Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View

Steven J. Burton
GOOD FAITH IN ARTICLES 1 AND 2 OF THE U.C.C.: THE PRACTICE VIEW

STEVEN J. BURTON*

I. INTRODUCTION

The Uniform Commercial Code is a remarkably successful achievement, both for its innovations in contract and commercial law and for its near-uniform acceptance in the United States. Not the least of its achievements is the institution of a Permanent Editorial Board that monitors its operation, issues commentaries, and proposes revisions from time to time. Articles 1 and 2 currently are under revision. No one doubts that these articles have flaws, some of which glare in the light of four decades of experience. The present statutory articulation of good faith in the performance and enforcement of contracts is among the significant flaws.¹

The drafters of the U.C.C. did not think they were doing anything novel by codifying requirements of good faith.² Judicial practice over the years generally has favored the drafters' under-

* William G. Hammond Professor of Law, University of Iowa. I thank Professor Eric G. Andersen and Judge Richard A. Posner for their comments on the manuscript.

¹ Section 1-203 currently provides: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203 (1990). Several provisions in Articles 1 and 2 impose specific requirements of good faith as particular applications of the Article 1 obligation. See, e.g., id. §§ 1-208, 2-305(2), 2-306(1), 2-311(1), 2-706(5), 2-712(1). Other provisions further implement the Article 1 obligation without mentioning good faith in their texts. Id. § 1-203 cmt. Unless the context otherwise requires, Article 1 defines good faith for the entire U.C.C. as "honesty in fact in the conduct or transaction concerned." Id. § 1-201(19). For transactions within Article 2, "'good faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." Id. § 2-103(1)(b).

standing. With rare exception, the courts use the U.C.C. good faith requirements in aid and furtherance of the parties’ agreement, not to override the parties’ agreement for reasons of fairness, policy, or morality. Judicial practice generally has followed the counterpart common law obligation, often without distinguishing clearly statutory from common law authorities.


The greatest volume of litigation under Article 2 involves output and requirements contracts governed by § 2-306(1). Courts and commentators agree that the good faith performance obligation in these cases is the same as the preexisting common law obligation. See, e.g., Feld v. Henry S. Levy & Sons, Inc., 335 N.E.2d 320, 322 (N.Y. 1975); John D. Calamari & Joseph M. Perillo, THE LAW OF CONTRACTS § 4-13 (3d ed. 1987); E. ALLAN FARNSWORTH, CONTRACTS § 2.15 (2d ed. 1990); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 3-8 (3d ed. 1988); Burton, Breach of Contract, supra note 4, at 395-97; Burton, Good Faith Performance, supra note 3, at 7-9; Stacy A. Silkworth, Quantity Variation in Open Quantity Contracts, 51 U. PIT. L. REV. 235, 243 (1990) (stating that at least one court has suggested that the U.C.C. has codified the common law); John C. Weistart, Requirements and Output Contracts: Quantity Variations Under the UCC, 1973 DUKE L.J. 599. Consequently, varying the general U.C.C. obligation from the common law counterpart obligation without upsetting this body of happily settled law would be difficult. See Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 J. LEGAL STUD. 271, 296-303 (1992).
On their face, the U.C.C. good faith requirements are stated in the vaguest of terms, supported by definitions either too limited to be taken seriously in the performance and enforcement context (honesty in fact), or as opaque as good faith itself (reasonable commercial standards of fair dealing in the trade). In practice, most courts find their way to a reasonable construction of the obligation following litigation. Great resources, however, may be consumed in this process. A few courts have used the doctrinal vagueness as a pretext to impose unprecedented liabilities on commercial parties, notably lenders and suppliers to dealers or franchisees. Just enough unorthodox judgments occur to inspire ever-optimistic plaintiffs' counsel to keep the lawsuits coming.

A revision of Articles 1 and 2 should clarify the distinctions between good and bad faith in contract performance and enforcement so that plaintiffs will bring suits only when they stand a reasonable chance of succeeding and of succeeding for good reasons. This Article proposes a revision of the basic good faith requirement (section 1-203) and the definitions of good faith in Articles 1 and 2 (assuming these articles retain roughly their present shape). Bearing in mind the judicial propensity to mix statutory and common law authorities in good faith cases and a legislator's limited power to change settled judicial practices of this kind, this Article further proposes a codification of good faith that articulates the normative sense in judicial practice under the existing U.C.C. and the common law.

Accordingly, the revised Articles 1 and 2 should make two things clear. First, the good faith requirement limits a party's discretion in contract performance and enforcement. Second, in

7. See id.
10. Following the practice of the courts, in the absence of any existing provision defining the applicability of Article 1, and not knowing with what scope the revised Article 1 will apply, I will take into account in this Article commercial cases whether governed by the U.C.C. or the common law, including notably loan contracts.
order to protect justifiable expectations arising from an agreement, good faith limits discretion by requiring a discretion-exercising party to act only for reasons allowed by the parties' agreement when understood in the context in which it was made. This approach will be called the "practice view" of good faith because it codifies judicial practice.

II. A CRITIQUE AND A PROPOSAL

The abstractness of "good faith" allows advocates to project onto it any of many meanings. To some, good faith might require a contract party to act as a good and upright person, under the same set of circumstances, would act. To others, it might require compliance with communitarian or moral obligations. To still others, it might require a contract party to do whatever has the best consequences for both parties and the greater good, which would require acting as the parties would have agreed they should act had they negotiated on the matter under conditions congenial to economic efficiency. Good faith is sometimes considered a license to weigh all relevant factors on a case-by-case basis using situational ethics. Some may embrace "good


I presented my views on excluder analysis in Burton, More on Good Faith, supra note 4, at 499. To review key points of disagreement, excluder analysis focuses exclusively on cases of bad faith. See id. at 498. Most of the relevant precedents, however, hold that a party acted in good faith. In my view, a judge should consider
faith" as a doctrinal basis for reforming contract law so as to admit "relational obligations" not arising from the parties' agreement.\textsuperscript{15}

We are concerned with good faith, not as an abstract question, but as a legal requirement with practical consequences for commercial transactions. "Good faith" may take on a concrete meaning in the context of a practice that uses the concept. Like any term, it may be understood and applied in practice with a consistency of meaning that is missing from its abstract semantics. In fact, concrete and sensible meanings for good faith in contract performance and enforcement are emerging in judicial practice. I propose that the revised Articles 1 and 2 should reflect the judicial experience.

