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Proosed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery

by

THOMAS A. DIAMOND* and HOWARD FOSS**

Introduction

Despite its widespread recognition,1 the implied covenant of good faith and fair dealing is shrouded in mystery. Efforts to devise workable standards or relevant criteria for determining when the cov-
enant has been violated have been unavailing. The result is a doctrine whose application has been ad hoc, yielding inconsistent results and depriving parties of the ability to predict what conduct will violate the covenant. This article seeks to provide a structured framework that would substantially diminish ad hoc decision making. It also seeks to resolve confusion about when the covenant can be waived and what remedies the covenant provides.

I. Overview of the Covenant of Good Faith and Fair Dealing

The implied covenant of good faith and fair dealing is the residual gap-filling default rule of contract law. It imposes limits upon one contracting party's ability to negatively impact the contract's value to the other contracting party. It determines when a party may no longer pursue his own self-interest but must instead engage in cooperative behavior by deferring to the other party's contractual interests.


Only Texas has expressly refused to recognize the covenant's relevance to arms' length contracts and limited its application to cases in which a special relationship between the parties is found, such as in insurance contracts. See, e.g., Natividad v. Alexsis, Inc., 875 S.W.2d 695, 697 (Tex. 1994).

2. For convenience the authors will sometimes refer to the covenant of good faith and fair dealing as "the covenant of good faith" or "the covenant," and will sometimes use the term "defendant" when referring to the party who engages in conduct that is alleged to be in breach of the covenant and the term "plaintiff" when referring to the party who is adversely affected by that conduct. To avoid confusion that might otherwise arise when defendant and plaintiff are referred to by pronouns, masculine pronouns will be applied to defendant and feminine pronouns will be applied to plaintiff.

3. See Chrysler Credit Corp. v. Marino, 63 F.3d 574, 579 (7th Cir. 1995) (holding that good faith applies only as a method by which gaps are filled and that good faith is not applied to block use of terms that actually appear in the contract); Oregon RSA No. 6, Inc. v. Castle Rock Cellular Ltd. Partnership, 840 F. Supp. 770, 778-79 (D. Or. 1993) (holding that when the contract is silent as to the permissibility of conduct, the covenant of good faith may be used to fill the gap); Foley v. Interactive Data Corp., 765 P.2d 373, 389 (Cal. 1988) (holding that the duty of good faith is "a kind of safety valve that judges may turn to fill gaps" in the contract); Jacobs v. Great Pac. Century Corp., 499 A.2d 1023, 1024 (N.J. Super. Ct. App. Div. 1985) (holding that "an implied covenant can fill a gap in an agreement where the terms of the covenant can be inferred from the subject matter" of the contract); Bourgeois v. Horizon Healthcare Corp., 872 P.2d 852, 856 (N.M. 1994) (declining to "apply an implied covenant of good faith and fair dealing to override express provisions addressed by the terms of an integrated written contract"); Hauer v. Union State Bank, 532 N.W.2d 456, 464 (Wis. Ct. App. 1995) (holding that "as a method to fill gaps, it has little to do with the formation of contracts"); see also Monique C. Lillard, FiftyJurisdictions in Search of a Standard: The Covenant of Good Faith and Fair Dealing in the Employment Context, 57 Mo. L. Rev. 1233, 1237 (1992) (recognizing that the covenant of good faith serves a gap-filling function).

4. It has been recognized that the covenant of good faith and fair dealing is designed to foster cooperation between the parties to a contract.
Because it is a gap-filling default rule, the covenant applies only when the propriety of the conduct is not resolved by the terms of the contract or by another default rule. That situation ordinarily arises (1) when the contract is silent or ambiguous about the permissibility of the conduct, or (2) when the conduct is undertaken pursuant to a grant of discretion and the scope of that discretion has not been desig-

The requirement of good faith performance sets parameters for conduct and limits maximization of self-interest by one party when the contract is silent on the subject. As a general concept and explicit requirement, good faith performance is a tool used by the courts to police bargains to insure cooperation by one party so that the other may obtain the expected benefits of the contract.


6. Even when the conduct at issue is not covered by the terms of the contract, a default rule other than the covenant of good faith may be used as a gap filler to determine the permissibility of that conduct. If so, the covenant of good faith would be inapplicable. For example, a dispute whether the delivery of goods was timely would be resolved by the U.C.C. default rule, which provides that delivery must be within "a reasonable time." U.C.C. § 2-309(1) (1994). Similarly, if the quality of goods is in dispute, and the contract does not specify quality requirements, the issue would be resolved by the U.C.C. default rules regarding implied warranties. U.C.C. § 2-314(2)(c) (1994) (requiring that goods be fit for their "ordinary purposes" to satisfy the implied warranty of merchantability); id. § 2-315 (1994) (requiring that goods be fit for the buyer's "particular purpose" to satisfy the implied warranty of fitness for particular purpose).

nated. When, however, terms of the contract, whether express or derived from extrinsic sources such as usage of trade and admissible

8. See, e.g., Chrysler Credit Corp. v. Marino, 63 F.3d 574, 579 (7th Cir. 1995) (holding that application of the covenant of good faith is limited to instances in which a party is given discretion in enforcing certain provisions of the contract); Occusafe, Inc. v. EG&G Rocky Flats, Inc., 54 F.3d 618, 624 (10th Cir. 1995) (holding that a court's inquiry focuses on whether the defendant's conduct violated the contracting parties' justified expectations); Travelers Int'l v. Trans World Airlines, Inc., 41 F.3d 1570, 1575 (2d Cir. 1994) (holding "even when a contract confers decision-making power on a single party, the resulting discretion is nevertheless subject to an obligation that it be exercised in good faith"); Los Angeles Memorial Coliseum Comm'n v. National Football League, 791 F.2d 1356, 1361 (9th Cir. 1986) (holding that when one party retains a right of approval over the other party to a contract, "such powers must be exercised within the parameters of the duty of good faith"); Southwest Sav. & Loan Ass'n v. Sunamp Sys., Inc., 838 P.2d 1314, 1319 (Ariz. Ct. App. 1992) (holding that "a contract thus would be breached by a failure to perform in good faith if a party uses its discretion for a reason outside the contemplated range" of the parties); Carma Developers (Cal.) Inc. v. Marathon Dev. Cal., Inc., 826 P.2d 710, 726-27 (Cal. 1992) (holding that the covenant requires the party holding discretionary power to exercise it "for any purpose within the reasonable contemplation of the parties at the time of formation—to capture opportunities that were preserved upon formation of the contract"); Neiditz v. Housing Auth., 654 A.2d 812, 819 (Conn. Super. Ct. 1994), aff'd, 651 A.2d 1295, 1296 (Conn. 1995) (holding that the covenant of good faith presupposes that the terms of the contract are agreed upon and what is in dispute is the party's discretionary application); Chemical Bank v. Paul, 614 N.E.2d 436, 442 (Ill. App. Ct. 1993) (holding that parties with unfettered discretion cannot be allowed to exercise that discretion in bad faith); Julian v. Christopher, 575 A.2d 735, 739 (Md. 1990) (holding that if a lease does not spell out any standard for exercising discretion then the implied covenant of good faith and fair dealing should imply a reasonableness standard); Anthony's Pier Four, Inc. v. HBC Assocs., 583 N.E.2d 806, 820-21 (Mass. 1991) (holding that the use of a discretionary right under the contract as a pretext to "sweeten the deal" is a breach of the covenant of fair dealing and good faith); Weldon v. Montana Bank, 885 P.2d 511, 515 (Mont. 1994) (holding that "when the discretion conferred by the contract has been misused to deprive the other party of the benefit of the bargain" then there is a breach of the covenant of good faith); Centronics Corp. v. Genicom Corp., 562 A.2d 187, 193 (N.H. 1989) (holding that the exercise of discretion by one contracting party must be limited in so far as it is in accord with the parties' purpose in contracting); Uptown Heights Assocs. Ltd. Partnership v. Seafirst Corp., 891 P.2d 639, 644 (Or. 1995) (holding that parties normally contemplate discretion will be exercised for particular purposes; if the discretion is exercised outside these purposes then the party exercising the discretion has performed in bad faith); Olympus Hills Shopping Ctr., Ltd. v. Smith's Food & Drug Ctrs., Inc., 889 P.2d 445, 450 (Utah Ct. App. 1995); see also Steven J. Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 Harv. L. Rev. 369, 379-84 (1980) (stressing the importance of the covenant of good faith when a party engages in conduct allegedly pursuant to a grant of discretion). But cf. Riggs Nat'l Bank v. Linch, 36 F.3d 370, 373 (4th Cir. 1994) (holding that when the contract expressly gives one party "sole discretion," the implied duty of good faith cannot be used to renegotiate the terms of the contract).

9. Usage of trade may resolve the permissibility of conduct either by explaining an ambiguous contractual reference to such conduct or by adding a supplemental term. See Restatement (Second) of Contracts § 222(3) (1979); U.C.C. § 2-202(a) (1994); see also, e.g., Precision Steel Warehouse, Inc. v. Anderson-Martin Mach. Co., 854 S.W.2d 321, 325 (Ark. 1993) (trade usage explaining ambiguous term); Varni Bros. v. Wine World, Inc., 41 Cal. Rptr. 2d 740, 745-46 (Ct. App. 1995) (trade usage adding term permitting termina-
parol evidence,\textsuperscript{10} determine the permissibility of the conduct, no gap filler is needed\textsuperscript{11} and the covenant does not apply.

For example, assume a franchisee was granted a license to own and operate a franchisor's restaurant. Thereafter, the franchisor opened a new restaurant nearby, which undermined the profitability of the franchisee's operation.\textsuperscript{12} If the contract were silent regarding the permissibility of opening that restaurant, or if the contract gave the franchisor discretion without designated limits to open new restaurants, the propriety of such conduct would be resolved under the covenant. If, however, the contract expressly granted the franchisor unlimited discretion to open new restaurants, regardless of their proximity to the franchisee’s restaurant, then the covenant could not be utilized to override those terms.

\\textsuperscript{10}See cases cited supra note 5. This limitation on the application of the covenant is consistent with the general contract principle that in interpreting a contract, “an implication ... should not be made when the contrary is indicated in clear and express words.” Arthur L. Corbin, Corbin on Contracts § 64, at 298 (1960).

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\textsuperscript{12}For example, assume a franchisee was granted a license to own and operate a franchisor's restaurant. Thereafter, the franchisor opened a new restaurant nearby, which undermined the profitability of the franchisee’s operation.”
II. Current Approaches

Although there is agreement that the covenant of good faith and fair dealing applies when the permissibility of conduct otherwise is unclear, authorities differ about the methodology for determining whether conduct violates the covenant. Several approaches have been proposed by commentators and adopted by the courts. An evaluation of these approaches shows that they fail to provide workable guidelines for resolving good faith cases, compelling ad hoc decision making.

A. The Excluder Approach

One approach, introduced by Professor Summers and adopted by many courts, attempts to identify conduct that is excluded from the realm of good faith. This approach assumes that it is impossible to formulate standards or even relevant criteria for determining when conduct is to be so excluded. Instead, the approach offers descriptive categories and anecdotal examples of excludable conduct. These bad faith categories include evasion of the spirit of the bargain, lack of diligence and slacking off, willfully rendering only substantial performance, abuse of a power to determine compliance, and interference with or failure to cooperate in the other party's performance. However, there is no standard for determining when conduct falls into any of these categories. For instance, describing bad faith conduct as

13. See cases cited supra notes 5-6.
17. Professor Summers contends that good faith "is best understood as an 'excluder'—it is a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith." Summers, supra note 15, at 196.
18. Id. at 215 (stating that "[i]f an obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition").
19. Id. at 206 (arguing that "criteria must vary from context to context").
20. Id. at 234-35.
21. Id. at 235-37.
22. Id. at 237-38.
23. Id. at 240-41.
24. Id. at 241-43.
an evasion of the spirit of the bargain, even with an anecdotal example,\textsuperscript{25} offers little guidance on how to determine the spirit of the bargain or how to evaluate when it is being evaded.

This approach compels courts to resolve cases on an intuitive ad hoc basis, without guidelines,\textsuperscript{26} except in those rare cases in which patterns of conduct have become generally recognized as violating the covenant.\textsuperscript{27} Such an ad hoc approach is deficient because it promotes capricious and unpredictable decision making\textsuperscript{28} while increasing trans-

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\textsuperscript{25} Professor Summers offers this example of evasion of the spirit of the bargain: Suppose a seller develops and builds a market for product X and then sells his rights to manufacture and market it; the buyer of these rights is to pay royalties according to a rate based on the sales he makes. Later, the buyer develops product Y, which competes with X. Can the buyer keep X under his control until the market for Y has been built up and then safely forget X? The answer is "no," for the buyer would be evading the spirit of the deal and therefore would be acting in bad faith. \textit{Id.} at 235.

