Article 3 Demand Notes and the Doctrine of Good Faith

Carolyn M. Edwards

Follow this and additional works at: http://scholarship.law.marquette.edu/mulr

Part of the Law Commons

Repository Citation
Available at: http://scholarship.marquette.edu/mulr/vol74/iss3/7
ARTICLE 3 DEMAND NOTES AND THE DOCTRINE OF GOOD FAITH

CAROLYN M. EDWARDS

I. INTRODUCTION

Article 3 of the Uniform Commercial Code ("Code") governs the rights and liabilities of parties who sign negotiable instruments, including checks and promissory notes. Section 3-104 establishes the requirements that a writing must satisfy to fall within the scope of the Article. The principles contained in this section are virtually identical to those that existed under prior law. It is surprising, therefore, that from the time the Code was enacted by state legislatures, disagreement has existed over what rights and obligations flow between the maker of a note and its holder.

1. Article 3 covers commercial paper, including drafts, checks, certificates of deposit, and notes. It does not apply to money, document of title or investment securities. See U.C.C. §§ 3-103(1), 3-104 (1978). All Uniform Commercial Code references are to the 1978 version unless otherwise indicated.


3. Section 3-104(1) provides:
   (1) Any writing to be a negotiable instrument within this Article must
       (a) be signed by the maker or drawer; and
       (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and
       (c) be payable on demand or at a definite time; and
       (d) be payable to order or to bearer.
   U.C.C. § 3-104(1) (1978).

4. See Section 1 Uniform Negotiable Instruments Law (1896).

5. The National Conference of Commissioners on Uniform State Laws and the American Law Institute have approved changes to Article 3. For a discussion of these changes, see Robert G. Ballen et al., Commercial Paper Bank Deposits and Collections, and other Payment Systems, 46 BUS. LAW 1521 (1991). Section 3-108(a) of the Revised Article 3 provides that a promise is payable on demand if it "(i) states that it is payable on demand or at sight, or otherwise indicates that it is payable at the will of the holder, or (ii) does not state any time of payment." U.C.C. § 3-108(a) (1990).

6. Section 3-413(1) provides, "The maker or acceptor engages that he will pay the instrument according to its tenor at the time of his engagement or as completed pursuant to section 3-115 on incomplete instruments." U.C.C. § 3-413(1) (1978).
Today, attention is focused on the demand note.\(^8\) The classical definition of a demand note gives the holder of the note the right to call for payment at any time, with or without reason.\(^9\)

Numbers of debtors who have signed demand notes as makers have alleged that holders have called for payment in bad faith and that such calls have caused them to suffer severe and undue financial hardship.\(^10\) Debtors have argued that the principle of good faith, expressed in section 1-203,\(^11\) governs calls for payment and, therefore, creditors who fail to act in good

---

7. A holder is defined as "a person who is in possession of a document of title or an instrument or a certified investment security drawn, issued, or endorsed to him or his order or to bearer or in blank." U.C.C. § 1-201(20) (1978).

One disagreement flows from the provisions of section 1-208. Section 1-208 provides that if a note payable at a definite time, authorizes acceleration "at will" or when the holder "deems himself insecure" then the power to accelerate is to be exercised only in the good faith belief that the prospect of payment is impaired. See U.C.C. § 1-208 (1978). Courts have not agreed on the proper standard of good faith to be used. For a recent case which discusses the issue, see Watseka First Nat'l Bank v. Ruda, 135 Ill. 2d 140, 552 N.E.2d 775 (1990).

8. Section 3-108 provides that "[i]nstruments payable on demand include those payable at sight or on presentation and those in which no time for payment is stated." U.C.C. § 3-108 (1978). For a recent case that discusses whether a note is a time or demand instrument, see Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. Ct. App. 1986).

9. See U.C.C. § 3-122 and accompanying comments. In Fulton Nat'l Bank v. Willis Denney Ford, Inc., the court observed:

Thus, the only “duty” under the U.C.C. on a holder of a demand instrument is to seek enforcement of the instrument which is on its face “immediately” due and payable within the applicable statute of limitation . . . . The obligor, by his signature, has agreed that his obligation is on its face “immediately” due and payable and is subject to no contingencies. 154 Ga. App. 846, 849, 269 S.E.2d 916, 918 (1980).

10. In Centerre Bank v. Distributor Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985), the bank filed suit against the borrower and personal guarantors to collect the unpaid balance due on a demand note. The defendants counterclaimed and asserted that the evidence established an absence of good faith in demanding payment. A jury awarded over $7 million in actual and punitive damages to the defendants. The Missouri Appellate Court set aside the verdict on the ground that lack of good faith is not relevant to the call of a demand note. Id.

During the last decade, debtors initiated litigation designed to determine what rights and obligations exist in the debtor-creditor relationship. The cases involving demand notes represent only a small portion of the total number of cases which have appeared in the courts. For discussions on the topic of lender liability, see generally, Note, Lender Liability: Breach of Good Faith in Lending and Related Theories, 64 N.D. L. Rev. 273 (1988); Jonathan K. Van Patten, Lender Liability: Changing or Enforcing the Ground Rules? 33 S.D. L. Rev. 387 (1988).