A. Critique

Within the U.C.C., "good faith" functions in a variety of contexts with differing legal consequences. First, in the context of good faith purchase and holder in due course problems, good faith allocates the priorities among multiple claimants of property by setting a condition to a valid claim of ownership by a transferee.\textsuperscript{16} Second, bad faith may amount to fraud in contract formation or by debtors in possession of collateral or goods,\textsuperscript{17} analogically whether a new case is more like the precedents finding good faith than like those finding bad faith. A judge, however, cannot rely solely on analogies to decide a new problem case. See Steven J. Burton, An Introduction to Law and Legal Reasoning 31-36 (1985). A judge must use a rule, principle, policy, or convention of practice to decide whether similarities or differences are more important under the circumstances. See id.; Melvin A. Eisenberg, The Nature of the Common Law 83-96 (1988). By emphasizing the heterogeneity of cases of bad faith, excluder analysis denies the availability of needed rules, principles, policies, or conventions. Moreover, excluder analysis also could apply in reverse: one could determine what bad faith is by first asking what have courts found to be instances of good faith and reasoning by analogy from these cases? If we apply it both ways, excluder analysis is meaningless, yet no apparent reason exists why we should not apply excluder analysis both ways. See also Dennis M. Patterson, Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code, 68 Tex. L. Rev. 169, 199-202 (1989).

\textsuperscript{15} See infra notes 108-09, 117-27 and accompanying text.


\textsuperscript{17} See, e.g., id. §§ 2-328(4), 2-402(2). The common law of fraud remains applicable to U.C.C. transactions unless displaced by particular provisions therein. Id. § 1-103.
which may both invalidate a contract and ground an action in tort for compensation.\textsuperscript{18} Third, in contract modifications, bad faith may invalidate a modification for reasons more akin to duress.\textsuperscript{19} Fourth, in contract performance, good faith is a basis for implying obligations from the parties' agreement; bad faith performance is an ordinary breach of contract.\textsuperscript{20} Fifth, good faith in contract enforcement is a condition to the valid exercise of remedial rights that contract or statute provides.

The meaning of "good faith" varies with its function in these different contexts. A holder in due course, for example, might be acting in good faith when honest and careful, but honesty and care do not indicate that the party has not breached a contract.\textsuperscript{21} Nonetheless, the statutory definitions of good faith apply to all contexts. Resulting confusion tends to empty "good faith" of practical meaning, allowing it too easily to be cited as mere homily, and undermining its value for those cases in which it is needed.\textsuperscript{22}

Moreover, section 1-203 lumps performance and enforcement together as "obligations." Good faith in contract performance is an obligation, the breach of which is an ordinary breach of contract.\textsuperscript{23} Good faith in contract enforcement, however, is a condi-

\textsuperscript{18} See Bunge Corp. v. Recker, 519 F.2d 449, 452 (8th Cir. 1975) (citing cases that found "bad faith" to be synonymous with "fraud" and stating that under the U.C.C., "a lack of 'good faith' . . . means some type of affirmative action consisting of at least constructive fraud or a design to mislead or deceive another").


\textsuperscript{20} See U.C.C. §§ 1-106(2), 1-203, 2-305(2), 2-306(1), 2-311(1) (1990); see also infra text accompanying notes 36-52 (discussing remedies in a bad faith performance breach of contract action).

\textsuperscript{21} See infra text accompanying notes 36-52.

\textsuperscript{22} The Supreme Court of Alabama held that U.C.C. § 1-203 is "directive, not remedial." Tanner v. Church's Fried Chicken, 582 So. 2d 449, 452 ( Ala. 1991); Government St. Lumber Co. v. AmSouth Bank, 553 So. 2d 68, 72 (Ala. 1989); Chandler v. Hunter, 340 So. 2d 818, 821 (Ala. Civ. App. 1976). However, § 1-106(2) provides: "Any right or obligation declared by this Act is enforceable by action unless the provision declaring it specifies a different and limited effect." U.C.C. § 1-106(2) (1990). Therefore, a breach of the obligation stated in § 1-203 should be enforceable.

\textsuperscript{23} The remedies awarded in bad faith performance cases are the same as those
tion, the nonoccurrence of which disables a party from exercising contractual or statutory rights or powers of contract enforcement. 24 An aggrieved buyer who covers, for example, may recover damages measured by the difference between the cover price and the contract price if the buyer covers in good faith. 25 A buyer who covers in bad faith is not liable for damages to the seller; rather, bad faith disallows the cover-based remedy and remits the buyer to the market price formula. 26 Similarly, a lender with a power to accelerate payment of a loan when he is insecure has the “power to do so only if he in good faith believes that the prospect of payment or performance is impaired.” 27 A lender who acts in bad faith loses the power to accelerate, but is not liable for damages unless other actions constitute a breach. 28

More important problems center on the definitions of “good faith.” In Article 1, good faith is defined as “honesty in fact in the conduct or transaction concerned;” 29 in Article 2, for merchants, good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” 30 The main issue in most discussions involves the question of subjective and objective standards. “Honesty” is supposed to be a subjective standard, while “reasonable commercial standards of fair dealing” is an objective standard, though presumably not the same as standards of reasonableness, commercial reasonableness, or due care. Though the issue of subjective and objec-
tive standards can be significant, a larger problem merits primary attention: few discussions clarify what either standard seeks to measure and for what purpose. Not surprisingly, neither definition succeeds in distinguishing good from bad faith in contract performance and enforcement generally.

"Honesty in fact" was intended to govern in the good faith purchaser and holder in due course contexts. Perhaps the drafters thought contract performance and enforcement were contexts requiring a different meaning, allowed by the chapeau to section 1-201. If so, they should have made their intention clear. Some cases of bad faith in contract performance and enforcement involve dishonesty. But dishonesty generally does not distinguish good from bad faith in these contexts.

Consider *Dorsey Brothers, Inc. v. Anderson*, in which a farmer contracted to grow and sell a snap bean crop for a price to be calculated following harvest by the buyer. The contract provided that the buyer would "determine when the beans were ripe for harvest," thus conferring discretion on the buyer to determine the time for its own performance. A drought damaged much of the bean crop in the region, including a portion of the seller's crop. The buyer did not harvest the seller's crop when

31. See infra text accompanying notes 128-35.
33. See U.C.C. § 1-201 (1990) (stating that definitions provided in the section apply "unless the context otherwise requires"); see also Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1032-33 (Colo. Ct. App. 1987) (discussing the "context" in which good faith is required); Watseka First Nat'l Bank v. Ruda, 552 N.E.2d 775, 780-81 (Ill. 1990).
37. Id. at 271.
38. Id.
39. Id.
it was ripe, but delayed a few days to concentrate its harvesting activities at other farms, where the crops were less severely damaged.\textsuperscript{40} The delay in harvesting caused further damage to the seller's crop, reducing the price eventually paid.\textsuperscript{41} The court upheld the jury's finding that the buyer performed in bad faith by delaying the harvest because other harvesting activities were more attractive.\textsuperscript{42} The buyer, however, did not make any dishonest representations; it simply delayed harvesting the seller's crop.