\textsuperscript{26} Professor Summers acknowledges the ad hoc nature of his excluder approach. If an obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition. Courts should be left free, under the aegis of a statutory green light, to deal with any and all significant forms of contractual bad faith, familiar and unfamiliar. \textit{Id.} at 215; see also James H. Cook, Comment, Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: \textit{Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case, 71 Iowa L. Rev. 893, 899-900 (1986) (criticizing Professor Summers' excluder approach on the ground that it requires ad hoc decisions without guidelines).}


\textsuperscript{28} The need for predictable results is magnified by the litigiousness of society. We are a litigious people, but our litigiousness need not produce a mass of vague rules capriciously applied to produce unpredictable results. Our litigiousness argues instead for clear rules consistently applied to produce predictable results. This would discourage frivolous litigation, encourage prompt settlement of well-
action costs. Without a definitive rule, courts can impose unexpected burdens on either party. Plaintiff cannot determine when defendant may permissibly undermine her contractual interests. Defendant cannot determine when he will be prohibited from promoting his own contractual interests. Without the ability to make those determinations, the parties cannot assess contractual risks and may find themselves with unexpected contractual obligations to which they would not have agreed.

An ad hoc system also increases the likelihood of breach and fosters litigation. It increases the likelihood of breach because, without guidance about the limits of acceptable conduct, defendant will not know how to avoid breach. It fosters litigation because the parties founded litigation, and facilitate the just resolutions of those few lawsuits that did not settle.


29. Rules that are uncertain in result increase transaction costs because parties must expend time and resources to bargain around them. “The imposition of a default term whose effect is uncertain will not reduce transaction costs. On the contrary, it will increase them: parties will attempt to exclude by contract the added uncertainty of unpredictable judicial intervention.” Andrew Kull, *Mistake, Frustration, and the Windfall Principle of Contract Remedies*, 43 HASTINGS L.J. 1, 47 (1991); see also Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389, 395 (1993) (stating that “the policies of both contract and property law include creating certainty and predictability to reduce the parties’ planning and transaction costs”).


31. See Kull, *supra* note 29, at 47. Even courts that justify the vagueness of the covenant as an unavoidable necessity concede that “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.” Olympus Hills Shopping Ctr., Ltd. v. Smith’s Food & Drug Shopping Ctrs., Inc., 889 P.2d 445, 450 (Utah Ct. App. 1994) (quoting Southwest Sav. & Loan Ass’n v. Sunamp Sys., Inc., 838 P.2d 1314, 1319 (Ariz. Ct. App. 1992)).

32. Patrick J. Kelley, *Holmes’s Early Constitutional Law Theory and its Application in Takings Cases on the Massachusetts Supreme Judicial Court*, 18 S. ILL. U. L.J. 357, 365 (1994) (“Legal rules that are fixed, definite, and certain will be more effective than rules that are vague, indefinite and uncertain because people can better predict the legal consequences of fixed, definite, and certain rules and thus can better conform their conduct to
cannot determine the legal consequences of conduct and may be forced to seek judicial resolution of resulting disputes.33

B. The Foregone Opportunity Approach

Another approach, introduced by Professor Burton,34 contends that the covenant is violated when a party attempts to recapture a foregone opportunity.35 A foregone opportunity is one that defendant bargained away as the price for entering into the contract.36 Whether that opportunity has been foregone depends on the reasonable expectations of the parties.37 Only if the parties reasonably expected that defendant would not attempt to reap the benefits sought by his conduct will an opportunity be deemed foregone.38

The difficulty with this approach is that the determination whether particular conduct represents such a foregone opportunity is frequently beyond the court's ability to ascertain39 for the very reason

the rule") (citing Oliver W. Holmes, Jr., The Common Law 88-90 (Mark DeWolfe Howe ed. 1963)).

33. See Kull, supra note 29, at 47 (stating that "the uncertainty of outcome under any such [unpredictable] legal rule will encourage litigation"); see also Robinson & Huber, supra note 28, at 303 (stating that vague rules promote litigation); Mark Snyderman, What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending, 55 U. Chi. L. Rev. 1335, 1361 (1988) (stating that "[a]n unrequited cost of court interference is the wasteful litigation produced when courts demonstrate their willingness to rewrite contracts and create vague and inconsistent rules"); Joseph F. Weis Jr., Are Courts Obsolete?, 67 Notre Dame L. Rev. 1385, 1396 (1992) (stating that "[t]he ability of lawyers to advise their clients with some degree of certainty is critical in avoiding disputes").

34. Burton, supra note 8, at 387-92.
35. Id. at 387.
36. Id.
37. Id. at 390-91.
39. When defendant's conduct promotes his own interests while undermining plaintiff's, it will not be difficult for both sides to submit viable reasonable expectation arguments. In the restaurant franchise case, for example, defendant can plausibly assert that because the contract did not forbid or otherwise limit his ability to open new restaurants, his decision to do so in order to increase his profits was consistent with his reasonable expectations, irrespective of the fact that it resulted in a diminution of plaintiff's profits. Plaintiff, on the other hand, can argue that because the contract did not expressly confer upon defendant the ability to open new restaurants near plaintiff's, his decision to do so
that the conduct is not referred to in the contract. When the contract does not indicate the permissibility of conduct, there is no agreed-upon source for determining whether the parties reasonably expected that the conduct would constitute a foregone opportunity. Without guidelines, courts are forced to apply this approach on an intuitive basis with all the pitfalls of an ad hoc system.

C. The Reasonable Expectations Approach

Many courts have adopted half of Professor Burton's approach by focusing on the question whether the conduct was beyond the reasonable expectations of the parties, while ignoring the issue of foregone opportunities. Without a standard for determining when one party's expectations are reasonable, this approach suffers from the same deficiencies as the foregone opportunity approach.

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was inconsistent with her reasonable expectation that defendant would take no action to reduce the profitability of her franchise.


41. Professor Burton acknowledges the deficiencies of a pure reasonable expectations test to determine when conduct violates the covenant because those unfocused expectations "direct attention to the amorphous totality of the factual circumstances at the time of formation [of the contract], and fail to distinguish relevant from irrelevant facts within that realm." Burton, supra note 8, at 371-72. By directing attention to the specific issue of whether opportunities were foregone, Burton believed analysis would be advanced. Id. at 391. The problem, however, is that even knowing the relevant circumstances existing at the formation of the contract does not lead to a resolution of whether particular conduct is consistent with the parties' reasonable expectations.

The truth is that a party frequently contracts with the expectation that the other will be permitted to exploit his own self-interest to the extent that the contract does not expressly preclude such opportunistic behavior. See Clayton P. Gillette, Commercial Relationships and the Selection of Default Rules for Remote Risks, 19 J. LEGAL STUD. 535, 540, 560 (1990). Frequently she expects that the other will forego his self-interest and engage in cooperative behavior. Id. Whether a particular party expected one over the other and to what extent she expected it frequently cannot be fathomed from the circumstances surrounding the formation of the contract. Id. "The transactional signals parties send are too ambiguous to permit uniform interpretation." Id. at 581. Despite its theoretical appeal, Burton's test ultimately demands resolution by intuition or individualized value judgments.


43. See FARNSWORTH, supra note 40, § 7.16, at 546-47.
D. The Justice Approach

It has been proposed that the question whether the covenant has been violated should be determined by judicial concepts of justice rather than by the parties' expectations.\(^4\) This approach, however, also suffers from the same vagueness as the previously discussed approaches. It does not state the criteria for determining what constitutes justice,\(^5\) leaving courts with little besides their intuition to resolve good faith cases. Without articulated standards, a rule based solely on justice is an invitation to inconsistency. When competing interests are balanced, one party's notion of justice may be the other party's notion of injustice.

E. The Purpose Approach

Some courts find conduct in violation of the covenant if it is inconsistent with the parties' purpose for entering into the contract.\(^6\) This approach uses the same analysis applied to determine whether conduct violates an ambiguous statute. Courts will construe a statute to prohibit particular conduct if that prohibition is consistent with the legislature's purpose in enacting the statute.\(^7\) Unfortunately, this leg-

\(^{44}\) See id. § 7.16, at 547-48; see also Koehrer v. Superior Court, 226 Cal. Rptr. 820, 828 (Ct. App. 1986) (holding that "the obligations stemming from the implied covenant of good faith and fair dealing are imposed by law as normative values of society"); Lowe v. Feldman, 168 N.Y.S.2d 674, 680 (Sup. Ct. 1957) (holding that a court will, "where justice and expediency demand, infuse the contract with the spirit of good faith and fair dealing"). But see Don King Prods. v. Douglas, 742 F. Supp. 741, 767 (S.D.N.Y. 1990) (distinguishing between legal duties and ethical duties in the context of the covenant of good faith and indicating that only legal duties are enforceable).

\(^{45}\) See sources cited supra note 44. Furthermore, it is unclear whether "justice" should be determined from the societal perspective of notions of fairness and morality, from the parties' perspective based on their reasons for entering into the contract, or from the trade perspective of business ethics.


\(^{47}\) See, e.g., Concrete Pipe & Prods., Inc. v. Construction Laborers Pension Trust, 113 S. Ct. 2264, 2281-82 (1993) (reasoning that "we turn, as we would in the usual case of textual ambiguity, to the legislative purpose as revealed by the history of the statute, for such light as it may shed"); Rose v. Lundy, 455 U.S. 509, 517 (1982) (holding that "where the statute's language seem[s] insufficiently precise, the 'natural way' to draw the line 'is in line of the statutory purpose'" (quoting United States v. Bacto-Unidisck, 394 U.S. 784, 799 (1969))); Stephen Breyer, On the Uses of Legislative History in Interpreting Statutes, 65 S. CAL. L. REV. 845, 853 (1992) (stating that "[a] court often needs to know the purpose of a particular statutory word or phrase . . . in order to decide properly whether a particular circumstance falls within the scope of that word or phrase").
islative approach is unworkable in a contractual context. Parties have distinct and potentially conflicting purposes for entering into a contractual relationship. As a consequence, one party may engage in conduct that furthers his own contractual purpose but undermines the other’s. Frequently, in commercial contracts each party’s purpose is to maximize his profits, but those purposes are potentially conflicting. For example, when the restaurant franchisor opens a new restaurant in close proximity to an existing franchisee, that conduct will promote the franchisor’s purpose while simultaneously undermining the franchisee’s.

A fictional, nonexistent, unitary contractual purpose cannot determine whether conduct violates the covenant. From the perspective of contractual purpose, a violation of the covenant should depend on whether defendant’s promotion of his contractual purpose unduly intrudes upon plaintiff’s contractual purpose. The purpose approach does not define when that point is reached.

F. The Restatement Approach

The Restatement (Second) of Contracts has described the covenant of good faith in terms that combine elements of each of the foregoing approaches:

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 violate community standards of decency, fairness or reasonableness.


49. See cases cited supra note 46. Some courts have combined the reasonable expectations approach and the purpose approach by stating that conduct violates the covenant of good faith when it violates an agreed common purpose or is inconsistent with the parties’ reasonable expectations. See, e.g., Occusafe, Inc. v. EG&G Rocky Flats, Inc., 54 F.3d 618, 624 (10th Cir. 1995); Maljack Prods., Inc. v. Motion Picture Ass’n, 52 F.3d 373, 375 (D.C. Cir. 1995); Cross & Cross Properties, Ltd. v. Everett Allied Co., 886 F.2d 497, 502 (2d Cir. 1989); Scheck v. Burger King Corp., 798 F. Supp. 692, 694 (S.D. Fla. 1992); Blue Jeans Equities West v. City & County of San Francisco, 4 Cal. Rptr. 2d 114, 119 ( Ct. App. 1992); Wells Fargo Realty Advisors Funding, Inc. v. Uloli, Inc., 872 P.2d 1359, 1363 (Colo. Ct. App. 1994); Perry v. Jordan, 900 P.2d 335, 338 (Nev. 1995); First Nat’l Bank & Trust Co. v. Kissee, 859 P.2d 502, 509 (Okla. 1993); Olympus Hills Shopping Ctr., Ltd. v. Smith’s Food & Drug Ctrs., Inc., 889 P.2d 445, 451 (Utah Ct. App. 1995); Capital Impact Corp. v. Munro, 642 A.2d 1175, 1177 (Vt. 1994). This compound approach offers no greater clarity than either approach offers separately.

The above language from the Restatement, to which numerous courts have referred, specifically adopts the purpose, reasonable expectations, and excluder approaches. It does not expressly incorporate the justice approach, but it necessitates the same ad hoc value judgments by evaluating good faith based on undefined community standards of decency, fairness, or reasonableness. The Restatement does not indicate which of its component approaches is paramount if they conflict. More importantly, though this combined approach may create the illusion of guidance, the linking of several ad hoc approaches does not overcome their individual deficiencies.

G. The Fruits of the Contract Approach

A common aphorism asserts that conduct which would destroy or injure the other party's right to receive the fruits or benefits of the contract approach drawn, nearly verbatim, from Professor Summers's 1968 article introducing the excluder approach. Compare RESTATEMENT (SECOND) OF CONTRACTS § 205 cmts. d-e with Summers, supra note 15, at 216-17. Comment d provides, in agreement with Professor Summers' thesis, that "[a] complete catalogue of types of bad faith is impossible." See Summers, supra note 15, at 206.

Professor Summers reports that his 1968 article led to the drafting of § 205:
The late Robert Braucher, then Professor of Law at Harvard Law School, was the Reporter for the Restatement Second during the years when section 205 was in embryo, and he drafted it. Professor Braucher acknowledged that an article I wrote on the subject published in 1968 substantially influenced the recognition and conceptualization of good faith in section 205.


contract violates the covenant. This standard is overbroad to the extent it suggests that defendant can do nothing that would lessen plaintiff’s anticipated contract benefits. For example, in a requirements contract a buyer’s reduced requirements would not constitute a violation of the covenant merely because it reduced the seller’s anticipated profits. Nor would a court necessarily hold that the restaurant franchisor who opened a new restaurant violated the covenant merely because his new restaurant reduced the profits of the franchisee. This aphorism ignores that occasions will arise when defendant is entitled to injure plaintiff’s contractual interests to promote his own. Defendant’s conduct must unduly injure plaintiff’s contractual interests to violate the covenant. However, courts have been unwilling or unable to set criteria for determining undue injury.