11. Section 1-203 provides, “[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” U.C.C. § 1-203 (1978).

The comment to the section states, “[t]his section sets forth a basic principle running throughout this Act. The principle involved is that in commercial transactions good faith is required in the performance and enforcement of all agreements or duties.” U.C.C. § 1-203 cmt. (1978). Section 1-201(19) defines “good faith” as “honesty in fact in the conduct or transaction concerned.” U.C.C. § 1-201(19) (1978). Cf. Section 2-103(1)(b) which provides that “good faith” in the case of a merchant includes “observance of reasonable commercial standards of fair dealing in the trade.” U.C.C. § 2-103(1)(b) (1978).
DEMAND NOTES

faith\textsuperscript{12} should respond in damages. Courts, with few exceptions, have rejected this argument on the grounds that section 1-203 may not be applied to override the intention of the maker, who signed the instrument, to grant the holder the option to call for payment, with or without reason.\textsuperscript{13}

Although the controversy that surrounds demand notes is of recent origin, its roots extend far back into legal history. During the first half of this century, courts determined that in certain contract settings tension existed between the principles of good faith and freedom of contract. This tension was exposed when courts were asked to impose an obligation of good faith to limit or modify the expressed intention of the parties to a contract.\textsuperscript{14} Many courts eliminated the conflict by strict application of traditional contract rules which preserve private autonomy.\textsuperscript{15} Section 1-203, which grants express recognition to the concept of good faith performance and enforcement of contracts, ushered in a re-examination of the relationship between the two principles.\textsuperscript{16} In the decades that followed the adoption of the Code

\textsuperscript{12} See, e.g., Centerre Bank v. Distributor Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985), in which the debtor contended that the evidence showed bad faith in demanding payment of the note. The debtor argued, in part, that the creditor failed to disclose that it was concerned about the loan and that the loan was called only three days after personal guarantees were delivered to the creditor.

\textsuperscript{13} See infra note 73 and accompanying text.

\textsuperscript{14} Contracts which contained clauses granting the option to terminate at will were at the center of the debate. See, e.g., Bushwick-Decatur Motors, Inc. v. Ford Motors Co., 116 F.2d 675 (2d Cir. 1940) and cases cited therein. The question of whether there is an implied obligation to act in good faith in a contract relationship was seldom discussed by scholars during the first half of this century. Professor Robert S. Summers observed in his article published in 1968 that he was able to find only three general studies on the topic. Robert S. Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 VA. L. REV. 195, 196 (1968). On the other hand, the concept of good faith purchase received considerable attention. See Grant Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 YALE L.J. 1057 (1954).

\textsuperscript{15} The reluctance of some courts to apply principle of equity in contract relationships was evident in Martin v. Ford Motor Co., wherein the court stated:

Accordingly the court finds and concludes that . . . the provisions of the agreement dated October 20, 1944 with respect to termination were valid, effective and enforceable and by reason thereof defendant had the right to and did lawfully terminate said agreement and the dealership thereunder, and that such right to terminate was not subject to question on the ground of unreasonableness, unfairness, lack of good faith, bad faith or because of motive, intent or resultant detriment to plaintiff. . . . It is beyond the power of the judiciary to engraft conditions upon the exercise of such a contractual right.


\textsuperscript{16} A number of commentators have debated the scope of the section and the role that the principle of good faith should play in contract relationships. See Steven J. Burton, Good Faith Performance of a Contract Within Article 2 of The Uniform Commercial Code, 67 IOWA L. REV. 1 (1981); E. Allan Farnsworth, Good Faith Performance and Commercial Reasonableness Under the
by state legislatures, disagreement emerged over the scope of section 1-203 and the application of the principle of good faith to expressed contract terms. The question of whether calls for payment of demand notes are governed by this section has been at the center of the controversy.18

The purpose of this article is to examine some of the cases in which the conflict between freedom of contract and good faith was initially identified as well as those in which the proper scope of section 1-203 was called into question. These cases have provided the foundation for the conclusion reached by a number of courts in the last decade that the classical definition of the demand note has not been modified by the principle of good faith and, therefore, that the motives of a creditor in calling for payment are not subject to judicial scrutiny.19

A. Freedom of Contract and the Doctrine of Good Faith

Which promises, among all promises, ought our legal system enforce? Since the time of the Industrial Revolution, promises that compose either the formal contract or the informal contract have been deemed worthy of enforcement.20 These contracts provide the vehicles for the exchange of goods and services in the market place. The informal contract, which includes the bargain contract, depends upon an agreement and an exchange for its legal validity.21 The legal operation of the formal contract, including


17. Compare Baker v. Ratzlaff, 1 Kan. App. 2d 285, 564 P.2d 153 (1977) (good faith may be invoked to limit the exercise of a termination at will clause) with Smith v. Price's Creameries, 98 N.M. 541, 650 P.2d 825 (1982) (the principle of good faith is not applicable to a termination at will clause).

18. See infra notes 65-73 and accompanying text; see also Lawrence & Wilson, supra note 12.

19. On the other hand, a promissory note which is payable at a future date and contains a term providing that payment may be accelerated “at will” or when the holder “deems himself insecure” is subject to section 1-208. This section provides that the power to accelerate payment may be exercised only in the good faith that the prospect of payment is impaired. U.C.C. § 1-208 (1978).

The term “motive” is intended to include the circumstances that surround the call of a demand note. In other words, the classical definition of a demand note does not permit a court to examine any facts that surround a call to determine if the call was made in bad faith.

20. Formal contracts include contracts under seal, recognizances, negotiable instruments and documents, and letters of credit. Restatement (Second) of Contracts § 6 (1979). For a discussion of the differences between formal and informal contracts, see 1 CORBIN, CONTRACTS § 5 (1963). The Restatement recognizes that some promises are binding without consideration. The substantive basis for enforcement is usually reliance or unjust enrichment. See Restatement (Second) of Contracts §§ 82-94 (1979).

21. See Restatement (Second) of Contracts § 3 (1979).
the negotiable instrument, depends upon the form in which it is made.\textsuperscript{22} Thus, section 3-104\textsuperscript{23} sets forth the requirements for a writing to qualify as a negotiable instrument.

