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GOOD FAITH UNDER THE UNIFORM COMMERCIAL CODE—A NEW LOOK AT AN OLD PROBLEM

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INTRODUCTION

Every contract and duty included under the umbrella of the Uniform Commercial Code[1] imposes upon the parties thereto "an obligation of good faith in its performance or enforcement."[2] This obligation of good faith is without question one of the key sections of the Code.[3]

Furthermore, this obligation of good faith is one of the few requirements that cannot be varied by agreement between the parties, although "the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable."[4]

Because the definitions of "good faith" set forth in the Code are very broad, and because the guidelines are few, much confusion has resulted in determining what the term means in actual practice and how it should be applied.

The hypotheses of this article are that: *a*) the requirement of good faith under the Code is, in effect, a firm, far-reaching directive to the

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[1] Good faith is a requirement of many non-Code transactions, as well. Bankruptcy Courts, for example, have broad equity powers, and there are several important good faith provisions in the Bankruptcy Act. See L. Salter, *The Bankruptcy Court and the Creative Imagination.* 75 Com. L. J. 221 (1970), and Cont. Ill. Nat'l. Bk. v. Chicago R. I. & P. Ry. 294 U.S. 648 (1935), Local Loan Co. v. Hunt, 292 U.S. 234, 240 (1934), and 1 REMINGTON ON BANKRUPTCY §22, pages 44, 46.

[2] Uniform Commercial Code (hereinafter cited as U.C.C.) § 1-203. "Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement." Through judicial interpretation, the obligation of good faith extends to the performance *and* enforcement of code transactions.

[3] E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code,* 30 U. CHI. L. REV. 666 (1963), hereinafter cited as Farnsworth ,"Good Faith.'

[4] U.C.C. §1-102 (3). "The effect of provisions of this code may be varied by agreement except as otherwise provided in this code and except that the obligations of good faith, diligence, reasonableness and care prescribed by this code may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable."

business community; *b*) parties to a commercial transaction must conduct their business in a just and a moral manner, within the framework of generally accepted prevailing business practices and aware of what is happening; *c*) they "must beware", just as buyers and sellers in retail transactions "must beware";[5] *d*) the day has passed when courts will close their eyes to the facts involved and enforce a contract or transaction because it was purportedly entered into between seemingly knowledgeable and experienced businessmen who considered themselves to be in an equal bargaining situation when they entered into the transaction or agreement.

This article will point out the statutory and common law requirements of good faith. It will then demonstrate the confusion that has resulted from the attempts to define and redefine the term "good faith" so that the definition can have a broad, universal meaning which can be applied to all fact situations. Several non-Code areas will be mentioned where the "good faith" principle has been applied. Some of the burden of proof and evidentiary problems will be explored. The conclusion will then be drawn.

Requirements for "Good Faith"

The basic statutory "good faith" requirement for all Code transactions is set forth in Sec. 1-203, in the General Provisions Chapter. It states, "Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement."

"Good faith" is then defined in Sec. 1-201 (9) as "Honesty in fact in the conduct or transaction concerned."

The 1962 official text with comments points out that there are additional requirements. See, e.g. Secs. 2-103 (1) (b), 7-404.[6]

One of the sections setting forth additional requirements is Sec. 2-103, pertaining to Sales, which intends to give a somewhat more limited definition of good faith, defining it as follows:

> "Good faith" in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.[7]

It is evident that the definition of good faith in Sec. 2-103, for all practical purposes, is as nebulous as the definition in Sec. 1-201 (19). Nonetheless, the concept of good faith is of paramount importance in all Code transactions, as many counselors and clients have learned after underestimating its potency.

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[5] See Eisenberg, *Let the Seller Beware—A New Concept Under the U.C.C.*, 72 Com. L. J. 349 (1967).

[6] UNIFORM COMMERCIAL CODE, 1962 OFFICIAL TEXT WITH COMMENTS, The American Law Institute and the National Conference of Comm'rs on Uniform State Laws (1963), at 27, hereinafter cited as U.C.C. 1962 OFF. TEXT WITH COMMENTS.

[7] U.C.C. §2-103 (1) (b)

The importance of the good faith doctrine was clearly pointed out by Professor E. Allan Farnsworth when he illustrated that "there is an express mention of 'good faith' in some fifty out of the four hundred sections of the Code."[8] An example of how the doctrine can be of vital importance in a specific fact situation can be imagined by reading Sec. 2-311 (1):

> An agreement for sale which is otherwise sufficiently definite (s. 2-204 (3)) to be a contract is not made invalid by the fact that it leaves particulars of performance to be specified by one of the parties. Any such specification must be made in good faith and within limits set by commercial reasonableness.

In addition, there are numerous sections of the Code that do not expressly mention "good faith", but in which the concept is implied and is required. An example is Sec. 2-601, Buyer's rights on improper delivery:

> Subject to Sec. 2-612 on breach in installment contracts and unless otherwise agreed under ss. 2-718 and 2-719 on contractual limitations of remedy (ss. 2-718 and 2-719), if the goods or the tender of delivery fail in any respect to conform to the contract, the buyer may
> (a) reject the whole; or
> (b) accept the whole; or
> (c) accept any commercial unit or units and reject the rest.