H. The U.C.C. Approach

According to the Uniform Commercial Code, good faith always requires honesty in fact in the conduct or transaction concerned. The U.C.C. neither defines the meaning of the term “honesty in fact,” nor describes prohibited conduct, nor indicates whether the term


55. The Official Comments to the U.C.C. provision governing requirements contracts state:

Reasonable elasticity in the requirements is expressly envisaged by this section and good faith variations from prior requirements are permitted even when the variation may be such as to result in discontinuance. A shutdown by a requirements buyer for lack of orders might be permissible when a shutdown merely to curtail losses would not. The essential test is whether the party is acting in good faith.


56. See cases cited supra notes 53-54.

57. The U.C.C. imposes a duty of good faith on all parties. U.C.C. § 1-203 (1994); see supra note 1. Good faith is defined to mean “honesty in fact in the conduct or transaction concerned.” U.C.C. § 1-201(19) (1994). The honesty in fact requirement of § 1-201(19) is a baseline requirement for good faith throughout the Code. According to the Official Comment to U.C.C. § 1-201, “Good faith, whenever it is used in the Code, means at least what is here stated.” U.C.C. § 1-201 cmt. 19 (1994). Although special definitions of good faith can be found in the Code, those definitions all include the element of “honesty in fact.” See, e.g., U.C.C. §§ 2-103(1)(b), 3-103(a)(4) (1994).

58. The Official Comment to U.C.C. § 1-201(19) offers no elaboration on the meaning of “honesty in fact” or the kinds of conduct that would be prohibited by defining good faith in this way. U.C.C. § 1-201 cmt. 19 (1994). The Official Comments to the special defini-
should be given a broad\textsuperscript{59} or narrow\textsuperscript{60} meaning. Judicial interpretations state that the phrase requires defendant to demonstrate a "white heart" even if his conduct reflects an "empty head."\textsuperscript{61} The "white heart, empty head" terminology is amorphous, providing no meaningful guideline for identifying dishonest conduct.

In limited circumstances, in addition to honesty, the U.C.C. requires "observance of reasonable commercial standards of fair dealing in the trade."\textsuperscript{62} The U.C.C. does not define the term "reasonable commercial standards of fair dealing in the trade".\textsuperscript{63} If it means that each trade defines fair dealing, this aspect of the U.C.C. is of minimal significance because in most trades there are no generally accepted and well-defined standards of fair dealing.\textsuperscript{64} If the term means that

\begin{itemize}
  \item good faith are also silent on the meaning to be ascribed to "honesty in fact." See, e.g., U.C.C. § 2-103 cmts. (1994); id. § 3-103 cmt. 4 (1994).
  \item "In its broader meaning, 'dishonesty' is defined as a breach of trust, a 'lack of . . . probity or integrity in principle,' 'lack of fairness,' or 'a disposition to betray.'" United States v. Brackeen, 969 F.2d 827, 829 (9th Cir. 1992) (citing WEBSTER'S third new international dictionary 650 (unabridged ed. 1986)).
  \item "In its narrower meaning, however, 'dishonesty' is defined as deceitful behavior, a 'disposition to defraud [or] deceive,' . . . or a '[d]isposition to lie, cheat, or defraud.'" Id. (citing BLACK'S law dictionary 421 (5th ed. 1979)).
  \item In Article 2 (Sales), "'good faith' in the case of a merchant is honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." U.C.C. § 2-103(1)(b) (1994). This definition of good faith is also used in Article 2A (Leases). U.C.C. § 2A-103(3) (1994).
  \item In Article 3 (Negotiable Instruments), good faith is defined to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing." U.C.C. § 3-103(a)(4) (1994). This definition is also used in Article 4 (Bank Collections). U.C.C. § 4-104(c) (1994).
  \item The U.C.C. fails to define what would constitute observance of reasonable commercial standards, other than to distinguish it from due care. Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction.
  \item U.C.C. § 3-103 cmt. 4 (1994).
  \item There are remarkably few decisions in which courts have made an effort to ascertain a given trade's standards of fair dealing. See e.g., Morgold, Inc. v. Keeler, 891 F. Supp.
\end{itemize}
standards outside the trade are applicable, it gives no guidelines to which standards to apply. Courts frequently cite the U.C.C. language regarding reasonable standards of fair dealing, without explaining the meaning of that language, and then announce a conclusion about whether the conduct at issue is prohibited. Some courts cite this term and then select from among the above described approaches to resolve the issue, thereby incorporating the deficiencies of whatever approach is selected.

III. The Proposed Standards

The authors disagree with Professor Summers’ conclusion that neither standards nor criteria can be devised for resolving when conduct violates the covenant of good faith. We submit that a framework of standards can be created that would substantially reduce ad hoc decision making in covenant cases.

We propose a series of standards defining when conduct will violate the covenant of good faith. These standards are divided into two categories. One category covers violations of the covenant involving commercial unreasonableness, and the other covers violations in-
volving dishonesty. These two categories will give content and definition to the U.C.C. terminology.

The proposed standards would not apply when the express terms of the contract, admissible extrinsic sources such as trade custom or parol evidence, or another default rule such as an implied warranty determine the permissibility of conduct. Nor would these standards replace existing rules providing heightened obligations of good faith, such as those involving fiduciaries and insurance contracts. Additionally, these standards would not supersede the courts’ ability to prohibit conduct that violates public policy.

71. See infra subpart III.B.
72. The U.C.C. definitions of good faith distinguish between the requirement of honesty and the requirement of observing reasonable commercial standards of fair dealing. See supra note 62. Honesty is required by all U.C.C. definitions of good faith, whereas commercial reasonableness is required by some but not all. See U.C.C. §§ 1-201(19), 2-103(1)(b), 2A-103(3), § 3-103(a)(4), 4-104(e) (1994).
73. See supra notes 5-6 and accompanying text.
74. One who holds a fiduciary duty to another must act with the utmost degree of good faith and loyalty in order to properly discharge that duty. That obligation of good faith, however, stems not from the implied covenant of good faith and fair dealing, but from the fiduciary relationship itself. See, e.g., Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 906 F.2d 1206, 1215 (8th Cir. 1990); Johnson v. Pacific Lighting Land Co., 817 F.2d 601, 607 (9th Cir. 1987); CSFM Corp. v. Elbert & McKee Co., 870 F. Supp. 819, 830 (N.D. Ill. 1994); Bay Shore Properties, Inc. v. Drew Corp., 565 So. 2d 32, 34 (Ala. 1990); Barry v. Raskov, 283 Cal. Rptr. 463, 467 (Ct. App. 1991); Robert S. Adler & Richard A. Mann, Good Faith: A New Look at an Old Problem, 28 AKRON L. REV. 31, 34 (1994). But see Wilf v. Halpern, 599 N.Y.S.2d 579, 580 (App. Div. 1993) (holding that a partner’s refusal to consent to renegotiation of partnership debt for solely personal reasons was “in contravention of the fundamental implied covenant of good faith and fair dealing governing the parties’ fiduciary obligations to one another”).
76. This distinction between violations of public policy and violations of the covenant of good faith is consistent with the current state of the law. Conduct that violates public policy is prohibited irrespective of and independent of the parties’ contractual agreement.
A. Commercial Unreasonableness

The proposed standards under this category impose limitations on defendant's ability to injure plaintiff's contractual interests, irrespective of dishonesty. These standards impose a cooperative element in the performance of contracts by obligating defendant to give due consideration to plaintiff's interests when engaging in conduct that is not otherwise prohibited.

(I) Causing Material Injury

Defendant would violate the covenant when he had reason to know that his conduct would cause plaintiff material contractual injury unless the conduct was necessary to avoid material contractual injury to himself.

(a) Materiality

The analysis of materiality would be similar to that required to determine whether a mistake is material for purposes of rescission or whether a breach is material for purposes of excusing plaintiff's performance. Under those doctrines, the degree to which the ag-

77. Under the Restatement (Second) of Contracts the materiality of a mistake is a factor in determining whether the mistake constitutes grounds for rescission of the contract. For mutual mistakes, section 152 provides in part:

Where a mistake of both parties at the time a contract was made as to a basic assumption on which the contract was made has a material effect on the agreed exchange of performances, the contract is voidable by the adversely affected party unless he bears the risk of the mistake . . . .

RESTATEMENT (SECOND) OF CONTRACTS § 152(1) (1979). For unilateral mistakes, section 153 provides in part:

Where a mistake of one party at the time a contract was made as to a basic assumption on which he made the contract has a material effect on the agreed exchange of performances that is adverse to him, the contract is voidable by him if he does not bear the risk of the mistake . . . .


78. According to the material breach rule of the Restatement (Second) of Contracts, "it is a condition of each party's remaining duties to render performances to be exchanged under an exchange of promises that there be no uncured material failure by the other party to render any such performance due at an earlier time." RESTATEMENT (SECOND) OF CONTRACTS § 237 (1979); see also id. § 164 (1979) (material misrepresentation inducing one party's assent may make contract voidable); RESTATEMENT OF RESTITUTION § 9(2) (1937) (innocent misrepresentation and non-disclosure are grounds for restitution only if material); id. § 28 (1937) (material misrepresentation is grounds for restitution).
grieved party's essential contractual purpose was undermined is a fundamental factor.\textsuperscript{79} Under the proposed standard, material contractual injury exists when conduct defeats a party's essential purpose for entering into the contract. In the restaurant franchise case, if the newly opened restaurant were located in such close proximity to plaintiff's franchise that her contractual purpose of maintaining a viable franchise were defeated, the franchisor's conduct would cause a material contractual injury to plaintiff. If, however, the new restaurant were sufficiently distant that its likely impact would be to reduce profitability but not eliminate the viability of plaintiff's franchise, the injury, while significant, would not be material.\textsuperscript{80}

A contract is a cooperative venture by which the parties have chosen to link their respective self-interests.\textsuperscript{81} In order to generate anticipated advantages for both, the parties have agreed to relinquish

\textsuperscript{79} 17A Am. Jur. 2d Contracts § 573, at 586 (1991) (stating that a material breach is "such a breach of a contract as substantially defeats its purpose"). It has been held that a "material breach is one which touches the fundamental purposes of the contract and defeats the object of the parties in making the contract." Rogers v. Relyea, 601 P.2d 37, 41 (Mont. 1979); see also Ogle v. Wright, 360 N.E.2d 240, 244 (Ind. Ct. App. 1977) (holding that material breach goes to the "heart of the contract"). According to the Restatement (Second) of Contracts, one factor to be considered in determining whether a party's breach is material is "the extent to which the injured party will be deprived of the benefit which he reasonably expected." \textit{Restatement (Second) of Contracts} § 241(a) (1979).

Often the issue of whether a party has materially breached is stated in terms of whether that party has failed to substantially perform the contract. If a party has substantially performed, then he has not materially breached and therefore the injured party is not excused from performance. \textit{Farnsworth, supra} note 40, § 8.16, at 638. The accepted test for substantial performance is whether performance meets the essential purpose of the contract. By implication the test for material breach is whether performance defeats that purpose. \textit{See}, e.g., Stein v. William C. Cox, Inc., 57 B.R. 1016, 1021-22 (E.D. Pa. 1986); Bruner v. Hines, 324 So. 2d 265, 269-70 (Ala. 1976); Hickox v. Bell, 552 N.E.2d 1133, 1144 (Ill. App. Ct.), \textit{cert. denied}, 555 N.E.2d 376 (Ill. 1990); Southwestern Bell Yellow Pages, Inc. v. Robbins, 865 S.W.2d 361, 367 (Mo. Ct. App. 1993); Micro-Margins, Inc. v. Gregory, 434 N.W.2d 97, 103 (Wis. Ct. App. 1988).

\textsuperscript{80} In Scheck v. Burger King Corp., 798 F. Supp. 692, 699-700 (S.D. Fla. 1992), on which the example in the text is based, the court did not analyze the propriety of the new location according to the materiality standard but applied an amorphous standard requiring reasonable conduct on the part of the franchisor.

[W]here the covenant of good faith and fair dealing is, in fact, implied into a franchise agreement, decisions by a franchisor as to where to establish new franchises must be made in good faith and in a reasonable manner so that a party's right to enjoy the fruits of the contract is not obviated. \textit{Id.} at 697 n.9. The court did not resolve whether Burger King's conduct was reasonable, leaving that for the trial court, where Burger King "should be prepared to defend its position on a good faith—that is, reasonable conduct—basis." \textit{Id.} at 700.

\textsuperscript{81} "A contract is a mutually advantageous cooperative venture according to rules, by which each party voluntarily restricts his or her own liberty in ways necessary to yield advantages for both parties." \textit{Stephen J. Burton, Default Principles, Legitimacy, and the Authority of a Contract}, 3 S. Cal. Interdisciplinary L.J. 115, 161 (1993). "[T]he dominating motivation of commercial contractors is to induce cooperative risk reduction."
their freedom to act inconsistently with the terms of the contract. It would be antithetical to that cooperative spirit to allow one party to defeat the other party's contractual purpose merely because the terms of the contract do not prohibit it.