The rules that govern the formation, performance, and enforcement of the formal contract and the informal contact are different. Also, the law applicable to each has generally been treated as an independent subject.\textsuperscript{24} The principle of freedom of contract, however, is common to both. Freedom of contract has been defined as the power to decide whether or not to enter into a contract and to establish the terms of the contract.\textsuperscript{25} The principle, which gained express recognition during the Industrial Revolution, flows from the concept of laissez-faire and the notion that pursuit of enlightened self-interest promotes the common good.\textsuperscript{26} Thus, from the time contract law was in its infancy, the notion that individuals who enter the market place should determine their own needs and expectations and decide how to maximize their economic well-being has been at the core of contract theory.\textsuperscript{27}

Courts have always recognized that freedom of contract is preserved only if the sanctity of the contract is protected from arbitrary or capricious

\begin{itemize}
  \item \textsuperscript{22} See U.C.C. §§ 3-104 to -112 (1978).
  \item \textsuperscript{23} See supra note 2 and accompanying text. See also WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 3-104:02 (1984), for a discussion of the requirements that a writing must satisfy to qualify as a negotiable instrument.
  \item \textsuperscript{24} For an outline of the reasons why negotiable instruments law is treated as a distinct subject area, see 2 ALPHONSE M. SQUILLANTE & JOHN R. FONSECA, THE LAW OF MODERN COMMERCIAL PRACTICES §§ 5:1 to 5:3 (1980).
  \item \textsuperscript{25} An often quoted expression of the principle of freedom of contract states: \[ \text{[I]f there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of justice.} \]
  \begin{flushleft}
  Printing and Numerical Registering Co. v. Sampson, 19 L.R.-Eq. 462, 465 (1875) (Jessel, M.R.). The principle of freedom of contract has been discussed by numerous scholars. See, e.g., Friedrich Kessler, Contracts of Adhesion - Some Thoughts About Freedom of Contract, 43 COLUM. L. REV. 629 (1943); Karl N. Llewellyn, What Price Contract? - An Essay in Perspective, 40 YALE L.J. 704 (1931). The opportunity to bargain over terms to be included in a negotiable instrument is limited by Section 3-104 which sets forth the requirements for a writing to qualify as a negotiable instrument. Further, the insertion of certain terms may affect negotiability. See U.C.C. §§ 3-105, 3-112 (1978).
  \end{flushleft}
  \item \textsuperscript{26} Adam Smith was the principal proponent of the view that the pursuit of self-interest promotes the public interest. ADAM SMITH, THE WEALTH OF NATIONS 423 (E. Cannan ed., 1937).
  \item \textsuperscript{27} Courts have recognized that freedom of contract may not function in practice as it does in theory. For a discussion of the impact that the standardized contract has on the exercise of this freedom, see Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960).
\end{itemize}
Judicial interference.\textsuperscript{28} Judicial restraint is both necessary and desirable because contracts are deemed to be the result of free bargaining between the parties who have concluded that the terms of the contract satisfy their economic needs. In most instances, any hardship that flows from the performance or enforcement of a contract is a risk to be assumed and the price to be paid for the right to private autonomy.\textsuperscript{29}

After the turn of the century, markets for goods and services expanded and parties to contracts who asserted that they had suffered financial losses challenged the principle of judicial restraint. These parties demanded that the court displace the principle in order to mitigate their losses. These demands appeared initially in bargain contract transactions and often took one of two forms.

The first demand usually arose out of consumer transactions and focused on the contention that the contract, which had been entered into between parties of grossly unequal bargaining power, contained oppressive and unfair terms.\textsuperscript{30} By 1960, courts, in a number of cases, modified or invalidated unconscionable terms or contracts.\textsuperscript{31} Judicial action flowed from the recognition that freedom of contract was not exercised in circumstances where one party possessed superior bargaining strength and imposed terms

\textsuperscript{28} The refusal of courts to inquire into the adequacy of consideration, absent a claim of abuse in the bargaining process, illustrates the exercise of judicial restraint. \textit{See, e.g.}, Buckner v. McIlroy, 31 Ark. 631 (1877).

\textsuperscript{29} The principles were stated in Planters Nat'l Bank v. E.G. Heffin Co., Inc., 160 Va. 166, 173-74, 184 S.E. 216, 219 (1936).

Mere failure of consideration or want of consideration will not ordinarily invalidate an executed contract. The owner of the historic estate of "Blackacre" can give it away, and he can sell it for a peppercorn. Courts, though they have long arms, cannot relieve one of the consequences of a contract merely because it was unwise. They are not guardians in general to the people at large.

\textit{Id.}

\textsuperscript{30} Courts have been willing, on rare occasion, to police against oppressive and unfair contracts and contract provisions in commercial transactions. \textit{See} Ellen R. Jordan, \textit{Unconscionability at the Gas Station}, 62 MINN. L. REV. 813 (1978).

Most courts have concluded that oppressive terms must be combined with absence of meaningful choice to produce unconscionability. \textit{See, e.g.}, Goldstein v. S & A Restaurant Corp., 622 F. Supp. 139 (D.C. 1985). However, comments to Section 208 of the \textit{Restatement (Second) of Contracts} suggests that it is possible, at least in theory, for a contract to be unconscionable even though there "is no weakness in the bargaining process and no single term which is itself unconscionable." \textit{Restatement (Second) of Contracts} \textsection{208 cmt. c (1979)}.

\textsuperscript{31} Common law courts were reluctant to openly police bargains for unfairness. Often they would resort to various techniques, including manipulation of traditional contract rules, to grant relief from inequitable bargains. \textit{See} Jack W. Peters, \textit{Iowa Guardianships}, 45 IOWA L. REV. 336, 343 (1960). Courts of equity did not share this reluctance. \textit{See, e.g.}, Campbell Soup v. Wentz, 172 F.2d 80 (3d Cir. 1948).
upon the other party.\textsuperscript{32} Courts concluded that if these circumstances produced oppression and unfair surprise, displacement of the principle of judicial restraint did not destroy freedom of contract, but instead served to prevent its abuse.\textsuperscript{33}

The second demand for judicial action flowed from commercial transactions. The demand for judicial action was based on the claim that one party had acted in bad faith after performance of the contract had begun and that such action had caused the other party to suffer substantial and undue financial hardship. This claim often arose in situations in which a franchise or distributorship agreement had been terminated pursuant to a provision that authorized termination, with or without cause.\textsuperscript{34} In these factual settings, courts were unlikely to invalidate such clauses on grounds of unconscionability because courts seldom found gross inequality of bargaining power and absence of meaningful choice in commercial contexts. Therefore, the injured party, who believed that the termination was in bad faith, rarely relied upon the claim of unconscionability to mitigate losses flowing from the termination. Instead, the terminated party's principal argument was that the contract contained an implied obligation to act in good faith and that the adverse party had breached this obligation by exercising the option to terminate.\textsuperscript{35}

\begin{enumerate}
\item \textsuperscript{32} The recognition was that:

\begin{quote}
[T]he weaker party in need of the goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly (natural or artificial) or because all competitors use the same clauses. His contractual intention is but a subjection more or less voluntary to terms dictated by the stronger party, terms whose consequences are often understood in a vague way, if at all.
\end{quote}

Kessler, \textit{supra} note 25, at 632.