In reference to this section, the official comment says: "Changes: Partial acceptance *in good faith* is recognized. . . ."[9] (emphasis added)

In addition to the statutory requirements of good faith are similar requirements imposed by the courts. These common law good faith requirements are reiterated with regularity. A good example is the recent case of Beaugureau v. Beaugureau[10] in which the Arizona Court of Appeals declared:

> In every agreement there is an implied covenant of good faith and fair dealing, i.e. an implied obligation by each party to cooperate with the other so that he may obtain the full benefit of performance. Such implied terms are as much a part of a contract as are the expressed terms. (cited cases omitted)

WHAT IS "GOOD FAITH"

One would think that because the good faith requirement is pervasive throughout the Code, a series of definitions and guidelines would be given. That is not the case, however. No guidelines are given, and the definitions, as previously pointed out, are broad and nebulous. It is

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[8] Farnsworth, *Good Faith* supra note 3 at 667.
[9] UNIFORM LAWS ANNOTATED, U.C.C. Vol. 1, P. 355 (West, 1968).
[10] 11 Ariz. App. 234, 463 P.2d 540 (1970). For an interesting discussion of requirements contracts and the termination thereof, see Squillante, *Common Law Bankruptcy and Requirements Contracts*, 75 COMM. L. J. 164 (1970).

therefore only natural to expect that legal scholars and trial judges would look for universal guidelines and more specific definitions which could be applied whenever the "good faith" issue was raised. Needless to say, that is what happened.

Judges were faced with the difficult choice of either refining the definitions in the Code so as to have them apply to as many situations as possible and to try to develop a set of guidelines, or to decide each case solely on the basis of the facts at hand, and base each case solely on principles of equity with regard to other decisions, definitions, and guidelines. Most judges understandably were reluctant to take the latter approach since they realized that good faith in the final analysis would be simply what a judge said it was, and that what would be considered to be a fair business transaction in one community would be held to be just the opposite in another locality, even if the same litigants and the same fact situation were involved, and even if the parties were in agreement as to the moral basis of the transaction.[11]

The result was further confusion.

[11] It is not difficult to comprehend the importance of this problem. Suppliers of merchandise do not want to be put in a position whereby they must defend lawsuits in other communities throughout the country when purchasers claim that the seller failed to meet the good faith requirement at some point in the transaction.

This problem is now being resolved by two methods. First, when there is a written contract, the seller specifies that the law in his state shall govern the transaction.

Second, effective "long-arm statutes" are being passed by state legislatures. A creditor is thus able to bring an action in his native state and county, with local judges passing upon the various aspects of the transaction.

A good example of such a statute in the new §410..10 of the California Code of Civil Procedure. According to Gorfinkel and Lavine, in their article *Long-Arm Jurisdiction in California Under New Section 4v0 10 of the Code of Civil Procedure,* 21 HASTINGS L. J. 1163, 1165 (1970), it is "the most comprehensive long arm statute of any state." It simply states:

> "A court of this state may exercise jurisdiction on any basis not inconsistent with the Constitution of this state or of the United States."

A thorough analysis of the legal basis for this California statute is found in the "Comment—Judicial Council", West ANNOTATED CAL. CIVIL PROC. CODE (Supp. 1970 at 94).

Other states have statutes which are meant to accomplish essentially the same purpose An example is WIS. STAT. §262.05. It states, in part:

> "A court of this state having jurisdiction of the subject matter has jurisdiction over a person served in an action pursuant to Sec. 262.06 (either within or without this State) under any of the following circumstances . . . :
>
> (5) Local Services, Goods, or Contracts.
> In any action which:
> (a) Arises out of a promise made anywhere to the plaintiff or to some third party for the plaintiff's benefit, by the defendant to perform services within this state or to pay for services to be performed in this state by the plaintiff; or . . .
> (b) Arises out of a promise, made anywhere to the plaintiff or some third party for the plaintiff's benefit, by the defendant to deliver or receive within this state or to ship from this state goods, documents of title, or other things of value; or . . .
> (c) Related to goods, documents of title, or other things of value shipped from this state by the plaintiff to the defendant on order or direction. . . ."

DICTIONARIES

Perhaps the first source to which the judges and attorneys looked for a workable definition of "good faith" was the law dictionaries. Since the dictionaries themselves give definitions which quote from cases, the accepted definition in the dictionary would depend on what source the editors would accept as authoritative.

One of the most quoted definitions of "good faith" comes from Bouvier's Law Dictionary.[12] This is the often-quoted definition generally credited to *Warfield Natural Gas Co. v. Allen,*[13] in which the definition appears. It states:

> (Good faith is an) honest intention to abstain from taking any unconscientious advantage of another, even through the forms and technicalities of law, together with an absence of all information or benefit of facts which would render the transactions unconscientious.

The leading definition in Black's Law Dictionary[14] was take from *Siano v. Helvering*:

> Honesty of intention and freedom from knowledge which ought to put the holder upon inquiry.[15]

The next definition in Black's Law Dictionary is the quote from *Warfield v. Allen.*[16]

A somewhat different approach is taken in Ballentine's Law Dictionary.[17] It gives different definitions for different areas of law. For example, the definition of "good faith" used for cases involving the issuance of stock is different than the definition used in cases involving acceptance of a forged check.

OTHER STANDARD REFERENCE BOOKS

There is no section directly on point in Williston on Contracts.[18]

Perhaps for the same reason that Williston has so little, *Words and Phrases*[19] has numerous entries. Several of the definitions are as follows:

Several years ago it was pointed out in the perceptive article *Developments in the Law, State—Court Jurisdiction,* 73 HARV. L. R. 909, 1007-8, 1014, that such statutes were feasible, and that states were "taking advantage of the available opportunities" as a result of the United States Supreme Court "redefining the constitutional limitations on state jurisdiction."

[12] BOUVIER'S LAW DICTIONARY, P. 1359 (3rd Ed., West, 1914).

[13] 248 Ky. 646, 59 S.W. 2d 534, 538 (1933). Although the decision, of course, antedates the Code, the definition is often used in Code cases.

[14] at page 822. West (Rev. 4th Ed., 1968).

[15] 13 F. Supp. 776, 780, (D.C.N.J., 1936).

[16] Warfield v. Allan, supra note 13.

[17] W. S. Anderson, Editor, Lawyers Co-Op & Bancroft-Whitney at 258 (3rd Ed., 1969).

[18] WILLISTON ON CONTRACTS (Rev. & 3rd Ed., 1957, 1970). There are some sections which discuss "good faith" in specific situations, e.g. the "effect of vendor's (good faith) upon measure of damages in land sale contract". 11 WILLISTON ON CONTRACTS § 1399 (3rd Ed., 1968).