This standard focuses on the parties' contractual purposes, and thus bears a semantic similarity to the current purpose approach. However, unlike the current approach, it acknowledges that the parties have distinct and potentially conflicting purposes and defines when defendant's promotion of his own purpose will be deemed an undue intrusion upon plaintiff's.

Cases will occasionally arise when defendant must either defeat plaintiff's contractual purpose by engaging in particular conduct or defeat his own contractual purpose by refraining from such conduct. In those cases, defendant would not be required to protect plaintiff's contractual purpose at the expense of his own. Self-defeating altruism would not be required. To illustrate, assume defendant leased commercial property from plaintiff to operate a department store with rent equal to a percentage of the store's gross revenue. As a result of a subsequent change in demographics, some of the store's operations became so unprofitable that they eliminated the profitability of the entire store. Relocating the unprofitable operations would cause a material contractual injury to plaintiff by reducing the rental revenues below her carrying costs. If, however, defendant did not relocate the unprofitable operations, the department store would remain unprofitable, causing him material injury. Defendant's decision to relocate would not violate the covenant of good faith because his relocation was necessary to avoid defeating his own contractual purpose. If, however, defendant relocated merely for more favorable rental terms, but his operations were profitable at plaintiff's premises, defendant's conduct would violate the covenant of good faith because defendant was not avoiding material injury to himself.

82. See Burton, supra note 81, at 161.
83. See supra subpart II.E.
84. See Baird, supra note 48, and accompanying text.
85. The example in the text is based on the facts of Grisaffi v. Dillard Dep't Stores, 43 F.3d 982, 983 (5th Cir. 1995). Many authorities have addressed the question whether the covenant of good faith is breached when a defendant, having agreed to pay rent to plaintiff based on a percentage of defendant's gross revenues derived from operations at the leased premises, discontinues or curtails those operations, thereby reducing or eliminating plaintiff's rent. See cases cited infra note 86; see also Burton, supra note 8, at 384-85 (commercial percentage lease cases invoke the covenant of good faith).
86. Although none of the percentage lease decisions explicitly recognizes a defendant's right to exercise discretion so as to protect himself from material harm, defendant's reason for discontinuing or shutting down operations at the rented premises is nevertheless
(b) Reason to Know

Under this standard, defendant must have reason to know that his conduct would cause plaintiff material contractual injury. Defendant would have reason to know if he had information from which a person of ordinary intelligence would infer that material injury was probable.87 "Reason to know," unlike "should have known," imposes no duty to inquire about the true state of facts,88 thereby freeing defendant from the burden of ascertaining the effect of contemplated conduct when it did not appear likely that such conduct would cause plaintiff material injury.

In order for defendant to have reason to know that his conduct would cause plaintiff material contractual injury, he must not only have reason to know of plaintiff's contractual purpose but also that his conduct would defeat that purpose. It would be necessary for defend-
ant to have reason to know of plaintiff's contractual purpose prior to the contract's formation and reason to know his conduct would defeat that purpose prior to his engaging in the conduct.

Because this standard applies only when defendant has reason to know of plaintiff's contractual purpose prior to the contract's formation, plaintiff has an incentive to disclose that purpose when it is not otherwise apparent. Such disclosure provides defendant an opportunity to determine whether he is willing to restrict his conduct to honor plaintiff's purpose.\textsuperscript{89} Plaintiff's incentive to disclose her purpose would be similar to that imposed by the rule of \textit{Hadley v. Baxendale},\textsuperscript{90} a penalty default\textsuperscript{91} rule designed to encourage the obligee's disclosure\textsuperscript{92} of her special circumstances unknown to the obligor by denying her recovery of consequential damages resulting from these special circumstances.\textsuperscript{93}

No disclosure of plaintiff's purpose prior to formation would be necessary if the terms of the contract or the underlying circumstances made that purpose apparent to defendant. For example, assume that the lessor of a shopping mall leased premises to defendant's supermarket chain. The lease provided that defendant was the anchor ten-

\textsuperscript{89} Defendant's risks under the contract are increased to the extent that his ability to engage in opportunistic behavior is decreased. Disclosure of these risks is important. See Frank H. Easterbrook & Daniel R. Fischel, \textit{Limited Liability and the Corporation}, 52 U. CHI. L. REV. 89, 117 n.45 (1985) ("Disclosure . . . allows the other party to take extra precautions or to charge appropriate compensation for bearing increased risk"); see also Stephen McG. Bundy & Einer Elhauge, \textit{Knowledge About Legal Sanctions}, 92 MICH. L. REV. 261, 291 (1993) ("Consider two important goals of contract law: ensuring an accurately priced transaction by encouraging the identification and disclosure of relevant information and, in long-term contracts, reducing opportunistic behavior").


\textsuperscript{91} Professors Ayres and Gertner coined the phrase "penalty default" to describe a rule that would encourage desired conduct or discourage undesired conduct by use of a penalty. Ian Ayres & Robert Gertner, \textit{Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules}, 99 YALE L.J. 87, 97-104 (1989).


\textsuperscript{93} According to \textit{Hadley}, the obligee cannot recover consequential damages resulting from special circumstances unless those circumstances were communicated, prior to the formation of the contract, to the obligor. 156 Eng. Rep. at 151. The Restatement (Second) of Contracts has modified the language of \textit{Hadley} to provide that consequential damages may be recovered if they were foreseeable as "a probable result of [the] breach [when the contract was made] . . . as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know." \textit{RESTATEMENT (SECOND) OF CONTRACTS} § 351(2) (1979).
ant but was otherwise silent about the use of the premises. After opening a supermarket, defendant relocated it to a nearby neighborhood. Rather than terminate the lease with plaintiff, thereby allowing a competing supermarket to open at plaintiff’s premises, defendant chose to utilize the premises to operate a warehouse box store. This use defeated plaintiff’s contractual purpose of having the anchor tenant’s premises used to draw a high volume of customers to the mall. By the very fact of being the anchor tenant, defendant would have reason to know of that purpose and disclosure would not be necessary.

 Plaintiff’s disclosure of her purpose would be necessary on the following variation of the facts of the previous case. Assume that defendant did not relocate but, to plaintiff’s surprise, used the premises to operate a high-traffic department store. If plaintiff’s undisclosed purpose was to have a supermarket as anchor tenant rather than a department store so that it would pose no competitive threat to the other retail tenants, plaintiff could not successfully claim that her contractual purpose was defeated by defendant’s choice of operations, as defendant would not have reason to know of that purpose without disclosure.

 Although defendant must have reason to know of plaintiff’s purpose before contract formation, defendant need only have reason to know prior to his conduct that his conduct would defeat that purpose. In contrast to plaintiff’s purpose for entering into the contract, which will invariably be known by plaintiff at the time of the contract’s formation, plaintiff will frequently not know at the time of the contract’s formation the conduct that defendant is contemplating or the consequences that conduct will have upon her. Therefore, the law should

94. This example is based on the facts of Olympus Hills Shopping Ctr. v. Smith’s Food & Drug Ctrs., 889 P.2d 445, 448-49 (Utah Ct. App. 1994).
95. The location of defendant’s new store was one and one-half miles from defendant’s first store. Id. at 448.
96. Id. at 448, 452.
97. According to the court, Smith’s role as the “anchor tenant” at the center was to generate significant customer traffic which was necessary to the financial health and operation of the Olympus Hills Shopping Center. Id. at 452. Smith’s box store generated less than 10% of the proceeds generated by its supermarket and customer traffic at the shopping center was down sixty percent after the opening of the box store. See id. at 453.
98. In its decision, the court did not inquire whether Smith’s had reason to know of Olympus Hills’s contractual purpose. Instead, it decided the good faith issue from Olympus Hills’s perspective, based on whether Olympus Hills justifiably expected that Smith’s would select a reasonable economic use for the premises. Olympus Hills, 889 P.2d at 451. Since reasonable minds could differ on whether Smith’s acted in violation of Olympus Hills’s reasonable expectation, the court held that the issue of good faith was properly submitted to the jury. Id. at 451-52.
99. “[P]arties do not anticipate all future contingencies. This is particularly so in long-term contracting, because there are inevitable cognitive limitations on the human mind’s
not impose a penalty upon plaintiff for failing to disclose at the time of the contract's formation the consequences of defendant's future conduct. Rather, the law should impose upon defendant an obligation to adjust his conduct according to the circumstances. At some time prior to his conduct, however, defendant must have reason to know of its material impact on plaintiff's contractual interests in order to violate this standard. This requirement is necessary in order to prevent defendant from being liable by surprise and afford him a reasonable opportunity to avoid breach.101

Because there is no bright line to demarcate material injury,102 cases will arise under this standard when the materiality of injury and plaintiff's reason to know of it are in dispute. Nevertheless, the test of

information processing capacity." John C. Coffee Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 GEO. L.J. 1495, 1505 (1990). The inability to anticipate contingencies is the reason that default terms are necessary. "[A] key purpose of state-supplied terms is to save parties from the necessity of formulating a complete set of express conditions for contingencies that may be difficult to anticipate, or are at least easily overlooked." Charles J. Goetz & Robert E. Scott, The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms, 73 CAL. L. REV. 261, 270 (1985).

100. Defendant's intent to engage in particular conduct may be unknown to plaintiff at the time of formation of the contract. Defendant himself may have had no such intent at that time and may have been induced to engage in the conduct by circumstances arising subsequent to formation. Even if plaintiff knew at the time of formation that defendant anticipated engaging in particular conduct, she may not have known that it would cause her material injury. For example, assume in the restaurant franchise case that defendant opened the new restaurant five miles away from plaintiff. Plaintiff may not have reasonably anticipated at the time of formation that defendant would open another restaurant in that vicinity. Defendant himself may not have so anticipated. Even if plaintiff had known of defendant's intention, she might not have known that her franchise would be so marginal that a new restaurant five miles away would cause it to be unprofitable.

101. Whether this requirement was satisfied would be the critical issue in resolving a hypothetical based on a variation of the facts of Kansas Baptist Convention v. Mesa Operating Ltd. Partnership, 864 P.2d 204 (Kan. 1993). Assume a gas well operator had a contract with the owners of land and mineral rights whereby the operator had been given discretion, after initial drilling, to drill subsequent wells at the expense of the owners. After the initial drilling, the operator opted to drill a subsequent drainage well for the purpose of maximizing gas production. However, the subsequent drilling caused the investors to forfeit their interests, thereby defeating their contractual purpose of engaging in a profit-making transaction, because the cost of drilling the drainage well exceeded the income that the investors would ever recover from the operating wells. If drilling costs exceed income for the reason that plaintiffs had contracted to sell the gas output to third parties for abnormally low prices, it would be irrelevant that defendant had no reason to know prior to formation of the contract about the price limitation and the resulting adverse economic effect that his drilling would have on plaintiffs. Rather, what is relevant is whether he had reason to know of it, through plaintiffs' disclosure or otherwise, prior to his conduct.

102. See Restatement (Second) of Contracts § 241 cmt. a (1979) (acknowledging that the determination of materiality cannot be made with precision).
materiality has, in other contexts, proven to be workable and should be similarly effective in this context.\textsuperscript{103}

(2) \textit{Failure to Utilize a Less Harsh Alternative}

Defendant would violate the covenant when he engages in conduct that injures plaintiff's contractual interests if he had reason to know that there was an alternative which would have provided him essentially the same benefits while substantially reducing plaintiff's contractual injuries.

Although this standard does not require defendant to give equal weight to plaintiff's contractual interests or to balance his gains against her losses, it does require that he accomplish his goals by avoiding conduct that injures plaintiff if it can be done at minimal or no additional cost to defendant. This standard imposes a base level of contractual cooperation by preventing defendant from gratuitously injuring plaintiff and by requiring him to modify his conduct to avoid contractual injuries to plaintiff that are not necessary to promote his own legitimate self-interest. The fact that the alternative conduct would entail insignificant incidental expense would not relieve defendant from his obligations under this standard. Requiring defendant to substantially reduce plaintiff's contractual injuries when it can be done at minimal cost to defendant promotes economic efficiency, a recognized tenet of contract law,\textsuperscript{104} because if there is a less harsh alternative it will necessarily create a greater net benefit to the parties.\textsuperscript{105}

The operation of this rule is illustrated by a variation of the facts of the restaurant franchise case. Assume the new restaurant reduced, but did not eliminate, the profitability of plaintiff's franchise.\textsuperscript{106} If defendant was aware of an alternative, more distant location for the new restaurant which would have given defendant essentially the same fi-

\textsuperscript{103} See supra notes 77-79.


\textsuperscript{105} The term 'efficiency' has a meaning to the economist that differs from its plain English usage. In general, a situation is considered economically efficient if it maximizes aggregate benefits less aggregate costs." Meyerson, supra note 104, at 624.

\textsuperscript{106} Because the profitability of the restaurant was not eliminated, the materiality standard would not be violated, and plaintiff would have to seek relief under a different standard.
financial benefits and which would have reduced substantially plaintiff’s loss of business, his failure to choose this less harsh alternative would violate the covenant.