\item \textsuperscript{33} In Henningsen v. Bloomfield Motors, Inc., the court observed:

\begin{quote}
Freedom of contract is not such an immutable doctrine as to admit of no qualification in the area in which we are concerned. As Chief Justice Hughes said in his dissent in Morehead v. People of State of New York \textit{ex rel} Tipaldo, 298 U.S. 587, 627, 56 S. Ct. 918, 930, 80 L.Ed. 1347, 1364 (1936):

"We have had frequent occasion to consider the limitations on liberty of contract. While it is highly important to preserve that liberty from arbitrary and capricious interference, it is also necessary to prevent its abuse, as otherwise it could be used to override all public interests and thus in the end destroy the very freedom of opportunity which it is designed to safeguard."
\end{quote}

\textit{Henningsen}, 32 N.J. at 388, 161 A.2d at 86.

\item \textsuperscript{34} For a discussion of various types of termination clauses, including those which provide for termination upon notice, see McLaughlin & Jacobs, \textit{Termination of Franchises: Application of the Implied Covenants of Good Faith and Fair Dealing}, 7 \textit{FRANCHISE L.J.} 1 (1987).

\item \textsuperscript{35} Claims that termination clauses are unconscionable have been successful on occasion. \textit{See} Jordan, \textit{supra} note 30, at 813. Professor Gellhorn analyzes some of the cases in which evidence suggested that the motives for termination were to cause injury and discusses how financial losses
It is not surprising that termination at will clauses contained in commercial contracts were challenged in the courts. A party to a contract containing such a clause is deemed to reasonably expect termination at any time. Moreover, such clauses do not place any limitations on the motives or reasons for termination. Therefore, neither party can reasonably expect that termination will be for cause. However, reasonable expectations measured by contract theory do not mitigate the sense of inequity that exists when one party chooses to exercise the option to terminate without any warning and the other party, who incurs financial hardship, believes that the decision to terminate flowed from evil motives.

In scores of cases, courts addressed the question of whether a covenant of good faith ought to be invoked as a matter of equity to limit the exercise of an option to terminate at will. Two different views emerged. One of the leading cases to conclude that an obligation of good faith could be grounded on principles of equity was *Philadelphia Storage Battery Co. v. Mutual Tire Stores*. In *Philadelphia Storage*, the terminated party claimed that the option had been exercised in pursuance of a scheme to defraud him and he claimed damages to mitigate losses. The court concluded that though the option to terminate was unambiguous and valid it could only be exercised "in equity and good conscience."

Other courts, however, refused to inquire into the causes for termination where the contract language made such causes irrelevant. These courts determined that a conflict existed between good faith and freedom of contract and insisted that an obligation of good faith could be implied only if it was consistent with the objective intention of the parties. The comments of Ernest Gelhorn, *Limitations on Contract Termination Rights - Franchise Cancellations*, 1967 Duke L.J. 465, 466-74 (1967).

36. Where a contract contains no express provision for termination without cause, a good cause requirement for termination may be imposed. See, eg., Dayan v. McDonald's Corp., 125 Ill. App. 3d 972, 466 N.E.2d 958 (1984); Atlantic Richfield Co. v. Razumic, 480 Pa. 366, 390 A.2d 736 (1978).

37. Even though a contract expressly provides that it is terminable at will, some limitations may be imposed by a court on the exercise of the power to terminate. For an outline of these limitations, including that of notice, see Gelhorn, *supra* note 35, 478-79.

38. 161 S.C. 487, 159 S.E. 825 (1931).


40. Courts have not agreed on what language indicates that the parties intended to grant an option to terminate without cause. For an analysis of this disagreement, see McLaughlin & Jacobs, *supra* note 34, at 1.
the court in *Bushwick Decatur Motors, Inc. v. Ford Motor Co.*,\(^{41}\) illustrate the reasoning that appeared in many cases during the first half of this century. The court observed:

With a power of termination at will here so unmistakably expressed, we certainly cannot assert that a limitation of good faith was anything the parties had in mind. Such a limitation can be read into the agreement only as an overriding requirement of public policy. This seems an extreme step for judges to take.\(^{42}\)

According to the court, the express provisions of the contract made it clear that the parties intended to grant the power to terminate for any reason or for no reason. Application of the principle of good faith to modify termination at will would override this intention and conflict with the parties' reasonable expectations.\(^{43}\) Thus, motives for termination were deemed immaterial and hardship was viewed as a risk that flowed from the expressed terms of the contract.

Underlying the court's observation is the assumption that the contract provisions relating to termination reflected the will of both parties. This assumption served to distinguish, at least in part, the cases where the issue was one of good faith from those in which contract provisions were challenged on the ground that they were unconscionable. In factual settings where parties alleged that gross inequality of bargaining power resulted in oppressive and unfair contract terms, courts focused on the circumstances that existed at the time the contract was executed.\(^{44}\) On the other hand, in cases where the issue was whether an obligation of good faith should be imposed to govern termination at will, the attention of the court was usually directed to a later phase in the transaction. Unless one party claimed unconscionability, courts assumed that freedom of contract was exercised, at least to some degree, at the time the contract was executed. Indeed, some courts recognized that freedom of contract did not always function perfectly in an imperfect world where the bargaining power of parties to a contract unequal. However, once the assumption was made that this free-

---

41. 116 F.2d 675 (2d Cir. 1940). Courts that refuse to impose the principle of good faith to govern an express contract term may recognize a cause of action for bad faith dealing in the areas of insurance law and employment at will. See, e.g., Highway Equip. Co. v. Caterpillar, Inc., 707 F. Supp. 954, 958 n.2 (S.D. Ohio 1989), aff'd, 908 F.2d 60 (6th Cir. 1990).

