

# Implied Terms and Good Faith

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The parties obligations can originate from various sources. The sections on interpretation and the parol evidence rule focus on terms that the parties agreed to explicitly, mostly in their written agreements, as well as promises that were made separately, for example, during the negotiation process, that might be part of the parties' contract. In this section, we focus on a different source of contractual terms: implied terms (sometimes referred to as "constructive terms") that were not agreed to explicitly by the parties.

While contracts are voluntary, and while the main terms of a contract are for the parties to agree upon, implied terms are unavoidable. The contracts that parties agree to are never complete. Too many things might happen during performance, and it will be a waste of resources for the parties to reach an agreement regarding every such possible contingency. In an agreement over the sale of goods, for example, the goods may be lost at sea, or their production might be delayed because of a strike or a global pandemic, or their market price might change. The parties might negotiate how to perform their contract under some of those circumstances, but they are unlikely to explicitly agree in advance how to tackle each and every one of those possibilities. They might try and renegotiate and agree on how to handle certain contingencies once they happen. But once that fails, the burden shifts to courts to try and fill those gaps in the parties' explicit agreement.

The notion of implied terms is closely related to that of default rules. When a court needs to fill a gap in a contract it can provide an ad hoc solution. For example, it can look at the parties before it and tries to assess what they were most likely to agree to if they would have considered the issue they left open (an approach sometimes referred to as *hypothetical bargaining*) and/or what is the fair and just term to read into their contract. Such an approach to gap-filling is possible, but a complete de novo determination of the parties' rights in every dispute concerning a contractual gap can be problematic for various reasons, including the uncertainty and the high litigation costs that it would entail. Luckily, because some types of gaps tend to appear in many contracts, courts have developed standard approaches to fill many common gaps. Over time, those standard approaches, those precedents, become default rules: off-the-shelf implied terms that courts use any time a common gap is encountered. From the parties' perspective, the existence of such default rules indicates how courts would fill standard gaps, which saves the parties resources in negotiating those arrangements on their own.

The caselaw is just one source of default rules. Statues are another. The UCC, for example, includes multiple terms concerning the performance that the parties can contract around if

they choose to do so. For example, Section 2-308(a) states that “unless otherwise agreed,” goods will be delivered at the seller’s place of business, and if it has none, at his residence. We will see additional multiple examples of UCC default rules later in this chapter.

Professor Alan Farnsworth lists five “representative” implied terms that courts often read into contracts. ALAN FARNSWORTH, *CONTRACTS*, § 7.17. We will encounter three of them in this chapter: terms imposing a duty to use best efforts, terms concerning the termination of a contract, and the implied duty to perform contracts in good faith. The other two common (and extremely important) types of implied terms have to do with the order of performance and with the circumstances under which performance will be excused. Those will be discussed in the chapter on performance and breach.

Implied terms can sometimes play a role during contract formation as well. While courts mostly use their gap-filling power when a situation arises during performance that the contract does not explicitly address (e.g., can the seller deliver goods a week late when it was delayed because of a pandemic?), implied terms can also be useful in deciding whether a contract was formed at all. In particular, implied promises can be the consideration for the other side’s explicit promise, and they can add volume to the contract, thus addressing a possible indefiniteness problem. We will see examples of those situations later in this chapter. As such, the materials in this chapter are especially module and can be tackled in various parts of your study of contract law.

## A. Implied Terms Under The Common Law

To get a feel for implied terms, take a look at two cases in which the New York Court of Appeals essentially decided to add terms to a written contract.

### **Haines v. City of New York**

364 N.E. 820 (New York Court of Appeals 1977)

GABRIELLI, J.

In the early 1920’s, respondent City of New York and intervenors Town of Hunter and Village of Tannersville embarked upon negotiations for the construction of a sewage system to serve the village and a portion of the town. These negotiations were prompted by the city’s need and desire to prevent the discharge of untreated sewage by residents of the area into Gooseberry Creek, a stream which fed a reservoir of the city’s water supply system in the Schoharie watershed.

In 1923, the Legislature enacted enabling legislation authorizing the city to enter into contracts with municipalities in the watershed area “for the purpose of providing, maintaining [and] operating systems and plants for the collection and disposal of sewage.” . . .

The negotiations culminated in an agreement in 1924 between the city and intervenors. By this agreement, the city assumed the obligation of constructing a sewage system consisting of a sewage disposal plant and sewer mains and laterals, and agreed that “all costs of construction and subsequent operation, maintenance and repair of said sewerage system with the house connections thereof and said disposal works shall be at the expense” of the city. The agreement also required the city to extend the sewer lines when “necessitated by future growth and building constructions of the respective communities.” . . .

It is interesting to here note that a modification of the original agreement occurred in 1925 wherein the village agreed to reimburse the city for a specified amount representing the expense of changing the location of certain sewer lines. The plant was completed and commenced operation in 1928. The city has continued to maintain the plant through the ensuing years and in 1958 expended \$193,000 to rehabilitate and expand the treatment plant and facilities.

Presently, the average flow of the plant has increased from an initial figure of 118,000 gallons per day to over 600,000 gallons daily and the trial court found that the plant “was operating substantially in excess of design capacity.” The city asserts, and it is not disputed by any of the parties in this action, that the system cannot bear any significant additional “loadings” because this would result in inadequate treatment of all the sewage and consequently harm the city’s water supply. The instant controversy arose when plaintiff, who is the owner of a tract of unimproved land which he seeks to develop into 50 residential lots, applied to the city for permission to connect houses, which he intends to construct on the lots, to existing sewer lines. The city refused permission on the ground that it had no obligation to further expand the plant, which is presently operating at full capacity, to accommodate this new construction.

Plaintiff then commenced this action for declaratory and injunctive relief, in which intervenors town and village joined as plaintiffs, maintaining that the 1924 agreement is perpetual in duration and obligates the city to expend additional capital funds to enlarge the existing plant or build a new one to accommodate the present and future needs of the municipalities. . . .

We conclude that the city is presently obligated to maintain the existing plant but is not required to expand that plant or construct any new facilities to accommodate plaintiff’s substantial, or any other, increased demands on the sewage system. The initial problem

encountered in ascertaining the nature and extent of the city's obligation pursuant to the 1924 agreement, is its duration. We reject, as did the courts below, the plaintiff's contention that the city is perpetually bound under the agreement. The contract did not expressly provide for perpetual performance and both the trial court and the Appellate Division found that the parties did not so intend. Under these circumstances, the law will not imply that a contract calling for continuing performance is perpetual in duration.

On the other hand, the city's contention that the contract is terminable at will because it provides for no express duration should also be rejected. In the absence of an express term fixing the duration of a contract, the courts may inquire into the intent of the parties and supply the missing term if a duration may be fairly and reasonably fixed by the surrounding circumstances and the parties' intent. It is generally agreed that where a duration may be fairly and reasonably supplied by implication, a contract is not terminable at will.

While we have not previously had occasion to apply it, the weight of authority supports the related rule that where the parties have not clearly expressed the duration of a contract, the courts will imply that they intended performance to continue for a reasonable time. For compelling policy reasons, this rule has not been, and should not be, applied to contracts of employment or exclusive agency, distributorship, or requirements contracts which have been analogized to employment contracts. The considerations relevant to such contracts do not obtain here. Thus, we hold that it is reasonable to infer from the circumstances of the 1924 agreement that the parties intended the city to maintain the sewage disposal facility until such time as the city no longer needed or desired the water, the purity of which the plant was designed to insure. The city argues that it is no longer obligated to maintain the plant because State law now prohibits persons from discharging raw sewage into streams such as Gooseberry Creek. However, the parties did not contemplate the passage of environmental control laws which would prohibit individuals or municipalities from discharging raw, untreated sewage into certain streams. Thus, the city agreed to assume the obligation of assuring that its water supply remained unpolluted and it may not now avoid that obligation for reasons not contemplated by the parties when the agreement was executed, and not within the purview of their intent, expressed or implied.

Having determined the duration of the city's obligation, the scope of its duty remains to be defined. By the agreement, the city obligated itself to build a specifically described disposal facility and to extend the lines of that facility to meet future increased demand. At the present time, the extension of those lines would result in the overloading of the system. Plaintiff claims that the city is required to build a new plant or expand the existing facility to overcome the problem. We disagree. The city should not be required to extend the lines to plaintiffs'

property if to do so would overload the system and result in its inability to properly treat sewage. In providing for the extension of sewer lines, the contract does not obligate the city to provide sewage disposal services for properties in areas of the municipalities not presently served or even to new properties in areas which are presently served where to do so could reasonably be expected to significantly increase the demand on present plant facilities. . . .

### Notes and Questions

1. Generally speaking, New York's approach to the interpretation of written contracts has been very text-focused. Is there something about its willingness to find implied terms here that sits in tension with text-focused interpretation of writings? Or should we say that texts reasonably contain lots of implied terms ("implicatures" in the language of linguistics) because all contracts are incomplete in some way—and courts should not deny that reasonable interpretation invites divining implied terms?
2. Are implied terms justified under the theory that they are more expensive to bargain about *ex ante* than they are to adjudicate *ex post*? If that were right about especially low-probability events like—for example—a global pandemic, how can you justify adding terms to a deal after the fact? Are these just majoritarian defaults justified by a hypothetical bargain: what rational and reasonable parties would have agreed to had they took to bargaining? Do you have confidence judges will get such hypothetical contracts correct?
3. Do you understand why the implied duration in this case differs from "termination at will," which the court says applies in employment agreements?
4. Although we will focus on gap-filling provisions of the UCC in the next part of this book, it is worth noting here that the UCC parallels the implied term from *Haines*. Here is UCC § 2-309:

**§ 2-309. Absence of Specific Time Provisions; Notice of Termination.**

(1) The time for shipment or delivery or any other action under a contract if not provided in this Article or agreed upon shall be a reasonable time.

(2) Where the contract provides for successive performances but is indefinite in duration it is valid for a reasonable time but unless otherwise agreed may be terminated at any time by either party.

(3) Termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable.

Would Haines be decided any differently if the UCC had applied to it? Why or why not?

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In the next case, the New York Court of Appeals saves a contract from otherwise containing an illusory promise that could have invalidated the whole agreement. Is that an appropriate use of developing an implied term or just a pragmatic way to give expression to the deal the parties probably had? Even in New York?

### **Wood v. Duff-Gordon**

118 N.E. 214 (New York Court of Appeals 1917)

CARDOZO, J.

The defendant styles herself “a creator of fashions.” Her favor helps a sale. Manufacturers of dresses, millinery and like articles are glad to pay for a certificate of her approval. The things which she designs, fabrics, parasols and what not, have a new value in the public mind when issued in her name. She employed the plaintiff to help her to turn this vogue into money. He was to have the exclusive right, subject always to her approval, to place her indorsements on the designs of others. He was also to have the exclusive right to place her own designs on sale, or to license others to market them. In return, she was to have one-half of “all profits and revenues” derived from any contracts he might make. The exclusive right was to last at least one year from April 1, 1915, and thereafter from year to year unless terminated by notice of ninety days. The plaintiff says that he kept the contract on his part, and that the defendant broke it. She placed her indorsement on fabrics, dresses and millinery without his knowledge, and withheld the profits. He sues her for the damages, and the case comes here on demurrer.

The agreement of employment is signed by both parties. It has a wealth of recitals. The defendant insists, however, that it lacks the elements of a contract. She says that the plaintiff does not bind himself to anything. It is true that he does not promise in so many words that

he will use reasonable efforts to place the defendant's indorsements and market her designs. We think, however, that such a promise is fairly to be implied. The law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal. It takes a broader view today. A promise may be lacking, and yet the whole writing may be "instinct with an obligation," imperfectly expressed. If that is so, there is a contract.

The implication of a promise here finds support in many circumstances. The defendant gave an *exclusive* privilege. She was to have no right for at least a year to place her own indorsements or market her own designs except through the agency of the plaintiff. The acceptance of the exclusive agency was an assumption of its duties. We are not to suppose that one party was to be placed at the mercy of the other. Many other terms of the agreement point the same way. We are told at the outset by way of recital that "the said Otis F. Wood possesses a business organization adapted to the placing of such indorsements as the said Lucy, Lady Duff-Gordon has approved." The implication is that the plaintiff's business organization will be used for the purpose for which it is adapted. But the terms of the defendant's compensation are even more significant. Her sole compensation for the grant of an exclusive agency is to be one-half of all the profits resulting from the plaintiff's efforts. Unless he gave his efforts, she could never get anything. Without an implied promise, the transaction cannot have such business "efficacy as both parties must have intended that at all events it should have." But the contract does not stop there. The plaintiff goes on to promise that he will account monthly for all moneys received by him, and that he will take out all such patents and copyrights and trademarks as may in his judgment be necessary to protect the rights and articles affected by the agreement. It is true, of course, as the Appellate Division has said, that if he was under no duty to try to market designs or to place certificates of indorsement, his promise to account for profits or take out copyrights would be valueless. But in determining the intention of the parties, the promise *has* a value. It helps to enforce the conclusion that the plaintiff *had* some duties. His promise to pay the defendant one-half of the profits and revenues resulting from the exclusive agency and to render accounts monthly, was a promise to use reasonable efforts to bring profits and revenues into existence.