Defendant must have reason to know that a less harsh alternative to his conduct was available. Defendant need not inquire about the presence of less harsh alternatives, but if he knows of facts from which he could have reasonably concluded that a less harsh alternative was available, he cannot close his eyes to those facts and injure plaintiff’s contractual interests through indifference. For example, assume that defendant, as a secured lender, exercised his discretion to foreclose on the collateral of a defaulting plaintiff, even though plaintiff had obtained a buyer who was willing to purchase the collateral at a sum that would fully compensate defendant while allowing plaintiff to retain a portion of the proceeds that she would not be able to obtain through a foreclosure sale. Defendant would violate the covenant by blocking the proposed voluntary sale if it were apparent that the foreclosure sale would deprive plaintiff of a portion of the proceeds and that no reduction in defendant’s contractual benefits would accrue by accepting plaintiff’s proposal. But if this information were not apparent, defendant would have no reason to know that a less harsh alternative existed, and his foreclosure sale would not violate the covenant.

This standard would apply when defendant had discretion to engage in particular conduct, but chose a manner that was more injurious than necessary. The following case exemplifies that situation. Defendant conferred upon plaintiff the exclusive right to retail defendant’s product line within a designated territory and retained dis-

107. For the meaning of the term “reason to know” see supra note 87.
108. See supra notes 87-88 and accompanying text.
110. A case in which a foreclosing lender’s good faith was in issue when it refused to permit a voluntary sale in lieu of foreclosure was Bennett v. Genoa Ag Ctr., Inc., 154 B.R. 140, 148 (Bankr. N.D.N.Y. 1992). In that case defendant lender exercised its contractual right to foreclose on plaintiff borrower’s farmland. Id. at 143. Plaintiff then entered into a contract with a third party to sell the property. Id. at 144. Defendant refused to accept plaintiff’s plan to retain $3,700 of the sale proceeds and remit the balance to defendant. Id.

The bankruptcy court initially held that defendant had breached the covenant of good faith by refusing plaintiff’s plan. Id. at 148-49. This holding is consistent with how the case would be resolved under the proposed less harsh alternative standard because defendant, at no additional expense, would have gotten more by accepting plaintiff’s proposal than by foreclosing. Id. at 148. However, the court later reconsidered this holding and determined that the covenant of good faith had not been breached because defendant had an express contractual right to foreclose and the implied covenant of good faith could not detract from that express right. Id. at 154.

cretion to terminate the relationship.\textsuperscript{112} Pursuant to that contract, plaintiff accepted orders from customers who resided in another dealer's territory.\textsuperscript{113} As a result of complaints from the other dealer, defendant engaged in a smear campaign to drive plaintiff out of business.\textsuperscript{114} Assuming that defendant could have achieved the same benefits merely by exercising the termination right,\textsuperscript{115} defendant's conduct would violate the covenant of good faith.\textsuperscript{116}

If defendant were motivated solely by spite or ill will, he could not successfully argue that he should be excused from seeking a less harsh alternative on the ground that reducing plaintiff's injury in any way would deprive him of the benefit of satisfying his spite. Defendant would have to show that his conduct was motivated by a legitimate business interest and that there was no less harsh alternative to promote that interest. The tort of intentional interference with contractual relations holds persons liable who attempt to undermine another's contractual relations with a third party with no interest in doing so except spite or ill will.\textsuperscript{117} If one is liable in tort for maliciously undermining a contract with a third party, he should be found in violation of this standard when his sole motivation\textsuperscript{118} is to mali-

\begin{itemize}
\item \textsuperscript{112} Both parties had the contractual right to terminate the contract with or without cause. \textit{Id.} at 539.
\item \textsuperscript{113} The dealer was told by defendant not to turn away business from other areas outside his own. \textit{Id.} at 538.
\item \textsuperscript{114} \textit{Id.} at 540.
\item \textsuperscript{115} In fact, defendant had the right to terminate because the contract was terminable at will. \textit{Id.} at 539. For a discussion of how the authors would treat contracts terminable at will, see \textit{infra} text accompanying notes 191-93, 198.
\item \textsuperscript{116} The court's analysis did not employ the less harsh alternative standard but found bad faith from a combination of defendant's actions, including the smear campaign, defendant's refusal to communicate with or assist plaintiff for several months, and defendant's contradictory and misleading communications to plaintiff on the subject of whether defendant intended to terminate the agreement. \textit{Id.} at 540. The court observed that if defendant had merely terminated the agreement, as it was entitled to do under the contract, then there would have been no bad faith. \textit{Id.}
\item \textsuperscript{118} As with the tort of intentional interference with contractual relations, if defendant had a legitimate business interest for engaging in his conduct, he would not be in violation of this standard even though his conduct was motivated partly by animosity toward plaintiff. See, e.g., \textit{Alyeska Pipeline}, 604 P.2d at 1093; \textit{Ethyl Corp.}, 386 So. 2d at 1225; \textit{Wagoner}, 440 S.E.2d at 124.
\end{itemize}
ciously undermine his own contracting partner's contractual benefits.\textsuperscript{119}

Permitting a defendant to forego a less harsh alternative only when it promotes his legitimate business interests is consistent with the line of cases holding that a lessor's expressly reserved power to withhold consent to an assignment of a lease cannot be denied for arbitrary reasons and must be in furtherance of a legitimate business interest.\textsuperscript{120} Because a lessor who denies consent to an assignment for other than legitimate business reasons could have derived essentially the same protectable benefits from the less harsh alternative of granting consent, his denial of consent would be in violation of this standard.

Occasionally this standard will require that defendant give plaintiff prior notice of his intent to engage in particular conduct. If, for example, defendant had a requirements contract with plaintiff, and after the formation of the contract his requirements increased significantly, he would be obligated to give plaintiff reasonable notice in order to afford her an opportunity to increase production or obtain alternative sources of supply.\textsuperscript{121} Defendant's failure to give notice prior to increasing his requirements would constitute a violation of the covenant because notice would have substantially reduced the likelihood of plaintiff's contractual injuries at minimal or no expense.

(3) All Other Cases

In cases that are not covered by the above two standards, defendant's decision to pursue his own commercial interests should be deemed commercially reasonable even though his conduct may cause injury to plaintiff's contractual interests.

It might be argued that in such residual cases commercial reasonableness should be determined based on whether defendant had reason to know that his conduct would cause a greater loss to plaintiff

\textsuperscript{119} Because the covenant of good faith would not apply to conduct that is pursuant to an express grant of absolute discretion, a spiteful exercise of that discretion would not violate the covenant. For example, termination of an employee induced solely by personal animosity would be permitted under a contract terminable at will. See infra text accompanying notes 191-93, 198.


\textsuperscript{121} Advance notification by the buyer to the seller of the buyer's requirements is not expressly required by U.C.C. § 2-306, the U.C.C. provision dealing with requirements contracts, nor by its Official Comments. See U.C.C. § 2-306 (1994). The proposed rule therefore represents an expansion of the seller's express rights under the U.C.C. in a requirements contract.
than defendant would have sustained by foregoing the conduct.\textsuperscript{122} This argument should fail, however, because such a balancing would frequently be contrary to the intent of the parties and would be unfeasible.

When the contract confers discretionary powers on defendant, there is frequently a tacit understanding that he will give priority to his own self-interest.\textsuperscript{123} Plaintiff might willingly confer this broad discretionary power as a trade-off for more favorable contract terms in return. To prohibit defendant from exercising discretion in a manner that would cause more harm to plaintiff than benefit to defendant would, therefore, frequently be contrary to the intent of parties.

Such a balancing approach would be unfeasible because of the difficulty of measuring and comparing the parties' respective losses. If the standard of measurement is purely monetary, it is often extremely difficult to assess the dollar effect of particular conduct upon the parties.\textsuperscript{124} More importantly, it is not clear that a comparison of monetary harm with monetary benefits is an appropriate standard for

\textsuperscript{122} Professor Scott postulates that a strategy of joint maximization of benefits and mutual risk reduction dominate the mindset of contracting parties.

If we assume rationality, then it follows that, regardless of the risk attitudes of particular parties, the dominant strategy for contractual risk allocation is to maximize the expected value of the contract for both parties. Only by allocating risks in order to maximize the joint expected benefits from their contractual relationship can the parties hope to maximize their individual utility. Any deviation from joint maximization generates an inefficient and thus an unstable contract.

Scott, supra note 81, at 602.

\textsuperscript{123} See, e.g., Gillette, supra note 41, at 540, 560.

\textsuperscript{124} Frequently the determination of the economic impact of defendant's conduct requires an assessment of the gains that defendant will ultimately acquire and the profits that plaintiff will ultimately lose by that conduct. The calculation of future profits or losses is "inevitably speculative to some degree." Haven Assocs. v. Donro Realty Corp., 503 N.Y.S.2d 826, 830 (App. Div. 1986). In making that calculation, the court and jury necessarily "enter 'into the realm of the imprecise and uncertain.'" Park v. El Paso Bd. of Realtors, 764 F.2d 1053, 1066 (5th Cir. 1985), cert. denied, 474 U.S. 1102 (1986) (quoting Lehrman v. Gulf Oil Corp., 464 F.2d 26, 45 (5th Cir. 1972), cert. denied, 409 U.S. 1077 (1972)). The courts are willing to calculate damages based on future profits or losses, notwithstanding a degree of uncertainty in such a calculation, when defendant, by his wrongdoing, created the uncertainty. See, e.g., Bigelow v. RKO Radio Pictures, Inc., 327 U.S. 251, 264 (1946) (stating that the jury may reasonably eliminate damage according to "relevant data" when the defendant's own wrong renders uncertain an exact computation of damages). Once defendant's wrongdoing has been established, any error in estimation affects only the amount of damages that plaintiff will recover. If, however, the determination whether defendant violated the covenant is based upon a comparison of defendant's future gains with plaintiff's future losses, tolerating uncertainty in those amounts cannot be justified on the premise that defendant was a wrongdoer, because the determination of wrongdoing would depend upon the calculation. And if there is an error in calculation, the effect will not merely be to give plaintiff more or less damages than those to which she was entitled; it may result in the finding of liability when in fact none should be found, or the failure to find liability when it should be found. As a result, basing the determination
determining when conduct violates the covenant. But measuring losses from a qualitative perspective, such as by the degree to which each party's purpose is impaired, is also extremely difficult. Although contract law can distinguish between material and immaterial injuries, there is no workable method for measuring and comparing impairment to a plaintiff's contractual purpose with avoided impairment to a defendant's contractual purpose.

The determination of commercial reasonableness under the covenant would be governed solely by the above two standards; however, a plaintiff could still establish through extrinsic evidence that the parties intended greater obligations of cooperation than would be imposed by those standards. Furthermore, defendant may still violate the covenant if his conduct involved dishonesty, despite the commercial reasonableness of such conduct.

B. Dishonesty

The rules encompassed within this category seek to prevent defendant from causing contractual injury through deceptive or disingenuous means. They impose minimum levels of integrity in the performance of contracts.

Two patterns of conduct presently recognized to violate the covenant of good faith properly fall within this category: first, when defendant's duty to perform is dependent upon his personal satisfaction and he misrepresents his dissatisfaction; and second, when defendant deliberately prevents plaintiff's performance and then attempts to take advantage of her nonperformance by disingenuously claiming whether conduct violates the covenant solely upon economic efficiency is not only unfeasible, but dangerous.

125. See Jean W. Burns, Vertical Restraints, Efficiency and the Real World, 62 FORDHAM L. REV. 597, 624-30 (1993) (noting that to focus solely on economic efficiency in creating default rules for contract law ignores the reality that fairness, too, is a relevant factor and fairness frequently depends upon criteria that cannot be measured by a simple comparison of the respective monetary injuries and gains of the parties).

126. See supra notes 77-79 and accompanying text.

127. See supra note 9 and accompanying text.

128. See supra note 27.

Proof of dishonesty in this context will be difficult. However, if defendant's claimed dissatisfaction is objectively unreasonable, dishonesty may be inferred from that fact alone. For example, assume defendant homeowner enters into a home improvement contract under which defendant can terminate the contract if he is not personally satisfied with plaintiff's performance. Although plaintiff complies with the objective specifications of the contract, defendant nevertheless terminates the contract claiming dissatisfaction and hires another contractor at a cheaper price. Under these circumstances, a court may find that the true reason for termination was to obtain the work at a cheaper price and that defendant was in fact dishonest and in violation of the covenant when he claimed dissatisfaction.
breach. In addition to those patterns, the following types of conduct should be regarded as dishonest.

(1) Dishonest Evaluation of Facts or Circumstances

When the contract confers discretion upon defendant to determine whether particular facts or circumstances exist, his misrepresentation of the determination would violate the covenant.

This rule would simply extend the presently recognized rule concerning dishonest expressions of dissatisfaction to cases in which defendant dishonestly expresses his evaluation of facts or circumstances. There is no reason to treat these two situations differently.

The following case illustrates the operation of the proposed standard. Plaintiff entered into a contract with defendant Motion Picture Association of America (M.P.A.A.), allowing defendant the discretion to rate plaintiff's movie according to stated criteria. Defendant categorized plaintiff's movie as X-rated, thereby severely limiting the potential audience. If defendant's rating of plaintiff's movie was not based on defendant's honest belief, but rather reflected a practice by defendant to rate more strictly movies submitted by those who were not members of the M.P.A.A., defendant's dishonest rating would violate the covenant.