42. *Bushwick*, 116 F.2d at 677.

43. *Id.*

44. The notion that unconscionability must exist at the time the contract is formed is recognized in section 2-302 of the Uniform Commercial Code and section 208 of the *Restatement (Second) of Contracts* (1979).
dom had not been abused by one party, the conclusion was drawn that judicial restraint must be applied to protect expressed intention.\textsuperscript{45}

Thus, prior to 1960 two different demands for judicial action emerged. These demands were designed to test contract theory as applied to contract practice. Only one of these demands was a direct challenge to classical contract theory and principles.\textsuperscript{46} As more courts addressed the question of what relationship ought to exist between freedom of contract and good faith in commercial contract settings, and to determine whether the principle of judicial restraint should be set aside, tension between the opposing views grew. In the decades to follow, it would become apparent how deeply ingrained this tension had become in judicial thinking.

It was against this background that state legislatures adopted the Uniform Commercial Code. Given this background, it was not surprising that a section which grants express recognition to the doctrine of unconscionability was included in Article 2.\textsuperscript{47} It was surprising, however, that express recognition was given in section 1-203 to the principle of good faith and to the concept of good faith performance and enforcement of contracts.\textsuperscript{48} Was the purpose of the section to override the view that expressed terms are not subject to modification by a covenant of good faith? The language of the section and the section’s accompanying comments suggested, at least at first glance, that the drafters had hoped to resolve the conflict that courts had identified between good faith and freedom of contract and to chart a new

\textsuperscript{45} The \textit{Bushwick} court recognized that the parties were not of equal bargaining strength. The court observed:

[\textit{W}e certainly cannot assert that a limitation of good faith was anything the parties had in mind. . . . The onerous nature of the contract for the successful dealer and the hardship which cancellation may bring him have caused some writers to advocate it. . . . But, generally speaking, the situation arises from the strong bargaining position which economic factors give the great automobile manufacturing companies: the dealers are not misled or imposed upon, but accept as nonetheless advantageous an agreement in form bilateral, in fact one-sided. To attempt to redress this balance by judicial action without legislative authority appears to us a doubtful policy. \\
\textit{Bushwick}, 116 F.2d at 677.

\textsuperscript{46} The doctrine of unconscionability has been criticized, however, on the grounds that it is contrary to freedom of contract and that it creates instability in the market place. For commentary on these criticisms, see 2 \textsc{Hawkland, Uniform Commercial Code Series} § 2-302 (1984).


\textsuperscript{48} During the first half of this century, scholars and courts focused primarily on the concept of good faith purchase. The concept of good faith performance and enforcement of contracts received only scant attention. \textit{See} Farnsworth, \textit{supra} note 16, at 670.
course in contract relationships. However, scholarly debates centering on the scope of the section and its impact on classical contract rules appeared immediately.\textsuperscript{49} In hindsight, the debates served as a warning that the section would be surrounded by controversy and that the question of whether the right to private autonomy ought to give way to at least some sense of fairness would continue to trouble the courts.

\textbf{B. The Uniform Commercial Code and Good Faith}

Within two decades of the Code's adoption, courts had decided a number of cases designed to test the limits of section 1-203. Given the controversy that had surrounded termination at will clauses before the Code was adopted, it was inevitable that many of these cases would focus on the question of whether such clauses, expressed in contracts governed by the Code,\textsuperscript{50} fall within the scope of the section.\textsuperscript{51} Disagreement emerged\textsuperscript{52} and it became apparent that many courts were convinced that freedom of contract would be in jeopardy and that the benefits flowing from the exercise of this freedom would disappear unless section 1-203 was limited in scope.\textsuperscript{53}

\textsuperscript{49} See generally Burton, \textit{supra} note 16; Farnsworth, \textit{supra} note 16; Summers, \textit{supra} note 16.
\textsuperscript{50} A number of courts have relied upon common law to read a good faith limitation into termination clauses. See, e.g., de Treville v. Outboard Marine Corp., 439 F.2d 1099 (4th Cir. 1971); Tele-Controls Inc. v. Ford Indus., Inc., 388 F.2d 48 (7th Cir. 1967).
\textsuperscript{51} The question of whether termination is either performance or enforcement within the meaning of section 1-203 has been debated. Compare Summers, \textit{supra} note 16, at 252 (to terminate is neither to perform nor enforce) with \textsc{Hawkland, Uniform Commercial Code Series} § 1-203 at 157 (1984) (termination should be covered by good faith). Courts have also discussed this question in demand note cases. In Centerre Bank v. Distributor Inc., 705 S.W.2d 42, 48 (Mo. Ct. App. 1985), the court observed that the call of a demand note "transcends the performance or enforcement of a contract. . . ." For a criticism of the court's position, see Lawrence & Wilson, \textit{supra} note 12, at 827-30.
\textsuperscript{52} Compare Baker v. Ratzlaff, 1 Kan. App. 2d 285, 564 P.2d 153 (1976) (section 1-203 may be applied to a termination at will clause) with Highway Equip. Co. v. Caterpillar, Inc., 707 F. Supp. 954 (S.D. Ohio 1989) (the principle of good faith is not applicable to expressed contract terms). A number of courts have pointed out that section 2-309(2) indicates that the drafters approved of termination at will clauses.
Termination of franchise contracts have prompted scores of cases and considerable discussion among the commentators over the usefulness of the good faith concept to curb abuses. See, e.g., Charles M. Hewitt, \textit{Termination of Dealer Franchise and the Code-Mixing Classified and Coordinated Uncertainty with Conflict}, 22 \textsc{Bus. Law.} 1075 (1967); Gellhorn, \textit{supra} note 35; Charles M. Hewitt, \textit{Good Faith or Unconscionability Franchise Remedies for Termination}, 29 \textsc{Bus. Law} 227 (1973).
Given the broad sweep of the section's language, how did some courts arrive at the conclusion that termination at will clauses are not within its scope? Unfortunately, courts were reluctant to offer an analysis of legislative intent. Instead, they relied upon the reasoning that had been developed in prior decades. In Corensweet, Inc. v. Amana Refrigeration, Inc.,\textsuperscript{54} for example, the court stated:

