a commitment on the part of the licensee to devote best efforts to the development of the technology is

140. Markovits, *supra* note 134, at 280.

141. *Id.* at 291.

142. *Id.* at 276 (quoting E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666, 670 (1963)).

143. *Id.* at 291.

144. *See, e.g.*, Designer Direct, Inc. v. DeForest Redevelopment Auth., 313 F.3d 1036, 1043 (7th Cir. 2002) (describing a failure take steps to make contractor's performance possible as a "lack of good faith").

145. Simon v. Etgen, 107 N.E. 1066, 1067–68 (N.Y. 1915) (finding when the sale of a building is a condition to be fulfilled before payment was due, good faith requires sale within a reasonable time).

146. 956 F.2d 1436 (7th Cir. 1992).

147. *See id.* at 1437, 1442, 1145.

a substantial commitment which should not be automatically inferred."[148] But the defendant was under a duty "to exercise reasonably its discretion in developing and marketing the Beraha needle."[149] If, in its "business judgment," development of the needle was unwise, it acted in good faith "even if it exerted no efforts at all to develop" it.[150]

b. Negative Duties of Cooperation

In contrast, sometimes a party's duty to cooperate is negative rather than positive. He must not obstruct the other party from receiving a benefit which induced that party to contract. The issue of good faith arises because it is difficult to specify in advance all the actions that a party should not take.

Unfortunately, many courts say that a duty to act in good faith can only be implied from a duty or condition that is set out in the contract. All the negative duties to cooperate cannot be set out in advance. There is no limit to the ways in which, by failing to act, one party could obstruct the other's opportunity to receive a benefit that was anticipated by both parties and induced that party to contract on the terms that he did.

The benefits that a party anticipated and that induced him to contract may be part of the compensation he was supposed to receive under the contract. Or they may be additional benefits such as the opportunity to make advantageous bargains with others. We will discuss each situation in turn.

In *Seidenberg v. Summit Bank*,[151] the benefits that the plaintiffs expected were part of the compensation that they were supposed to receive.[152] In return for selling stock in two corporations to Summit Bank, they were to retain their positions as the corporations' executives and "to be placed in charge of the daily operations of any other [similar] insurance business" that Summit acquired.[153] They also agreed to salary reductions "in exchange for a bonus to which they would be entitled based on the growth of the [corporations]."[154] The plaintiffs alleged that the Summit's obstructive conduct showed that it "'never had any intention to perform to begin with,' and that Summit 'from the start, . . . never [was] committed to developing the business with [plaintiffs], but rather simply wanted to acquire the business and seek out their

148. *Id.* at 1442–43 (alternation in original) (quoting Permanence Corp. v. Kennametal, Inc., 908 F.2d 98, 103 (6th Cir. 1990)).

149. *Id.* at 1444.

150. *Id.* at 1445.

151. 791 A.2d 1068 (N.J. 2002).

152. *Id.* at 1072.

153. *Id.*

154. *Id.* at 1073.

own broker to run it or grow it.'"[155] If so, the court held, the defendant acted in bad faith.[156] In this case, the court implied the duty to act in good faith from an express provision in the contract. The contract said: "Summit and [plaintiffs] shall work together to formulate joint marketing programs . . . ."[157]

Sometimes the compensation a party is to receive depends on the extent to which the other party uses or profits from the goods or services he provides. In *Ryder Truck Rental, Inc. v. Central Packing Co.*,[158] the rent charged for truck trailers to transport frozen food depended on how many miles the trucks were driven.[159] There was no minimum rental and no requirement that the trailers be driven a minimum number of miles.[160] The lessee's assignee did not use them at all.[161] The court held that he had acted in bad faith by "interfer[ing] with the right of the other to the fruits of its bargain."[162] The court was correct. The risk that the lessor assumed by charging by the mile was not that the lessee would acquire a back-up fleet and pay nothing for it.

Unfortunately, instead of simply asking what risks the parties assumed, the court felt compelled to imply a duty of good faith from an express clause in the lease. The lease said that the lessee would "use and operate the motor vehicle equipment . . . in the normal and ordinary conduct of *its* business."[163] That clause had nothing to do with the non-use of the trailers—a problem that the drafters never considered. By reading the clause as though it did, the court reached the right result while claiming it did not "imply an additional covenant enlarging [the] terms" of a "seemingly complete" agreement.[164] This is a dangerous line of argument. It suggests that if the lease had not happened to mention "use," the result would be different.

That line of argument led to the wrong result in *Mutual Life Insurance Co. of New York v. Tailored Woman, Inc.*[165] The plaintiff leased its basement and first three floors fronting Fifth Avenue to the

155. *Id.*

156. *Id.* at 1078.