Another example of this standard would involve an employment contract terminable for good cause in which the employer is given

129. See supra note 27.
131. According to the actual facts of the case, the plaintiff failed to allege what those criteria were. Id. at *3.
132. Id. at *1.
133. Plaintiff alleged that its movie, Henry: Portrait of a Serial Killer, was rated in a discriminatory manner in comparison with more violent films that received an R rating. Id. at *3. Plaintiff also claimed that the reason for the discrimination was that plaintiff was not a member of the Motion Picture Association of America. Id. at *4 n.4.
134. Although the court's discussion indicates that the covenant of good faith would have been violated if defendant had deliberately misapplied stated ratings criteria merely because plaintiff was not a member of the Motion Picture Association of America, the court actually held that plaintiff had not sufficiently alleged facts from which defendant's bad faith discrimination against it could be found. Plaintiff did not allege any ratings criteria that defendant had failed to apply or had misapplied. Plaintiff's allegation that other films more violent than its own had received more lenient ratings was insufficient to support a claim of bad faith. A simple mistake by defendant would be consistent with that allegation. Id. at *3.
135. An employment contract that can be terminated only for good cause is subject to the covenant of good faith. See Schultz v. Spraylat Corp., 866 F. Supp. 1535, 1540 (C.D. Cal. 1994) (holding that burden is on plaintiff to demonstrate that a "covenant of good faith and fair dealing" existed and that plaintiff's termination by defendant without cause represented a breach of that covenant); Barrett v. Asarco Inc., 799 P.2d 1078, 1081 (Mont.
discretion to base salary increases upon his evaluation of specified criteria. If plaintiff is denied a raise based on defendant's personal animosity toward her, rather than on the specified criteria, defendant's dishonest evaluation would violate this standard.  

Even when defendant honestly believes that his determination of facts or circumstances is correct, his conduct should nonetheless be deemed dishonest if he refused to allow plaintiff the opportunity to present evidence that might reasonably have induced him to make a contrary determination. The failure to consider such information demonstrates defendant's lack of integrity, indicates that he does not want to know the truth, and amounts to dishonesty. The following case illustrates this point. Defendant Educational Testing Service administers the Scholastic Aptitude Test ("SAT") and in its contract with students retains discretion to cancel test scores of any student whom it determines to have cheated. Plaintiff, a high school student, twice took the SAT and achieved a dramatically higher score on the second test. Defendant's experts checked plaintiff's answer
sheets from both tests and concluded that the handwriting was inconsistent. Based on its determination that the student had cheated, defendant canceled plaintiff's test scores and would not release them to academic institutions. Defendant refused to consider plaintiff's abundant, credible evidence that no cheating had occurred. That evidence might reasonably have induced defendant to make a contrary determination, and therefore, defendant's refusal would violate the covenant.

Defendant should not escape this standard by asserting that plaintiff's evidence would not have induced him to make a contrary determination. Defendant's post hoc assertion is of doubtful veracity and unverifiable. Therefore, the determination of whether the relevant criteria are satisfied or the relevant factual conditions exist should be made not by defendant but by the court. In the SAT case, the determination of whether plaintiff cheated would be made by the court based on all the evidence, including that which plaintiff was denied the opportunity to present.

(2) Inducing Inadvertent Surrender of Contractual Rights

Defendant would violate the covenant when he engaged in conduct with the purpose and effect of inducing plaintiff to inadvertently surrender her contractual rights.

This rule would not be violated by defendant's mere failure to apprise plaintiff of her contractual rights. It seeks to prevent defend-

141. Id.
142. Id. at 744.
143. The evidence offered by plaintiff included the following: affidavits from ETS proctors that plaintiff had attended the November 1991 SAT; affidavits from other test takers who had seen him at the November 1991 SAT; documentation that plaintiff had mononucleosis at the time of the May 1991 SAT; plaintiff's enrollment in a six-week review course prior to the November SAT; plaintiff's honors record in high school; and an affidavit from plaintiff's handwriting expert indicating that the handwriting on plaintiff's May and November tests was consistent. Id. at 743-44.
144. The court held that defendant Educational Testing Service had violated the covenant of good faith by "ignoring Dalton's evidence without even initiating a preliminary investigation." Id. at 744.
146. Although the proposed rule would require the court to determine whether the plaintiff had in fact cheated, the court in Dalton v. Educational Testing Service made no such determination. The court simply ordered defendant Educational Testing Service to release the test scores on the grounds that defendant had violated the covenant of good faith by refusing to consider plaintiff's evidence. Dalton, 614 N.Y.S.2d at 743-44.
tant from engaging in affirmative conduct undertaken for the purpose of entrapping plaintiff into inadvertently surrendering contractual rights. Such conduct is a sophisticated form of dishonesty. The following case demonstrates the application of this standard. A long-term shopping center lease provided that lessee could request negotiations with lessor for the purpose of having lessor finance leasehold improvements. Paragraph 34 of the lease provided that, if such negotiations failed, lessee had the option to purchase the property at a price computed according to a predetermined formula. Many years later, lessee contacted lessor to purchase the property but considered lessor’s offer of $3 million to be excessive. The paragraph 34 purchase option formula, however, yielded the bargain price of $1 million. Lessee therefore requested negotiations for financing, hoping that lessor had forgotten paragraph 34 and would cause the purchase option to be invoked by refusing to negotiate. Lessee’s hopes were realized. Under the proposed rule, defendant lessee's conduct would violate the covenant.

147. This conduct constitutes dishonesty in its narrow sense in that defendant seeks to deceive plaintiff. See supra note 60.
149. In 1968, J.C. Penney entered into a sale and leaseback arrangement with General Electric Pension Trust, whereby J.C. Penney sold properties to the Trust and leased them back for a period of 25 years. Id. at 591. As part of that arrangement, the trust agreed to negotiate the financing of improvements desired by J.C. Penney. Id.
150. The formula for determining the price at which J.C. Penney could buy back the property provided a base price approximately equal to the amount of the original sale price under the sale and leaseback, plus six percent for each year elapsed since the initial sale. Id.
151. In 1987, J.C. Penney assigned the lease to Market Street Associates Limited Partnership. Id. In 1988, twenty years after the inception of the lease, Market Street Associates got an opportunity to add a drugstore as a tenant to the leased shopping center provided that it obtain the financing to build the drugstore. Id. at 591. Market Street Associates then contacted third-party lenders who demanded a mortgage on the property as a precondition of any loan. Id. Id. at 592. Market Street Associates could grant such a mortgage only if it owned the property. Id.
152. Id.
153. Id. at 592.
154. Id. at 591-92.
155. The Seventh Circuit (Judge Posner) remanded the case for a trial on the issue whether Market Street Associates had tried to deceive the pension trust or whether Market Street Associates believed instead that the pension trust knew or would find out about Paragraph 34 of the lease. Id. at 597-98. The court framed the issue similarly to the proposed rule herein:
Violation of this standard could also occur through defendant's deliberate misrepresentation that induced plaintiff to surrender her contractual rights. Assume in the previous case that, in response to lessee's request for financing, lessor asked whether the lease covered that subject. Lessee, knowing the truth, assured lessor that it did not. If lessor relied on that deliberate misrepresentation and refused to negotiate, lessee's conduct would violate the covenant.

It might appear unnecessary to extend this rule to misrepresentations since that conduct would be independently invalidated under the doctrine of equitable estoppel. However, to establish equitable estoppel, plaintiff would have to prove that her reliance was justifiable. Many courts hold that reliance is unjustified if the truth could have been readily discovered. In those jurisdictions, plaintiff could not successfully claim estoppel based upon defendant's misrepresentations concerning the terms of the contract as plaintiff could have readily ascertained the truth by reading the contract.

The more stringent reliance requirements of equitable estoppel should not apply under this standard. The effect of this standard is to protect plaintiff from surrendering a vested contract right, whereas the doctrine of equitable estoppel also permits a party to acquire rights that would not otherwise have existed. Greater constraints upon

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Id. at 596.


157. Dobbs, supra note 156, § 2.3(5), at 85.


159. See, e.g., Young, 898 P.2d at 66; accord Sisler, 614 N.Y.S.2d at 988-89; Five Oaks, 331 S.E.2d at 298.

160. "Equitable estoppel is the effect of the voluntary conduct of a party whereby he is absolutely precluded ... from asserting rights which might perhaps have otherwise existed ... against another person ... who on his part acquires some corresponding right, either of property, of contract, or of remedy." 3 J. POMEROY, EQUITY JURISPRUDENCE, § 804 (5th ed. 1941), quoted in Waterville Homes, Inc. v. Maine Dep't of Transp., 589 A.2d 455, 457 (Me. 1991); Inlet Assoc. v. Assetegauge House Condominium Ass'n, 545 A.2d 1296, 1307 (Md. 1988); Grand Lodge Indep. Order of Odd Fellows v. Marvin, 369 N.W.2d 54, 58 (Neb. 1985); Gonzales v. Gonzales, 867 P.2d 1220, 1228 (N.M. Ct. App. 1993); R.J.
deception should apply when the deception results in plaintiff’s surrendering preexisting contractual rights.  

(3) Precontractual Nondisclosure of Contemplated Injurious Conduct

If at the time of the contract’s formation, defendant had reason to know but failed to disclose that he would engage in conduct that might reasonably have induced plaintiff to forego entering into the contract or to insist on altered terms, then defendant would violate the covenant if he thereafter engaged in such conduct.

Although this standard does not impose a pre-formation duty of disclosure upon defendant, his decision not to disclose relevant risk-related information would restrict his post-formation ability to engage in conduct whose permissibility is not resolved by the terms of the contract. It is his pre-formation nondisclosure, coupled with the decision to exploit that nondisclosure, which should be regarded as a form of dishonesty to be prohibited under the covenant of good faith.

This standard is intended to promote defendant’s disclosure of risk-related information prior to the formation of the contract. As noted, contract law encourages the obligee to disclose the consequences of breach. The reason for encouraging that disclosure is to afford the obligor the opportunity to assess intelligently the risks associated with the contract. The reasoning supporting disclosure in the Hadley context, where nondisclosure protects the breaching party, is even more compelling in cases covered by the proposed standard, where nondisclosure protects the innocent party.

To avoid unnecessary burdens of disclosure, this standard should apply only when disclosure might reasonably have induced plaintiff to forego the contract or to insist on altering its terms. For example, assume that a bank granted a line of credit to a borrower for a substantial origination fee. The contract conferred discretion on the


161. Affording greater protection for vested rights than for prospective rights is consistent with constitutional jurisprudence. Weaver v. Graham, 450 U.S. 24, 29-30 (1981) (“Evaluating whether a right has vested is important for claims under the Contracts or Due Process Clauses which solely protect pre-existing entitlements.”).

162. This conduct constitutes dishonesty in its broad sense. See supra note 59.

163. Such disclosure is encouraged by the rule of Hadley v. Baxendale, which limits consequential damages to those that were foreseeable to the breaching obligor at the time of the formation of the contract. See supra notes 90-93 and accompanying text.

164. See supra notes 92-93 and accompanying text.

165. The example in the text is based on the facts of Kham & Nate’s Shoes No. 2 v. First Bank, 908 F.2d 1351 (7th Cir. 1990). On the actual facts, however, defendant bank had made available a $300,000 line of credit for different consideration than the substantial origination fee referred to in the text. The bank made the line available in order to achieve priority over other claimants in the borrower’s bankruptcy proceeding. Id. at 1353-54.
bank to terminate the line of credit.\textsuperscript{166} Three days after entering into the contract and collecting the origination fee, the bank terminated the line of credit.\textsuperscript{167} Had the borrower been aware of the bank's intention, it is reasonable to assume that she would have chosen to forego the contract or to insist on limiting the bank's discretion to terminate. The bank's immediate termination of the line of credit without having disclosed the likelihood of that termination would therefore violate the covenant.\textsuperscript{168}

Conduct would not violate this standard unless at the time of formation defendant had reason to know that he would engage in that conduct. In the line of credit case, the temporal proximity between the formation of the contract and the bank's conduct makes it evident that the bank had reason to know prior to the formation of the contract that it would terminate the line of credit. If, however, the termination had occurred two months later, it would be far more difficult to establish this fact. In that case, the bank's decision could more plausibly be attributed to post-formation circumstances.\textsuperscript{169}

The following case is another illustration of this standard. Assume the Internal Revenue Service asserted a claim for unpaid taxes against husband and wife.\textsuperscript{170} Thereafter husband and wife separated, and wife paid the entire claim to the I.R.S. The parties instituted divorce proceedings, and their property settlement agreement provided that husband would pay wife a specified amount, which was understood by both parties to include a credit to wife for half the tax pay-

\textsuperscript{166} The contract establishing the line of credit provided for cancellation on five days' notice. \textit{Id.} at 1353.

\textsuperscript{167} In \textit{Kham & Nate's Shoes}, the lender waited five weeks and then gave an additional one week's notice of termination to the borrower. \textit{Id.} at 1354.

\textsuperscript{168} Contrary to the outcome proposed in the text, the Seventh Circuit (Judge Easterbrook) held that the lender did not violate the covenant of good faith when it exercised its contractual discretion to cancel the line of credit so soon. According to the court, the covenant of good faith did not block the use of terms, such as the cancellation term, that actually appeared in the contract establishing the line of credit. \textit{Id.} at 1357. According to the court, the cancellation term should prevail because "[b]anks sometimes bind themselves to make loans . . . and sometimes reserve the right to terminate further advances. Courts may not convert one form of contract into the other after the fact . . . ." \textit{Id.} at 1356-57. This reasoning ignores the possibility that the parties did not intend discretion to be absolute. Only if the parties clearly intended discretion to be absolute should the protections of the covenant be deemed unavailing. \textit{See infra} notes 191-99 and accompanying text.