The court's judgment seems correct.\textsuperscript{43} Now, imagine the buyer had been completely honest in acknowledging the seller's crop was ripe, explaining forthrightly that other opportunities would be more profitable. Taking seriously the definition of "good faith" as honesty in fact, and nothing else, would suggest that the imaginary buyer would have acted in good faith. I doubt any court would so hold.

In the case of a merchant like the buyer in \textit{Dorsey Brothers}, some may think, "reasonable commercial standards of fair dealing in the trade" can make up for the deficiencies of "honesty in fact."\textsuperscript{44} In the several decades since the U.C.C. was promulgated, however, this definition has done little discernible work in the courts. Many courts ignore it, or cite it and then ignore it, as they do the honesty definition. A few take the merchant's definition seriously, requiring expert testimony to prove the existence of such standards.\textsuperscript{45} Parties attempting the proof, however, often fail.\textsuperscript{46}

In a case like \textit{Dorsey Brothers}, the merchant's definition does not articulate the distinction between good and bad faith performance of the contract. Imagine the buyer had proved that buy-

\begin{thebibliography}{9}
\bibitem{40} Id. at 272.
\bibitem{41} Id.
\bibitem{42} Id.
\bibitem{43} \textit{See infra} text accompanying notes 47-48.
\bibitem{44} \textit{See U.C.C. § 1-203} (1990).
\bibitem{46} \textit{See Brattleboro Auto Sales, 633 F.2d at 651; Zapatha, 408 N.E.2d at 1378.}
ers in the trade often treated growers in the same way, though comparable contracts did not usually include a promise to harvest when the buyer decided the crop was ripe. In that case, standards of fair dealing in the trade might be either reasonable and applicable or unreasonable and irrelevant. If the standards are reasonable, they exonerate the buyer of bad faith. If unreasonable, exoneration is avoided, but no objective standard is substituted. The U.C.C. then provides no legal basis to hold the buyer in breach when he discloses his reason for delaying the harvest.

Yet, I suggest, the frank buyer should be held in breach whether or not standards of fair dealing in the trade so require. The basis for this conclusion lies in U.C.C.-governed cases holding that good faith requires action for reasons within the parties’ justifiable expectations. These cases supplant the U.C.C. definitions with the counterpart common law obligation. The crux in Dorsey Brothers is that the buyer committed to harvesting when the crop was ripe. The buyer thereby gave up the opportunity to harvest when it was most advantageous to do so (should the two times prove incompatible). The buyer recaptured the

---

47. E.g., Davis v. Sears, Roebuck & Co., 873 F.2d 888, 896-97 (6th Cir. 1989) (holding that a failure to approve a distributor’s assignment was in bad faith because discretion was not used for a valid business reason); A.U. Rustproofing Ctr. v. Gulf Oil, 755 F.2d 1231, 1235-36 (6th Cir. 1985) (holding that a supplier must set prices in a distribution contract in a commercially reasonable manner); Best v. United States Nat’l Bank, 739 F.2d 554, 558 (Or. 1987) (requiring that a bank set its fee for insufficient funds for reasons within the reasonable expectations of the parties); Columbus Milk Producers Co-Op v. Wisconsin Dep’t of Agric., 180 N.W.2d 617, 622 (Wis. 1970) (holding that a price must be set at the competitive price as would be reasonably expected); see also Richard Short Oil Co. v. Texaco, Inc., 799 F.2d 415, 422 (8th Cir. 1986) (requiring that the claimant show “prohibited motive” in establishing bad faith).


forgone opportunity by delaying the harvest to pursue the better crop elsewhere. Such a buyer performs in bad faith, however candid its communications with the seller and however opportunistic the practice in the trade: the buyer acted for a reason disallowed by the parties' agreement. As the court held, the jury could conclude that the buyer's decision not to harvest the beans was unreasonable because it was not based on reasons allowed by the agreement.

The lesson of Dorsey Brothers can be widely generalized, as Eric Andersen and I have shown in several publications and will document fully in our forthcoming treatise. Neither "honesty in fact" nor "reasonable commercial standards of fair dealing in the trade" articulate the distinction between good and bad faith in contract performance and enforcement. In these contexts, the new definitional provisions should emphasize the crucial role of reasons allowed and disallowed by the parties' agreement, understood contextually.

B. Proposals for Revision

Section 1-203 should distinguish between the performance and enforcement contexts as follows:

§ 1-203. Principle of Good Faith.

(1) Every contract within this Act includes an obligation of good faith in its performance.

(2) Every contract within this Act includes a condition that enforcement rights provided by the contract or this Act be asserted in good faith.

The comment should indicate that good faith changes its meaning as its function changes in different contexts, making clear that section 1-203 concerns the performance and enforcement functions of good faith. The comments also should repeat that the section 1-203 good faith requirements are not the basis for

50. Id.
51. Id. at 273. The court declined to apply the U.C.C. because the parties had not briefed or argued its applicability to this type of transaction. Id.
52. See Burton & Andersen, supra note 3; Burton & Andersen, The World of a Contract, supra note 4, at 75-76; Burton, Good Faith Performance, supra note 3, at 11; Burton, More on Good Faith, supra note 4, at 500.
claims in tort nor other claims independent of the parties' agreement. These requirements implement the parties' agreement, understood in its commercial context, excluding subterfuges and evasions. Clarifying this section's scope of application and dependence on the parties' agreement should help to discourage prayerful litigation.

The difficulties are greater in drafting the definitions. It may be tempting to change section 1-201(19) to track the simple formula in the revised U.C.C. section 3-103(a)(4): "Good faith means honesty in fact and the observance of reasonable commercial standards of fair dealing." This would be a mistake, repeating the most serious error in drafting the current good faith provisions. A definition aimed at the problems of holders in due course is not appropriate when the performance and enforcement of contracts is in issue. The goal should be to articulate the distinction between good and bad faith in contract performance and enforcement as distinct from other contexts in which good faith functions.

Accordingly, I propose the following definitional provision:

---

53. PEB COMMENTARY SECTION 1-203, supra note 3, at 5 (stating that § 1-203 does not support an independent cause of action).

54. See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. c (1979); Summers, "Good Faith", supra note 14, at 207-16.


56. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. b (1979); Farnsworth, supra note 32, at 668.

57. Incidentally, U.C.C. § 1-102, prohibiting disclaimers of the requirement of good faith, should be clarified as follows, with brackets indicating deletions from the current text and italics indicating additions:

§ 1-102. Purposes; Rules of Construction; Variation by Agreement

(3) The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the [obligations] requirements of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement [but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable]. The parties may by agreement determine what in particular such requirements shall permit or prohibit, provided such agreement does not render the contract unenforceable.