### Notes and Questions

1. Cardozo didn't know it but Wood had agreed to represent Rose O'Neill, the kewpie doll inventor, in a prior agreement that led to litigation. That contract had an explicit "best efforts" clause. Should that matter? Would you feel differently if you knew Wood purposely avoided adding such a clause here? See VICTOR GOLDBERG, FRAMING

CONTRACT LAW: AN ECONOMIC PERSPECTIVE (2006) (discussing the case, with reference to Wood’s different agreement with O’Neill). Goldberg’s chapter about this case is so full of interesting details that you just might want to read it for yourself in your spare time. Just a taste: Lucy and her husband Cosmo Duff-Gordon were Titanic survivors—whose reputations were somewhat tarnished when Cosmo was accused of bribing sailors for places in the lifeboats. The couple even made an appearance in James Cameron’s movie, *Titanic* (played by Rosalind Ayres and Martin Jarvis):



After their experience on that “unsinkable ship”, Lucy managed to become an influencer all the same and worked around Wood to sign deals with Sears, as she sought to capture a more middle-class market for her designs. Think of her like Martha Stewart (or maybe a Kardashian?) lending her name to K-Mart sheets.

2. Didn’t Wood have all the right incentives in this agreement, since he couldn’t have made money without promoting his client? Why did the court feel the need to add to the agent’s obligations? Can you identify what would have made this an “illusory” contract without an implied “reasonable efforts” clause?

Generally, reading implied duties into a contract might help make an imbalanced contract more balanced. Alternatively, at least in some cases, courts can hold that the imbalanced agreement is illusory. And finally, in some cases, court can refuse to enforce the imbalanced contract, for example, by finding it unconscionable.

3. Couldn’t Wood make a consideration claim of his own? Isn’t Duff-Gordon permitted to refuse any of the endorsement contracts he finds – disabling him from making any

money under this contract at her whim? How would a court interested in implied terms solve *that* problem?

4. Is this an example of a kind of New York “formalism” giving way to common sense “pragmatism” at least in the area of consideration? Are the lessons here portable outside of formation to interpretation or would that undermine New York’s interpretation regime in a more fundamental way? Does it make sense to be formalistic about interpretation but pragmatic about formation? Why would that be?
5. Might there be a difference between a “reasonable efforts” clause that is implied and a “best efforts” clause that is explicit? Do you think either of these clauses change primary behavior of parties empirically? Are courts in good positions to evaluate conduct against these standards? It is, of course, one thing to use an implied term to solve a technical deficiency with consideration – and it is quite another to evaluate conduct against that term and enforce it.
6. UCC § 2-306(2) implies into exclusive dealing arrangements that the seller must use “best efforts to supply the goods and by the buyer to use best efforts to promote their sale.” This imposition of terms occurs, as with most terms in the UCC, “unless otherwise agreed.” Could a party disclaim the “best efforts” implied under the Code in favor of “reasonable efforts”? What about “no effort required”? Would that be invalid under the UCC? Maybe read the next case before coming to firm conclusions about that.

## B. Implied Terms Under The UCC

### **Bethlehem Steel Corp. v. Litton Industries, Inc.**

468 A.2d 748 (Superior Court of Pennsylvania 1983)

WICKERSHAM, Judge:

. . . Basically the complaint alleged that on or about April 25, 1968 Litton entered into an agreement with Bethlehem whereby Litton would construct and deliver and Bethlehem would purchase a one thousand foot self-unloading ore vessel. The vessel constructed under that agreement was delivered, accepted, and the price paid therefor.

The complaint further alleged that Litton extended to Bethlehem by letter dated April 25, 1968 “a written offer good until December 31, 1968 for the entry into an option agreement for five

vessels.” Furthermore, it was alleged that on or about December 31, 1968 Bethlehem accepted the Litton’s offer to enter into an option agreement under which Bethlehem was granted the right for a period of five years after the execution of the option agreement to obtain from Litton from one to five vessels for prices varying between \$22,400,000.00 and \$18,400,000.00 each. Further, the complaint alleged that Bethlehem, pursuant to the option agreement, by letter dated November 16, 1973 exercised its option for two vessels and thereby ordered the first and second vessels in accordance with the option agreement. On December 26, 1973 Bethlehem, pursuant to the option agreement, exercised its option for an additional (third) vessel.

Finally, the complaint alleged that Litton expressly and unequivocally refused to perform in accordance with its obligations under the option agreement; that Litton demanded the payment of a price for each vessel many millions of dollars in excess of the price provided for in the option agreement and indicated delivery dates substantially later than the delivery provided in the option agreement. Damages were sought in a sum in excess of \$95,000,000.00 together with interest and costs. ...

In its defense, Litton responded, *inter alia*: (1) PX-1 (the letter of December 31, 1968) was never intended to be and was not a contract; (2) no contract was formed in any event because the vital terms left for later negotiation could not be filled by the court on a reasonably certain basis; (3) any purported “option agreement” had been rejected prior to exercise by Bethlehem’s assertions that it would “never” order another vessel from Litton; (4) since an “option” unsupported by consideration is revocable at will, any purported “option agreement” had been revoked prior to exercise by Litton’s notice to Bethlehem that the Erie shipyard was to be closed; (5) any purported “option” had never been properly exercised; and (6) Litton had never breached or repudiated any “agreement” which might have existed.

On June 28, 1978 a non-jury trial began and Judge Louik filed his adjudication on June 6, 1979 which provided, in part, as follows:

#### “ADJUDICATION

LOUIK, J.

After a protracted trial of approximately nine months with over 12,000 pages of testimony and some 500 exhibits, this matter is now before the Court for determination. The claim in excess of 95 million dollars, together with a counterclaim, is based on a two-page letter between two giant corporations. ...

For background purposes, it should be noted that on April 25, 1968, at a formal signing ceremony, the plaintiff and defendant entered into a ship-construction contract for a newly designed 1,000 foot self unloading ore vessel. This vessel, known as Hull 101, was commissioned "The Cort."...

In addition, there is in evidence as PX-4 a document which was executed on that very same day, April 25, 1968, together with a document dated December 31, 1968, in evidence as PX-1. These are the documents in issue in the instant case.

The primary and fundamental question now before the Court is whether or not there has been an option contract. The plaintiff's claim is based upon the following two-page letter:

ERIE MARINE, INC.

ERIE, PENNSYLVANIA

April 25, 1968 Bethlehem Steel Corporation Bethlehem, Pennsylvania  
Attn: Ralph K. Smith

Gentlemen:

Reference is made to the ship construction contract signed by our companies this date for the construction by us of a 1,000' self-unloading ore vessel for you. Reference is also made to my letter to you of this date extending to you an option to purchase either one or two additional vessels upon the terms therein set forth.

We hereby extend to you an offer to enter into an option agreement to have us construct for you from one to five additional vessels in accordance with "Specifications covering the Construction of a Self-Unloading Bulk Carrier for Bethlehem Steel Corporation" (Number Y 917) dated March 1968, addendum number 1 thereto dated March 28, 1968 and addendum number 2 thereto dated April 17, 1968. This offer to enter into an option agreement shall be firm and irrevocable until December 31, 1968 at 5:00 P.M. E.S.T.

The terms of the option agreement are to be as follows:

- (a) The specifications for the vessels shall be the specifications referred to above, except for mutually agreeable reduced test

schedules of the vessels, if the testing of the vessel to be delivered under the contract executed this date proves successful.

(b) Bethlehem to have the right at any time within five years after the effective date of the option agreement to order from one to not more than a total of five vessels, for delivery within 24 months from the date of the order for the first vessel ordered and for delivery within 24 months plus 4 months for each additional vessel ordered within any one calendar year; provided however no vessel shall be scheduled for delivery between November 31 and March 31.

(c) The price of the vessel shall be as follows:

1st vessel ordered \$22,400,000.00

2nd \$21,400,000.00

3rd \$20,400,000.00

4th \$19,400,000.00

5th \$18,400,000.00

(d) The vessel prices are subject to escalation for both labor and material for a base price of \$20,400,000.00 for each vessel and based upon Fourth Quarter 1968 mutually agreed upon index such as:

Material — Material index for Bureau of Ships steel vessel contracts furnished to the Naval Ship Systems Command by the Bureau of Labor Statistics of the U.S. Department of Labor.

Labor — Index of changes in straight-time average hourly earnings for selected shipyards (June 1962 = 100) for steel ship construction, furnished to the Naval Ship Systems Command by the Bureau of Labor Statistics of the U.S. Department of Labor. At the time of exercise of the option for any vessel, the escalation shall be computed to the date of contract execution, and an appropriate contract clause will be included therein providing for quarterly escalation thereafter. We will furnish you the labor and material percentages subject to escalation by May 15, 1968.

(e) The terms and conditions of the ship construction contracts to be in accordance with the attached terms and conditions and any other mutually agreed to terms and conditions and shall contain a clause giving to Bethlehem the right to cancel at any time upon the payment of all of our costs incurred to date of cancellation, including similar vendor and subcontractor cancellation charges, plus 15% of such costs.

Very truly yours,

George K. Geiger

In response to this letter, a letter dated December 31, 1968 was sent by Bethlehem to Erie which stated in part 'We hereby accept your offer of an option to have you construct for us from one to five additional vessels. . .' In all other respects, the letter of December 31, 1968 is merely identical repetition of the language in the letter of April 25, 1968. This letter of December 31, 1968 appears in the record as PX-1.

On November 16, 1973, plaintiff sent a letter to defendant stating that it exercises its option to order two vessels and then on December 26, 1973, plaintiff sent another letter to defendant stating that it exercises its option to order a third vessel. ...

Defendant did not enter into any ship construction contract with plaintiff and did not construct any vessels under the letters of November 16, 1973 and December 26, 1973.

The issue then is whether these letters, considered with the surrounding circumstances, constitute a contract. The plaintiff's position is that they do constitute a contract, both under general common law and under the Uniform *Commercial Code*. The defendants' basic position is that under neither the general common law nor the Uniform Commercial Code do these letters constitute a contract, but at most, are merely an agreement to agree.

#### CONCLUSION OF LAW

Bethlehem has not sustained its burden of proof, either in law or in fact, of imposing liability on Litton-Erie, and a finding accordingly will be entered in favor of Litton-Erie on Bethlehem's claim....

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## SCOPE OF REVIEW

It is quite clear that the scope of appellate review of a finding on contractual intent is limited — indeed narrowly circumscribed.

The “intent to contract” is a question of fact for the trier-of-fact. . . .

We have reviewed the entire trial record and viewing the evidence in the light most favorable to the victorious party below, a fair distillation of the evidence would indicate the following scenario.

This controversy arose out of ship construction on the Great Lakes. Litton, a newcomer to the Lakes, tried unsuccessfully through its subsidiary, Erie, to develop a market for a unique and revolutionary supertanker-type ore vessel, 1,000 feet long with novel self-unloading features. In seven years of effort (from 1967 to 1973), however, Litton sold only one ore vessel (“Hull 101”) — to Bethlehem.

In 1968, Litton and Bethlehem exchanged two incomplete letters, one dated April 25, 1968 (PX-4) and the other dated December 31, 1968 (PX-1), concerning an offer to negotiate a long-term option agreement for construction of up to five novel multi-million dollar vessels at Litton’s new shipyard. In the words of Judge Louik: “If anything, there is one matter that is absolutely clear, and that is that the writing provides that further agreements between the parties are necessary.” During the ensuing years, Litton repeatedly attempted to interest Bethlehem in commencing the negotiations contemplated. These efforts were in vain, however, and from late 1972 through early 1973 Litton repeatedly informed Bethlehem of its intention to close the Erie shipyard unless ship construction orders were immediately forthcoming. When Bethlehem disclaimed interest in purchasing any additional ships and no other contracts were obtained, Litton began closing its Erie yard and disbanding its workforce.