[19] 18A WORDS AND PHRASES 83-131 (West, 1956).

> Generally speaking, "good faith" means being faithful to one's duty or obligation.[20]
> Good faith is the opposite of fraud and of bad faith, and its non-existence must be established by proof.[21]
> Good faith, in the popular sense, is used to denote the actual existing state of mind, without regard to what it should be from given standards of law or reason.[22]
> Good faith includes not only personal upright mental attitude and clear conscience, but also intention to observe legal duties.[23]

Corbin on Contracts,[24] like Williston, has no section right on point. Several sections do discuss various aspects of the problem, however, particularly in situations involving contractors.[25] No attempt is made to define "good faith", or to show when and how it must be used or applied.

Professor Gilmore, in his outstanding work, Security Interests in Personal Property,[26] limits his comments on "good faith" to the following:

> (A buyer under Sec. 9-3-7 (2)) "is of course subject to the general obligation of 'good faith' which the Code imposes on all transactions (Sec. 1-203)...."

In the Restatement of Contracts,[27] there is no specific heading under "good faith", but an example is given in the section on reformation, in which reformation is permitted when one party knows that the writing doesn't express the intention of the other party, and also knows what the intention of the other party is.[28]

Good Faith as an "Excluder"

Professor Robert S. Summers, in an intelligently conceived, well written and thought provoking article,[29] takes the following position:

> Good faith, as judges generally use the term in matters contractual, is best understood as an "excluder"—a phrase with no general meaning or meanings of its own. Instead, it functions to rule out many different forms of bad faith.[30]

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[20] Hilker vs. Western Automobile Ins. Co. of Ft. Scott, Kan., 204 Wis. 1, 13, 235 N. W. 413, 414 (1931).
[21] McConnel v. Street, 17 Ill. (7 Peck) 253, 254 (1855).
[22] Seymour v. Cleveland, 9 S.D. 94, 68 N.W. 171, 173 (1896), citing Wright v. Mattison, 59 U.S. (How.) 50, 56 (1855).
[23] Fujikawa v. Sunrise Soda Water Works Co., 158 F.2d 490, 494 (9th Cir., 1946).
[24] 1 CORBIN ON CONTRACTS § 150 (West, 1963).
[25] CORBIN ON CONTRACTS § 644-5 (West, 1960).
[26] G. Gilmore, SECURITY INTERESTS IN PERSONAL PROPERTY 717, (Little Brown & Co., 1965).
[27] RESTATEMENT OF THE LAW OF CONTRACTS, A.L.I. (1932).
[28] Id. at § 505, "Reformation Where A Mistake of One Party Is known to the Other." ". . . (with various exceptions) if one party at the time of the execution of a written instrument knows not only that the writing does not accurately express the intention of the other party to the terms to be embodied therein, but knows what that intention is, the latter can have the writing reformed to that it will express that intention."

Continuing in the same article, Professor Summers states:

> In a particular context the phrase takes on specific meaning, but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out.[31]

He then says:

> (T)he typical judge who uses this phrase is primarily concerned with ruling out specific conduct, and only secondarily, or not at all, with formulating the positive content of a standard. Good faith, then, take on specific and variant meanings by way of contrast with the specific and variant forms of bad faith *which judges decide to prohibit.* . . . (emphasis added) Likewise, the judge who sees that good faith functions as an excluder should not waste effort formulating his own reductionist definitions. Instead, *he should characterize with care the particular forms of bad faith he chooses to rule out;* bad faith rather than good wears the pants in this dichotomy.[32] (emphasis added)

Professor Summers' idea raises several questions. If, as he suggested, a judge should "characterize the particular forms of bad faith he chooses to rule out", couldn't he as easily formulate guidelines for acceptable conduct? Wouldn't both approaches be applicable to some situations which arise, but the specific characterizations of objectionable forms of bad faith could be endless.

Furthermore, is "good faith" simply what a judge says it is? Wouldn't each judge, in such a system, determine what his own personal standards are and apply them to the case at hand, even if the litigants themselves have different standards which they both agree upon and which they agree were taken into consideration when they entered into the transaction? Wouldn't such a system create a great deal of litigation

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[29] Robert S. Summers, *Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code,* 54 VA. L. REV. 195 (1968), hereinafter cited as Summers, "Good Faith".

A somewhat similar approach was taken by M. P. Ellinghaus in his article *In Defense of Unconscionability,* 78 YALE L. J. 759 (1968-9) in which the concept of "good faith" was called "something Pound would have termed a 'standard,' in contrast to a 'rule,' 'principle' or 'conception' (quoting Pound, *The Theory of Judicial Decision,* 36 HARV. L. REV. 641, 645-46 (1923). Ellinghaus also says that these standards are "closely (though not perhaps exclusively) tied to the maintenance of 'residual categories'." He continues, quoting T. Parsons, THE STRUCTURE OF SOCIAL ACTION 17 (1937):

> "If, as is almost always the case, not all of the actually observable facts of the field, or those which have been observed, fit into the sharply, positively defined categories, they tend to be given one or more blanket names which refer to categories negatively defined. . . ."

The Ellinghaus article then continues:

> The maintenance of such residual categories—'reasonable', 'due care', and 'good faith' are obvious if maximally dissimilar examples—is essential to the well-being of any system, and serves to counteract its inherent tendency to become logically closed.

[30] Id. at 262.

[31] Id. at 200.

[32] Id. at 202 to 207.

because one party to the contract decides to break and realizes that he has nothing to lose by raising the "good faith" issue, hoping that notwithstanding what he thought, the judge might see the facts otherwise and rule for him?

Each judge would then be tempted to formulate his own unique rules and code of conduct. The Uniform Commercial Code would not be uniform at all, and chaos in the good faith field would result. The sad fact is that even now, the decisions on good faith are far from uniform.