This proposal clarifies that the abstract requirements of good faith, etc., apply in every contract, while the parties give them concrete meaning by their agreement.
§ 1-201. General Definitions.

Subject to additional definitions contained in the subsequent Articles of this Act which are applicable to specific Articles or Parts hereof, and unless the context otherwise requires, in this Act:

(19) "Good faith" of a purchaser or holder means honesty in fact. "Good faith" in contract performance means exercising any discretion for reasons within the parties' justifiable expectations arising from their agreement. "Good faith" in contract enforcement means asserting any remedial powers, whether provided by contract or law, when justified by their remedial purposes.

No special definition is needed for merchants in Article 2 transactions. The fact that consumers have justifiable expectations of fair dealing from merchants is subsumed in this definition, and this fact might be pointed out in a comment to the definition of "merchant" in Article 2. Merchants, however, also may have justifiable expectations that consumers will exercise discretion reasonably, as when a consumer benefits from a condition of satisfaction.\(^{58}\) In principle, the obligation should run both ways, although, in practice, it may constrain merchants more often and more tightly.

The proposed definition of good faith in contract performance is intended to articulate the distinction between good and bad faith in that context. It supposes that the distinctive mission of a good faith performance obligation is to police a contract party's exercise of contractual discretion. In *Dorsey Brothers*,\(^{59}\) the contract conferred discretion on the buyer to decide when the crop was ripe.\(^{60}\) Discretion similarly may be conferred on a party whose requirements or output determine the quantity of goods to be delivered,\(^{61}\) whose satisfaction determines the required quality of goods or services,\(^{62}\) who retains a power to set the

---

59. See supra text accompanying notes 36-52.
61. See supra note 5.
contract price,\textsuperscript{63} who controls the occurrence of a condition to its own duties of contract performance,\textsuperscript{64} or who similarly may take any of a range of actions based on its own business judgment. The kinds of discretion that may arise in contract performance cannot be catalogued exhaustively. The cases clearly indicate, however, that good faith functions distinctively to place limits on a party’s discretion in contract performance.\textsuperscript{65}

The proposed definition rejects the position that contractual discretion is unbridled unless the parties limit it by express terms.\textsuperscript{66} Rather, it supposes, parties have expectations arising from commitments presupposed by their agreement, which expectations concern the reasons for which discretion may be exercised. In \textit{Dorsey Brothers},\textsuperscript{67} for example, both parties justifiably expected that the buyer could delay the harvest for any reason bearing on the ripeness of the beans—their color, size, dryness.\textsuperscript{68} The seller might disagree with the buyer’s judgment on ripeness without legal recourse of any kind. When the buyer delayed the harvest because harvesting other growers’ crops sooner was more profitable, the buyer acted for a reason outside the seller’s justifiable expectations. A reasonable seller would have such expectations arising from the agreement for the buyer to harvest “when he decides the crop is ripe.” The agreement thus permits the buyer to delay the harvest for some reasons and disallows other reasons for the same act. Good faith is a

\textsuperscript{63} See Burton, \textit{Breach of Contract, supra} note 4, at 397-99; Burton, \textit{Good Faith Performance, supra} note 3, at 9-10.

\textsuperscript{64} See Burton, \textit{Breach of Contract, supra} note 4, at 401-02.


\textsuperscript{66} See infra text accompanying notes 71-90.

\textsuperscript{67} Dorsey Bros., Inc. v. Anderson, 287 A.2d 270 (Md. 1972).

\textsuperscript{68} Id. at 271.
matter of exercising discretion for reasons within the justifiable expectations of the parties, arising from their agreement, understood in the context in which the agreement was made.

The proposed definition also rejects the position that good faith is a post-formation counterpart to the unconscionability doctrine, licensing courts to impose obligations on the parties for reasons of general fairness, morality, or policy. Questions concerning the range of enforceable promises depend significantly on general principles of fairness, morality, and policy, as implemented by the law. Such principles may justify a broader or narrower domain in which freedom of contract prevails in a society. Once a court has decided that an agreement is enforceable, however, it has decided that the agreement is within the domain of private ordering. The obligation to keep the agreement then replaces overriding principles of fairness, morality, and policy. Unless some event after formation justifies different treatment, as when doctrines of modification, estoppel, waiver, material breach, unjust enrichment, or commercial impracticability apply, no justification warrants imposing additional obligations on the parties irrespective of their voluntary words and acts.

The proposed definition affirms the autonomy of the parties to structure their own relationship within the domain of freedom of contract and against the backdrop of commercial practice. The U.C.C.'s existing definition of "agreement" is a broad one, emphasizing the parties' actual bargain as evidenced by the contract language or by implication from other circumstances including course of dealing, usage of trade, or course of performance, when appropriate. The bargain of the parties in fact may include implied agreement on allowed and disallowed reasons for exercising discretion in contract performance or enforcement.

69. See infra text accompanying notes 91-127.
70. U.C.C. § 1-201(3) (1990); see Patterson, supra note 14, at 175.
III. THE PRACTICE VIEW

The foregoing proposal will be called the "practice view" because it codifies the dominant approach in judicial practice. That is, the proposal arises from a synthesis of hundreds of cases in which courts have interpreted and applied common law and statutory requirements of good faith in contract performance and enforcement. "Good faith" thus takes on a concrete and workable meaning from its use as a practical matter.

A legislator, however, is free to change even a settled judicial practice. In this matter, I will argue, a change would be unwise. Two main alternatives compete with the practice view. One would constrict the role of good faith by giving effect to the express terms of a contract, literally interpreted, unless a party is acting "opportunistically" and incompatibly with economic efficiency. The other would enlarge the role of good faith greatly by authorizing courts to impose new requirements on contract parties from a sense of contractual morality arising from their evolving relationship. I will argue that the dominant strain in judicial practice occupies a middle ground that better accommodates the interests of the public and the parties to a commercial contract with discretion.