Thereafter, however, Bethlehem notified Litton that it wished to negotiate a ship construction contract pursuant to PX-1. When the parties were unable to agree on contractual terms, Bethlehem commenced this action, contending that despite the parties’ failure to agree upon the myriad terms explicitly left for future negotiations, the mere exchange of the letters in 1968 bound the parties to a “contract” for the construction of novel ships worth millions of dollars.

The April 25, 1968 Letter (PX-4)

After four months of careful negotiation and drafting and redrafting of contract terms, representatives of Litton and Bethlehem met on April 25, 1968 for the ceremonial exchange of a contract for the immediate construction of Hull 101, the only one thousand foot vessel actually sold by Litton, for the firm fixed price of \$17,994,138.00 (“Hull 101 Contract”). Bethlehem’s Board of Directors had insisted upon “great precision” in every aspect of the sale, especially price. The Hull 101 Contract was fully performed and is not at issue here.

During the two to three hours that the parties were together on April 25, 1968, primarily for the exchange of the Hull 101 contract, they jointly drafted a two-page letter (PX-4), extending a last minute sales promotional offer to negotiate a long-term option agreement for up to five additional Hull 101 type vessels. The parties clearly understood that PX-4 was not part of the consideration for the Hull 101 Contract. With one exception, none of the representatives at the April 25 meeting even was aware before that meeting that such an offer was to be made or drafted that day. On its face, PX-4 clearly was not an option agreement; rather, it expressly provided for future negotiations which, if successfully completed, would have resulted in an option agreement which, in turn, if properly exercised, would have resulted in formal execution of a formal written ship construction contract.

In hurriedly drafting PX-4 during a part of their short meeting on April 25, the parties explicitly agreed that price escalation would be included in any long-term option agreement and ship construction contract upon which they might subsequently agree. The parties further expressly acknowledged, however, that because escalation was so critical and so complex, they would postpone the negotiations necessary for agreement upon that vital subject.

PX-4 thus was jointly drafted during the less than three-hour meeting on April 25 in the form of a two-step offer to enter into a future option agreement in order to provide until the end of the year for the parties to investigate and develop the terms of an appropriate escalation clause and the other important matter intentionally left for future negotiation and agreement.

Having taken more than four months to negotiate a contract for a single vessel (Hull 101), on which construction was to begin immediately for a fixed price with no escalation, the parties recognized that negotiation of a long-term option agreement for up to five novel multi-million dollar vessels providing for price escalation would be infinitely more complex and time consuming.

On several occasions from May through November of 1968, Litton sought to negotiate the terms of an option agreement. On each occasion, Bethlehem replied that it was not yet willing to spend the time and effort required for such negotiations, since it would not even consider

additional 1000 foot ore vessels until the revolutionary Hull 101 had been successfully operated for at least one season.

By December of 1968, aware that the PX-4 offer was about to lapse, but still unwilling to devote the time necessary to negotiate the terms essential for a definitive option agreement and ship construction contract, Bethlehem sought to preserve the status quo.

Between April 25 and December 31, 1968, there were no discussions, negotiations or agreements between the parties with respect to any of the terms, including escalation, expressly left for future negotiation and mutual agreement under PX-4.

In short, whatever the parties had intended by drafting PX-4 was unchanged by PX-1. In PX-4 the parties had explicitly contemplated negotiations and agreements necessary to create a binding option contract. PX-1 did not resolve any of the substantive terms left open for negotiation in PX-4; as the record clearly reveals, it was adopted as an accommodation to Bethlehem's request for a "holding pattern."

From 1968 through 1973, Litton attracted no other customers to its Erie shipyard. Indeed, by early 1973, Litton officials warned Bethlehem that the Erie yard would be closed unless Bethlehem ordered additional ships. Bethlehem officials had previously stated, however, that they were "disgusted" by the "slow" construction of Hull 101, and by 1973, rather than express any objection to the closing of the Erie yard, repeatedly insisted that they would never order any additional ships from Litton. Thus, without any hope of future business from Bethlehem, Litton "mothballed" its Erie yard.

Thereafter, in full knowledge of the fact that the Erie Shipyard had dismissed most of its labor force for lack of business, Bethlehem notified Litton by letter that it was planning to "exercise its options" for ore vessels. Significantly, however, Bethlehem expressly acknowledged that the terms of an option agreement had to be negotiated before Bethlehem could exercise any option.

At subsequent meetings, Litton advised Bethlehem that although it had closed down its shipyard in reliance upon Bethlehem's representations, it was willing to build vessels if the parties could reach agreement on a ship construction contract, which Litton was at all times willing to negotiate. The parties, however, never agreed on any of the material terms left open in PX-4 and PX-1, including escalation — found by the trial judge to be "one of the most critical provisions of a ship construction contract." Nor would Bethlehem accept any of Litton's alternative proposals.

Judge Louik carefully considered all the relevant factors under the common law and under the Uniform Commercial Code — the letters themselves, the discussions at the time of the exchange of the letters, the surrounding circumstances, subsequent conduct, the nature of the contemplated construction contract, and the parties' prior dealings — and found that the parties did not intend to enter a binding agreement until they mutually agreed on the critical terms intentionally deferred, including the terms of a price escalation clause, and reduced those terms to a formal ship construction contract. The Court alternatively found that under Section 2-204(3) of the UCC, no contract had been formed — because the Court simply could not, on “a reasonably certain basis,” fill in the price escalation terms and other missing contract provisions in order to provide for “an appropriate remedy.”

#### Nature Of Escalation

It is literally impossible to understand PX-4 and PX-1 without a knowledge of escalation and the nature of an escalation clause . . . . Expert testimony on this complex subject consumed 23 trial days and nearly 3,000 pages of transcript. The trial judge, having become fully familiar with the intricacies and complexities of this highly technical discipline, recognized the critical importance of escalation in long-term multi-million dollar ship construction during a period of double digit inflation and found that a court cannot fashion an escalation clause for parties who are unable to do so for themselves. The difference in the amount of escalation by varying just some of the elements of hypothetical escalation clauses which Bethlehem created for purposes of trial was shown to amount to millions of dollars per vessel. In the words of the trial judge: “All of the expert testimony indicated that an escalation clause could not be materialized from the air by the Court. Because of the nature of negotiations in shipbuilding and the extreme complexity of the undertaking, an escalation clause requires careful negotiations between the parties and must be custom tailored to fit the project.”

Returning now to relevant portions of the adjudication of Judge Louik dated June 6, 1979, our review of the record supports the correctness of the court's conclusions, as follows:

#### DISCUSSION

While a great many legal issues have been presented by both parties in this trial, their determination and even their relevance depend upon the resolution of one elementary factual dispute: Did both Bethlehem and Litton intend a legally binding option to arise from the two-page letter of April 25, 1968? . . .

#### UNIFORM COMMERCIAL CODE

One of the contentions of Bethlehem is that these agreements come within the Uniform Commercial Code and, therefore, gaps, (if any appear in the documents), may be filled in by the Court. Presented for the Court's consideration are the following Sections of the Uniform Commercial Code:

§ 2-204(3) Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.

§ 2-207(3) Conduct by both parties which recognized the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.

§ 2-305(1) The parties if they so intend can conclude a contract for sale even though the price is not settled. In such a case the price is a reasonable price at the time for delivery if

- (a) nothing is said as to price; or
- (b) the price is left to be agreed by the parties and they fail to agree; or
- (c) the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.

§ 2-305(4) Where, however, the parties intend not to be bound unless the price be fixed or agreed and it is not fixed or agreed there is no contract. In such a case the buyer must return any goods already received or if unable so to do must pay their reasonable value at the time of delivery and the seller must return any portion of the price paid on account. . . .

If a contract did exist, there are three general areas in which gaps appear which would require the Court's intervention to fill.

The first term obviously left open was the original escalation index which would be used to calculate the increase in cost per vessel over the time between PX-1 to the date of contract execution.

The only aspect of this stage of escalation that the documents provided is that an index method of escalation shall be used for this portion of escalation, and

that the index shall be mutually agreed upon, as evidenced by the language ‘mutually agreed upon index such as. . .’ Because the parties established the method of arriving at the index as mutual agreement, and because of the complexity of negotiations of escalation clauses in the shipbuilding industry, the Court cannot fill in such a gap in light of Code Section 2-305(4).

\* \* \* \* \*

The second gap relates to ‘second stage escalation’ which PX-4 and PX-1 establishes as the escalation from the execution of the construction contract to the end of the escalation period:

‘. . . an appropriate contract clause will be included therein providing for quarterly escalation thereafter.’

An escalation clause is a complex, detailed contractual provision negotiated between parties to provide a means necessary to calculate and pay escalation. It is an equitable concept that escalation clauses must be such as not to give the builder a windfall nor to have the builder suffer losses due to inflation. Because of inflation since the middle 1960’s, the escalation clauses became one of the most critical provisions of a ship construction contract. There are many essential elements to be negotiated in an escalation clause, some of which are very critical, such as the indexes to be used, the escalatable amount, the amount escalatable each computation period, the duration of escalation, payment, and the method of computation. These elements can have numerous possible variations resulting from negotiations between the parties. One of the most critical elements and perhaps the heart of an escalation clause is the amount escalatable each computation period. This is called the ‘apportionment’ which can have an infinite number of possible variations and will vary from ship to ship depending upon the time of construction, the place of construction, needs and desires of the parties.

The third gap which the Court would have to fill if it found a contract otherwise existed, arises from the language indicated that the terms and conditions were to be in accordance with the sample contract and ‘any other mutually agreed upon terms and conditions.’ In view of the fact that the sample form of contract was for a fixed price contract, there must of necessity be changes required since the writings clearly indicate that the parties contemplated an escalation contract.

Such a contract would require additional terms and conditions from those that appear in the sample form.

In addition, there are numerous other terms which might be expected to be in a ship construction contract of this magnitude. Evidence of this can be found in the contract (DX-12) proposed by the plaintiffs at the September 24, 1973 meeting with defendants. This proposed contract varied substantially from the sample contract in at least twelve separate items. These altered or added terms strongly suggest that, at least in the mind of Bethlehem, there were many items left out of the sample contract, or left to be negotiated at a later time.

The breadth of these gaps can only be appreciated in light of the nature of the vessel. According to David Klinges, Bethlehem's Senior Maritime Attorney:

As you can appreciate this was to be a new departure for maritime transportation for Great Lakes. It contemplated a new revolutionary way of building ships and a new revolutionary way of transporting and discharging —

The apportionment in quarterly escalation, if nothing else, must be one to be negotiated between the parties. Apportionment does not depend upon the actual use of labor or material in a particular quarter, but is an item negotiated between the parties depending upon what the parties are aiming at, either for the purpose of securing payments earlier during the construction period or for a later payment, but higher escalation. The extent of the escalation period can also vary, the payment of escalation amounts can vary, and a host of factors can move the parties to a variety of allocation of apportionment. This is also recognized by plaintiff in its Request for Findings, Point 30.59 where they ask the Court to find:

In the shipbuilding industry, a party entering a contract would, in negotiating an escalation clause, submit to the other party the form of escalation clause desired, and if the owner submitted a proposal that the builder did not like, the builder would make his feelings known to the buyer.

All of the expert testimony indicated that such clauses could not be materialized from the air by the Court. Because of the nature of negotiations in shipbuilding and the extreme complexity of the undertaking, such a clause would require careful negotiations between the parties and would need to be custom tailored to fit the project. There is nothing in the record upon which the Court could extract such a clause.

Because of the nature of the gaps as has been discussed in this Option, it would appear that only the parties are the exclusive entities capable of filling in the gaps. Because these gaps are so wide, the Court cannot make a new contract for the parties.

When we consider all of the above elements and the fact that the parties involved here are two of the largest corporations in this country, and PX-4 is only a two-page letter, the language of Mr. Justice Cohen in the case of *Essner v. Shoemaker* is most appropriate:

It is difficult to believe that the principals, experienced in real estate dealings as they were, would intend to . . . [assent unequivocally] to an oral agreement in a transaction involving more than a quarter of a million dollars, [and] complicated by assignments, mortgages and taxes. . .

In summary, we agree with the finding of the lower court that there was no enforceable contract between the parties. It is true, of course, that under the UCC a court may be able to supply missing terms in a contract. Under section 2-204(3) of the UCC, however, a court should only perform this “gap-filling” duty if it determines the parties did in fact intend to make a contract. Here, the lower court found that the absence of the terms necessary to calculate the escalation in price to be allowed for inflation and to apportion that escalation over time pointed not to the mere omission of a few terms in an otherwise complete contract, but instead to the absence of an intent to contract between the parties. A determination as to the intent of parties presents a question of fact that may not be reversed on appeal in the absence of an abuse of discretion. We find no such abuse of discretion here, therefore, we affirm the order of the lower court.