It seems unlikely to this writer that the sophisticated scholars and practicing attorneys, who drafted the Code before "long arm statutes" were as developed as they are now,[33] would permit large manufacturers in the metropolitan areas to be put at the mercy of rural county judges across the country, or vice versa, whenever the parties were involved in disputes over good faith conduct. It is evident that the drafters of the Code believed that uniform decisions in the good faith area could come about so that under ordinary circumstances businessmen in one part of the nation could transact business without fear of their counter-parts a good distance away.

It is unlikely that the Code would ever be uniformly interpreted if each judge would "characterize the particular forms of bath faith *he* chooses to rule out," which must be done when good faith is treated as an "excluder". It was succinctly pointed out in *Pace Electronic Supplies, Inc. v. Triton* that "(I)n order, in fact, to have a uniform commercial code operate it should be substantially uniform in practice."[34]
That objective cannot be obtained if each judge set his own standards and decided his cases according to his own individual views.

Historical Analysis

Shortly after the first several states adopted the Code, Professor E. Allan Farnsworth wrote an excellent article on the concept of "good faith" and commercial reasonableness under the Code.[35] The purpose of the article as it applied to "good faith" was to give an historical analysis of the concept, and to explain the term in its present context in the Code. No attempt was made to resolve the problems which Professor Farnsworth saw would, and did, develop.

Professor Farnsworth showed that the term "good faith" has been used for many years.

Field used it in his Civil Code;[36] Chalmers, in the British Bills of Exchange and Sales of Goods Act; Crawford, in the Negotiable Instruments Law, and Williston, in the Uniform Sales Act. . . . Under the

[33] See *Supra* note 11.
[34] Cir. Ct. Milwaukee County, Wis. (1968), 5 UCC Rep. 1102.
[35] Farnsworth, "Good Faith", supra note 3 at 667-8.
[36] FIELD'S CIVIL CODE Sec. 642 (New York State Comm'rs' Draft of a Civil Code for the State of New York (1862)).

Labor-Management Relations Act of 1947, employer and union are bound to 'confer in good faith';[37] under the Bankruptcy Act a petition for a Chapter X reorganization must be filed in "good faith" . . .[38]

After analyzing the concept of good faith, Professor Farnsworth took the position that the term "good faith" is used in the Code in two fundamentally separate senses.[39] First, and in the larger group of provisions, the term describes "good faith purchase".

> Here "good faith" is used to describe a state of mind. A party is advantaged only if he acted with innocent ignorance or lack of suspicion. This meaning of "good faith" is very close to that of lack of notice. . . .[40] In addition, the Code also uses "good faith" —as did prior law—in substantially the same sense in protecting others than purchasers, and these situations will be included in this discussion under the generic term "good faith purchase".[41]

Professor Farnsworth continues:

> In a second and smaller group of Code provisions, "good faith" is used to describe performance or enforcement rather than purchase. In this sense "good faith" has nothing to do with a state of mind—with innocence, suspicion or notice. Here the inquiry goes to decency, fairness or reasonableness in performance or enforcement. This sense of the term may be characterized as "good faith performance" to distinguish it from "good faith purchase" and is the sense in which "good faith" is used in the general obligation of good faith. It is also the sense in which that term is used in a number of more specific sections.[42]
>
> (It results) in an implied term of the contract requiring cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations.[43]

Professor Farnsworth says, "The inclusion of an obligation of good faith performance in the Code revives an ancient, although largely forgotten, principle."[44] He traced the concept back to Roman Law. The

[37] Sec. 8 d, 61 Stat. 142 (1947); 29 U.S.C. § 158 (d) (1958).

[38] Sec. 141, 52 STAT. 887 (1938), 11 U.S.C. § 541 (1958); see also § 146, 52 STAT. 887 (1938), 11 U.S.C. § 546 (1958).

[39] Farnsworth, "Good Faith", *supra* note 3 at 667, 678.

[40] Id. at 668. Prof Farnsworth gives as an illustration the fact that being a holder in due course of a negotiable instrument requires a purchase in good faith. U.C.C. § 3-302 (1). Also see U.C.C. § 2-403 (1).

[41] Id. at 668. As an illustration, Prof. Farnsworth points out that "whether a warehouseman or carrier who receives stolen goods and redelivers them to the thief is protected as against the true owner depends, under the Code, upon whether he received and delivered them in good faith." U.C.C. § 7-404.

[42] Id. at 668. Here, as an example, Prof. Farnsworth refers to parties to a sales contract leaving price or performance terms open. U.C.C. § 2-505 (2), § 2-311 (1). Also see A. M. Squillante, *Common Law, Bankruptcy and Requirements Contracts,* 75 COM. L. J. 164 (1970).

[43] Id. at 669.

[44] Id. That statement notwithstanding, the term "good faith" and the concept often appeared in often-cited pre-Code cases, e.g. Docter v. Furch, 91 Wis. 464, 476, 65 N.W. 161, 164 (1895). In that case, involving the sale of land, the court, as usual, chose to frame a new definition of "good faith". It said that "good faith" means "honesty; absence of fraud, collusion or deceit; really, actually, without pretense."

concept, however, regularly appeared in the Bible,[45] and in various writings from Biblical times. It was written, "Let the property of thy fellowman be as dear to thee as thine own,"[46] "What is displeasing to thee, that do thou not to others,"[47] and "Thou shalt love thy fellow-man as thyself."[48]

What conclusion can be drawn from reviewing all of the definitions, essays, historical analyses, and various approaches taken by acknowledged experts and scholars? The main conclusion is that "good faith" means different things to different people at different times. The statutes are broad, the guidelines are few, and the variations in fact situations and apparent equities are many. It is no wonder that confusion has resulted, and that universal definitions although noble in design, have proven to be less than useful or practical.