When a contract contains a provision expressly sanctioning termination without cause there is no room for implying a term that bars such a termination. In the face of such a term there can be, at best, an expectation that a party will decline to exercise his rights.\textsuperscript{55}

The court's comments have a familiar ring. The reasons courts had given in earlier decades for refusing to modify objective intention are the reasons offered to explain the conclusion that section 1-203 is limited in scope. In other words, the principle of good faith contained in section 1-203 is not to be applied in circumstances in which its application would change the reasonable expectations of the parties. Accordingly, termination at will clauses are not within the scope of the section. This interpretation of section 1-203 accomplished the same objective that the principle of judicial restraint had achieved in similar fact settings during the first half of this century. Judicial interpretation had replaced judicial restraint as the tool used to protect the exercise of freedom of contract. The court was not willing, however, to rely only on contract theory to support its conclusion. The court stated:

As a tool for policing distributorship terminations, moreover, the good faith test is erratic at best . . . . The better approach . . . is to test the disputed contract clause for unconscionability under section 2-302 of the Code. The question these cases present is whether public policy forbids enforcement of a contract clause permitting unilateral termination without cause. Since a termination without cause will almost always be characterized as a "bad faith" termination, focus on the terminating party's state of mind will always result in the invalidation of unrestricted termination clauses. We seriously doubt, however, that public policy frowns on any and all contract clauses permitting termination without cause. Such clauses can

\textsuperscript{54} 594 F.2d 129 (5th Cir. 1979).

\textsuperscript{55} Id. at 138. Although the court concluded that the principle of good faith does not apply to a termination at will clause, it did suggest that such a clause could be tested for unconscionability. Id. at 139. Compare Goldstein v. S & A Restaurant Corp., 622 F. Supp. 139 (D.C. 1985) (at will agreements which were a product of a meeting of the minds were not unconscionable) with Ashland Oil v. Donahue, 159 W. Va. 463, 223 S.E.2d 433 (1976) (ten day termination clause available only to Ashland Oil was Unconscionable).
DEMAND NOTES

have the salutary effect of permitting parties to end a soured relationship without consequent litigation.56

These comments indicate that the court relied upon practical considerations to buttress its conclusion. Thus, the decision to protect traditional values did not flow from an absent minded and rigid application of theory that fails to take market realities into account. Indeed, recognition was granted to the notion that contract practice does function as contract theory predicts to produce terms which meet the needs of parties who enter the commercial marketplace.57

Controversy over the scope of section 1-203 continued, however, and questions about the proper relationship between good faith and freedom of contract lingered.58 The controversy left the door open for new litigation. It was at this point that demand notes became part of the debate. The debtor who signs such a note is deemed to reasonably expect a call for payment at anytime, with or without reason.59 However, reasonable expectations may become pitted against the reality of hardship when a call is made and the circumstances suggest that the motives for demanding payment were arbitrary.60 It was inevitable, therefore, that some debtors would challenge the classical definition of the demand note on the same grounds that parties to bargain contracts had questioned termination at will clauses. Would the interpretation of section 1-203, which protects private autonomy, withstand another challenge from a different context? The demand note cases which contained claims that severe financial losses flowed from calls made in bad faith would test, once again, the commitment which many courts had expressed to classical contract principles.

56. Corenswet, 594 F.2d at 138-39. The court relied upon Professor Gellhorn's criticism of the principle of good faith as a tool to prevent abuses in termination. Id.; see Gellhorn, supra note 35, at 465.

57. Corenswet, 594 F.2d at 138-39.


59. In Allied Sheet Metal Fabricators, Inc., v. Peoples Nat'l Bank, 10 Wash. App. 530, 535 n.5, 518 P.2d 734, 738 n.5 (1974), the court observed that though the facts surrounding the calls for payment of the notes "might raise questions as to the bank's business judgment, they create no factual issue as to the bank's right to do what it did, and so are not material facts."

60. See, e.g., Pavco Indus. v. First Nat'l Bank, 534 So. 2d 572 (Ala. 1988), in which the debtor claimed that the creditor had agreed to modify the contract so that payment could be demanded only if the debtor's financial condition deteriorated and that when the creditor unexpectedly demanded payment the debtor incurred substantial costs to obtain the balance due.

In a number of cases, the facts relied upon to establish bad faith are not presented. See, e.g., Fulton Nat'l Bank v. Willis Denney Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980).
C. Demand Notes and the Principle of Good Faith

Negotiable instruments law dates from the eighteenth century. The law has always recognized that freedom of contract functions, at least to some degree, in formal contract transactions.\(^1\) The focus of the law, however, has been on the need to promote the marketability of commercial paper.\(^2\) In order to ensure marketability, the law establishes rights and obligations between parties to negotiable paper.\(^3\) At the time the Code was adopted, courts acknowledged that some of these rights and obligations caused debtors to suffer severe and undue financial hardship. They were reluctant, however, to tamper with rules that were designed to make credit available at reasonable costs.\(^4\) Thus, the principal purpose of judicial restraint as it functioned in negotiable instruments law was to serve the needs of the credit market.

Judicial reluctance to interfere with the principles established in Article 3 created a seemingly insurmountable barrier against changes in established rules. However, the debate which surrounded the scope of section 1-203 offered a glimmer of hope that the courts would render the traditional definition of the demand note obsolete.\(^5\) One of the first cases to consider the

---

\(^1\) For a case which illustrates that debtors and creditors have power to bargain over various terms without affecting the negotiability of the writing which evidences the debt, see Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986).


\(^3\) See, e.g., U.C.C. § 3-305 (1978) which sets forth the rights of a holder in due course.