Order affirmed.

HESTER, Judge, dissenting:

The grossly-oversimplified issue in this matter is “Did the parties intend to make a contract?” Better stated, Did Bethlehem and Litton intend to enter into an option agreement, whereby Bethlehem would have the right to exercise its option to order as many as five one thousand foot self-unloading ore vessels at any time during a five year period? Following a non-jury trial which lasted approximately nine months and which involved in excess of twelve thousand pages of testimony and five hundred exhibits, the Court of Common Pleas . . . held that the parties had not intended a binding, enforceable contract. . . .

For the reasons that follow, I would reverse and remand to the lower court for further proceedings consistent with this Opinion. . . .

The threshold issue to be resolved in the instant appeal concerns the contractual intent of the parties. Unlike the majority, which views this issue as a question of fact, I believe the issue of contractual intent is a question of law or ultimate fact. Undeniably, the basic findings of fact of the lower court should not be disturbed if these findings are based upon competent evidence, unless the lower court committed an abuse of discretion or error of law in admitting the evidence from which the findings of fact were derived. However, the contractual intent of the parties as an ultimate fact or conclusion of law is subject to independent appellate scrutiny. . . .

In arriving at its conclusion that the parties did not intend a legally-binding contract, the lower court stated the general principles of contractual interpretation upon which it relied. Significantly, the lower court did credit authorities recognized under the common law of Pennsylvania. The lower court also considered the applicability of the Pennsylvania Uniform Commercial Code. However, the lower court did not specifically hold that the Uniform Commercial Code applied to the instant case. This was error. . . . [I]t is clear that the Code applies to the instant case. . . .

The Code states:

Options and cooperation respecting performance

(a) Specifying particulars of performance — An agreement for sale which is otherwise sufficiently definite (section 2204(c)) 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. 13 Pa.C.S.A. § 2311(a).

In the instant case, the time of performance, and whether performance would be required at all, was specifically left to Bethlehem as an option. The time within which Bethlehem was required to exercise its option was specified, so there is no issue concerning “commercial reasonableness.”

Therefore, since the Uniform Commercial Code applies to the instant case, the applicability of other general principles of law is limited. The Code states

Unless displaced by particular provisions of the title, the principles of law and equity, including the law merchant and the law relative to capacity to contract,

principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy or other validating or invalidating cause shall supplement its provision. 13 Pa.C.S.A. § 1103.

The applicability of the Code to this case is significant beyond the mere question of choice of law. The lower court did not specifically decide whether the Code applies. Rather, the trial court improperly relied upon numerous pre-Code decisions and other authority not involving a contract for the sale of goods. . . . [The dissent then provided some examples of relying on common law rather than Code.]

Concerning the formation of a contract, the Code provides:

#### Formation in General

(a) General rule — A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.

(b) Effect of undetermined time of making agreement — An agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined.

(c) Effect of open terms — Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy. (emphasis supplied)

13 Pa.C.S.A. § 2204.

The Comment to this Section of the Code states:

Subsection [(c)] states the principle as the ‘open terms’ underlying later sections of this Article. If the parties intend to enter into a binding agreement, this subsection recognizes that agreement as valid in law, despite missing terms, if there is any reasonably certain basis for granting a remedy. The test is not certainty as to what the parties were to do nor as to the exact amount of damages due to the plaintiff. Nor is the fact that one or more terms are left to be agreed upon enough of itself to defeat an otherwise adequate agreement. Rather, commercial standards on the point of ‘indefiniteness’ are intended to be applied, this Act making provision elsewhere for missing terms needed for performance, open price, remedies and the like.

The more terms the parties leave open, the less likely it is that they have intended to conclude a binding agreement, but their actions may be frequently conclusive on the matter despite the omissions.

From § 2204 of the Code, it is clear that the existence of a contract is initially dependent upon the intent of the parties. If the parties have intended to contractually obligate and benefit each other, their contract is enforceable even if certain terms are left open or are left to be agreed upon in the future. In other words, the Code specifically contemplates that the parties may “agree to agree” with respect to certain terms. The comment to § 2204 acknowledges that, depending upon how many terms are uncertain, an agreement may be defeated due to “indefiniteness” if there is no reasonably certain basis for granting an appropriate remedy. However, the Code specifically provides “gap-filling” so as to avoid defeating a contract which the parties otherwise intended.

Prior to the enactment of the Code in Pennsylvania, a contract would normally not be enforced, due to indefiniteness, if specific terms were missing. . . .

A review of Pennsylvania appellate decisions prior to the enactment of the Uniform Commercial Code indicates that the courts were not inclined to fill any gaps. . . .

The lower court correctly recognized that it must first find an intent to enter into a contract by the parties before attempting to complete any terms left open by the parties. However, the lower court incorrectly reasoned that “because these gaps are so wide, the court can not make a new contract for the parties.” In effect, the lower court held that, since the parties expressly agreed to agree concerning certain terms, they did not intend to create any enforceable contractual rights or obligations. However, the official comment to 13 Pa.C.S.A. § 2204 states, “nor is the fact that one or more terms are left to be agreed upon enough of itself to defeat an otherwise adequate agreement.”

Under the Code, parties can expressly agree to be contractually bound, even though certain terms are left open to be negotiated or agreed upon at a future time. It does not matter whether the original agreement is “a preliminary accord,” “an agreement to agree,” or “an agreement to negotiate.” The crucial inquiry is whether the parties intended to enter into an agreement; and, if the parties left certain terms to be negotiated at a future time, then those parties contemplate that those terms will be filled in, on a reasonable basis, through the mutual good-faith negotiations of the parties.

“Good faith” is an essential and prevailing concept of the Code. As defined by the Code, “In the case of a merchant, good faith means honesty in fact and the observance of reasonable

commercial standards of fair dealing in the trade.” 13 Pa.C.S.A. § 2103. . . . The Code also states “Every contract or duty within this title imposes an obligation of good faith in its performance or enforcement.” 13 Pa.C.S.A. § 1203. Therefore, if parties agree to agree concerning certain open contractual terms, then both parties must attempt to negotiate those terms, on a reasonable basis and in good faith.

As evinced by the letter of April 25 and December 31, 1968, as well as other discussions, negotiations, communications and “course of dealing” between the parties, it is clear that the parties intended to enter into an agreement which would give Bethlehem the right to exercise its option to order as many as five one thousand foot, self-unloading ore vessels from Litton at any time during a five year period.

13 Pa.C.S.A. § 1[303] states:

- (a) Definition of course of dealing — a course of dealing is a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct. . . . (c) Effect on agreements — a course of dealing between parties and any usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware give particular meaning to and supplement or qualify terms of an agreement.

The letter of April 25, 1968, from Litton to Bethlehem states, *inter alia*:

We hereby extend to you an offer to enter into an option agreement to have us construct for you from one to five additional vessels . . . this offer to enter into an option agreement shall be firm and irrevocable until December 31, 1968 at 5 p.m. E.S.T.

This correspondence expressly represents itself to be “an offer to enter into an option agreement,” which is “firm and irrevocable.” See 13 Pa.C.S.A. § 2205.

The letter of December 31, 1968, from Bethlehem to Litton states “We hereby accept your offer of an option to have you construct for us from one to five additional vessels. . . .” Said letter of December 31, 1968, was executed by George K. Geiger on behalf of Litton and Erie under a heading "AGREED TO".

Since the letter of December 31, 1968, was agreed to by Litton and since the letter of December 31, 1968, did not change any of the material terms set forth in the letter of April

25, 1968, no discussion of 13 Pa.C.S.A. § 2207 (Additional terms in acceptance or confirmation — “The Battle of the Forms”) is necessary.

These two letters are “sufficient to show agreement” for the purposes of 13 Pa.C.S.A. § 2204(a). The letter of December 31, 1968, operated as an acceptance of Litton’s offer to enter into an option agreement, for the purposes of 13 Pa.C.S.A. § 2206 (a).

Furthermore, the conduct of the parties manifests that they both recognized the existence of such a contract. . . .

In determining that the parties had not intended to create a legally-binding option agreement, the lower court heavily relied on “the fact that the parties involved here are two of the largest corporations in this country, and [the letter of April 25, 1968] is only a two-page letter.”

I cannot agree with the majority that this reasoning is supported by the evidence. The letters of April 25 and December 31, 1968, incorporate by reference the detailed specifications concerning the construction of the self-unloading ore carrier for Bethlehem Steel Corporation, which were used by the parties in connection with the construction of the Cort. These specifications serve the purposes of identifying the specially-manufactured vessels, as contemplated by the parties at the inception of their agreement.

Furthermore, both letters incorporated by reference the *pro forma* Ship Construction Contract which consists of 26 pages and 21 articles and which was also used as the basis of the agreement between the parties for the construction of the Cort. This *pro forma* contract sets forth in detail many contractual terms including specifications, approval and inspection, delivery schedule and manner of delivery, terms of payment, manner of inspection, trial runs, schedule of trial runs, place of delivery and acceptance, allocation of risk of loss, allocation of insurance proceeds, events of default, remedies in the event of default, manner of modification of the agreement, responsibility to defend alleged patent infringements, confidential information, passing of title, schedule of payments, selection of vendors and subcontractors, choice of materials and manufacturers, manner of assignment, governing law, settlement of disputes by arbitration, indemnification against third party personal injury claims, manner of notice, a “no oral modification” clause and an integration or “zipper” clause.

As stated in the letters of April 25 and December 31, 1968, “the terms and conditions of the ship construction to be in accordance with the attached terms and conditions and any other mutually agreed to terms and conditions . . .” Thus, the parties specifically agreed that any ship construction contract concerning any vessel ordered by Bethlehem pursuant to its option

would be based upon the detailed *pro forma* contract as drafted by Mr. Davis, an attorney for Litton. . . .

The use of the *pro forma* contract by the parties as the basis of the Ship Construction Contract of April 25, 1968, sharply brings into focus the relevancy of the “course of dealing” between the parties. 13 Pa.C.S.A. § 1[303]. It is apparent from the documentation of the transaction between the parties which occurred on April 25, 1968, that Litton’s offer to Bethlehem to enter into an option agreement was part of this overall transaction, perhaps a contract “sweetener.” The course of dealing between the parties with respect to the construction of the Cort amplifies the intentions of the parties to be legally bound to each other on the basis of the option agreement. Litton obviously desired to enter the shipbuilding industry as evinced by its construction of a ship for Bethlehem. Clearly Litton was hopeful that it would be able to build additional vessels for Bethlehem in the future and granted options to Bethlehem accordingly. As part of the ship construction contract for the Cort, Litton specifically gave Bethlehem a right of first refusal to purchase any of the ships described in its quarterly shipbuilding schedule. . . .

This “course of dealing” between the parties was not considered by the court below. However, Litton itself recognized the relevancy of this course of dealing and the interrelationship between the construction of the Cort and the option agreement. The letter of April 25, 1968, which was drafted by Litton, began as follows:

Reference is made to the ship construction contract signed by our companies this date for the construction by us of a one thousand self-unloading ore vessel for you. Reference is also made to my letter to you of this date extending to you an option to purchase either one or two additional vessels upon the terms therein set forth.

Thus did Litton make references to the “course of dealing” between the parties. This evidence cannot be ignored, for under the Code, “course of dealing” is always relevant. . . .

As author of the letter of April 25, 1968, Litton was in control of the terms of the offer. Litton also offered and controlled the attached *pro forma* contract. I cannot understand how Litton, as a large corporation, could conceivably have delivered the letter of April 25, 1968, to Bethlehem without intending to be legally bound by the terms stated herein. The letter of April 25, 1968, created a power of acceptance by Bethlehem, which was exercised by the jointly-executed letter of December 31, 1968, was prepared by both the parties and was intended to be a final expression of the terms included therein. . . .

In addition to the previously mentioned course of dealing between the parties, the following conduct by both parties additionally supports the existence of a contract, for the purposes of 13 Pa.C.S.A. § 2204(a): [The dissent listed 16 instances; we excerpt five.]

2. Mr. Ellis Gardner, A Senior Vice-President of Litton, provided certain terms for the letter of April 25, 1968, relating to escalation, and he approved and authorized the signing of the letter of April 25, 1968, after it was read to him in its entirety;

6. In February, 1973, before Bethlehem notified Litton of the exercise of its option, Litton internally listed "Bethlehem Steel Corporation's option to purchase five additional vessels" as one of its "Contractual Obligations."