What is needed is a new approach to the problems at hand and some "horizontal", rather than further "vertical" thinking. This author's suggestion is set forth later in the article under the "Analysis and Recommendation" heading. It is first necessary to illustrate other aspects of the problem and to detail further necessary background information.

When Good Faith Is Required During A Transaction

When must parties to a contract exercise good faith? All the time! Good faith is required at every point, from negotiations[49] through performance.

Professor Robert S. Summers, who did an impressive amount of research and an outstanding job of succinctly condensing a great volume of cases, pointed out[50] that the good faith concept may be invoked during negotiations;[51] where one party negotiates "without serious intent to contract";[52] "abuses the privilege to withdraw a proposal or an

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[45] *Exodus* xx 15. "Thou shalt not steal." According to established authority, "This Commandment has a wider application than theft and robbery." (J. H. Hertz, THE PENTATEUCH 299 [Soncino Press, London, 1960]). As M. Friedlander pointed out in commenting on the same Commandment in THE JEWISH RELIGION, P. 294 (Kegan Paul, Tranch, Trubner, & Co., Ltd. London, 1891), "There are transactions which are legal and do not involve any breach of the law, and which are yet condemned by the principles of morality as base and disgraceful. Such are all transactions in which a person takes advantage of the ignorance or embarrassment of his neighbour for the purpose of increasing his own property."

[46] *Aboth* ii 12.

[47] *Babylonian Talmud, Shabbath* 31 a.

[48] Leviticus xix 18.

[49] This is true even though § 1-203 imposes the good faith obligation in the "performance or enforcement" of a contract. The extension of the requirement in most instances to contract *negotiations* was brought about by judicial interpretation and decision which utilized other legal concepts and doctrines as well, e.g. promissory estoppel. cf. Hoffman v. Red Owl Stores, Inc., 26 Wis. 2d 683, 133 N.W.2d 267 (1965).

[50] Summers, "Good Faith," *supra* note 29 at 216.

[51] *Id.* at 216, 220.

[52] *Id.* at 221. As authority Prof. Summers cites Heyer Products Co. v. United States, 140 F. Supp. 409 (Ct. Cl. 1956).

offer";[53] or enters a deal "not intending to perform or recklessly disregards the prospective inability to perform";[54] or in the event of the "seller's disclosure of known infirmities in goods";[55] or if one party takes "advantage of another in driving a bargain."[56]

The issue of a lack of good faith also arises with regularity when a contract is, or should be, performed. Prof. Summers neatly categorized and detailed those breaches as follows: "evasion of the spirit of the deal";[57] "lack of diligence and slacking off";[58] "wilfully rendering only 'substantial' performance";[59] "abuse of power to specify a contract term";[60] "abuse of a power to determine compliance", that is, a party, without just cause, refusing to be satisfied;[61] and "interfering with or failing to cooperate in the other party's performance".[62]

Good faith must be exercised even after the contract has been performed if disputes arise. The parties must raise the disputes and attempt to resolve their grievances in good faith. It is both good common sense and the law that one of the parties can't conjure up a dispute,[63] or take advantage of the other person while settling the disagreements.[64] There are also numerous sections of the Code which require that, even when

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[53] *Id.* at 223. As authority Prof. Summers cites Hoffman v. Red Owl, *supra* note 49.

[54] *Id.* at 227. The cause of action could lie in deceit. Prof. Summers cites as authority Arentson v. Moreland, 122 Wis. 167, 99 N.W. 790 (1904).

[55] *Id.* at 228. If there is an active concealment of the truth, the cause of action lies in tort. Prof. Summers cites W. PROSSER, TORTS 711 (1964). On the other hand, if the non-disclosure is passive, the remedy would probably lie under the warranty provisions of the Code. Prof. Summers cites § 2-314 and § 2-315.

[56] *Id.* at 230. If the contract is unconscionable, Prof. Summers refers the reader to Scott v. United States, 70 U.S. 443 (1870) and Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965), 2 UCC REP. SERV. 955. If the "other party has no real alternative," he refers to Henningson v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960). "(I)f the other party is disinclined to read a printed form," refer to Klar v. H. & M. Parcel Room, Inc., 270 App. Div. 538, 61 N.Y.S.2d 285, aff'd 296 N.Y. 1044, 73 N.E.2d 912 (1947). If the "other party has inferior negotiating skill," refer to COLLINS, 1962 ANN. SURVEY OF AM. LAW 451, 459-62 (1963). If the "other party has a lack of knowledge," refer to Kellogg v. Iowa State Traveling Men's Ass'n., 239 Iowa 196, 211-12, 29 N.W.2d 559, 568 (1947). If the problem arises due to the "other party's emotional state," refer to Newman & Snell's State Bk. v. Hunter, 243 Mich. 331, 220 N.W. 665 (1928).

[57] *Id.* at 234. Prof. Summers cites Food Fair Stores, Inc. v. Blumberg, 234 Md. 21, 534-35, 200 A.2d 166, 174 (1964). See also 1 CORBIN ON CONTRACTS Sec. 150, P. 666, 3A CORBIN ON CONTRACTS §§ 644-45 (West, 1963).

[58] *Id.* at 235, citing Sylvan Crest Sand & Gravel v. United States, 150 F.2d 642, 644 (2nd Cir. 1945).

[59] *Id.* at 237, citing, as authority, A. CORBIN, CONTRACTS, ch. 36 (1960).

[60] *Id.* at 239, citing, as authority, Simon v. Etgen, 213 N.Y. 589, 107 N.E. 1066 (1915).

[61] *Id.* at 240, citing, as authority, O'Hare v. McGee, 116 Pa. Super. 318, 176 A. 525, 526 (1935).

[62] *Id.* at 241, citing as authority, Kehm Corp. v. United States, 93 F. Supp. 620 (Ct. Cl. 1950).

[63] Modern Dust Bag Co. v. Commercial Trust Co., 34 Del. Ch. 354, 104 A.2d 378 (1954). See also Sylvan v. United States, *supra* note 58.