157. *Id.* at 1072.

158. 341 F.2d 321 (10th Cir. 1965).

159. *Id.* at 322.

160. *Id.* at 322, 325.

161. *Id.* at 322.

162. *Id.* at 323, 324.

163. *Id.* at 322.

164. *Id.* at 323, 324 (quoting Stern v. Dunlap Co., 228 F.2d 939, 942 (10th Cir. 1955)).

165. 128 N.E.2d 401 (N.Y. 1955).

defendant, a women's clothing store, in return for 4% of all sales made "on, in, and from the demised premises."[166] Six years later, it leased the defendant part of the fifth floor for a fixed rent.[167] The defendant moved its fur department, which sold its most expensive clothes, to the fifth floor.[168] The plaintiff sued a year later, when it "learned for the first time that it was not receiving its percentage from the sales of furs."[169]

The court said that it accepted "the good old rule that there is in every contract an implied covenant of fair dealing."[170] Yet it found for the defendant because it thought it had to tease an answer out of words in the original lease "on, in, and from the demised premises."[171] These words were drafted before the possibility of moving the fur department had arisen.[172] Yet the court did not ask why the defendant did so. If the reason was not to increase sales but to lower the amount of its rent, then it should have been held liable for violating its obligation to act in good faith. The rent in the original lease was not increased to compensate the lessor for the risk that the lessee would sell his most expensive goods from a floor yet to be rented.

Sometimes, the benefit of which a party has been deprived is not part of the compensation he was to receive under the contract. It is an opportunity that the contract provides for him to enter into profitable bargains with others. Because of his expectations, the other party may have been able to contract on more favorable terms. If so, to deprive him of this opportunity violates the duty to act in good faith.

An example is *Sanders v. FedEx Ground Package System, Inc.*[173] "FedEx recruited . . . Sanders to be an independent contractor charged with making pick-ups and deliveries along a specified route."[174] Sanders claimed that FedEx told him "that he would have the ability to grow his business by buying routes from other contractors as they became

166. *Id.* at 402 (adopting "the facts of this controversy, and the issues, [as] discussed in the Appellate Division opinion"); *Mutual Life Ins. Co. v. Tailored Woman, Inc.*, 126 N.Y.S.2d 573, 574 (N.Y. App. Div. 1953).

167. *Tailored Woman*, 126 N.Y.S.2d at 575. ("It was specifically provided that the landlord should not be entitled to any percentage of receipts from sales or services on the demised premises and that the lease should not have any 'effect' on the 1939 lease of the basement and lower three floors.").

168. *Id.*

169. *Id.* at 575–76.

170. *Tailored Women*, 128 N.E.2d, at 403 (citing Kirke La Shelle Co. v. Paul Armstrong Co. et. al., 188 N.E. 163 (N.Y. 1933)).

171. *Id.* at 402–03.

172. *Id.* at 402.

173. 188 P.3d 1200 (N.M. 2008).

174. *Id.* at 1202.

available."[175] FedEx obstructed his efforts to do so for reasons that had nothing to do with his qualifications to operate the routes.[176] The lower court reached the wrong result by the line of reasoning just described. "[T]he implied covenant of good faith and fair dealing must be tied to a specific clause or term of the contract."[177] Its decision was reversed on the grounds that the implied covenant of good faith "prohibit[s] one party from obstructing the other party's benefit, whether that benefit is express or implied."[178] FedEx had charged Sanders an amount that reflected the benefit Sanders expected from buying additional routes.[179] FedEx could no more deprive him that benefit than of the amount of money promised him in the contract.

In *Olympus Hills Shopping Center, Ltd. v. Smith's Food & Drug Centers, Inc.*,[180] the lessee in a shopping center frustrated the expectations concerning the use he would make of the premises that had led the owner to lease on the terms that it did.[181] The premises were leased for a grocery store or "any other lawful retail selling business not directly in conflict or competition with another major tenant."[182] The lessee opened a grocery store nearby and used the space it had leased as a "box store" which, the shopping center claimed, "was a 'sham' operation designed to improperly 'freeze' the space in Olympus Hills and to force customers to its new location."[183] The court held correctly that this use violated the shopping center owner's "justified expectations."[184] The lessee's "minimum rent was below the break-even point for the shopping center's operating costs" because it was the anchor tenant at the center, generating significant customer traffic that was necessary to the financial health and operation of the shopping center.[185]

Yet ten years later, on similar facts, the same court that had declined to grant certiorari in *Olympus Hills Shopping Center* reached the opposite result. It did so by employing the line of argument we have criticized. It tried to extract an answer from the language of a contract that was never meant to deal with the issue. In *Oakwood Village, L.L.C.*

175. *Id.*

176. *Id.* at 1202, 1205.