7. In its internal Financial Forecast of February, 1973, Litton calculated certain escalated contract prices, for the estimated cost of ore vessels and concluded "the contract value, based upon the Bethlehem letter of December, 1968 does not support pursuing this business."

9. In its financial plan of July, 1973, Litton acknowledged the outstanding option as follows: "It should be noted that Bethlehem has an option for construction of up to five (5) new vessels. That option will not expire until December 31, 1973. The terms of the option, if exercised by Bethlehem, would result in substantial losses by Litton."

11. In 1970, Mr. Gardner of Litton documented a conversation with U.S. Steel in which he informed U.S. Steel "that Bethlehem Steel had an option for five ore boats and that if they should exercise this option, they would tie up the only available ship manufacturing facility on the Lakes for a period of three or four years."

Finally, and perhaps most importantly, my review of the record does not indicate a single instance whereby Litton denied Bethlehem's right to exercise its option, nor did Litton ever deny that the letter of December 31, 1968, was intended to be a legally-binding agreement, prior to the expiration of the option period on December 31, 1973. . . .

Having concluded that the parties intended to make a contract, the next question to be addressed is whether "there is a reasonably certain basis for giving an appropriate remedy." 13 Pa.C.S.A. § 2204(c).

The Official Comment to this Section explains, "The test is not certainty as to what the parties were to do nor as to the exact amount of damages due to the plaintiff."

In addition to the previously-mentioned contractual terms contained in the specifications and *pro forma* contract, the letters of April 25 and December 31, 1968, contain definite terms relating to the period of the option, time of delivery of the vessels, base prices for the vessels, a base index of “Fourth Quarter 1968,” “quarterly escalation” of price during construction, specific labor and material percentages (supplied by Litton's letter of May 8, 1968), and a clause providing for Bethlehem's right to cancel subject to liquidated damages.

The terms which were left open by the parties are as follows:

- (1) The index by which the material and labor cost escalation would be computed;
- (2) “an appropriate contract clause . . . providing for quarterly escalation thereafter;”
- (3) “any other mutually agreed to terms and conditions,” in addition to the terms and conditions of the *pro forma* ship construction contract. . . .

Concerning “any other mutually agreed to terms and conditions,” the word “any” implies that the failure of the parties to agree to any such additional terms would not affect their intention to be legally bound pursuant to the option agreement. Litton repeatedly recognized the suitability of the *pro forma* contract for the construction and purchase of the vessels in question. Not only did Litton author the *pro forma* contract, but it repeatedly submitted the *pro forma* contract to Bethlehem in connection with Bethlehem's various options for the purchase of the vessels....

The parties intended to be bound by the option agreement of December 31, 1968. Therefore, the ultimate price of the vessels was “left to be agreed by the parties and they fail[ed] to agree.” 13 Pa.C.S.A. § 2305 (a)(2). . . .

Under the circumstances, the price for the vessels “is a reasonable price at the time for delivery.” However, the parties did specifically agree to stated base prices for the vessels. Therefore, the “reasonableness” of the ultimate price term must be related to the stated base prices, as escalated by a “reasonable” index (using a base of “Fourth Quarter 1968”).

The lower court bifurcated this case and received only evidence relating to the issue of liability. Since the lower court improperly held that the parties had not intended a binding agreement, and since the lower court did not address the various sections of the Code cited herein, this case should be remanded for additional findings of fact, conclusions of law and on the development of an appropriate record on matters not already in the record. I would reverse.

## Notes and Questions

1. Were you surprised to see how much gap-filling the UCC contemplates? Do you think there is a difference between courts implying terms into specific agreements and legislatures providing explicit terms into contracts as default rules, against which all parties bargain? Does this make more sense in the firm-to-firm environment than it does in the consumer context?
2. Given the UCC's gap-filling regime, was the dissent right that the majority decision seemed too informed by the common law's "indefiniteness" law? Can you specify the relationship between indefiniteness and implied terms?
3. Bob Scott has published a study of the modern indefiniteness doctrine. Collecting cases over a five-year period (1998-2002), he found that of 89 cases directly implicating the indefiniteness doctrine in his sample, 34 had the court enforce the agreement even though the defendant claimed indefiniteness—and 55 instances had the court refusing to enforce on indefiniteness grounds. Only one of the cases granting enforcement in this sample was a UCC case. He also produced the following interesting conclusion: even in the states that acknowledge a presumption in favor of gap-filling and enforcement (California and Pennsylvania (!)), courts divided on enforcement in actual cases. Whatever else you make of the study, it suggests that indefiniteness doctrine remains central to the law-in-action, even in a world with substantial comfort with gap-filling from the UCC and implied terms from the common law. *See* Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641 (2003).
4. The dissent probably cited more of the UCC than the majority in this case. But wasn't the difficulty of calculating the remedy the real problem for the dissent here? Was there anything useful in all the implied terms from the UCC that distracted attention from the remedial issue in § 2-204(3)? If you have already studied remedies, would it be enough that restitution could be on the table as a remedy?
5. When this case went up on appeal, it was affirmed by an even vote. *See Bethlehem Steel Corp. v. Litton Industries, Inc.*, 488 A.2d 581 (1985). But one judge there saw a consideration problem. Do you? Can you see a difference between a firm offer—governed by § 2-205—which is sometimes called an "option" and can be made without consideration under the UCC on the one hand and an option agreement which always needs consideration on the other? Is there a way out of that issue? Would a reliance workaround work here? Why or why not?

6. The dissent was likely correct that “agreements to agree” were disfavored under the common law—but the UCC was willing to embrace them. The dissent focused, in part, on the duty of good faith in performance for all agreements. But what might it mean to perform in good faith if the agreement is only a preliminary agreement to agree? Is this a way to smuggle a duty to negotiate in good faith into the UCC when it is clearly not a requirement for the common law of contracts in the US? Other jurisdictions do have law that requires parties to negotiate in good faith—but the US has resisted that as a default rule (though, of course, parties could opt in to such an obligation). Is the UCC’s position that if you have an agreement to agree what you have also agreed to is a duty to negotiate in good faith? Is that the best way to read what the dissent here is really urging? You might be wondering what all this talk of “good faith” is about or whether it is distinctive to the UCC. Stay tuned.

## C. The Duty of Good Faith

### **Market Street Associates LP v. Frey**

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

POSNER, Judge.

Market Street Associates Limited Partnership and its general partner appeal from a judgment for the defendants, General Electric Pension Trust and its trustees, entered upon cross-motions for summary judgment in a diversity suit that pivots on the doctrine of “good faith” performance of a contract. Wisconsin law applies — common law rather than Uniform Commercial Code, because the contract is for land rather than for goods, UCC § 2-102; Wis.Stat. § 402.102, and because it is a lease rather than a sale and Wisconsin has not adopted UCC art. 2A, which governs leases. . . .

In 1968, J.C. Penney Company, the retail chain, entered into a sale and leaseback arrangement with General Electric Pension Trust in order to finance Penney’s growth. Under the arrangement Penney sold properties to the pension trust which the trust then leased back to Penney for a term of 25 years. Paragraph 34 of the lease entitles the lessee to “request Lessor [the pension trust] to finance the costs and expenses of construction of additional Improvements upon the Premises,” provided the amount of the costs and expenses is at least \$250,000. Upon receiving the request, the pension trust “agrees to give reasonable consideration to providing the financing of such additional Improvements and Lessor and Lessee shall negotiate in good faith concerning the construction of such Improvements and the financing by Lessor of such costs and expenses.” Paragraph 34 goes on to provide that,

should the negotiations fail, the lessee shall be entitled to repurchase the property at a price roughly equal to the price at which Penney sold it to the pension trust in the first place, plus 6 percent a year for each year since the original purchase. So if the average annual appreciation in the property exceeded 6 percent, a breakdown in negotiations over the financing of improvements would entitle Penney to buy back the property for less than its market value (assuming it had sold the property to the pension trust in the first place at its then market value).

One of these leases was for a shopping center in Milwaukee. In 1987 Penney assigned this lease to Market Street Associates, which the following year received an inquiry from a drugstore chain that wanted to open a store in the shopping center, provided (as is customary) that Market Street Associates built the store for it. Whether Market Street Associates was pessimistic about obtaining financing from the pension trust, still the lessor of the shopping center, or for other reasons, it initially sought financing for the project from other sources. But they were unwilling to lend the necessary funds without a mortgage on the shopping center, which Market Street Associates could not give because it was not the owner but only the lessee. It decided therefore to try to buy the property back from the pension trust. Market Street Associates' general partner, Orenstein, tried to call David Erb of the pension trust, who was responsible for the property in question. Erb did not return his calls, so Orenstein wrote him, expressing an interest in buying the property and asking him to "review your file on this matter and call me so that we can discuss it further." At first, Erb did not reply. Eventually Orenstein did reach Erb, who promised to review the file and get back to him. A few days later an associate of Erb called Orenstein and indicated an interest in selling the property for \$3 million, which Orenstein considered much too high.

That was in June of 1988. On July 28, Market Street Associates wrote a letter to the pension trust formally requesting funding for \$2 million in improvements to the shopping center. The letter made no reference to paragraph 34 of the lease; indeed, it did not mention the lease. The letter asked Erb to call Orenstein to discuss the matter. Erb, in what was becoming a habit of unresponsiveness, did not call. On August 16, Orenstein sent a second letter — certified mail, return receipt requested — again requesting financing and this time referring to the lease, though not expressly to paragraph 34. The heart of the letter is the following two sentences: "The purpose of this letter is to ask again that you advise us immediately if you are willing to provide the financing pursuant to the lease. If you are willing, we propose to enter into negotiation to amend the ground lease appropriately." The very next day, Market Street Associates received from Erb a letter, dated August 10, turning down the original request for financing on the ground that it did not "meet our current investment criteria:" the pension

trust was not interested in making loans for less than \$7 million. On August 22, Orenstein replied to Erb by letter, noting that his letter of August 10 and Erb's letter of August 16 had evidently crossed in the mails, expressing disappointment at the turn-down, and stating that Market Street Associates would seek financing elsewhere. That was the last contact between the parties until September 27, when Orenstein sent Erb a letter stating that Market Street Associates was exercising the option granted it by paragraph 34 to purchase the property upon the terms specified in that paragraph in the event that negotiations over financing broke down.

The pension trust refused to sell, and this suit to compel specific performance followed. Apparently the price computed by the formula in paragraph 34 is only \$1 million. The market value must be higher, or Market Street Associates wouldn't be trying to coerce conveyance at the paragraph 34 price; whether it is as high as \$3 million, however, the record does not reveal.

The district judge granted summary judgment for the pension trust on two grounds that he believed to be separate although closely related. The first was that, by failing in its correspondence with the pension trust to mention paragraph 34 of the lease, Market Street Associates had prevented the negotiations over financing that are a condition precedent to the lessee's exercise of the purchase option from taking place. Second, this same failure violated the duty of good faith, which the common law of Wisconsin, as of other states, reads into every contract. In support of both grounds the judge emphasized a statement by Orenstein in his deposition that it had occurred to him that Erb mightn't know about paragraph 34, though this was unlikely (Orenstein testified) because Erb or someone else at the pension trust would probably check the file and discover the paragraph and realize that if the trust refused to negotiate over the request for financing, Market Street Associates, as Penney's assignee, would be entitled to walk off with the property for (perhaps) a song. The judge inferred that Market Street Associates didn't want financing from the pension trust — that it just wanted an opportunity to buy the property at a bargain price and hoped that the pension trust wouldn't realize the implications of turning down the request for financing. Market Street Associates should, the judge opined, have advised the pension trust that it was requesting financing pursuant to paragraph 34, so that the trust would understand the penalty for refusing to negotiate.

We begin our analysis by setting to one side two extreme contentions by the parties. The pension trust argues that the option to purchase created by paragraph 34 cannot be exercised until negotiations over financing break down; there were no negotiations; therefore they did not break down; therefore Market Street Associates had no right to exercise the option. This argument misreads the contract. Although the option to purchase is indeed contingent,

paragraph 34 requires the pension trust, upon demand by the lessee for the financing of improvements worth at least \$250,000, “to give reasonable consideration to providing the financing.” The lessor who fails to give reasonable consideration and thereby prevents the negotiations from taking place is breaking the contract; and a contracting party cannot be allowed to use his own breach to gain an advantage by impairing the rights that the contract confers on the other party. Often, it is true, if one party breaks the contract, the other can walk away from it without liability, can in other words exercise self-help. But he is not required to follow that course. He can stand on his contract rights.