\textsuperscript{169} Defendant would not be in violation of the covenant if he was induced to engage in the conduct at issue for reasons independent of the undisclosed information. For example, there would be no violation when the bank failed to disclose prior to the formation of the contract an intent to summarily terminate plaintiff's line of credit, and after the formation of the contract the bank discovered that plaintiff had supplied false financial statements, giving the bank an independent basis for termination.

\textsuperscript{170} The example in the text is a modified version of the facts of Neilson v. Beck, 881 F. Supp. 455 (D. Or. 1995).
ment. Subsequent to the execution of the settlement agreement, wife filed a claim with the I.R.S. pursuant to I.R.C. § 6013(a)(3) for an innocent spouse refund. The refund was granted to wife, causing husband to incur liability for the refunded taxes. If a court found that wife intended at the time of the settlement agreement to file for the refund, her nondisclosure, coupled with her filing for the refund, would violate the covenant. Husband might reasonably have insisted on a modification of the terms of the settlement agreement if he had known of wife’s intent to file.

(4) Unconscionable Conduct

If an express term authorizing particular conduct would have been unconscionable, then defendant would violate the covenant of good faith by engaging in that conduct.

Under the doctrine of unconscionability, a court may invalidate an unduly offensive contract term. If defendant engages in conduct that is unduly offensive, and the contract is silent about the conduct at issue, however, the conduct may not be invalidated under the doctrine of unconscionability because there is no contract term to invalidate. There would be an indefensible gap in the law if outrageous conduct that was expressly authorized by the terms of the contract would be found invalid while that same conduct would be permitted in the absence of such authorization. Defendant would be able to increase his contractual rights by the simple expedient of silence. The proposed rule closes that gap. It denies defendant the ability to engage in con-

171. Id. at 456.

172. Disclosure was an important aspect of the court’s decision in Neilson v. Beck, 881 F. Supp. at 459. On the actual facts, Beck’s (wife’s) attorney had discussed with Neilson’s (husband’s) attorney the possibility that Beck would file for a refund of taxes under the innocent spouse provision. Id. at 456. The court emphasized this disclosure as an important reason why Beck’s subsequent actions in obtaining a refund were not in violation of the covenant of good faith. Framing the issue of good faith in terms of the parties’ reasonable expectations, the court explained the effect of such a disclosure on Neilson’s reasonable expectations as follows:

Neilson’s attorney . . . knew . . . that Beck was considering applying for a refund. Although it may have been reasonable for Neilson to have expected that the IRS would not give Beck a refund under the innocent spouse provision, it was not reasonable for Neilson to have expected that Beck would not pursue refunds of the taxes she had paid.

Id. at 459.

173. The U.C.C. section on unconscionability authorizes a court to invalidate an unconscionable contract or clause. “(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause . . . .” U.C.C. § 2-302(1) (1994). The court need not invalidate an unconscionable clause, however, but may instead limit or modify it to avoid an unconscionable result. U.C.C. § 2-302 cmt. 2 (1994).
tractual deception by attempting to circumvent the ambit of the doctrine of unconscionability.

Many courts require both procedural and substantive unconscionability for a term to be invalidated. 174 Procedural unconscionability is present, *inter alia*, when a party is surprised by the offending term, 175 as when it is hidden in a prolix printed form. 176 When the particular conduct at issue is not referred to in the contract, a term permitting that conduct is not just hidden in the contract; it does not exist. As a result, in cases governed by this standard, procedural unconscionability should never be an obstacle, and the focus should be solely on whether the conduct, had it been expressed as a term, would have been substantively unconscionable. A term is substantively unconscionable when it is so offensive as to shock the conscience. 177 Therefore, conduct that is so offensive as to shock the conscience would violate the covenant. 178

Under this standard, courts will be forced to make case by case decisions about whether conduct is unconscionable. However, this


175. The procedural component requires either oppression or surprise in connection with a contract term. Oppression results when the term is not open to negotiation because the party with superior bargaining power insists on its inclusion. Surprise exists when a term is hidden so that a party is denied a reasonable opportunity to be aware of the term's inclusion in the contract. See, e.g., *Phoenix Leasing*, 843 F. Supp. at 1385-86; *Emlee Equip.*, 626 A.2d at 312 n.12; Martin Rispens & Son v. Hall Farms, Inc., 601 N.E.2d 429, 443 (Ind. Ct. App. 1992); *Master Lease Corp.*, 580 N.Y.S.2d at 954.


177. The substantive component of unconscionability requires that the term be so egregious in its operation against the oppressed or surprised party that it shocks the conscience or is overly harsh. Nelson v. McGoldrick, 896 P.2d 1258, 1262 (Wash. 1995); see also Clermont v. Clermont, 603 N.Y.S.2d 923, 924 (App. Div. 1993) (shocks the conscience); *A & M Produce Co.*, 186 Cal. Rptr. at 122 (overly harsh).

178. This conduct would constitute dishonesty in its broad sense. See *supra* note 59.
standard contains sufficient guidelines to narrowly restrict its application. Only in rare cases will conduct be deemed so outrageous that it shocks the conscience. For example, this standard would govern the following situation. Plaintiff purchased a country store and private residence from defendant, making a substantial down payment and agreeing to pay defendant monthly installments for ten years. Defendant could retake the property and keep plaintiff’s payments upon plaintiff's default on any installment. Defendant retained a residence on the adjacent property. After the sale, defendant, not liking plaintiff and seeking to take advantage of the forfeiture provision made continual efforts to drive plaintiff off the property by acts of intimidation and harassment. If a term of the contract had authorized such outrageous conduct, it would have been found substantively unconscionable. Consequently, the conduct would violate the covenant.

IV. Waiver

Because the covenant of good faith is a gap-filling default rule, the parties have the ability to indirectly waive its protections by expressly authorizing particular conduct. The question whether the cov-

179. The example in the text is based on the facts of Cenac v. Murry, 609 So. 2d 1257 (Miss. 1992).
180. Plaintiff Mrs. Cenac paid defendant Murry a down payment of $30,000 and agreed to make monthly installments of $925 for ten years. Defendant retained title to the property. If all payments were made, then defendant would convey title to plaintiffs Mr. and Mrs. Cenac. Id. at 1259.
181. Id. at 1259-60.
182. Id. at 1261.
183. According to the court, “Murry’s motive is clear. With $30,000 in hand and $925.00 monthly payments . . . Murry would also get the store back, a healthy windfall, if he could only drive the Cenacs out of town forcing a forfeiture of the contract.” Id. at 1272.
184. The court agreed with plaintiffs that “Murry’s abusive, aberrant, intimidating, harassing behavior . . . has made their life a living hell.” Id. at 1272. Some of Murry’s tactics included roaming shirtless and beating his chest to drive away plaintiffs’ customers, interfering with plaintiffs’ telephone calls by making loud noises, threatening to “get” plaintiffs, firing a pistol near them, laughing at plaintiffs from nearby locations, mocking them, and videotaping them. Id. at 1262-63.
185. A forfeiture clause providing that Murry could get the store back and keep the Cenacs’ payments if he could drive out the Cenacs through intimidation and harassment would be substantively unconscionable. It would shock the conscience, and it would be overly harsh. See supra note 177 and accompanying text.
186. The court in Cenac v. Murry held that Murry's conduct violated the covenant of good faith. It did not, however, adopt the above standard for evaluating that conduct. The court articulated no standard at all, instead following its instincts. The court stated, “We trust that the facts of this case establish Murry’s breach of the good faith duty and have nothing to add.” Id. at 1272.
187. See supra notes 3, 5-8, and accompanying text.
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enant can be waived, therefore, arises only when the conduct at issue is not expressly authorized and the contract attempts to bypass the protections of the covenant either by expressly disclaiming its applicability or by conferring upon defendant the power to exercise his discretion without limits.

Of the courts that have addressed the issue, most, but not all, have agreed that the covenant cannot be waived. However, the meaning of that proposition is unclear. If it is to have any meaning, a disclaimer clause stating that the covenant does not apply should have no legal effect. There are independent substantive reasons for this conclusion. The conduct that would be prohibited by the covenant is so insidious, so contrary to plaintiff's reasonable expectations, and so destructive of plaintiff's contractual purpose that a sweeping attempt to validate all such conduct should, as a matter of policy, be unenforceable. When, instead of a disclaimer of the covenant, the contract provides that a party will have absolute discretion to engage in any conduct not prohibited by the terms of the contract, that provision should be equally unenforceable for the same policy reasons.

When the contract's terms convey to defendant absolute discretion with regard to a specified aspect of performance, such as absolute discretion to open new franchises, relocate lessee operations under a percentage lease, or terminate the contract, that specific grant should be given effect. If, for instance, defendant retained absolute discre-


191. The rule that a grant of absolute discretion regarding a specific aspect of performance should be given effect is consistent with current case law. Big Horn Coal Co. v. Commonwealth Edison Co., 852 F.2d 1259, 1267 (10th Cir. 1988); accord Tymshare, Inc. v. Covell, 727 F.2d 1145, 1153 (D.C. Cir. 1984) (“It is possible to so draw a contract as to leave decisions absolutely to the uncontrolled discretion of one of the parties and in such a case the issue of good faith is irrelevant.”); W. Alton Jones Found. v. Chevron U.S.A., Inc.,
tion to terminate plaintiff's distributorship, termination would not constitute a violation of the covenant irrespective of the injury it caused. The policy reasons that make a generalized waiver of the covenant unenforceable are not applicable in this context. Because the area of unfettered discretion is contractually defined, plaintiff cannot reasonably argue that her contractual purpose or expectations are undermined by defendant's exercise of that discretion. In the case of defendant's termination of plaintiff's distributorship, plaintiff cannot reasonably contend that her purpose was to have the contract continue indefinitely. Her purpose was to reap contractual benefits until defendant decided, in his absolute discretion, to terminate her continued receipt of those benefits.

In these cases, the covenant would remain applicable to conduct not encompassed within the defined area of absolute discretion. If defendant accompanied the termination with a concentrated effort to destroy plaintiff's reputation for the purpose of inducing customers to cease dealing with plaintiff, that effort would not be encompassed within the grant of discretion and would therefore be subject to the covenant of good faith.

Courts, however, should be reluctant to interpret such a grant of discretion as absolute. It should not lightly be inferred that the parties intended to bypass the protections afforded by the covenant of good faith. Only if the contract unambiguously evidences an intent by the parties to make such discretion absolute, as would be the case where defendant is given the power to exercise it "for any reason," or where his decision as to an aspect of performance shall be "final and

194. See supra notes 111-16 and accompanying text.
195. Id.
conclusive,"197 or when the agreement is terminable at will,198 should a court so conclude.199

Although a grant of absolute discretion with regard to specific conduct would waive the covenant of good faith, it would not deprive the courts of the ability to find that the conduct violated public policy.200 In an employment contract terminable at will, for example, an employer's decision to terminate an employee because of the employee's race may be held to violate public policy,201 and for that reason could be prohibited, irrespective of the fact that the covenant had been waived.


199. A grant of authority allowing defendant to exercise his "sole discretion" regarding an aspect of performance should not suffice. The term has an equivocal meaning. It is possible the parties understood it to mean that defendant has unfettered discretion and is not subject to the constraints of the covenant of good faith. It can also be understood to mean that defendant has the exclusive power to determine the manner of performance but is not free to ignore plaintiff's interests totally in deciding how to exercise that discretion. Because of its ambivalent meaning, the covenant would be deemed to apply. This is consistent with how most courts have construed this term. See, e.g., Travellers Int'l v. Trans World Airlines, Inc., 41 F.3d 1570, 1575 (2d Cir. 1994); BA Mortgage & Int'l Realty Corp. v. American Nat'l Bank & Trust Co., 706 F. Supp. 1364, 1373 (N.D. Ill. 1989); Midwest Management Corp. v. Stephens, 291 N.W.2d 896, 913 (Iowa 1980); Centronics Corp. v. Genicom Corp., 562 A.2d 187, 193 (N.H. 1989); Resource Management Co. v. Weston Ranch & Livestock Co., 706 P.2d 1028, 1037 (Utah 1985). Contra Patel v. Dunkin' Donuts, Inc., 496 N.E.2d 1159, 1161 (Ill. App. Ct. 1986); Super Valu Stores, Inc. v. D-Mart Food Stores, Inc., 431 N.W.2d 721, 726 (Wis. Ct. App. 1988).

Courts have the power to prohibit or invalidate conduct that violates public policy, regardless whether the conduct is authorized by the contract. While a grant of absolute discretion regarding specific conduct would waive the covenant of good faith, it would not deprive the courts of the ability to find that the conduct violated public policy. In an employment contract terminable at will, for example, an employer's decision to terminate an employee based on the employee's race may be held to violate public policy, and for that reason could be prohibited, irrespective of the fact that the covenant had been waived.

200. See supra note 76 and accompanying text.

V. Remedies

A violation of the covenant constitutes a breach of contract.202 Whether the breach will entitle plaintiff to compensatory contract damages203 will depend on the nature of the violation. A court may be able to prevent contractual injury to plaintiff by designating conduct as a violation of the covenant. In the case where shopping center lessee violated the covenant by inducing failed negotiations in order to invoke the lease term requiring a forced sale of the premises, the effect of holding that conduct to violate the covenant would be to prohibit the invocation of the term, thereby allowing plaintiff to maintain ownership and avoid any compensable loss.204


204. That was the result in Market Street Assocs. Ltd. Partnership v. Frey, 941 F.2d 588 (7th Cir. 1991); see supra notes 148-55 and accompanying text. Upon remand following the above decision, the district court remedied defendant lessee's violation of the duty of good
Frequently, however, compensatory damages are proper. Defendant's violation may injure plaintiff's contractual interests, necessitating monetary relief.\textsuperscript{205} Such would be the case if the restaurant franchisor, in breach of the covenant, opened a new franchise in such close proximity to plaintiff as to materially injure her contractual interests. Plaintiff's monetary remedy would be for consequential damages stemming from her lost profits.