[64] *See* Kellog v. Iowa State Traveling, *supra* note 56, and Hackley v. Headley, 45 Mich. 569, 574, 8 N.W. 511, 512 (1881).

there is a bona fide dispute, the notice of the dispute be given timely to the other concerned parties, and that measures be taken promptly to correct the defects and to mitigate damages.[65]

Although this section has referred primarily to sales, good faith is also required in all other commercial areas as well. For example, good faith in entering into an agreement to obtain commercial paper is a requisite to becoming a holder in due course.[66] There is no separate definition of "good faith" in Article 3 on Commercial Paper, although several other definitions are given.[67] The general definition of "good faith" in Sec. 1-201 applies to commercial paper.[68] Similar parallels can be found in other sections of the Code.

Related Legal Principles, Doctrines and Cases

There are many situations in which "good faith" is an issue, but good faith language is not used as such.[69] In other cases, good faith language is used, but the subject matter is of the type which is not covered in the code.

In the recent case of *Estate of Chayka,*[70] the good faith doctrine was held to apply to a probate matter involving joint, mutual and reciprocal wills by a husband and wife. In that case the husband died, and his widow then tried to give away the property which she received under the joint will. The Wisconsin Supreme Court held that the inter vivos transfer of a substantial portion of the property received under the will was "violative of the agreement of the parties, and *as a matter of law not made in* good faith." (emphasis added) The Court made the following statement which appears regularly in good faith cases:

"(T)he covenant of good faith . . . accompanies every contract."[71]

Good faith language often appears in promissory estoppel cases.[72] On the other hand, there are some cases such as those involving unjust enrichment matters where the issue of good faith is not raised even though it might be relevant.[73]

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[65] U.C.C. Secs. 2-508, 2-601, 2-602, 2-603, 2-605, 2-606, 2-607, 2-608, 2-609, 2-610, 2-612, 2-616, 2-702, 2-706. Sec. 2-609 (1) states, in part, "A contract for sale imposes an obligation on each party that the other's expectation of receiving eud performance will not be impaired."

[66] U.C.C. Sec. 3-302.

[67] U.C.C. Sec. 3-102.

[68] U.C.C. 1962 Off. Text with Comments, *supra* note 6 at 273.

[69] Cf. Kessler & Fine, Culpa in Contrahendo, Bargaining in Good Faith and *Freedom of Contract: A Comparative Study,* 77 Harv. L. Rev. 401, 408 (1964).

[70] 47 Wis. 2d 102, 106, 176 N.W.2d 561, 564 (1970).

[71] *Id.* at 107. The court cited 17 Am. Jur. 2d, Contracts § 256, P. 653, which states "Every contract implies good faith and fair dealing between the parties to it, and a duty of cooperation on the part of both parties." The court also cited Wis. Stats. § 401.203 (U.C.C. § 1-203), which states, Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement," and Wis. Stats. § 401.201 (19) (U.C.C. § 1-201 (19)), which defines good faith as "honesty in fact."

[72] Hoffman v. Red Owl Stores, Inc., 26 Wis. 2d 683, 133 N.W.2d 267 (1965).

[73] *See* Goff v. Mass Protective Ass'n., Inc. 46 Wis. 2d 712, 176 N.W.2d 576 (1970).

Good faith can play an important role in secured transaction cases. In *Thompson v. United States,*[74] the Court held that Section 85-1-203 (U.C.C. Sec. 1-203) "permits the consideration of the lack of good faith . . . to alter priorities which otherwise could be determined under Article 9."

In *Star Credit Corp. v. Molina,*[75] a consumer case involving the purchase of a refrigerator with subsequent assignment of the contract to a finance company with the usual provision preventing the buyer from asserting his defenses against the assignee (U.C.C. Sec. 9-206 (L)), the Court permitted the buyer to rescind for good faith reasons. The Court held that the assignee of the contract was "not an assignee of these contracts 'in good faith', and thus is not entitled to the 'cut-off' provisions of Sec. 9-206."

In another secured transaction case, the good faith doctrine was used to hold the filing of a financing statement to be ineffective. The debtor moved from one state to another. The secured party, before refiling in the new state, changed the signed copy of the financing statement that it had in its possession without obtaining the permission of the debtor. The court held that the secured creditor "showed a lack of good faith in attempting to continue the perfection of its lien." The refiling was held to be ineffective.[76]

Perhaps the most important use of the good faith doctrine came after World War I. The value of the German mark fell to less than a billionth of its value at the time of the armistice. The country was faced with the difficult problem of revaluating all debts to be consistent with the real purchasing power of the mark, even though the German government ordered that the mark be legal tender. According to Professor E. Allan Farnsworth, "(I)t was the obligation of good faith that was used as the principal basis of revaluation of debts."[77]

Kramer Heating & Mfg. Inc. v. United Bonding Ins. Co.,[78] is a recent case which definitely will have far-reaching effects. Although the term "good faith" was not mentioned as such in the decision, the concept was clearly responsible for the ruling. This was an action by a subcontractor to collect for work and materials against an insurance company under the terms of a performance bond. The attorneys for the insurance company attempted to raise an issue at the time of the trial which had not been raised either in the pleadings or in the pre-trial motions. The Court refused to permit the issue and the defense to be raised since it was not raised in the answer as an affirmative defense.

[74] 408 F.2d 1075, 1084 (8th Cir. 1969), 6 UCC Rep. 20.
[75] 298 N.Y.S.2d 570 (1969), 6 U.C.C. Rep. Serv. 70.
[76] *In Re* Parks, 16 Ohio Misc. 135 (U.S.D. Ct. N.D. Ohio 1908), 5 UCC Rep. 1107.
[77] Farnsworth, "Good Faith," *supra* note 3 at 679.
[78] 47 Wis. 2d 191, 177 N.W.2d 119 (1970).