But what exactly are those rights in this case? The contract entitles the lessee to reasonable consideration of its request for financing, and only if negotiations over the request fail is the lessee entitled to purchase the property at the price computed in accordance with paragraph 34. It might seem therefore that the proper legal remedy for a lessor’s breach that consists of failure to give the lessee’s request for financing reasonable consideration would not be an order that the lessor sell the property to the lessee at the paragraph 34 price, but an order that the lessor bargain with the lessee in good faith. But we do not understand the pension trust to be arguing that Market Street Associates is seeking the wrong remedy. We understand it to be arguing that Market Street Associates has no possible remedy. That is an untenable position.

Market Street Associates argues, with equal unreason as it seems to us, that it could not have broken the contract because paragraph 34 contains no express requirement that in requesting financing the lessee mention the lease or paragraph 34 or otherwise alert the lessor to the consequences of his failing to give reasonable consideration to granting the request. There is indeed no such requirement (all that the contract requires is a demand). But no one says there is. The pension trust’s argument, which the district judge bought, is that either as a matter of simple contract interpretation or under the compulsion of the doctrine of good faith, a provision requiring Market Street Associates to remind the pension trust of paragraph 34 should be read into the lease.

It seems to us that these are one ground rather than two. A court has to have a reason to interpolate a clause into a contract. The only reason that has been suggested here is that it is necessary to prevent Market Street Associates from reaping a reward for what the pension trust believes to have been Market Street’s bad faith. So we must consider the meaning of the contract duty of “good faith.” The Wisconsin cases are cryptic as to its meaning though emphatic about its existence, so we must cast our net wider. We do so mindful of Learned Hand’s warning, that “such words as ‘fraud,’ ‘good faith,’ ‘whim,’ ‘caprice,’ ‘arbitrary action,’ and ‘legal fraud’ . . . obscure the issue.” *Thompson-Starrett Co. v. La Belle Iron Works*, 17 F.2d 536, 541 (2d Cir. 1927). Indeed they do. The particular confusion to which the vaguely

moralistic overtones of “good faith” give rise is the belief that every contract establishes a fiduciary relationship. A fiduciary is required to treat his principal as if the principal were he, and therefore he may not take advantage of the principal’s incapacity, ignorance, inexperience, or even naivete. *Meinhard v. Salmon*, 249 N.Y. 458, 463-64 (1928) (Cardozo, C.J.). If Market Street Associates were the fiduciary of General Electric Pension Trust, then (we may assume) it could not take advantage of Mr. Erb’s apparent ignorance of paragraph 34, however exasperating Erb’s failure to return Orenstein’s phone calls was and however negligent Erb or his associates were in failing to read the lease before turning down Orenstein’s request for financing.

But it is unlikely that Wisconsin wishes, in the name of good faith, to make every contract signatory his brother’s keeper, especially when the brother is the immense and sophisticated General Electric Pension Trust, whose lofty indifference to small (= \$7 million) transactions is the signifier of its grandeur. In fact the law contemplates that people frequently will take advantage of the ignorance of those with whom they contract, without thereby incurring liability. *Restatement* § 161, comment d. The duty of honesty, of good faith even expansively conceived, is not a duty of candor. You can make a binding contract to purchase something you know your seller undervalues. Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. Legal Stud. 1 (1978). That of course is a question about formation, not performance, and the particular duty of good faith under examination here relates to the latter rather than to the former. But even after you have signed a contract, you are not obliged to become an altruist toward the other party and relax the terms if he gets into trouble in performing his side of the bargain. . . .

But it is one thing to say that you can exploit your superior knowledge of the market — for if you cannot, you will not be able to recoup the investment you made in obtaining that knowledge — or that you are not required to spend money bailing out a contract partner who has gotten into trouble. It is another thing to say that you can take deliberate advantage of an oversight by your contract partner concerning his rights under the contract. Such taking advantage is not the exploitation of superior knowledge or the avoidance of unbargained-for expense; it is sharp dealing. Like theft, it has no social product, and also like theft it induces costly defensive expenditures, in the form of overelaborate disclaimers or investigations into the trustworthiness of a prospective contract partner, just as the prospect of theft induces expenditures on locks.

The form of sharp dealing that we are discussing might or might not be actionable as fraud or deceit. That is a question of tort law and there the rule is that if the information is readily available to both parties the failure of one to disclose it to the other, even if done in the

knowledge that the other party is acting on mistaken premises, is not actionable. [Virtually a]ll of the [tort] cases, however . . . involve failure to disclose something in the negotiations leading up to the signing of the contract, rather than failure to disclose after the contract has been signed. The distinction is important[:] Before the contract is signed, the parties confront each other with a natural wariness. Neither expects the other to be particularly forthcoming, and therefore there is no deception when one is not. Afterwards the situation is different. The parties are now in a cooperative relationship the costs of which will be considerably reduced by a measure of trust. So each lowers his guard a bit, and now silence is more apt to be deceptive.

Moreover, this is a contract case rather than a tort case, and conduct that might not rise to the level of fraud may nonetheless violate the duty of good faith in dealing with one's contractual partners and thereby give rise to a remedy under contract law. This duty is, as it were, halfway between a fiduciary duty (the duty of *utmost* good faith) and the duty merely to refrain from active fraud. Despite its moralistic overtones it is no more the injection of moral principles into contract law than the fiduciary concept itself is. It would be quixotic as well as presumptuous for judges to undertake through contract law to raise the ethical standards of the nation's business people. The concept of the duty of good faith like the concept of fiduciary duty is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute. The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties' joint goal.

It is true that an essential function of contracts is to allocate risk, and would be defeated if courts treated the materializing of a bargained-over, allocated risk as a misfortune the burden of which is required to be shared between the parties (as it might be within a family, for example) rather than borne entirely by the party to whom the risk had been allocated by mutual agreement. But contracts do not just allocate risk. They also (or some of them) set in motion a cooperative enterprise, which may to some extent place one party at the other's mercy. . . . The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule. . . . The contractual duty of good faith is thus not some newfangled bit of welfare-state paternalism or the sediment of an altruistic strain in contract law, and we are therefore not surprised to find the essentials of the modern doctrine well established in nineteenth-century cases.

The emphasis we are placing on postcontractual versus precontractual conduct helps explain the pattern that is observed when the duty of contractual good faith is considered in all its

variety, encompassing not only good faith in the *performance* of a contract but also good faith in its *formation*, and in its *enforcement*. The formation or negotiation stage is precontractual, and here the duty is minimized. It is greater not only at the performance but also at the enforcement stage, which is also postcontractual. “A party who hokes up a phony defense to the performance of his contractual duties and then when that defense fails (at some expense to the other party) tries on another defense for size can properly be said to be acting in bad faith.” At the formation of the contract the parties are dealing in present realities; performance still lies in the future. As performance unfolds, circumstances change, often unforeseeably; the explicit terms of the contract become progressively less apt to the governance of the parties’ relationship; and the role of implied conditions — and with it the scope and bite of the good-faith doctrine — grows.

We could of course do without the term “good faith,” and maybe even without the doctrine. We could, as just suggested, speak instead of implied conditions necessitated by the unpredictability of the future at the time the contract was made. Suppose a party has promised work to the promisee’s “satisfaction.” As Learned Hand explained, “he may refuse to look at the work, or to exercise any real judgment on it, in which case he has prevented performance and excused the condition.” *Thompson-Starrett Co. v. La Belle Iron Works*. That is, it was an implicit condition that the promisee examine the work to the extent necessary to determine whether it was satisfactory; otherwise the performing party would have been placing himself at the complete mercy of the promisee. The parties didn’t write this condition into the contract either because they thought such behavior unlikely or failed to foresee it altogether. In just the same way — to switch to another familiar example of the operation of the duty of good faith — parties to a requirements contract surely do not intend that if the price of the product covered by the contract rises, the buyer shall be free to increase his “requirements” so that he can take advantage of the rise in the market price over the contract price to resell the product on the open market at a guaranteed profit. If they fail to insert an express condition to this effect, the court will read it in, confident that the parties would have inserted the condition if they had known what the future held. Of similar character is the implied condition that an exclusive dealer will use his best efforts to promote the supplier’s goods, since otherwise the exclusive feature of the dealership contract would place the supplier at the dealer’s mercy. *Wood v. Duff-Gordon*, 222 N.Y. 88 (1917) (Cardozo, J.).

The dispositive question in the present case is simply whether Market Street Associates tried to trick the pension trust and succeeded in doing so. If it did, this would be the type of opportunistic behavior in an ongoing contractual relationship that would violate the duty of good faith performance however the duty is formulated. There is much common sense in

Judge Reynolds' conclusion that Market Street Associates did just that. The situation as he saw it was as follows. Market Street Associates didn't want financing from the pension trust (initially it had looked elsewhere, remember), and when it learned it couldn't get the financing without owning the property, it decided to try to buy the property. But the pension trust set a stiff price, so Orenstein decided to trick the pension trust into selling at the bargain price fixed in paragraph 34 by requesting financing and hoping that the pension trust would turn the request down without noticing the paragraph. . . .

The only problem with this recital is that it construes the facts as favorably to the pension trust as the record will permit, and that of course is not the right standard for summary judgment. The facts must be construed as favorably to the nonmoving party, to Market Street Associates, as the record permits . . . . When that is done, a different picture emerges. On Market Street Associates' construal of the record, \$3 million was a grossly excessive price for the property, and while \$1 million might be a bargain it would not confer so great a windfall as to warrant an inference that if the pension trust had known about paragraph 34 it never would have turned down Market Street Associates' request for financing cold. And in fact the pension trust may have known about paragraph 34, and either it didn't care or it believed that unless the request mentioned that paragraph the pension trust would incur no liability by turning it down. Market Street Associates may have assumed and have been entitled to assume that in reviewing a request for financing from one of its lessees the pension trust would take the time to read the lease to see whether it bore on the request. Market Street Associates did not desire financing from the pension trust initially — that is undeniable — yet when it discovered that it could not get financing elsewhere unless it had the title to the property it may have realized that it would have to negotiate with the pension trust over financing before it could hope to buy the property at the price specified in the lease.

On this interpretation of the facts there was no bad faith on the part of Market Street Associates. It acted honestly, reasonably, without ulterior motive, in the face of circumstances as they actually and reasonably appeared to it. The fault was the pension trust's incredible inattention, which misled Market Street Associates into believing that the pension trust had no interest in financing the improvements regardless of the purchase option. We do not usually excuse contracting parties from failing to read and understand the contents of their contract; and in the end what this case comes down to — or so at least it can be strongly argued — is that an immensely sophisticated enterprise simply failed to read the contract. On the other hand, such enterprises make mistakes just like the rest of us, and deliberately to take advantage of your contracting partner's mistake during the performance stage (for we are not talking about taking advantage of superior knowledge at the formation stage) is a breach of good faith.

To be able to correct your contract partner's mistake at zero cost to yourself, and decide not to do so, is a species of opportunistic behavior that the parties would have expressly forbidden in the contract had they foreseen it. The immensely long term of the lease amplified the possibility of errors but did not license either party to take advantage of them.

The district judge jumped the gun in choosing between these alternative characterizations. The essential issue bearing on Market Street Associates' good faith was Orenstein's state of mind, a type of inquiry that ordinarily cannot be concluded on summary judgment, and could not be here. If Orenstein believed that Erb knew or would surely find out about paragraph 34, it was not dishonest or opportunistic to fail to flag that paragraph, or even to fail to mention the lease, in his correspondence and (rare) conversations with Erb, especially given the uninterest in dealing with Market Street Associates that Erb fairly radiated. To decide what Orenstein believed, a trial is necessary. As for the pension trust's intimation that a bench trial (for remember that this is an equity case, since the only relief sought by the plaintiff is specific performance) will add no illumination beyond what the summary judgment proceeding has done, this overlooks the fact that at trial the judge will for the first time have a chance to see the witnesses whose depositions he has read, to hear their testimony elaborated, and to assess their believability.

The judgment is reversed and the case is remanded for further proceedings consistent with this opinion.

### Notes and Questions

1. When the case went back to the trial court, Mr. Ornstein was found to be trying to trick the defendant by not mentioning section 34—a finding that was affirmed on appeal.
2. The court describes this deal as “a sale and leaseback arrangement.” In such a deal, a company that owns real estate raises funds by selling it to an investor, but it stays on the property and pays rent going forward. Those arrangements often include an option to buy back the property once the lease terminates. In other words, from an economic perspective this transaction is comparable to secured financing (a loan secured by a mortgage). The choice between the two has to do with complex considerations (such as differences in tax treatment) that are beyond the scope of a course in contract law. It is challenging to a seller in a sale and leaseback transaction to finance future improvement on the land it now does not own, and therefore, sale and leaseback agreements often include mechanisms to deal with future improvements. Section 34 in

*Frey* is part of one such mechanism. Reread that provision with that background in mind. Why do you think it was drafted the way that it was?