A. A Constricted Alternative

A legislator may consider whether operation of the U.C.C.'s good faith requirements should be weaker than the prevailing practice view. This could be accomplished by giving the parties' express agreement a literal interpretation and good faith a subordinate and narrow role. On this view, a contract party acts in bad faith only when acting opportunistically to undermine the efficiency of the bargain, as when one party has performed first or otherwise relied to its detriment and the other party demands benefits for which it did not bargain. The classic example would be the contract modification cases supporting the preexisting duty rule.\(^\text{71}\)

---

Judge Frank Easterbrook's opinion in *Kham & Nate's Shoes No. 2 v. First Bank of Whiting*72 illustrates the constricted approach.73 A creditor appealed the bankruptcy court's order subordinating the lender's secured claim to unsecured status because of the lender's bad faith conduct.74 The lender had extended credit to a retail merchant for some years.75 After the merchant filed a Chapter 11 petition, the bankruptcy court approved a loan agreement establishing a $300,000 line of credit for the merchant.76 The agreement gave the lender a lien on most of the borrower's post-petition assets.77 The lender advanced funds under the post-petition line of credit to repay previous unsecured advances, in effect securing a previously unsecured debt.78 Two weeks later, the lender notified the borrower that it would terminate the line of credit in two weeks.79 The bankruptcy court found that this abrupt termination of the line of credit constituted a breach of the obligation of good faith; consequently, the court returned the lender to unsecured status.80 The appeals court vacated the order subordinating the lien.81 Judge Easterbrook, in obvious eagerness to distance his views from those in *K.M.C. Co. v. Irving Trust Co.*,82 rested the decision on the literal meaning of the contract for the post-petition line of credit, which required five days' notice of cancellation and, further, that "nothing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time".83

---

72. 908 F.2d 1351 (7th Cir. 1990).
73. Judge Easterbrook took a similar approach in *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 438 (7th Cir. 1987).
74. *Kham & Nate's*, 908 F.2d at 1353.
75. Id.
76. Id.
77. Id.
78. Id. at 1354.
79. Id.
80. Id.
81. Id. at 1363.
82. 757 F.2d 752 (6th Cir. 1985) (applying New York law). See infra text accompanying notes 91-127 (discussing the *K.M.C.* case).
83. *Kham & Nate's*, 908 F.2d at 1353.
We do not doubt the force of the proverb that the letter killeth, while the spirit giveth life. Literal implementation of unadorned language may destroy the essence of the venture . . . . Yet knowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of "kindness" in performance, or of judicial oversight into whether a party had "good cause" to act as it did. Parties to a contract are not each others' fiduciaries; they are not bound to treat customers with the same consideration reserved for their families.84

Judge Easterbrook's opinion should be criticized for construing the contract without attempting as the standard rules of contract interpretation and implication require to protect the justifiable expectations of the parties arising from their agreement, understood in its commercial context.85 He posed two alternatives: interpret literally or open the door to requirements of kindness and Monday morning quarterbacking by judges and jurors. He rejected the latter and endorsed the former by default. His conclusion might be defensible if these were the only alternatives. However, a third alternative is available. The court in Southwest Savings & Loan Association v. Sunamp Systems, Inc.,86 a case factually similar to Kham & Nate's, presented the practice view well:

If contracting parties cannot profitably use their contractual powers without fear that a jury will second-guess them under a vague standard of good faith, the law will impair the predictability that an orderly commerce requires. Yet contracting parties, hard as they may try, cannot reduce every understanding to a stated term. Instances inevitably arise where

84. Id. at 1357.
one party exercises discretion retained or unforeclosed under a contract in such a way as to deny the other a reasonably expected benefit of the bargain . . . . The law of good faith, though inexact, attempts a remedy for such abuse . . . .

In this case, therefore, inquiry does not end with recognition that [the lender] had contractual authority to freeze, and ultimately terminate, [the borrower's] credit line. The question is whether the jury might reasonably have found that [the lender] wrongfully exercised this power "for a reason beyond the risks" that [the borrower] assumed in its loan agreement or for a reason inconsistent with [the borrower's] "justified expectations." 87

On the practice view, the borrower's advocate in Kham & Nate's should have emphasized that only two weeks passed between concluding and cancelling the loan agreement. The lender did not present evidence of events during those two weeks that would justify the lender in changing its assessment of the borrower's creditworthiness or security for the loan. 88 If the lender entered the loan agreement solely as a pretext to convert unsecured debt into secured debt, intending all along to pull the plug on the borrower after an indecent interval, it committed promissory fraud. 89 Even if the lender decided to cancel later, the borrower would reasonably expect cancellation only for reasons showing that the borrower's creditworthiness or the lender's security was impaired by subsequent events, not for reasons available to the lender before the loan was extended. Nothing prevented the lender from declining to enter the agreement for any reason whatever. Having entered the agreement, however, the lender gave up the opportunity to cancel for reasons of regret—previously available reasons of creditworthiness or insecurity.

The litigation and decision in Kham & Nate's should have focused on whether the lender had a reason to downgrade the borrower's creditworthiness or otherwise feel insecure based on

87. Id. at 1319-20 (citations omitted).
88. Kham & Nate's, 908 F.2d at 1353-54.
89. See Bunge Corp. v. Recker, 519 F.2d 449, 452 (8th Cir. 1975) (characterizing bad faith as involving "fraud or a design to mislead or deceive another").
information received after it made the loan, which would justify its decision to cancel. If the lender had such a reason for cancellation, the court should have respected its business judgment. The agreement allowed the lender to protect its interest in repayment; presumably the lender agreed to a lower interest rate in exchange for the right to cancel the loan if its interest became insecure. Without such a reason, however, the lender acted in bad faith by using its cancellation power for reasons outside the justifiable expectations of the parties (and the bankruptcy judge). The practice view allows cases to be litigated and decided on such a basis, avoiding Judge Easterbrook’s conceded mismatch of literal terms to party expectations in the commercial context.

The public has a general interest in the security of contractual transactions. In contract performance and enforcement, this interest supports protecting the parties’ justifiable expectations arising from agreements that have passed the tests of enforceability. Specifically, a nondiscretion-exercising party may have justifiable expectations, arising from the parties’ agreement, that the other will exercise discretion for expectable reasons in the relevant business context. By contrast, a discretion-exercising party has no legitimate interest in preserving an opportunity to exercise discretion for any and all reasons, including those outside the expectable range, such as reasons of cronyism or regret at having entered the contract.

The practice view is a workable alternative allowing courts to protect the nondiscretion-exercising party’s justifiable expectations. It does not impose obligations of kindness or unwarranted second-guessing. Accordingly, the practice view should be preferred to a constricted view focused on the literal meaning of the express contract terms.