The trial judge, Elliot N. Walstad, ruled in language which was approved by the Wis. Supreme Court:

> You have to apprise him (the opposing counsel) as to the issue raised. You haven't raised it as far as this court is concerned. I don't think you have raised it as far as the plaintff's counsel (is concerned). The plaintiff was concerned about it, as you knew. You can't lie back. Pleadings are supposed to apprise parties of the cause of action and what defense is to be raised. This isn't a game we are playing.[79]

The court, in effect, held that good faith among litigants and their attorneys requires that the issues involved and all defenses be disclosed at an appropriate time before the trial so that the opposition can study and analyze them, and be able to present its own case and defenses fully and fairly to the Court with time for adequate preparation.

Burden of Proof and Problems of Evidence

The burden of proof *of the allegations in the Complaint* rests upon the plaintiff.[80] It is not necessary, however, that the plaintiff allege in the complaint that good faith was an integral part of the transaction at each stage. That is an affirmative defense which must be raised by the defendant, if at all.

It is a well established doctrine that "every contract implied good faith and fair dealing between the parties to it . . ."[81] That doctrine is further fortified by decisions such as *H. P. Hood & Sons v. Heins,* in which the court in a case involving a performance contract, held:

> In all such business undertakings, an obligation of good faith is implied.[82]
> Finally, it has been stated, with authority, that:
> One is under no obligation to prove that which is not made an issue in the case by the pleadings. . . . Nor, in order to recover, need a party prove allegations which are immaterial as a matter of pleading.[83]

If the issue of good faith is raised by the defendant in his responsive pleadings, the burden of proof on that issue falls upon the defendant.

> The burden of proof is upon the defendant as to all affirmative defenses which he sets up in an answer to the plaintiff's claim or cause of action, upon which issue is joined, whether they relate to the whole case or only to certain issues in the case.[84]

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[79] *Id.* at 195-7, 177 N.W.2d at 122.
[80] Strictly speaking, the burden in proving the allegations of the complaint rests upon the plaintiff because the plaintiff asserts the affirmative of the issue set forth in the complaint, and because, if no evidence were given, the plaintiff would be unsuccessful in that situation. 29 Am. Jur. 2d Evidence §§ 127, 140.
[81] 17*A C.J.S.* Contracts § 318 at P. 187.
[82] 124 Vt. 331, 205 A.2d 561 (1964).
[83] 29 Am. Jur. 2d Evidence § 127.
[84] *Id.* at § 129.

The official comments to the 1962 text of the U.C.C. states:

> (I)n the Article on Sales, Section 2-103, good faith is expressly defined as including in the case of a merchant observance of fair dealing in the trade, so that throughout that Article, whenever a merchant appears in the case, an inquiry into his observance of such standards is necessary to determine his good faith.[85]

The purpose of the Comment appears to be to make it clear to the court that it can look into the question of good faith of its own volition should it choose to do so. It does not imply that a change is being made in the established rules of evidence and burden of proof by requiring good faith to be affirmatively pled by the plaintiff nor proved by him if the defense is not raised by the defendant (or by the court).[86]

If the issue of good faith is raised with respect to performance, the issue is generally decided by a jury.[87] Under certain circumstances, however, a judge can certainly rule on the issue as a matter of law.[88] The issue as to whether a party to a contract breached an implied covenant of good faith and fair dealing is ordinarily a question of fact.[89]

It is often difficult to prove a lack of good faith because of the rules of evidence. The defendant, in raising the affirmative defense, often finds it necessary to circumvent the parole evidence rule, which, according to Wigmore, states:

> Generally, parol evidence is inadmissible to vary, alter or contradict the terms of a writing which is a completely integrated legally operative instrument.[90]

Can a litigant allege a lack of good faith, and thereby circumvent the parol evidence rule and put into record testimony otherwise inadmissible but probably necessary to establish the defense? Looking at the same problem from the other end, can a judge refuse to permit testimony to be taken on a good faith question because the rules of evidence will be violated when there is nothing else in the record to substantiate the claim? Doesn't such testimony have to be permitted at some point,

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[85] U.C.C. 1962 TEXT WITH COMMENTS, *supra* note 6 at 27.

[86] An interpretation to the contrary apparently was responsible for the dictum giving an opposite view in Old Colony Trust Co. v. Penrose Industries Corp., U.S.D.C. E.D. Pa. (1968), 4 UCC Rep. 977, 996-7. This case involved the sale of collateral by asecured party under Article 9 of the Code. One of the issues involved the reasonableness of the sale of the collateral after default. The defendant, amongst other things, in effect questioned the good faith of the plaintiff. The court held that the "good faith" requirements of the Code carefully temper the "commerciably reasonable" test. The Court also said, "The *plaintiffs* must have shown 'honesty in fact' in the conduct or transaction concerned, Sec. 1-201 (19), as well as fulfill the pragmatic tests of commercial reasonableness. . . . The record in this case makes quite clear that *plaintiffs have carried their burden of showing their good faith.*"

[87] 17*A C.J.S.*, CONTRACTS § 630 (b) at P. 1270.

[88] See Estate of Chayka, 47 Wis. 2d 102, 176 N.W.2d 561 (1970. This case is mentioned in the section on "Related Legal Principles, Doctrines and Cases."

[89] Pernet v. Peabody Engineering Corp., 248 N.Y.S.2d 132 (1964).

[90] 9 WIGMORE EVIDENCE § 2425 (3rd ed., 1940).

since the judge often must be familiar with the conduct of the parties and the facts of what went on before the parties entered into the agreement in order to make a proper ruling on the good faith issue.

Unfortunately as of this time there are no appellate decisions on these points of law. It is only a matter of time before the issues are raised in an appeal and the case law develops. In the meantime there certainly is no reason why under ordinary circumstances the trial judge should not permit a fairly wide latitude in questioning, and reserve a ruling on the admissibility of the testimony until the testimony has developed to a point where an intelligent ruling can be made. Such a procedure is safe and usually causes few practical problems. If the judge desires, he can always excuse the jury while the preliminary testimony is taken, and thus avoid problems of instructing the jury as to excluded testimony.