177. *Id.* at 1203–04.

178. *Id.* at 1203.

179. *See id.* at 1206.

180. 889 P.2d 445 (Utah Ct. App. 1994), *cert. denied*, 899 P.2d 1231 (Utah 1995).

181. *Id.* at 448.

182. *Id.*

183. *Id.* at 448, 451.

184. *Id.* at 449, 451–52.

185. *Id.* at 452.

v. Albertsons, Inc.,[186] a shopping center leased space to the lessee for a supermarket and guaranteed that it would be the only supermarket in the center.[187] It expected the lessee "to function as the center's anchor tenant."[188] "[A]fter perceiving a better opportunity in a new shopping center across the street, [it] . . . moved one block south to become the anchor tenant in the Marketplace," another shopping center.[189] "After [it] relocated, [it] 'went dark' at its [old] location . . . while continuing to pay the monthly rent on the now vacant building."[190] "[Its] counsel admitted at trial, that [it] intentionally kept the old building unoccupied in order to restrict competition with its new store."[191] It is hard to imagine that the shopping center assumed the risk it would do so in return for an increase in rent. Yet the court held that the tenant was entitled to act like a "dog in the manger."[192] The reason was that the doctrine of good faith "cannot be read to establish new, independent rights or duties to which the parties did not agree ex ante."[193] The court distinguished *Olympus Hills Shopping Center* on the grounds that there, "the lease contained an express covenant of continuous operation and a restriction on the nature of operations."[194] That is an odd way to characterize a clause that said that the lessee can operate "any lawful retail selling business not directly in conflict or competition with another major tenant."[195] In any event, once again this line of reasoning led to the wrong result.

II. Other Conceptions of Good Faith

Scholars have failed to agree on the meaning of good faith. Robert Summers claimed that the phrase cannot be defined positively, but only negatively, as what he calls an "excluder."[196] According to other schol-

186. 104 P.3d 1226 (Utah 2004).

187. *Id.* at 1229–30.

188. *Id.* at 1229.

189. *Id.* at 1230.

190. *Id.*

191. *Id.*

192. *Id.* at 1241.

193. *Id.* at 1240.

194. *Id.* at 1241.

195. Olympus Hills Shopping Ctr., Ltd. v. Smith's Food & Drug Ctrs., Inc., 889 P.2d 445, 448 (Utah Ct. App. 1994).

196. Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195, 196 (1968).

ars, the doctrine is pernicious because it conflicts with standard methods of contract interpretation.[197] Some say it is unnecessary because it merely recapitulates them.[198] Some say that the doctrine ensures fairness, but their conception of fairness borders on altruism.[199] Some say the doctrine promotes economic efficiency.[200] They all differ from Gerhart's approach, but there is an element of truth in each of them.

A. Good Faith as an "Excluder"

In a seminal article, Robert Summers claimed that one cannot define "good faith." "[G]ood faith is an 'excluder.' It is a phrase without general meaning (or meanings) of its own and serves to exclude a wide range of heterogeneous forms of bad faith."[201] According to Robert Braucher, who then served as Reporter, Summers's approach influenced that of the *Restatement (Second) of Contracts*.[202] The *Restatement (Second)* does not define good faith. It provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[203] According to Braucher:

> [T]he trouble with this section, of course, is that it's very general, very abstract, and it needs specification the worst way, and specification is not to be had. I am indebted for its formulation here in the comments—formulations in the comments—to Professor Summers . . . .[204]

He was referring primarily to comment (a): "Meanings of 'good faith."

> The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they

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197. *See* Dobbins, *supra* note 72, at 231.

198. *See* 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, 563 (2006).

199. *See* Scott, *supra* note 41, at 850.

200. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369, 373 (1980).

201. Summers, *supra* note 196, at 201 (footnote omitted).

202. *Friday Afternoon Session May 22, 1970,* 47 A.L.I. Proc. 489–90 [hereinafter 47 A.L.I. Proc.].

203. Restatement (Second) of Conts. § 205 (Am. L. Inst. 1981).

204. 47 A.L.I. Proc., *supra* note 202, at 490.

> violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.[205]

The comment neither refers to "good faith" as an excluder, nor says that a definition is impossible. Nevertheless, it does not provide the "specification" which, according to Braucher, the section "needs . . . [in] the worst way."[206] The reason, presumably, is that it "is not to be had."[207]

The term "good faith" has indeed been used in heterogenous situations. It does not follow that the term cannot be defined but rather that one definition will not fit all of them. In a follow-up article, Summers enumerated these situations. They concern issues of consideration ("conjuring up a pretended dispute in order . . . to lay a basis for a settlement"), the fairness of the modification of the terms of a contract ("taking advantage of another's necessitous circumstances to secure a favorable modification"), the general problem of how to interpret the language of a contract ("asserting an overreaching or 'weaseling' interpretation or construction of contract language"), and problems of conditions and remedies ("wilful rendering of only substantial performance"; "making harassing demands for assurances of performance; wrongfully refusing to accept performance; and wilfully failing to mitigate damages"[208]). In each of those contexts, "good faith" does have a different meaning. But that does not show its meaning cannot be defined in the situations we have discussed in which a duty of good faith is needed to provide flexibility or to ensure cooperation.[209]

Some of those situations are mentioned obliquely in Summers's enumeration. A contract gives a party "a power to determine compliance or to terminate a contract" and thereby provide flexibility.[210] "[I]nterference with, or failure to cooperate in, the other party's performance" may constitute bad faith, as may "lack of diligence and slacking off."[211]

Summers also observed that bad faith also means "evasion of the spirit of the deal."[212] That idea sounds like a vague expression of the principle we have seen to be at stake in all the situations that we have

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205. Restatement (Second) of Conts. § 205 cmt. a (Am. L. Inst. 1981).

206. 47 A.L.I. Proc., *supra* note 202, at 490.

207. *Id.*

208. Summers, *supra* note 73, at 813.

209. *See supra* Part I(B)(1).

210. Summers, *supra* note 73, at 812–13.

211. *Id.*

212. *Id.*

discussed. Summers identified it with what Burton called the "recapture" of "forgone opportunities,"[213] an idea that we will discuss next. Summers claimed that Burton's formulation was no more precise than his own.[214] We have tried to show how the principle that we have suggested can be given precision. Be that as it may, if one can explain the meaning of "the spirit of the deal," one can explain the meaning of good faith.[215] The term is not merely an "excluder."

Summers's idea that some terms function as "excluders" is one way of reacting against the conceptualism of the 19th-century jurist.[216] They defined concepts without regard to purposes and have rightly been criticized for ignoring the purposes that the law serves.[217] In our account, the duty to act in good faith was explained in terms of the purposes of providing for flexibility and promoting cooperation.[218] Summers lists six "different methods of conceptualization," one of which is by using an "excluder."[219] None of them define a concept in terms of its purposes.

The first is typical of 19th-century conceptualism: "1. Conceptualization by formal definition—*e.g.,* resort to necessary and sufficient conditions for the use of a word or phrase."[220]

The element of truth in Summers's approach is that legal concepts cannot be defined in this way. If they could, the dream of the 19th-century jurists could be realized. When a new case arose, one would simply ask whether the necessary and sufficient conditions for using a term have been satisfied.

Such definitions ignore the purposes that the law serves. What human beings make or do must be defined in terms of its purposes, but the definition will not contain a set of "necessary and sufficient conditions for the use of a word or phrase."[221] The purpose of a chair is for a person to sit on it; the purpose of swimming is to move one's body forward through the water. By defining objects or activities such as these in terms of their purposes, one can explain why any chair or any swimming stroke has the features that it does. The definition can even suggest the features that a chair or stroke might have to perform its purpose better. But it does not identify necessary and sufficient conditions for an object to be a chair or an activity to be swimming. The

213. *Id.* at 830.

214. *Id.* at 833.

215. *Id.* at 812–13; *see supra* Part I.

216. *Id.* at 818–19.

217. James Gordley, The Jurists: A Critical History 276–77 (2013).

218. *See supra* Part I(B).

219. Summers, *supra* note 73, at 817–18.

220. *Id.* at 817.

221. *Id.*

same is true of legal terms and institutions. Defining good faith in terms of the purposes of providing flexibility or ensuring cooperation does not produce a list of conditions that must be met before we can say that a person has acted in good faith. But it does explain how those purposes may be served.

Summers's next four methods are attempts to define a term without providing a formal definition:

> 2. Conceptualization by synonymous paraphrase of the word or phrase in question (including contrastive paraphrase).
> 3. Conceptualization by paradigmatic sample, specifying what is required for the use of the word or phrase.
> 4. Conceptualization mainly by recital or representative examples illustrating the application of the word or phrase.
> 5. Conceptualization by specification of family resemblances that run through diverse uses of the word or phrase.[222]

As Summers recognized, none of these methods can provide an adequate, usable definition of good faith. To explain one term by a paraphrase or synonym (method 2) sidesteps the question of how to define the synonym or the terms used in the paraphrase. To explain a term by a paradigm (method 3) or representative examples (method 4) sidesteps the question of what makes the paradigm paradigmatic or the examples representative.[223] The idea of using family resemblances (method 5), as Summers recognized, was borrowed from Wittgenstein.[224] Wittgenstein's illustration, as explained by Lon L. Fuller, was the term "game." If a parent asked a babysitter to teach his children a game, and the babysitter taught them to duel with kitchen knives, the parent would say, "That's not the kind of game I meant." The example is supposed to show that one can only explain what a game is in terms of resemblances between different instances of what we call games.[225] What it actually shows is that words should be understood in terms of their purposes. The parents used the term "game" with one purpose in mind: to provide diversion for their children. Where the purpose is different, as in athletic competitions or games of chance, what counts as a "game" will be different.