B. An Enlarged Alternative

The extremity of Judge Easterbrook’s opinion in Kham & Nate’s appears to have been in reaction to a far broader view of

90. As Judge Cardozo famously put it, “We are not to suppose that one party was to be placed at the mercy of the other.” Wood v. Lucy, Lady Duff-Gordon, 118 N.E. 214, 214 (N.Y. 1917).
good faith endorsed by the court in *K.M.C. Co. v. Irving Trust Co.*

In *K.M.C.*, the court held a lender liable for failing to give notice before refusing to make further advances under a line of credit. The lender had agreed to extend credit to a maximum of $3 million, increased later to $3.5 million, with outstanding amounts payable on demand. The borrower pledged its accounts receivable and inventory as security, with the availability of credit depending on a borrowing base formula. In addition, the parties agreed to a cash management lockbox arrangement, whereby the borrower deposited all of its receipts in a blocked account; consequently, the borrower had access to working capital only by borrowing under the line of credit. Some years later, the lender refused a request to raise the credit limit and, days later, refused without notice to advance $800,000 requested by the borrower, despite the fact that the financing agreement allowed the advance. The lender then dishonored checks drawn by the borrower, causing the borrower's business to collapse. A jury awarded the borrower damages amounting to $7.5 million.

91. *757 F.2d 752* (6th Cir. 1985). A similar reaction may have led the Supreme Judicial Court of Maine to deny any requirement of good faith performance or enforcement outside the U.C.C. and to confine the U.C.C. requirements to the letter of the statutory definitions. *See Diversified Foods, Inc. v. First Nat'l Bank,* 605 A.2d 609, 613-14 (Me. 1992) (limiting § 1-203 to transactions governed by the U.C.C. and refusing to recognize a common law obligation of good faith); *see also First NH Banks Granite State v. Scarborough,* 615 A.2d 248 (Me. 1992) (limiting "good faith" in § 1-203 to honesty in fact). The federal courts, applying Maine law, had given good faith an expansive meaning comparable to that in *K.M.C.* *See Reid v. Key Bank,* Inc., 821 F.2d 9 (1st Cir. 1987); *Ricci v. Key Bancshares of Me., Inc.,* 662 F. Supp. 1132 (D. Me. 1987). These decisions in effect have been repudiated, to the great dismay of the federal district judge for the district of Maine. *See People's Heritage Sav. Bank v. Recoll Management, Inc.,* 814 F. Supp. 159, 165-70 (D. Me. 1993); *see also English v. Fischer,* 660 S.W.2d 521, 522 (Tex. 1983) (rejecting an implied tort duty of good faith and fair dealing in contracts under Texas law).

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

93. *Id. at 754.*

94. *Id.*

95. *Id. at 759.*

96. *Id. at 754, 762.*

97. *Id. at 754.*

98. *Id. at 755.*
The Sixth Circuit upheld the jury award. The lower court magistrate had observed that a personality conflict existed between the loan officer and the borrower’s chief officer and that the loan officer, without giving notice, refused to lend more due to his disapproval of this officer’s management philosophy. Several bankers testified that, because the loan was adequately secured, a reasonable lender would have given notice. The borrower had requested an increase in the credit limit days before, and the lender may have been concerned about whether the borrower’s checks would all clear, even with the requested advance and an increased line of credit. Nonetheless, evidence of a mix of reasons for and against the lender’s belief that the borrower was in trouble supported the verdict. The court also emphasized the long-term interactive relationship of the parties and the lender’s lockbox control over the borrower’s cash flow.

K.M.C. illustrates an approach to good faith known to academics as “relational contract law.” Classical or neoclassical contract law is supposed to isolate each transaction from any web of transactions in which it might be embedded and to freeze the parties’ rights and duties as they were at the time of contracting. Relational contract law, by contrast, emphasizes a particular contract’s connections with the parties’ previous and future dealings and allows their rights and duties to evolve during the course of performance. The norms of contractual relations are complex, involving the values of reciprocity, solidarity, cooperation, and risk sharing. Leading academic the-

99. Id. at 766.
100. Id. at 761.
101. Id. at 761-62.
102. Id. at 762.
103. Id. at 760-63.
104. Id. at 759-62.
orists have endorsed the expansion of relational considerations in contract law,\textsuperscript{108} sometimes hanging the relational hat on the doctrinal peg of good faith,\textsuperscript{109} despite a paucity of existing authority for construing good faith to require decency or altruism beyond the agreement.\textsuperscript{110}

By imposing an agreement-independent "contractual morality" on the lender,\textsuperscript{111} the relational view of good faith clearly goes beyond the common requirement that a discretion exercising party act for reasons permitted by the agreement. K.M.C. licenses judges and jurors to second-guess the business judgment of discretion-exercising parties far more than standards aiming to protect the parties' justified expectations arising from their agreement. In this case, one need not go so far as the lender, who argued that its discretion was unbridled or that no good faith obligation attached to a refusal to advance funds because the loans were payable on demand anyway. The lender could have maintained that it was under a good faith obligation and acted in good faith.

According to the practice view, the court should review the loan officer's decision to terminate the line of credit to protect the justifiable expectations of borrower and lender. The borrower justifiably expects the lender to base its decision whether to advance further funds on ordinary business reasons, such as the borrower's creditworthiness and the security for the loan. The lender justifiably expects its judgments of creditworthiness and insecurity to be final, as the parties intended by allowing the bank to lend less than the credit limit and to call the notes due

\textsuperscript{108} The leading figure in this movement is Ian R. Macneil. See, e.g., IAN R. MACNEIL, THE NEW SOCIAL CONTRACT (1980); Macneil, Adjustment of Long-Term Economic Relations, supra note 105; Macneil, Values in Contract, supra note 107.


\textsuperscript{110} In addition to K.M.C., reported appellate opinions arguably supporting distinctively relational interpretations of good faith in contract performance and enforcement are J.J. Brooksbank Co. v. Budget Rent-A-Car Corp., 337 N.W.2d 372 (Minn. 1983); Bak-A-Lum Corp. v. Alcoa Bldg. Prods., Inc., 351 A.2d 349 (N.J. 1976); see also Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d 772, 805-06 (9th Cir. 1981).

on demand. Analytically, a loan officer makes a judgment of creditworthiness or insecurity in three steps: she identifies all relevant reasons, weighs those reasons, and decides as indicated by the stronger reasons. According to the practice view, the court should review the loan officer's decisions to determine whether she identified or could have identified contractually permitted reasons for easily terminating the line of credit. A court should not review the loan officer's business judgment to determine whether she weighed those reasons correctly.112

The court in K.M.C. acknowledged the crucial fact that the jury could not find that the loan officer did not have a valid business reason for refusing to advance the funds without prior notice.113 In particular, evidence indicated that the loan officer had a reasonable belief that the borrower's checks would bounce even with the advance.114 This gave the lender a permitted reason for terminating the line of credit, the weight of which was within its loan officer's discretion.