3. What does Judge Posner mean when he compares Market Street Associates actions' to theft? How are the two similar?
4. Was the pension trust's refusal to consider improvement that cost less than \$7M in good faith? Was David Erb's behavior a model of fair dealing? Will a decision like *Frey* incentivize them to better behave in the future?
5. Did you understand the distinction between precontractual moments between the parties where good faith is not required and during performance when it is? Is tort law adequate to the task of handling unfair dealing at the formation stage—or is there contract law we could bring to bear in that phase of negotiation, too?
6. Would it be “quixotic as well as presumptuous for judges to undertake through contract law to raise the ethical standards of the nation's business people,” as Posner argues here? Is the duty of good faith plausibly cut off from human morality? Can you identify the arguments for and against incorporating some moral of human interactions into our contract law? Was Posner successful in distracting attention from the moral vocabulary of good faith and explaining in terms of hypothetical bargains?
7. Do you see the parallels between “good faith” law and the law of implied terms or conditions that Posner makes in the opinion, cross-referencing requirements contracts, satisfaction contracts and best efforts clauses?

**Centronics Corp. v. Genicom Corp.**

132 N.H. 133, 562 A.2d 187 (Supreme Court of New Hampshire 1989)

SOUTER, Justice.

A contract between the buyer and seller of business assets provided for arbitration of any dispute about the value of the property transferred, to which the purchase price was pegged, and required an escrow deposit of a portion of the price claimed by the seller pending final valuation. The seller has charged the buyer with breach of an implied covenant of good faith in refusing, during arbitration, to release a portion of the escrow fund claimed to be free from “dispute.” The Superior Court granted summary judgment to the buyer, which we affirm.

The agreement between the plaintiff-seller, Centronics Corporation and corporations related to it (Centronics), and the defendant-buyer, Genicom Corporation (Genicom), sets the

purchase price at the consolidated closing net book value (CCNBV) of the assets plus four million dollars. CCNBV is defined as the value reflected in Centronics's consolidated balance sheet as of the closing date, minus certain liabilities. Because CCNBV could not be stated definitely in advance, the parties agreed to derive it by a series of steps that we describe here in a somewhat simplified distillation of their contract documents.

[The process set forth in the agreement stated that Centronics would first propose what the value of the CCNBV would be (following a detailed process set forth in the agreement). If Genicom does not object that value is considered accepted. If Genicom proposed a different value and Centronics doesn't object, Genicom's value is accepted. If both object to the other party's value the dispute]

would be referred to a New York accounting firm for final and binding "determination in accordance with the terms of [the] Agreement," a process that each party now describes as arbitration.

Although the parties agreed to use their best efforts to promote the resolution of disputed issues within fifteen days of their submission to the arbitrator, even on the optimistic assumption that arbitration would conclude that soon the parties faced a potential delay of more than one hundred days between closing and final calculation of the purchase price. Instead of deferring all payment for such a time or longer, they agreed that upon closing Genicom would pay Centronics an amount equal to the purchase price based on the September balance sheet, less \$5,000,000 to be placed in escrow. They also agreed that if Centronics proposed [valuation indicate] a higher purchase price Genicom would promptly increase the escrow deposit by the difference, to be known as the Adjustment Amount.

Distribution from the escrow fund was to be governed by two sets of provisions. Insofar as the escrow agreement relates to the issue before us, it simply provided that "[i]n accordance with Section 2.07 of the Purchase Agreement, the Escrow Agent shall hold the Escrow Fund in its possession until instructed in writing" by respective New York counsel for Centronics and Genicom "to distribute the same or some portion thereof to Centronics or [Genicom] as the case may be," whereupon the escrow agent was to make the distribution as ordered. Section 2.07 of the Purchase Agreement, entitled "Final Payment of Purchase Price," began with a provision that "[f]inal settlement and payment of the Purchase Price shall be made not later than ten days after determination of [CCNBV] and computation of the Purchase Price," whether by agreement of the parties or decision of the arbitrator. There followed detailed instructions for payment out of escrow and final settlement between the parties, which are of no significance in the matter before us, being intended to provide for the payment to

Centronics of whatever balance it might be owed on the purchase price, and the distribution to Genicom of any amount it might be found to have overpaid.

The parties took the first step in applying these valuation and payment provisions at the closing held on February 13, 1987. Centronics's consolidated September balance sheet showed a net book value of \$72,529,000 for the assets to be transferred, to which amount \$4,000,000 was added, to give a preliminary purchase price of \$76,529,000. Genicom placed \$5,000,000 in escrow and paid Centronics the balance of \$71,529,000.

On March 30, 1987, Centronics delivered a revised balance sheet to reflect operations for the four and one-half months before the closing. The revised net book value was \$83,396,000, and Genicom accordingly increased the escrow by depositing the required Adjustment Amount of \$10,867,000, representing the difference between the earlier and later figures. Genicom's accountants then proposed downward adjustments to the revised figures, which would reduce the net book value, and purchase price, by \$10,213,164, almost back to the earlier figure. Centronics objected, and the dispute was submitted to the arbitrator.

The arbitration had begun to drag by the summer of 1987, when Centronics sought a distribution of \$5,653,836 from the escrow fund, being the difference between the total fund of \$15,867,000 and the \$10,213,164 in downward adjustments Genicom had proposed. Centronics described the amount requested as free from dispute and complained of a loss of economic opportunity to use the funds for its corporate purposes. Genicom replied that the purchase agreement provided for no distribution from escrow prior to determination of CCNBV and the final purchase price, which, as it turned out, would presumably be at the close of arbitration.

[The trial court treated Centronics's ill-pleaded complaint as one for a breach of the implied covenant of good faith and fair dealing (which the court will simply call good faith) for Genicom's refusal to release the undisputed amount from the escrow. Originally, Centronics also accused Genicom of delaying the arbitration but at this stage of the litigation it is agreed that the slowness of that process is neither party's fault.]

Genicom moved for summary judgment on the theory that, given the dispute over CCNBV, the terms of the parties' agreements required payments out of escrow only upon completion of arbitration, thus barring the implication of any duty to authorize a distribution before that event. Centronics objected and sought its own summary judgment, grounded on affidavits said to indicate that Genicom's refusal was meant to pressure Centronics into conceding a disputed item worth a substantial amount.

The trial court ruled for Genicom, after construing the contract to provide that the

“only way funds can be released is upon final determination of the purchase price, which, as the parties agree, is in the hands of the arbitrator.

The instant suit is no more than [an] attempt on the part of [Centronics] to rewrite the contract. Essentially, [Centronics] asks this Court to read between the lines of § 2.07 and insert therein a provision regarding partial disbursal of funds from escrow in light of the protracted arbitration. While it is true that the parties contemplated a short time period for resolution of disputes through binding arbitration, the Court cannot insert a provision in the contract for partial payments where such provision does not exist.

[Centronics] should have demanded a mechanism for partial payments from the Escrow Fund if the arbitration process lagged, or if the factual situation regarding adjustments to the final purchase price occurred as it did. The Court will not renegotiate the contract between the parties to obtain this result. To the extent [Centronics] made a less advantageous contract, it must now abide by the terms of that contract as originally agreed.”

Centronics reads the foregoing order as denying that any obligation of good faith is implied in the parties’ contract. We read it differently, as concluding that the express terms of the contract are inconsistent with the claim that an obligation of good faith and fair dealing, or any other sort of implied obligation, either requires Genicom to agree to an interim distribution or bars Genicom from refusing to agree except in return for Centronics’s concession on a disputed item. We consequently view this appeal as raising the related questions of whether the trial judge misunderstood the implied obligation of good faith or misconstrued the contract. We conclude that he did neither.

Although an obligation of good faith is imposed by statute in the performance and enforcement of every contract or duty subject to the Uniform Commercial Code, the parties before us have addressed the implied contractual obligation of good faith at common law.

Our own common law of good faith contractual obligation is not, however, as easily stated as we might wish, there being not merely one rule of implied good faith duty in New Hampshire’s law of contract, but a series of doctrines, each of them speaking in terms of an obligation of good faith but serving markedly different functions . . . we have relied on such an implied duty in three distinct categories of contract cases: those dealing with standards of conduct in contract formation, with termination of at-will employment contracts, and with limits on

discretion in contractual performance, which is at issue in the instant case. Although decisions in the first and second categories are not directly relevant here, a short detour through their cases will serve clarity by indicating the categorical distinctions.

In our decisions setting standards of conduct in contract formation, the implied good faith obligations of a contracting party are tantamount to the traditional duties of care to refrain from misrepresentation and to correct subsequently discovered error, insofar as any representation is intended to induce, and is material to, another party's decision to enter into a contract in justifiable reliance upon it . . .

By way of contrast, the good faith enforced in the second category of our cases is an obligation implied in the contract itself, where it fulfills the distinctly different function of limiting the power of an employer to terminate a wage contract by discharging an at-will employee . . . an employer violates an implied term of a contract for employment at-will by firing an employee out of malice or bad faith in retaliation for action taken or refused by the employee in consonance with public policy . . .

The differences between the obligations of good faith exemplified even in these first two groups of cases are enough to explain why the commentators despair of articulating any single concept of contractual good faith, even after the more than fifty years of litigation following in the wake of the American common law's first explicit recognition of an implied good faith contractual obligation in *Kirke La Shelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87 (1933). See Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L.Rev. 195, 196 (1968); Restatement, *supra* at § 205, comments a, d, e.

Even within the narrower confines of the third category of cases, those governing discretion in contractual performance, the one notable attempt to conceptualize implied good faith in a single, general definition, Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 Harv. L.Rev. 369 (1980), discussed *infra*, is opposed by the view that the obligation of good faith performance is better understood simply as excluding behavior inconsistent with common standards of decency, fairness, and reasonableness, and with the parties' agreed-upon common purposes and justified expectations . . . This view is consonant with our own cases in the third category, a canvass of which should inform our consideration of what good faith may or may not demand of Genicom in the circumstances before us....

In *Seaward Constr. Co. v. City of Rochester*, 118 N.H. 128 (1978), the city was obliged to pay for construction work only to the extent it received federal funds for that purpose, and the

contract expressed no duty on the city's part to seek the funds. When, however, the parties fell into dispute over amounts due, and the city blocked what it believed was the contractor's demand for excessive payment by the simple expedient of refusing to ask for any federal money, this court held that the city could not rely on a lack of federal funds in defending against the contractor's claim for payment, without also proving it had honored an implied obligation to make a good faith effort to obtain the money. Thus . . . the court imposed a limitation on one party's apparent discretion to thwart a reasonable expectation of the other party, going to the essence of the contract.

The next case arose from discretion over the timing of performance. *Lawton v. Great Southwest Fire Ins. Co.*, 118 N.H. 607 held that an insurance company would violate an implied obligation of good faith if it delayed payment owed to its own insured for the purpose of coercing the insured into accepting less than the full amount due. . . . Lawton may be seen as holding that under a contract leaving the time for performance unspecified, good faith limits discretion under a standard of commercial reasonableness. . . Since the timeliness of payment is often essential to the value of insurance, the insured in Lawton, like the . . . contractor in Seaward, could otherwise have been effectively deprived of consideration for his own prior performance (i.e., in paying the premiums due).

. . . once the time for performance has arrived, it would seem that any motive for withholding payment would be improper; e.g., withholding simply to enjoy continued use of the money would be wrong. . .

The remaining two cases have been cited by Centronics as stating relevant New York law. In *Wakefield v. Northern Telecom, Inc.*, 769 F.2d 109 (2d Cir.1985), an employer was held to have violated good faith in firing an employee for the sake of taking advantage of a contract clause extinguishing the employee's right to accrued commissions upon discharge. Here, too, we see an otherwise unregulated right to discharge limited so as to preclude the employer from depriving his employee of contract consideration to which the employee had already become entitled by virtue of his own performance.

Similarly, in *Zilg v. Prentice-Hall, Inc.*, 717 F.2d 671 (2d Cir.1983), a book publisher, whose contract with an author contained no restriction on its discretion to spend much or little in promoting the author's book, was held to be bound in good faith to make enough effort to give the book a reasonable chance of commercial success. Absent such a construction, the publisher would have been free to decline to publicize the book and so to deprive the author of virtually the entire value of the contract.