Since these five methods are inadequate to define good faith, Summers concluded that one must use a sixth: "6. Conceptualization by way of 'excluder analysis.'"[226]

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222. *Id.* at 818.

223. *Id.*

224. *Id.* at 818 (citing Ludwig Wittgenstein, Philosophical Investigations (G.E.M. Anscombe trans., 1958)).

225. Lon L. Fuller, The Concept of Law 138–39 (rev. ed. 1969).

226. Summers, *supra* note 73, at 818.

He took this idea from John Austin[227] and applied it to a much different problem. Austin was trying to solve the problem of Cartesian doubt: how do I know that everything I take to be real is not an hallucination or a dream?[228] Austin's answer was that the word "real" is an excluder: it is defined as that which is not real such as a dream or an hallucination.[229] The Aristotelian view, challenged by the philosophy of Descartes, was the opposite: reality is a first principle of human reason—what it grasps before it grasps anything else—and dreams or hallucinations are defined by the fact that they are not real.[230]

Be that as it may, Austin's approach is helpful if one knows what is being "excluded." If one knows what a dream or a hallucination is, one can say, "reality is not that." For the term "good faith" to function as an excluder, one would have to know what is meant by "bad faith." But how is one to know? Perhaps in the way that the *Restatement (Second)* suggests: "'bad faith' . . . violate[s] community standards of decency, fairness or reasonableness."[231] But if so, why say that good faith" is an excluder? Why not define it as conformity to "community standards of decency, fairness or reasonableness"? If that definition is too vague to mean anything, then how is one to know what "bad faith" means? Summers illustrates the meaning of bad faith by giving a series of examples and claiming that no definition of good faith can explain them all. But that would seem to be "conceptualization" by representative examples, a method, he said, which cannot be used to understand the meaning of "good faith."[232] Why, then, can it be used to understand "bad faith"?

B. The Good Faith as a Violation of Fundamental Principles of Interpretation

According to Teri Dobbins Baxter, "the parties' agreement should take precedence over the parties' expectations, to the extent that the two do not coincide."[233] The "parties may not share the same expectations and one party may be ignorant of the expectations of the other."[234] She concluded that, "in many contracts, the implied covenant

227. J.L. Austin, Sense and Sensibilia 70–71 (G.J. Warnock ed., 1962), *quoted in* Summers, *supra* note 73, at 819.

228. *Id.*

229. *Id.*

230. *Id.*

231. Restatement (Second) of Conts. § 205 cmt. a (Am. L. Inst. 1981).

232. Summers, *supra* note 73, at 818.

233. Dobbins, *supra* note 72, at 231.

234. *Id.* at 232.

of good faith is not capable or worthy of being saved from the chaos that currently surrounds it."[235]

The element of truth is that the duties to which the parties are held should be based on their expectations. The confusion is to use the term "expectations" too loosely. The parties' agreement is based on their expectations concerning the performances that each will receive and the risks and burdens that each will bear. Their agreement should be interpreted in terms of these expectations. Only these expectations matter. As long as a party was compensated for bearing a risk, it does not matter that he expected to win. Nevertheless, as we have seen, the risks that each party was assigned by the contract extend beyond those that either party had consciously in mind. These risks are not extraneous to the agreement. Consequently, they are not extraneous to the parties' "expectations" if we use that term in the same way as when we say a party who buys a car expects to get the car keys. He may not have consciously thought of the keys, but it is the most appropriate means to the end that both parties wished to achieve.

C. Good Faith as a Recapitulation of Fundamental Principles of Interpretation

In contrast, Jay Feinman argued that "[g]ood faith is simply another embodiment of the basic principle of contract law—the protection of reasonable expectations."[236] Similarly, according to Harold Dubroff, the difficulties of "defin[ing] good faith . . . would be eliminated if cases that are really about contract interpretation were approached that way without regard to the issue of good faith."[237] Contracts should be interpreted in accordance with "the actual intentions and expectations of the parties, although they may have been expressed imperfectly."[238]

The element of truth in this approach is that the doctrine of good faith, as we have seen, is based on the same principles as those that that explain why other terms are read into a contract to govern situations that the parties did not anticipate. As we have seen, however, the doctrine applies when the parties could not have provided a term to resolve an issue in advance. If one cannot say in advance what a party should or should not do, one might give one of the parties the discretion to decide later on. It is impossible to list in advance all the ways in which one party might prevent the other from obtaining a benefit that he was supposed to receive under the contract. One must interpret the contract to protect the parties' reasonable expectations.