The error in K.M.C., in my view, was in allowing the jury to reweigh the relevant reasons; disagreement merely on the weight of reasons led to a $7.5 million judgment against the lender. The business judgment—how serious the borrower's financial crisis was—should be left to the lender, where the agreement put it. Not surprisingly, almost all courts to speak on the holding in K.M.C. have questioned, limited, disapproved, or refused to follow it.115

112. For elaboration on weighing reasons, see STEVEN J. BURTON, JUDGING IN GOOD FAITH 51-62 (1992).
114. Id.
Once a court decides that an agreement is enforceable, it should enforce the agreement. The primary interests in contract performance, then, are the public interest in the security of contracts and the parties' expectation interests arising from their agreement. The nondiscretion-exercising party ordinarily has justifiable expectations that the other will exercise discretion for expectable reasons in the relevant business context. When this interest is fully protected by the practice view, no further contractual interest is deserving of legal protection by enlarged good faith requirements.

Discretion is often bargained for, resulting in offsetting benefits to the other party, as when the lender makes a loan at a lower interest rate because the loan agreement allows the loan to be terminated easily. A party with agreed discretion does not enjoy discretion as agreed unless its judgment on the weight of permitted reasons is final. The enlarged view of good faith does not respect this interest.

Judges and jurors are poorly suited to second-guess the judgments involved in commercial contracts allowing discretion. The cold judicial reception to cases exemplifying a relational approach suggests that codification of an enlarged view will invite too much litigation with no realistic prospect of recovery. Accordingly, the practice view is preferable to an enlarged view of contractual good faith.

C. Assorted Endnotes

Consideration of two other issues may be useful in light of the recent emergence of the practice view. The first is the more general question of whether the jurisprudence of Article 2 should be revised to incorporate relational contract theory, using good faith as a principal vehicle. The second concerns the role of subjective and objective standards of good faith.

---

116. See also Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 Duke L.J. 619 (arguing that expansive interpretations of the good faith obligation extends parties' obligations beyond bargained for contractual duties and leads to inconsistent enforcement of obligations).
1. Relational Contract Theory

Professor Richard E. Speidel, the Reporter to the Drafting Committee revising Article 2 for the National Conference of Commissioners on Uniform State Law, recently floated some proposals to incorporate relational contract theory into Article 2, using the definition of "good faith" as a principal vehicle. He is considering revising the definition to require "honesty in fact and the observance of reasonable [commercial] standards of fair dealing in the conduct or transaction involved." A comment would state that "sometimes good faith is the basis for proscribing behavior that violates basic standards of decency, either generally or in the particular conduct of the transaction involved. Examples include, but are not limited to, the use of subterfuges and evasions." He wrote that this definition would support a finding of bad faith "when one party's conduct deviates from internal norms generated by the relationship" beyond the agreement. These norms include reciprocity, solidarity, cooperation, and risk sharing, at least in longer term contracts with imprecise terms and interdependence between the parties beyond a single transaction.

I do not think this would be a wise innovation, in either Article 1 or 2. Following Ian Macneil, Professor Speidel understands relational norms not only to describe actual behavior, but also somehow to become "the 'ought' by which the relationship is governed." The jump to "ought" is crucial to any argument

118. Speidel, supra note 109, at 797 (crediting proposal for Article 1 from Professor E. Allan Farnsworth).
119. Id.
120. See id. at 792-93.
121. Macneil has argued:

   The common norms are essential to any behavior we might be willing to call contractual and they become, by conversion of is to ought, principles of right action as well. Similarly, given a discrete transaction, the discrete norm reflects both the behavior and the oughts growing out of it, just as, given relational contracts, the relational norms reflect both behavior and the oughts emerging from it.

Macneil, Values in Contract, supra note 107, at 346 (footnote omitted).
122. Speidel, supra note 109, at 793.
for legislating relational norms. Laws should be enforced against people only when they are under genuine obligations to do what the law commands.\textsuperscript{123}

I see three insurmountable problems with the relational "conversion of is to ought."\textsuperscript{124} First, as is well known to students of philosophy since Hume, empirical or analytical truths cannot be simply converted to normative status as guides to conduct. An additional normative argument is needed to avoid the obvious nonsequitur. Second, people are under no general obligation to do as they have done in the past or as everyone else does in similar circumstances. Situations in which decency or morality requires one to change behavior or resist the herd are common. Third, although relational norms express values, this is not sufficient to yield enforceable obligations. For example, generosity (like many virtues) is praiseworthy, but it should not be forced.

One could argue that people rely on relational patterns over time and that such reliance should be protected when reasonable.\textsuperscript{125} But reliance on facts not amounting to a commitment by a person is problematic as a basis for proceeding against that person. Protecting reliance, moreover, is not a relational norm. One could argue that the parties agreed to a type of relationship, like a franchise, that is defined by common practice to include obligations beyond the written contract.\textsuperscript{126} The ground of the obligation then would be the parties' agreement or fair play, not "the relationship" in the relevant sense. Consequently, there does not appear to be a legitimate ground for enforcing relational norms as such.\textsuperscript{127}

\begin{footnotesize}
\begin{enumerate}
\item[	extsuperscript{123}]{Steven J. Burton, \textit{Default Principles, Legitimacy, and the Authority of a Contract}, 3 S. CAL. INTERDISCIPLINARY L.J. 115 (1993).}
\item[	extsuperscript{124}]{Macneil, \textit{Values in Contract}, supra note 107, at 346.}
\item[	extsuperscript{125}]{See Gillian K. Hadfield, \textit{Problematic Relations: Franchising and the Law of Incomplete Contracts}, 42 STAN. L. REV. 927 (1990) (discussing the contractual relationship between franchisee and franchisor).}
\item[	extsuperscript{126}]{See \textit{id.} at 930; Randy E. Barnett, \textit{The Sound of Silence: Default Rules and Contractual Consent}, 78 VA. L. REV. 821, 875-85 (1992) (discussing the dual roles of subjective and objective consent in contractual relationships).}
\item[	extsuperscript{127}]{I am unaware of any argument showing that "the relationship" itself is a ground of political obligation. Relational contract theory is sociological in nature, not a matter of political morality.}
\end{enumerate}
\end{footnotesize}
Professor Macneil's development of relational contract theory nonetheless is important. Relational considerations are among the reasons leading to agreements and adjustments as performance evolves. Any understanding of contract practices, as distinct from contract law, would be sorely impoverished were it to neglect the relational perspective.

In my view, however, relational norms presumptively should remain implicit in the context. These norms may guide the parties' nonobligatory accommodations, such as those of gratitude and prudence, unless the norms lead to voluntary words or acts justifying an enforceable obligation. The parties have rights as of the time of contract formation. These rights should change only when subsequent events ground new rights, as when the parties agree to change them (modification), when one party intentionally and knowingly relinquishes them (waiver), when one party foreseeably induces reliance on new rights and the other party relies to its detriment (estoppel), or when changed circumstances undermine the authority of the parties' agreement (impracticability/frustration). Revised versions of Articles 1 and 2 can facilitate such changes in legal relations to protect party expectations evolving away from those at the time of contract formation.