\(^4\) In the decade following the Code's adoption, a number of cases illustrated the hardship that was created when a finance company or bank to which a consumer note had been negotiated held the note free of the consumer's contract defenses. See, e.g., Universal C.I.T. Credit Corp. v. Ingel, 347 Mass. 119, 196 N.E.2d 847 (1964). However, only a limited number of jurisdictions applied the close connectedness doctrine which subjected the finance company or bank to such defenses. See, e.g., Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967).

At the time debate focused on the use of the holder in due course doctrine in consumer credit transactions, concerns were expressed that changes in existing principles might affect the availability of consumer credit. See Albert J. Rosenthal, Negotiability - Who Needs It?, 71 Colum. L. Rev. 375, 378-85 (1971). Concerns about the availability of credit and its cost continue today. For example, courts have noted that some debtors would not be able to secure financing at any cost were it not for the protection that the demand feature of a demand note offers lenders. See, e.g., Taggart & Taggart Seed, Inc. v. First Tenn. Nat'l Bank, 684 F. Supp. 230, 236 (E.D. Ark. 1988).

\(^5\) In a number of cases, courts have determined that the instruments in question are not true demand instruments and that the principle of good faith governs the creditor's performance. See, e.g., Reid v. Key Bank of S. Maine, Inc., 821 F.2d 9 (1st Cir. 1987); In re Martin Specialty Vehicles, Inc., 87 B.R. 752 (Bankr. D. Mass. 1988), rev'd, 97 B.R. 721 (D. Mass. 1989); Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. Ct. App. 1986).
claim that section 1-203 governs calls for payment of demand notes was Fulton National Bank v. Willis Denney Ford, Inc. The court rejected the debtor's argument on the ground that:

the only "duty" under the UCC on a holder of a demand instrument is to seek enforcement of the instrument which is on its face "immediately" due and payable within the applicable statute of limitation. There is no reason why the obligor on an "immediately" due and payable instrument should be entitled to contest the holder's decision to enforce payment anytime within the statute of limitation as being in "bad faith." The obligor, by his signature, has agreed that his obligation is on its face "immediately" due and payable and is subject to no other contingencies. Qualifying that obligation by requiring that the holder demonstrates his "good faith" in seeking payment can have no beneficial result for either the holders or makers of demand instruments. As noted, a demand instrument by its "very nature permits call at anytime with or without reason." Interference with that commercial "nature" of demand notes is to be avoided.

The conclusion that the principle of good faith does not apply to a call for payment and, therefore, that the motives of a holder in making a call are not subject to judicial scrutiny was based on the same reasoning which many courts had used in the termination at will cases to protect private autonomy. The principle of freedom of contract, which had laid dormant for decades in negotiable instruments law, had surfaced to limit the application of section 1-203 and to preserve the classical definition of the demand note. In hindsight, it is not surprising that the court adopted an analysis which had been developed and refined for use in the bargain contract context. Although the rules which govern the formal and the informal contract are generally different, the question of whether the principle of good faith should govern expressed contract terms arises in both contexts. Underlying the court's conclusion is the assumption that the demand note does not possess any characteristic which might require that a response be tailored for the particular context. Once the court made this assumption, the court's only task was to choose between existing viewpoints.

The case went virtually unnoticed until 1985 when the conclusion drawn by the court was called into question. In K.M.C. v. Irving Trust

A creditor's refusal to advance funds allegedly resulted in the collapse of the debtor company. In its opinion, the court stated:

We agree . . . that just as Irving's discretion whether or not to advance funds is limited by an obligation of good faith performance, so too would be its power to demand repayment. The demand provision is a kind of acceleration clause, upon which the Uniform Commercial Code and the courts have imposed limitations of reasonableness and fairness.

The court made no reference to section 1-203, relying instead on section 1-208. Reliance on section 1-208 was misplaced for the section applies only to time paper which grants the power of acceleration. Nevertheless, other courts and commentators interpreted the comments as an approval of a good faith limitation on payment calls. The comments prompted extensive scholarly debate and a number of cases appeared in the courts that focused on the question of whether the traditional definition of the demand note remains intact.

Today, K.M.C. stands virtually alone. Most courts that have addressed the question have accepted the conclusion drawn by the court in Fulton and have invoked the principle of private autonomy to limit the scope of section 1-203. The courts, however, have not relied solely upon contract theory to reach their conclusion. The courts have adopted the same approach used in the termination at will cases and have emphasized

68. 757 F.2d 752 (6th Cir. 1985).
69. Id. at 760.
70. The comment to section 1-208 states: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at anytime with or without reason." U.C.C. § 1-208 cmt. (1978); see also Flagship Nat'l Bank v. Gray Distrib. Systems, Inc., 485 So. 2d 1336, 1341 (Fla. Ct. App. 1986), in which the court observed, "[w]e refrain from following K.M.C. because we find that the court's citation of sec. 671.208, which is inapplicable to demand notes, renders its holding somewhat suspect."
71. For the position that the K.M.C. court reached a correct result, see Lawrence & Wilson, supra note 12.
72. The case of In re Martin Specialty Vehicles, Inc., 87 B.R. 752, 765 (Bankr. D. Mass. 1988) involved a writing which the court determined was not a demand note. However, the court appeared to challenge the view that good faith does not apply to the call of such notes on the grounds that the clear statutory language of section 1-203 should override the drafters' comments to section 1-208.
the needs that demand notes meet in commercial lending markets.\textsuperscript{74} The demand feature of these notes has generally been regarded as having certain benefits for those who seek commercial loans as well as for those who offer them. This feature gives the creditor who has possession of the note maximum leverage over the debtor.\textsuperscript{75} Without the protection of this leverage, creditors would not be willing to lend to some debtors.\textsuperscript{76} In other words, demand notes make credit available to those who would not otherwise be able to borrow. Once again, judicial recognition is given to the notion that contract theory and practice are consistent and that the exercise of freedom of contract, though limited in formal contract settings by the principles contained terms that satisfy the economic interests of both parties.\textsuperscript{77}