235. *Id.* at 230.

236. Jay M. Feinman, *Good Faith and Reasonable Expectations*, 67 Ark. L. Rev. 525, 526 (2014).

237. Dubroff, *supra* note 198, at 563.

238. *Id.* at 569.

Here, however, the only way to describe their expectations is that each of them would act in good faith. One cannot dispense with that term and explain what their expectations are.

D. Good Faith as Altruism

Another approach, as described by Robert Scott, is for a court to

> fill in the "right" result or the "right relational" result by imposing an equitable adjustment that takes all of the relational and contextual factors into account as they appear at the time of adjudication. . . . There is simply a "gap in the agreement or risk allocation" that a court can fill based upon information available to it at the time of adjudication. In sum, courts should fill such gaps by creating contract terms that are fair ex post.[239]

According to Scott, "[t]his has been the solution most frequently suggested by the law-and-society branch of relational contract scholars."[240] He cited the work of Ian Macneil and Richard Speidel.[241]

Macneil developed a "relational theory" of contract law. "[E]very transaction is embedded in complex relations. . . . [E]ffective analysis of any transaction requires recognition and consideration of all essential elements of its enveloping relations that might affect the transaction significantly."[242] These relations are fluid. One cannot determine the parties' obligations by asking about their intentions, real or hypothetical, at the time that they contracted. As Eric Posner said, by this approach "the parties . . . cannot expect the court to enforce contractual obligations on the basis of the initial contract, given that the initial contract will most likely have nothing to say about events occurring many years later."[243]

Certainly, every contract, like every crime, tort, corporation, and the exercise of any private right is embedded in a set of circumstances, including relationships with others, without which it cannot be fully understood. It is hard to turn this insight into a theory. Macneil himself said: "Upon starting down th[is] road . . . it did not occur to me

239. Scott, *supra* note 41, at 850–51 (footnote omitted) (quoting Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & Com. 193, 207 (1982)).

240. *Id.* at 850.

241. *Id.* at 850 n.6 (citing Ian Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854 (1978); *id.* at 851 & nn.8–9 (first citing Richard E. Speidel, *Court-Imposed Price Adjustments Under Long-Term Supply Contracts*, 76 Nw. U. L. Rev. 369 (1981), and then citing Speidel, *supra* note 239).

242. Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 Nw. U. L. Rev. 877, 881 (2000).

243. Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 Nw. U. L. Rev. 749, 751 (2000).

consciously that I might be developing a theory. Rather, I was simply exploring and trying to make sense of reality, the reality of what people are actually *doing* in the real-life world of exchange."[244]

What, then, are the legal implications of understanding "what people are actually *doing* in the real-life world of exchange?" Macneil admonished those who look for such implications: "I challenge to a duel anyone who, after this notice, persists in converting my descriptions of relational contract law into prescriptions of what the law should be, particularly prescriptions of some universal application of relational contract law."[245]

According to Speidel, the implications are that the doctrine of good faith should be given much greater scope.[246] He commended a provision of the UNIDROIT Principles of International Commercial Contracts dealing with the problem of impracticability due to changed circumstances.[247] It provides that one party can require the other to negotiate, and, if negotiations break down, the court should "adapt the contract."[248] Speidel suggested that American courts expand the doctrine of good faith to impose a similar requirement when an issue was not resolved when the parties contracted.[249] The contract's negotiations, however, would be based on the parties' expectations of how a court would "adapt the contract" if negotiations broke down.[250] Speidel is no clearer than Macneil about how a court should do so.

Charles Goetz and Robert Scott explained that, ex ante, "[i]f the basic risk allocation provided by a legal rule fails to suit the purposes of particular parties, then bargainers are free to negotiate an alternative allocation of risks."[251] Nevertheless, in "relational" contracts, "[w]here the future contingencies are peculiarly intricate or uncertain, practical difficulties arise that impede the contracting parties' efforts to allocate

244. Macneil, *supra* note 242, at 879 (emphasis omitted).

245. *Id.* at 899. He qualified that remark. "Notwithstanding the challenge just offered, in my work I have gone beyond observation and included two types of prescription respecting relational contract law . . . . One is entirely personal to my perceptions of the good life." *Id.* at 900. It concerned "excessive bureaucratization of modern life." *Id.* at 900 n.81. The other "is a general idea that relational contract law should generally track the relational behavior and norms found in the relations to which it applies." *Id.* at 900.