Relational considerations should be introduced so that legislators and litigators can see the changes and their justifications clearly. Concepts of "good faith," "the relationship," and "solidarity" are too vague in the abstract to ensure accountability in the lawmaking process or later to discourage prayerful litigation. More important, good faith in contract performance and enforcement is close to acquiring a settled meaning within judicial practice. This meaning does not include a relational component. A better drafting strategy would allow good faith to settle down within the practice view, using other doctrinal concepts to break new ground.

2. Subjective and Objective Standards

As previously stated, the main issue in most academic discussions of good faith under the U.C.C. involves the question of
subjective and objective standards. Few discussions, however, clarify what either standard seeks to measure and for what purpose. A principal virtue of the practice view is that it makes the goal clear: good faith in contract performance and enforcement aims to ensure that a discretion-exercising party acts for reasons within the justifiable expectations of the other party. The question of subjective and objective standards enters the practice view when we try to determine which kinds of reasons are valid for this purpose.

A reason for action generally is the marriage of a rule, principle, value, desire, or other abstract prescription—paradigmatically, that some act should be done when some generic fact is instantiated—with a concrete fact that invokes it. For example, a complete reason might be stated as follows: all promises should be performed; Jake promised to mow the lawn whenever needed; the lawn needs mowing, so Jake should mow. Typically, however, people have several reasons for and against doing most of the things they do. Jake's promise is a reason to mow the lawn, but he also might mow it because he likes to maintain a manicured front yard, he wants to avoid his neighbor's disapproval, or the subdivision rules require him to do it, and so on. The facts may be such that all of these reasons are available to Jake, but only one of them may move him to mow the lawn. An objective conception of a reason for action emphasizes the availability of a reason in the circumstances of action; a subjective conception focuses on the reasons that move the actor.

Judicial practice supports either an objective or subjective interpretation of the reasons that may justify a discretion-exercising party's action. Most cases consider only whether the action was reasonable, commercially reasonable, or justified by a reason within the justifiable expectations of the parties. Some consider whether the discretion-exercising party was motivated by the right kinds of reasons. No cases have been

128. See supra text accompanying note 31.
130. E.g., Leberman v. John Blair & Co., 880 F.2d 1555, 1560-61 (2d Cir. 1989);
found that turn on the difference. The U.C.C. should address the problem, if at all, only in an official comment.

The better view emphasizes the objective interpretation of a reason for action, dispensing with any inquiry into subjective motivation. In addition to the well-known difficulties in proving subjective motivation, we should remember what contract law is trying to do. Much of the practice view of good faith is informed, I believe, by an awareness that bad faith performance is a breach of contract; the preferred remedy is compensation for harm to a nondiscretion-exercising party's expectation interest. Accordingly, a party should be held to perform in bad faith only when the other party's expectation interest was harmed. Assume a discretion-exercising party had available to it many contractually permitted reasons for terminating a line of credit but was motivated to terminate by disallowed reasons. Apparently, then, the breach does not harm the borrower's contractual expectation interest; the lender could have terminated the line of credit anyhow, and the borrower had no justifiable expectation otherwise. Laws against racial, gender, and similar invidious discriminations in employment might properly judge the character of a discriminating employer by focusing on its motivation and penalizing improper motivation. These laws attempt to reshape character to expel prejudice. Contract law, by contrast, provides compensation for harm; it does not punish wrongdoing or reshape character.

In any case, both permissible and impermissible reasons may be available in the circumstances of action, as the above discus-
sion of *K.M.C.* suggests. Problems of mixed reasons arise rarely in reported cases, however. Revised Articles 1 and 2 should address this issue only in comments, if at all. Under an objective standard, the analysis of mixed reasons would be relatively straightforward: the discretion-exercising party, not a judge or jury, is entitled to weigh the competing reasons. A party, therefore, would be acting in good faith whenever significant contractually permitted reasons for its actions were available. This result best accommodates the discretion-exercising party’s interest in deference by judge and jury with the other party’s interest in nonarbitrary and expectable reasons for exercising discretion.

Under a subjective standard, the problem is more complicated. The discretion-exercising party could be acting in bad faith if the excluded reasons were a factor, a significant factor, a substantial factor, or the predominant factor in the decision. The same accommodation of interests argues in favor of a more deferential standard for sorting mixed reasons—a substantial or predominant reason test.

IV. CONCLUSION

The basic good faith provisions in Articles 1 and 2 of the Uniform Commercial Code should be revised to articulate the practice view of good faith in contract performance and enforcement. The practice view is dominant in recent judicial practice. It holds that good faith in these contexts polices a party’s discretion by limiting the reasons for which discretion may be exercised legitimately. Good faith in contract performance should mean exercising any discretion for reasons within the parties’ justifiable expectations arising from their agreement understood in the commercial context in which the agreement was made. Similarly, good faith in contract enforcement should mean as-

134. See supra text accompanying notes 91-116.
135. The classic case is Parev Products Co. v. I. Rokeach & Sons, 124 F.2d 147 (2d Cir. 1941). See also Bloor v. Falstaff Brewing Corp., 601 F.2d 609 (2d Cir. 1979); Mechanical Ice Tray Corp. v. General Motors Corp., 144 F.2d 720 (2d Cir. 1944), cert. denied, 324 U.S. 844 (1945).
serting any remedial powers, whether provided by contract or law, when justified by their remedial purposes.

The public has an interest in the security of contractual transactions. In contract performance and enforcement, we should protect the parties' justifiable expectations arising from agreements that have passed the tests of enforceability. A party with agreed discretion has justifiable expectations that its discretionary judgments will be respected by judge and jury. A nondiscretion-exercising party may have justifiable expectations that the other will act for expectable reasons in the relevant business context. The practice view accommodates these interests. It requires review to ensure a discretion-exercising party's action is justifiable by reasons permitted by the parties' agreement, but leaves the weight of permitted reasons to that party's business judgment.

Competing alternatives tend to deny one or the other party's interests. The constricted view exalts the literal terms of a contract, leaving a nondiscretion-exercising party's reasonable expectations unprotected when they arise from commitments presupposed by the parties' agreement. The enlarged view demotes the parties' agreement in favor of vague "relational values" that too easily can deny a party discretion for which it bargained.

The practice view charts a middle path rooted in the parties' agreement, understood in its commercial context. It distinguishes good from bad faith in contract performance and enforcement. When articulated clearly and enacted as statutory text, the practice view should help ensure that parties bring suits only when they stand a reasonable chance of succeeding and of succeeding for good reason.