Why has a consensus emerged over the scope of section 1-203 as applied to demand notes while debate continues in other areas? One explanation lies in the comments to section 1-208. These comments provide:

Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason. This section applies only to an agreement or to paper which in the first instance is payable at a future date.\textsuperscript{78}

\textsuperscript{74} In Taggart & Taggart Seed, Inc. v. First Tenn. Nat'l Bank, 684 F. Supp. 230, 236 (E.D. Ark. 1988), the court refused to apply the principle of good faith to a demand note. The court observed:

The plaintiffs in this case are in no position to argue ignorance of the true nature of the contract. They are sophisticated businessmen and were assisted in the loan negotiations by an attorney and an accountant. In the court's view it is very likely that, were it not for the demand feature, the loan may never have been made in the first instance. And given the materiality of the demand provisions, the court will not undertake to eviscerate the contract without clear and convincing evidence of fraud. There is no such evidence here.

\textit{Id.}

\textsuperscript{75} For a discussion of the leverage that demand notes give a lender, see Hillis, \textit{supra} note 2, at 720-23.

\textsuperscript{76} The court in \textit{In re} Red Cedar Constr. Co., Inc., 63 B.R. 228, 238 n.7 (Bankr. W.D. Mich. 1986) observed:

A holding by this Court that the Court of Appeals in \textit{K.M.C.} intended to include within the scope of its notice rule obligations "whose very nature permits call at any time with or without reason" might seriously limit the availability of "at will" financing, without which many of the most troubled (and needy) commercial entities would be unable to obtain credit. We would not read that unnecessary result into the \textit{K.M.C.} decision, and we would not create a rule on our own which would produce such a result.


\textsuperscript{77} \textit{See} Blanchard v. Progressive Bank & Trust Co., 413 So. 2d 589, 591 (1982), in which the court concluded that the plaintiff had executed a demand note and that "[t]he plaintiff may not avoid an obligation merely by contending that provisions were not read and explained to him or that he did not understand them."

\textsuperscript{78} U.C.C. § 1-208 cmt. (1978).
The comments suggest that the drafters intended to preserve the classical definition of the demand note. If this definition is to be preserved, section 1-203 must be narrowly interpreted. The impact of these comments must not be underestimated. Given the number of courts which have relied upon them, the conclusion is inescapable that the comments have been a critical factor in tipping the scales in favor of one interpretation of section 1-203, at least in demand notes cases.

The demand note cases have become important for two reasons. First, the cases have focused attention on the role that freedom of contract plays in formal contract transactions. In the past, courts had neglected this role and concentrated on the need to ensure the marketability of commercial paper. However, this attention has not been to the debtor's advantage. It would appear that the only tool which remains to challenge the terms of a demand note is the doctrine of unconscionability and the likelihood of this challenge succeeding in a commercial context, where some degree of freedom of contract is usually exercised, is remote. Secondly, the rights and obligations that flow between the maker of a demand note and as holder have been clarified and the risks that debtors face as makers of such notes have been exposed. Indeed, the cases have highlighted these risks.

Is the law allowing injustice to occur? Courts have often identified injustice in our legal system and either manipulated rules to avoid it or recommended legislative action. In the demand note cases, courts have not been persuaded to modify traditional rules nor have they indicated that reform is necessary. What does this silence mean? Do the courts believe that undue hardship of intolerable proportions has not been created and that financial losses suffered when a call for payment is made are simply the price to be paid to preserve the availability of credit? Have they concluded that injustice does occur, but determined that existing theories, including unconscionability, are not usually appropriate to test contract provisions


80. Section 2-302, which recognizes the doctrine of unconscionability, applies only to contracts which fall within the scope of Article 2. U.C.C. § 2-302 (1978). Contracts which are not governed by the Article may be tested for unconscionability under section 208 of the RESTATEMENT (SECOND) OF CONTRACTS (1979).

81. For example, the unexpected call of a demand note may make it difficult, if not impossible, to obtain the funds necessary to pay the balance due. See Pavco Indus. v. First Nat'l Bank, 534 So. 2d 572 (Ala. 1988).
agreed to by parties in commercial transactions? Unfortunately, questions linger. If the courts are unwilling to act, should reforms by the legislature be demanded? Debtors are not organized to pressure legislators and any change in existing principle would be opposed by financial institutions.

Although changes in the law may not be forthcoming, potential debtors are in a better position today to understand the rights and obligations that exist once a demand note is executed and to evaluate the financial risks which may flow from a call for payment that is made without warning. Indeed, the holder's right to call for payment at any time, with or without reason, may be the most crucial factor in determining whether the transaction is a financial success or failure for the debtor. Hopefully, an understanding of potential risks will not deter those who wish to finance commercial ventures from seeking necessary capital. It would be ironic if the law ensured the availability of credit while at the same time it discouraged borrowing.

II. Conclusion

The conclusion drawn in the demand note cases that the classical definition remains intact will continue to cause controversy as financial hardship suffered by debtors collides with fundamental contract principles and theory. It is apparent, however, that this conclusion flows from principles established in cases decided decades earlier. These cases identified the issues that surrounded the application of good faith to contract relationships. At first glance, the question of whether calls for payment are governed by the principle of good faith does not appear to be an unusually difficult one to resolve. This appearance is deceiving because the question does, in fact, trigger issues that have been debated by the courts for at least a century. Today, it seems that the conclusion that calls for payment may be made with or without reasons is firmly entrenched. If any comfort is to be taken from this conclusion, it is simply that the commitment to preserving the traditional structure of contract law and to protecting the exercise of freedom of contract has not waivered.

82. For an interesting discussion of the circumstances that warrant application of the doctrine of unconscionability to a commercial transaction, see American Nursery Prod., Inc. v. Indian Wells Orchards, 115 Wash. 2d. 217, 797 P.2d 477 (1990).

Comment c to section 208 of the Restatement (Second) of Contracts suggests that it is possible, at least in theory, for a contract to be oppressive even though weakness in the bargaining process did not exist.