Another question is how a judge is to determine whether or not a party acted in good faith when subjective tests are used. Blatant offenses are no problem, but cases involving major violations constitute the minority of lawsuits in which the issue is raised.

Various suggestions have been made as to what standards should apply. Invariably the emphasis is on objective standards, although objective standards are extremely difficult to formulate. In the final analysis, even the objective standards and objective tests have important subjective elements and underlying standards. Prof. Farnsworth took the following position:

> Good faith performance properly requires some objective standard tied to commercial reasonableness. As to good faith purchase, the case can be made for either the subjective test of *Lawson v. Weston*[91] ("the pure heart and the empty head"), or the objective test of *Gill v. Cubitt*[92] (must exercise the prudence and caution of a reasonable man). *The inquiry goes to a state of mind.* There is, at least on the face of it, nothing inherently implausible in a subjective standard looking to actual ignorance or lack of suspicion, and nothing inherently implausible in an objective standard looking to the ignorance or lack of suspicion to be expected of a reasonable man under the same circumstances. *Authority happens to favor the subjective* test in order to promote the circulation of goods and commercial paper.[93] (emphasis added)

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[91] 4 Esp. 56, 170 Eng. Rep. 640 (K.B., 1801). In that case Lord Kenyon introduced the following subjective test of good faith: "the pure heart and the empty head."

[92] 3 B. & C. 466, 107 Eng. Rep. 806 (K.B., 1824). In that case also involving commercial paper, the objective test, according to Prof. Farnsworth, replaced the substantive test. To meet the requirements of the objective test, a person was required to exercise the prudnce and caution of a rasonable man. (Query: what's a reasonable man? Is that test truly objective?)

[93] Farnsworth, "Good Faith," *supra* note 3 at 671.

Judges, in inquiring into the state of mind of the litigants, are then being asked to do exactly what highly skilled psychiatrists are reluctant to do.[94] The judges are handicapped even further by the rules of evidence, which are definitely not geared to having a judge make a psychiatric judgment of the litigants in a relatively short period of time. The nature of the trial itself is another factor which makes it very difficult for a judge to "inquire into the state of mind" of the litigants, as suggested.[95]

Analysis and Recommendation

It is difficult to overestimate the importance of the term "good faith" and the concept which it represents. The term and the concept are ubiquitous throughout the Code and are requirements of all commercial transactions.

Notwithstanding the foregoing, there now exists at least as much confusion about the term and the concept and their application as at any time in the past. Attempts to refine the definitions given in the Code and to establish universal standards and guidelines have only added to the problems. It is unlikely that any such refined definitions or universal standards will evolve since the term and the concept take on meaning from the situations in which they are applied. As the factual situations vary, so will the application of the concept and the nuances of the term and the concept.

Although it is probably an impossible task to frame universal definitions and standards of good faith, it is not at all a difficult task to keep in mind at all times what the *concept* is meant to accomplish, and what it requires of businessmen on a daily basis. It is a concept which has proven viable for thousands of years,[96] and a concept which serves as one of the bases of our civilized society.

It is the *concept* of the term which must always be stressed and applied, not standardized definitions, refined definitions, analyses of definitions and of terms. Courts and businessmen can deal with, and handle, concepts and understand them and work with them, without getting "hung up" on definitions, classifications, and rules with exceptions which only result in confusion.

The purpose of the term "good faith", and the reason why it pervades the Code, is to constantly remind the business community that it must act in a just and righteous manner, and that it must transact its business in a moral manner, within the framework of generally accepted

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[94] See L. J. Friedman, M. D., *No Psychiatry in Criminal Court,* 56 A.B.A.J. 242 (1970).

[95] See Jerome Frank, *On Lawsuits as Inquiries Into the Truth,* from Courts on Trial in E. London, editor, The Law as Literature, Simon & Schuster (New York, 1966).

[96] See "Historical Analysis," *supra.*

prevailing business practices, and that it must be aware of what is going on. If a businessman does not act in that manner, the courts are available to impose its judgment upon the litigants and to enforce or to refuse to enforce the commercial agreements as is just and equitable under the circumstances presented to the courts.

The concept, when applied on a day to day basis, is therefore a warning to the business community that in all of its dealings with others, it "must beware", just as buyers and sellers "must beware" in retail transactions.

The analyses of the term "good faith" should be within the context of what the concept is trying to accomplish, rather than setting forth numerous definitions and universal standards that are limited in practice. The business community should not be required to study definitions and analyses of definitions to come to a conclusion as to whether it is acting within the framework of the good faith provisions of the Code. That is what has caused the confusion, and that is what is not necessary and can be eliminated.

If businessmen cannot understand the concept and what it is attempting to accomplish, their education will have to come in non-legal, as well as legal areas. If a businessman is not certain what standards will apply to a transaction which he is entering into, he should make inquiry of the other parties, and he should make a full disclosure of his standards and intentions.

That is the least that can be expected of businessmen in a civilized society. That is also the only effective way that the term and the concept can be given their full meaning and application. That is the only path which can be taken to keep the concept both viable and practical.

CONCLUSION

The time has come when courts will no longer automatically enforce contracts and approve the business dealings of purportedly knowledgeable and sophisticated businessmen who considered themselves to be in equal bargaining positions when they entered into their business agreements. For a contract to be enforceable or a transaction to be approved by a court, the parties must have acted in good faith.

The Code is not promulgating a new concept. It is making it as clear as can be that this concept of good faith is a vital part of the moral structure of our society, and is a requirement of all business transactions. It cannot be ignored by either the business community or by the Bar and Bench. Good faith must be an integral part of all business transactions, and the term and the concept must be applied in a manner to give the term justice, to make it viable, and to permit the concept to be used on a day-to-day practical level.