246. Richard E. Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U. L. REV. 823, 840–41 (2000).

247. *Id.* at 842–43.

248. UNIDROIT PRINCIPLES OF INT'L COM. CONTS. art. 6.2.3 (UNIDROIT INT'L INST. FOR THE UNIFICATION OF PRIV. L. 2016).

249. Speidel, *supra* note 246, at 840–41, 843.

250. *Id.* at 839, 842 & n.71.

251. Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1090 (1981).

optimally all risks at the time of contracting."[252] The question again arises of what a court should do then.

Since, by hypothesis, the court cannot look to the way the parties allocated the risks at the time of contracting, it must look to what seems be fair ex post. The implication is that courts would be empowered to do what is fair with no standard of what fairness entails. Perhaps the implication is that there should be no winners or losers, or, at least, that no one should be hurt too badly. Teri Dobbins Baxter objected that if the court imposes "a result that the court believes to be fair . . . , the implied covenant of good faith makes every party a guarantor of the other party's satisfaction with the outcome of the bargain."[253] Scott said that the consequences to one party will be deemed to be unfair if they are severe.[254]

The fear that courts will do so has haunted discussions of the doctrine of good faith. Robert Braucher, who served as Reporter for the *Restatement (Second)*, said of the section on good faith: "I have been asked about [this] Section . . . : Isn't this an attempt . . . to write the Sermon on the Mount into the Restatement of Contracts?"[255]

As Judge Posner observed, "even after you have signed a contract, you are not obliged to become an altruist toward the other party and relax the terms if he gets into trouble in performing his side of the bargain."[256] That point was made in another Seventh Circuit opinion in *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*.[257] The lower court held that a bank had "behaved inequitably in terminating [a] line of credit."[258] It "was fully aware of the Debtor's plight, and its reliance upon the line of credit, and disregarded the consequences for the Debtor and its creditors."[259] The Seventh Circuit reversed. "Debtor and Bank signed a contract expressly allowing the Bank to cease making further advances."[260] "Although Bank's decision left Debtor scratching for other sources of credit, Bank did not create Debtor's need for funds . . . ."[261] "'Good faith' is a compact reference to an implied undertaking not to

252. *Id.* at 1090–91.

253. Dobbins, *supra* note 72, at 236–37.

254. Scott, *supra* note 41, at 858.

255. 47 A.L.I. Proc., *supra* note 202, at 488–89.

256. Mkt. St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 594 (7th Cir. 1991).

257. 908 F.2d 1351, 1357 (7th Cir. 1990).

258. *Id.* at 1354.

259. *Id.* at 1356.

260. *Id.* at 1357.

261. *Id.* at 1358.

take opportunistic advantage in a way that could not have been contemplated at the time of drafting . . . ."[262] It "does not imply a general duty of 'kindness' in performance . . . ."[263]

Similarly, in *Martin v. Hamilton State Bank*,[264] a bank loaned the defendant more than $2.7 million.[265] When he failed to make several payments, the bank sued to recover the loan.[266] The defendant claimed that the bank had not acted in good faith because the parties were unable to agree on a plan by which "the indebtedness might be restructured."[267] The court held that it had not acted improperly, whatever its motivation might have been.[268] It had loaned the money and was entitled to be repaid.[269]

The element of truth in this approach is that it recognizes the critical role of fairness in explaining good faith. But fairness does not mean reaching a result ex post that commends itself to both of the parties. Fairness means reaching a result ex post that corresponds to how risks were assigned by the parties ex ante.

E. Good Faith as Means of Promoting an Efficient Result

The element of truth in the approach of those who explain the doctrine of good faith in terms of efficiency is that they recognize the importance of how risks were assigned ex ante. According to Steven Burton, "[b]ad faith performance occurs precisely when discretion is used to recapture opportunities forgone upon contracting — when the discretion-exercising party refuses to pay the expected cost of performance."[270]

Dubroff objected that any breach of contract is an attempt to recapture foregone opportunities:

> Clearly, parties who enter into contracts forgo their opportunities to act in specified and unspecified ways. The very nature of a bilateral contract is to create obligations in exchange for rights. Thus, if I promise to cut my neighbor's lawn in exchange for her

262. *Id.* at 1357.

263. *Id.*

264. 723 S.E.2d 726 (Ga. Ct. App. 2012).

265. *Id.* at 727.

266. *Id.*

267. *Id.*

268. *Id.* at 728.