Consequential damages are ordinarily limited to those that were foreseeable at the time of formation of the contract.\textsuperscript{206} When the covenant of good faith is violated, however, consequential damages should include those that were foreseeable at the time of defendant's breach. The proposed change in timing is based on a distinction between breach of the covenant and breach of the other terms of the contract. With respect to those other terms, the parties generally know at the time of formation the precise conduct that will constitute a breach.\textsuperscript{207} Limiting damages to those foreseeable at the time of the formation promotes the policy of allowing the parties to know the risks they are assuming.\textsuperscript{208} Furthermore, breach of terms other than the covenant may be inadvertent, occurring despite all reasonable efforts to prevent breach,\textsuperscript{209} or may be justified by factors such as economic efficiency that make limited liability appropriate.\textsuperscript{210}

\textsuperscript{205} See supra note 202.

\textsuperscript{206} U.C.C. § 2-715(2)(a) (1994); \textit{Restatement (Second) of Contracts} § 351 (1979); 3 \textit{Doob}, supra note 156, § 12.4(4).

\textsuperscript{207} With respect to express terms that forbid or require conduct, the parties necessarily know at the time of the contract's formation what conduct would constitute a breach of those terms. With respect to implied terms such as the warranty of merchantability, the parties have constructive notice of such terms and therefore know or have reason to know what conduct would constitute a breach of those terms.

\textsuperscript{208} See supra notes 90-93, 163-64, and accompanying text.

\textsuperscript{209} See \textit{Album Graphics, Inc. v. Beatrice Foods Co.}, 408 N.E.2d 1041, 1050 (Ill. App. Ct. 1980) ("Fault is irrelevant to breach of contract. Whether one intentionally, carelessly, or innocently breaches a contract, he is still considered to be in breach of that contract and the extent of his liability is generally the same.") (\textit{quoting in} \textit{Wait v. First Midwest Bank/Danville}, 491 N.E.2d 795, 802 (Ill. App. Ct. 1986)); \textit{Farnsworth}, supra note 40, § 12.8, at 875 ("[C]ontract law is, in its essential design, a law of strict liability, and the accompanying system of remedies operates without regard to fault.").

\textsuperscript{210} See \textit{Farnsworth}, supra note 40, § 12.3, at 845-49; \textit{Polinsky}, supra note 104, at 25-36; \textit{Posner}, supra note 92, at 104-07, 113-28 (contract law remedies have "the objective of giving the promisor an incentive to fulfill his promise unless the result would be an inefficient use of resources"); Robert L. Birmingham, \textit{Breach of Contract, Damage Measures, and Economic Efficiency}, 24 \textit{Rutgers L.J.} 273, 284-86 (1970) (arguing that regulations for reasons of economic efficiency may be socially desirable); Frank J. Cavico, Jr., \textit{Punitive Damages for Breach of Contract—A Principled Approach}, 22 \textit{St. Mary's L.J.} 357 (1990) ("In addition to permitting and encouraging contract parties to make efficient
With respect to the covenant of good faith, however, the parties cannot determine before entering into the contract what conduct will constitute a breach because that determination depends on the circumstances as they exist at the time of the conduct.\textsuperscript{211} The policy of allowing the parties to know the risks they are assuming would not, therefore, be promoted by limiting damages for breach of the covenant to those that were foreseeable at the time of the contract's formation. Furthermore, unlike breach of the contract's other terms, breach of the covenant under the proposed standards will always be reasonably avoidable because it is never inadvertent.\textsuperscript{212} Nor are violations of the covenant ever justifiable.\textsuperscript{213} Therefore, there is no reason to limit plaintiff's recovery merely because her losses could not have been foreseen at the time of the contract's formation. This rule allows plaintiff to receive compensation that approaches the extent of her breaches, the law, by implication, should also deter inefficient breaches\textsuperscript{214}; suggesting that expansive liability be limited in a manner that only deters inefficient breaches\textsuperscript{215}; Diamond, supra note 203, at 453-54; Thomas A. Diamond & Howard Foss, Consequential Damages for Commercial Loss: An Alternative to Hadley v. Baxendale, 63 FORDHAM L. REV. 665, 679-80 (1994); George K. Gardner, An Inquiry into the Principles of the Law of Contracts, 46 HARV. L. REV. 1, 32 (1932) ("The law affords only such remedies for breach of promise as seem most likely to promote the orderly and efficient conduct of the community's economic life."); Andrew L. Merritt, Damages for Emotional Distress in Fraud Litigation: Dignitary Torts in a Commercial Society, 42 VAND. L. REV. 1, 29 (1989) ("the law does not wish to discourage 'efficient' breaches of contract"); Joseph H. Sommer, The Subsidiary: Doctrine Without a Cause?, 59 FORDHAM L. REV. 227, 254 (1990) ("Contract law is designed to foster efficient breach . . . .").

\textsuperscript{211} There is one exception. When defendant's conduct violates the standard relating to precontractual nondisclosure of contemplated injurious conduct, defendant will know at the time of formation of the contract precisely what conduct will be in violation of the covenant. Theoretically, therefore, under the nondisclosure standard, defendant's liability should be limited to those damages that were foreseeable at the time of formation. However, defendant's nondisclosure, having prevented plaintiff from being able to assess her risks at the time of formation, should disqualify him from arguing that the proposed expansion of liability is unfair in that it deprives him of an opportunity to accurately assess his own risks.

\textsuperscript{212} Except for the standard prohibiting unconscionable conduct, all of the proposed standards require either that defendant had reason to know of the circumstances that made his conduct violate the covenant or that defendant engaged in deliberate deceit. Therefore, his violations are never inadvertent. As for the standard prohibiting unconscionable conduct, defendant will not be found to violate the standard unless his conduct was on its face manifestly unreasonable. See, e.g., Citizens Ins. Co. v. Proctor & Schwartz, Inc., 802 F.Supp. 133, 145 (W.D. Mich. 1992), aff'd, 15 F.3d 558 (6th Cir. 1994); Long Island Lighting Co. v. Transamerica Delaval, Inc., 646 F. Supp. 1442, 1458 (S.D.N.Y. 1986); In re Marriage of Stadheim, 523 N.E.2d 1284, 1287 (Ill. App. Ct. 1988); Adams v. John Deere Co., 774 P.2d 355, 362 (Kan. Ct. App. 1989). Therefore, by the very nature of his conduct, defendant will have reason to know that his conduct is violative of this standard as well.

\textsuperscript{213} Breach of the covenant is never justifiable in that by definition conduct in violation of the proposed standards necessarily falls below minimum acceptable levels of cooperation or integrity.
losses\textsuperscript{214} and deters impermissible conduct by requiring defendant to take into account post-formation circumstances affecting the consequences of breach.\textsuperscript{215}

As an alternative or supplement to compensatory damages, plaintiff may be able to enjoin defendant from violating the covenant

\textsuperscript{214} The trend in contract law is toward full compensation of losses. As business conditions have changed, as profits have come to be recognized as central to business value, and as economic analysis has shown that expectation damages are both fair and efficient, the artificial limits classical contract law placed on expectation damages and lost profits have gradually been falling away, and contact law has been moving toward the goal of full compensation. Melvin A. Eisenberg, \textit{The Principle of Hadley v. Baxendale}, 80 \textit{Cal. L. Rev.} 563, 612 (1992).

The expectation measure of damages is the preferred measure under the U.C.C., which provides that its remedies should be interpreted so that “the aggrieved party may be put in as good a position as if the other party had fully performed.” U.C.C. § 1-106(1) (1994). Section 1-106(1) adds a caveat, however, that consequential damages may not be had “except as specifically provided in this Act or by other rule of law.” U.C.C. § 1-106(1) (1994). Section 2-715(2) of the U.C.C., which provides the standard for when consequential damages may be recovered under the Sales Article, has been interpreted as limiting such damages to those that were foreseeable at the time of formation of the contract. See, e.g., Troxler Elecs. Lab., Inc. v. Solitiron Devices Inc., 722 F.2d 81, 84-85 (4th Cir. 1983); Anna Ready Mix, Inc. v. N.E. Pierson Constr. Co., 747 F. Supp. 1299, 1304 (S.D. Ill. 1990); Lenox, Inc. v. Triangle Auto Alarm, 738 F. Supp. 262, 266 (N.D. Ill. 1990); Sun-Maid Raisin Growers v. Victor Packing Co., 194 Cal. Rptr. 612, 614 (Ct. App. 1983); Cricket Alley Corp. v. Data Terminal Sys., Inc., 732 P.2d 719, 724-25 (Kan. 1987). Nonetheless, because U.C.C. § 1-106 permits consequential damages as specifically provided by “rule of law,” it can be argued that a judicially created rule of law permitting recovery of consequential damages for breach of the covenant of good faith to encompass those that were foreseeable at the time of breach would be in compliance with the U.C.C. See Roy Ryden Anderson, \textit{In Support of Consequential Damages for Sellers}, 11 J.L. & Com. 123, 148 (1992) (arguing that the “rule of law” provision of U.C.C. § 1-106(1) gives courts authority to award sellers consequential damages despite the fact that U.C.C. § 2-715(2)(a) apparently affords that remedy only to buyers).

This standard is similar to the tort standard of liability under which damages are recoverable if they were foreseeable at the time of defendant’s tortious conduct. See, e.g., Perrin v. Hilton Int’l, Inc., 797 F. Supp. 296, 299 (S.D.N.Y. 1992); Rosh v. Cave Imaging Sys., Inc., 32 Cal. Rptr. 2d 136, 141 (Ct. App. 1994); Doe v. Sisters of the Holy Cross, 895 P.2d 1229, 1234 (Idaho Ct. App. 1995); Andrepont v. Lake Charles Harbor & Terminal Dist., 602 So. 2d 704, 709-10 (La. 1992).

Although it is proper to expand liability for breach of the covenant of good faith, there must be limits on plaintiff’s recovery to avoid the disruptive and potentially catastrophic consequences that could follow if defendant were required to compensate plaintiff for damages that far exceeded what could have been contemplated at the time of breach. See Diamond & Foss, \textit{supra} note 210, at 700 n.157.

through the equitable remedy of specific performance. Plaintiff would have to establish that the legal remedy was inadequate, as would be the case when damages from defendant's violation of the covenant could not be measured with sufficient certainty. Additionally, a court will balance the equities in determining whether to grant specific performance. In ordinary contract breaches, a court may deny this remedy if it would cause defendant to suffer undue hardship or would cause injustice. Seldom, however, will the equities balance in defendant's favor when the breach involves a violation of the covenant of good faith. Such a breach is necessarily willful and unjustified, and defendant would be unable to show that denying him the ability to profit from his violation of the covenant would result in undue hardship.

For example, if the franchisor's new restaurant would materially injure plaintiff in violation of the covenant, she may be entitled to enjoin the opening of that restaurant. Because the amount of damages plaintiff would incur is difficult to measure with sufficient certainty and because enjoining a willful, unjustified violation of the covenant would not cause an undue hardship to defendant, the remedy of specific performance should be available.


220. See supra note 212 and accompanying text.

221. See supra note 213 and accompanying text.

222. A court may also choose to deny specific performance for practical reasons, such as when the contractual relationship demands too high a level of cooperation between the parties to continue that relationship against one of the parties' will. See, e.g., Woolley v. Embassy Suites, Inc., 278 Cal. Rptr. 719, 727 (Ct. App. 1991) (refusing to reinstate wrongfully terminated hotel manager); Chady v. Solomon Schechter Day Sch., 645 N.E.2d 983, 986 (Ill. App. Ct. 1995) (refusing to reinstate wrongfully terminated elementary school teacher); Goldfarb v. Robb Report, Inc., 655 N.E.2d 211, 219 (Ohio Ct. App. 1995) (refusing to reinstate wrongfully terminated franchisee).
Conclusion

This article, in addition to resolving issues concerning waiver of the covenant and remedies for its violation, has proposed a series of specific standards to determine when conduct violates the covenant. The proposed standards provide a structure that will substantially reduce the ad hoc decision making necessitated by current approaches.

Adoption of the proposed standards would not require the courts to abandon the terminology of the current approaches; the standards give content and meaning to the ambiguous terms utilized by those approaches. Under the foregone opportunities approach, for example, conduct would be deemed a foregone opportunity only if it violated any of the proposed standards. Under the purpose approach, conduct that violated any of the proposed standards would be deemed inconsistent with the parties' contractual purpose. In the same manner, the proposed standards define what constitutes the reasonable expectations of the parties, the fruits of the contract, justice, commercial reasonableness, and honesty.

The addition of the proposed standards will substantially reduce the confusion surrounding the applicability of the covenant of good faith. By diminishing the need for ad hoc decision making, the standards will allow parties to more intelligently assess the risks they are undertaking and to adjust their conduct accordingly, thus reducing the likelihood of breach and litigation. Although the standards may not answer all questions regarding the scope of the covenant of good faith, it is hoped that they will serve as a framework upon which a cohesive body of rules can be established.