269. *Id.*

270. Burton, *supra* note 200, at 373.

> promise to pay me $10, I have forgone the opportunities that might have been available to me by not cutting her lawn.[271]

Certainly. The difference is that, most often, one can determine whether a breach has occurred without considering what opportunities were foregone. If I promise to cut my neighbor's lawn for $10, the neighbor gives up her chance of getting it cut for less, and I give up my chance of using my time to cut someone else's lawn for more. In the first section, we saw that such a contract should be enforced because parties have given up these opportunities in order to avoid contracting with someone else on worse terms.[272] But one can determine whether there has been a breach of contract by asking whether I cut the lawn and whether she paid me $10. Sometimes, one has to ask what opportunities were foregone in order to determine whether there was a breach of contract. In those cases, courts speak of "good faith."

The element of truth in Burton's approach is that it is a violation of good faith to try to recapture a foregone opportunity. The key difference between Gerhart's and my approach and his is that, like others committed to economic analysis, he tried to explain good faith in terms of efficiency, not fairness. According to Burton, requiring a party to act in good faith:

> enhance[s] economic efficiency by reducing the costs of contracting. The costs of exchange include the costs of gathering information with which to choose one's contract partners, negotiating and drafting contracts, and risk taking with respect to the future. The good faith performance doctrine reduces all three kinds of costs by allowing parties to rely on the law in place of incurring some of these costs.[273]

In *Market Street Associates v. Frey*, Judge Posner, citing Burton, took the same approach.[274]

> The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule. "'Good faith' is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties."

271. Dubroff, *supra* note 198, at 605.

272. *See supra* text accompanying note 50.

273. Burton, *supra* note 200, at 393 (footnote omitted).

274. Mkt. St. Assocs. Ltd. P'ship v. Frey, 941 F.2d 588, 594–96 (7th Cir. 1991) (citing Burton, *supra* note 200, at 393, 372 n.17).

> . . . .
>
> [T]he overriding purpose of contract law . . . is to give the parties what they would have stipulated for expressly if at the time of making the contract they had had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero.[275]

Posner, like Burton, did not say that taking opportunistic advantage is unfair. He said:

> Such taking advantage . . . [l]ike theft, . . . has no social product, and also like theft it induces costly defensive expenditures, in the form of overelaborate disclaimers or investigations into the trustworthiness of a prospective contract partner, just as the prospect of theft induces expenditures on locks.[276]

Economic analysis is concerned with what is efficient, not what is fair. A transaction is efficient if at least one party is better off and no one is worse off. Theft does not make both parties better off. In this sense it “has no social product.” Transaction costs that are avoidable are inefficient since one or both parties would be better off without them. Theft is inefficient because “the prospect of theft induces expenditures on locks.” Taking opportunistic advantage is inefficient because “it induces costly defensive expenditures, in the form of overelaborate disclaimers or investigations into the trustworthiness of a prospective contract partner.” It increases “the costs of gathering information with which to choose one’s contract partners, negotiating and drafting contracts.”

Is that all? Suppose a party took opportunistic advantage in a way that was so unanticipated that it would not increase these costs? Can it really be that the reason a party should be prevented from acting in bad faith is to prevent others from overinvesting in defensive measures? As Posner suggested, it is like asking why the law condemns theft. Most people would say it is unjust to steal just as it is unjust to take opportunistic advantage of another contracting party. I suspect that only a disciple of economic analysis would think the real problem is to optimize money spent on locks or on negotiating and drafting.

It is a particularly poor explanation of the duty to act in good faith. As we have seen, this duty is implied in situations in which an appropriate term could not be supplied in advance if drafting a contract were costless. If discretion is conferred on a party to make the terms of a contract more flexible, it is impossible to specify in advance how that

275. *Id.* at 595–96 (7th Cir. 1991) (quoting Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1357 (7th Cir. 1990)).

276. *Id.* at 594.

discretion should be used. It is impossible to specify everything that each party must do or refrain from doing for the other to obtain the benefit for which he contracted, then a drafter could never succeed in doing so. The reason for implying a duty to act in good faith cannot be to save future parties the time, cost, and error inherent in negotiating contract terms and reducing them to writing.

Conclusion: Good Faith and Fair Exchange

We have seen why a violation of the duty to act in good faith is an injustice. It is unfair to impose a risk or burden on the other party that he was not compensated for bearing. As Peter Gerhart said, a party acts in good faith when he does not upset the "equilibrium" of the contract.[277] Hao Jiang and I have shown that this principle runs throughout contract law.[278] It was all but forgotten in the 19th century when jurists defined contract in terms of the will of the parties and identified their will with the terms on which they had expressly agreed. Gerhart is to be congratulated for pointing the way back.

277. Gerhart, Contract Law, *supra* note 2, at 137.

278. *See generally* Gordley & Jiang, *supra* note 8.