Despite the variety of their fact patterns, these cases illustrate a common rule: under an agreement that appears by word or silence to invest one party with a degree of discretion in performance sufficient to deprive another party of a substantial proportion of the agreement's value, the parties' intent to be bound by an enforceable contract raises an implied obligation of good faith to observe reasonable limits in exercising that discretion, consistent with the parties' purpose or purposes in contracting. A claim for relief from a violation of the implied covenant of good faith contractual performance therefore potentially raises four questions:

1. Does the agreement ostensibly allow to or confer upon the defendant a degree of discretion in performance tantamount to a power to deprive the plaintiff of a substantial proportion of the agreement's value?
2. If the ostensible discretion is of that requisite scope, does competent evidence indicate that the parties intended by their agreement to make a legally enforceable contract? In many cases, such as *Lawton and Seaward*, this question will not pose a serious issue, and it surely would not call for any extended consideration in the case before us. . .
3. Assuming an intent to be bound, has the defendant's exercise of discretion exceeded the limits of reasonableness? The answer to this question depends on identifying the common purpose or purposes of the contract, against which the reasonableness of the complaining party's expectations may be measured, and in furtherance of which community standards of honesty, decency and reasonableness can be applied.
4. Is the cause of the damage complained of the defendant's abuse of discretion, or does it result from events beyond the control of either party, against which the defendant has no obligation to protect the plaintiff? Although this question is cast in the language of causation, it may be seen simply as the other face of question three. Suffice it to say here that its point is to emphasize that the good faith requirement is not a fail-safe device barring a defendant from the fruits of every plaintiff's bad bargain, or empowering courts to rewrite an agreement even when a defendant's discretion is consistent with the agreement's legally contractual character.

Applying this analytical sequence to the instant case takes us no further than the first of the four questions, whether the agreement effectively confers such discretion on Genicom over the timing of distributions from the escrow fund that, in the absence of some good faith limitation, Genicom could deny Centronics a substantial proportion of the contract's benefit. Was Genicom, that is, given authority to deprive Centronics indefinitely of a portion of the

agreed consideration for the business assets previously transferred? The answer is obviously no. Unlike the contract in *Lawton*, for example, this one contains express and unequivocal provisions governing the timing of payment, which must occur no later than ten days after final resolution of the purchase price, presumably on conclusion of the mandatory arbitration. Genicom has no discretion to withhold approval for pay-out beyond that time, or to affect the timing of the arbitration itself. If, indeed, either party were dragging its heels in the conduct of the arbitration, it should go without saying that the dilatory conduct would be seen as a breach of contract, whether expressed in the language of bad faith or in traditional terms of the obligation to act within a reasonable time. In short, because contractual provisions mandating payment on conclusion of the valuation process determine the date on which Centronics will get its due, it is clear that what Centronics claims to be Genicom's discretion over the timing of distribution is in reality a power that each party may exercise, but only jointly with the other, to agree to remove some or all of the escrowed funds from the ambit of the otherwise mandatory pay-out provisions.

Although this discussion reflects the analytical structure of the prior good faith performance cases cited by Centronics and followed here, we should also note that the same result would obtain from applying an alternative analysis proposed by Professor Burton, referred to above, which Centronics has also urged us to employ. Burton's functional analysis of the obligation to observe good faith in discretionary contract performance applies objective criteria to identify the unstated economic opportunities intended to be bargained away by a promisor as a cost of performance, and it identifies bad faith as a promisor's discretionary action subjectively intended to recapture such an opportunity, thereby refusing to pay an expected performance cost. Centronics argues that its uncontradicted summary judgment affidavits establish that Genicom showed bad faith in Burton's sense, because its refusal to authorize distribution of the so-called undisputed amounts was an "attempt to recapture [the] degree of control concerning the amount of the final purchase price [which] it had agreed to place ... in the arbitrator's hands ... and thereby unjustifiably attain funds to which it was not entitled."

Genicom, of course, denies the uncontradicted evidentiary force that Centronics claim for its affidavits. But even assuming, *arguendo*, that the affidavits are uncontradicted and tend to prove what Centronics asserts, there are two respects in which the facts would fail the Burton test of bad faith as an exercise of discretion meant to recapture an opportunity foregone at the creation of the contract.

It is significant, first, that Genicom's refusal to consent to the distribution from escrow neither recaptures nor gains Genicom anything. In and of itself, the refusal removes no issue from the contingencies of arbitration and gives Genicom no present or future right to the money it

wishes to obtain. Genicom's behavior thus contrasts sharply with examples of bad faith given by Burton, in which the discretionary delay preserved the actual use of funds or other valuable resources to the party exercising the discretion. The point is that only when the discretionary act recaptures an economic opportunity does the exercise of discretion pass from the realm of applying leverage for the sake of inducing further agreement into the sphere of bad faith, in which no agreement is necessary to realize the offending party's advantage.

The contrast is equally stark between the result of Genicom's decision and the beneficial results obtained by defendants in the cases Centronics specifically relies upon. In *Lawton*, for example, by refusing to pay the policy proceeds, the insurance company retained control of the funds, for whatever investment opportunity might be to its advantage. The company had the money and kept it. So too in *Wakefield v. Northern Telecom, Inc.*, where the employer kept the commission money, and in *Zilg v. Prentice-Hall, Inc.*, where the publisher retained the money it refused to spend on advertising the author's book. In each of these cases, the defendant's discretionary act of bad faith kept money in its pocket, with the attendant opportunities to use that money as it saw fit. On the contrary, by Genicom's refusal, standing alone, it neither retains nor obtains a penny of the money it wishes to receive.

A second and more fundamental flaw infects Centronics's reliance on the Burton analysis, however. It will be recalled that Burton's conception of bad faith in performance is the exercise of discretion for the purpose of recapturing opportunities foregone or bargained away at the time of contracting, with the identification of such foregone opportunities depending on objective analysis of the parties' "[e]xpectations [as they] may be inferred from the express contract terms in light of the ordinary course of business and customary practice...." Hence, if an objective basis exists to infer that the parties never bargained away the right of either of them to condition any distribution on completing the arbitration of any disputes, then Genicom can not be guilty of bad faith by so insisting, whatever its subjective motive may be. We infer that the opportunity for such insistence never was bargained away.

Although the contract documents do not concisely state there will be no interim distribution, the texts come very close to such a provision . . .

This reading is confirmed by an understanding of the evident business purposes to be served by such a restriction on pay-out. We explained above that the original escrow of \$5,000,000 was to be increased by Genicom's deposit of an Adjustment Amount, which in effect was equal to the amount of Centronics's proposed revision of the final purchase price in excess of the preliminary purchase price. Although Centronics was obligated to follow accepted

accounting procedures when it revised the balance sheet to calculate any adjustment, the revision was to be unaudited and Genicom had no control over the setting of this amount.

Genicom, however, was not left entirely subject to Centronics's natural temptation to state a higher, rather than a lower, Adjustment Amount. It is reasonable to suppose each party appreciated that the extent of disagreement and the resulting duration of arbitration would be roughly proportional to the size of the Adjustment Amount. If Centronics had to wait upon the outcome of arbitration before it received any escrowed funds, then Genicom would be able to rely on Centronics's own self-interest to limit the probable length of arbitration by limiting the amount of the adjustment potentially subject to arbitration.

It is also reasonable to assume that neither party expected the other to emerge from arbitration with the whole escrow fund. Each therefore had reason to seek some mechanism for inducing the other side to promote speedy arbitration and the prompt distribution of escrowed money. Such a mechanism would be provided by a scheme conditioning any distribution on completing arbitration, since each would thus be induced to hasten the process for their common benefit.

The probability is, therefore, that each party expected the escrow to remain intact throughout arbitration. . . Whether, therefore, we rely on the analysis underlying our own prior cases, or on the rule as espoused by Burton, we affirm the trial judge's conclusion that Centronics is seeking a revision of the contract, not the enforcement of good faith in its performance.

*Affirmed.*

### Notes and Questions

1. Two facts in this case were agreed upon. First, about \$5.7M of the funds held in escrow were undisputed and were eventually bound to be transferred to Centronics. Second, if Genicom had accepted Centronics's request, and if the two companies had approached the escrow agent and asked to transfer those funds to Centronics, the agent would have done so. Why didn't Genicom agree to do it? Why didn't the court agree with Centronics that exercising such leverage is unfair and violates the duty of good faith? Considering Genicom's undisputed power to release those funds, can we really claim that it has no discretion to deny Centronics a significant part of the benefits of the transaction (meaning, receiving and using undisputed funds)?

2. The court seemed to place significant weight on section 2.07 of the parties' agreement, which stated that the funds in escrow would be distributed at the conclusion of the arbitration. Was such reliance justified considering the trial court's finding that "the parties contemplated a short time period for resolution of disputes through binding arbitration"?
3. In discussing the nature of good faith, the New Hampshire Supreme Court quoted the works of Professors Steven Burton and Robert Summers. Burton proposed a unified concept for good faith, and Justice Souter discussed his approach in detail at the end of his opinion. Summers, on the other hand, argued that good faith is "a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith." 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). He provides a partial list of circumstances where the courts found an activity to be in bad faith to demonstrate the inability to find a unified rule of this concept:

***Form of Bad Faith Conduct***

***Meaning of Good Faith***

I. seller concealing a defect in what he is selling

fully disclosing material facts

2. builder willfully failing to perform in full, though otherwise substantially performing

substantially performing without knowingly deviating from specifications

3. contractor openly abusing bargaining power to coerce an increase in the contract price

refraining from abuse of bargaining power

4. hiring a broker and then deliberately preventing him from consummating the deal

acting cooperatively

5. conscious lack of diligence in mitigating the other party's damages

acting diligently

6. arbitrarily and capriciously exercising a power to terminate a contract.

acting with some reason

- |   |                                       |
|---|---------------------------------------|
| 7. adopting an overreaching interpretation of contract language     | interpreting contract language fairly |
| 8. harassing the other party for repeated assurances of performance | accepting adequate assurances         |

*Id.*, at 203. The Restatement seems to express a somewhat similar notion, stating that “[t]he phrase ‘good faith’ is used in a variety of contexts, and its meaning varies somewhat with the context.” Restatement (Second) Contracts § 205, cmt. a. While the Court in *Centronics*, like Summers, seemed to also perceive good faith as a collection of rules, several other courts and commentators have adopted a more unified approach, similar to that of Burton. Is Judge Posner’s position in *Frey* closer to that of Summers or that of Burton?

4. What are the implications of a breach of the duty of good faith? In this case, Centronics originally pled it as a tort, but both the trial court and the state Supreme Court treated it as a breach of contract claim. That is the dominant approach, as the UCC makes clear: “This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract.” UCC § 1-304, cmt. 1. In other words, just like any other implied term, the duty of good faith is read into the contract itself.
5. The Court in *Centronics* listed a few typical categories in which the duty of good faith can be considered: during negotiation, where it is quite narrow, when dealing with at-will employment, and when one party has significant discretion that allows it to deny significant benefits of the deal from the other party. Notice that this is probably not a closed list—the facts of *Frey*, for example, seem to be outside of those categories. However, many situations in which courts apply the duty of good faith can be characterized by one party having meaningful discretion over the performance of the contract. Examples include requirement and output contracts, at-will employment agreements, promises to negotiate, the parties’ duty during contract modification, and more.

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We so far saw cases where courts applied the common law doctrine of good faith. Would the doctrine similarly apply in the UCC environment? Would there be any reason to think the law

of good faith would be different in that context? Keep this question in mind as you read the next case.

**Feld v. Henry S. Levy & Sons, Inc.**

335 N.E.2d 320 (New York Court of Appeals 1975)

COOKE, J.

Plaintiff operates a business known as the Crushed Toast Company and defendant is engaged in the wholesale bread baking business. They entered into a written contract, as of June 19, 1968, in which defendant agreed to sell and plaintiff to purchase “all bread crumbs produced by the Seller in its factory at 115 Thames Street, Brooklyn, New York, during the period commencing June 19, 1968, and terminating June 18, 1969,” the agreement to “be deemed automatically renewed thereafter for successive renewal periods of one year” with the right to either party to cancel by giving not less than six months notice to the other by certified mail. No notice of cancellation was served. . . .

Interestingly, the term “bread crumbs” does not refer to crumbs that may flake off bread; rather, they are a manufactured item, starting with stale or imperfectly appearing loaves and followed by removal of labels, processing through two grinders, the second of which effects a finer granulation, insertion into a drum in an oven for toasting and, finally, bagging of the finished product.

Subsequent to the making of the agreement, a substantial quantity of bread crumbs, said to be over 250 tons, were sold by defendant to plaintiff but defendant stopped crumb production on about May 15, 1969. There was proof by defendant’s comptroller that the oven was too large to accommodate the drum, that it was stated that the operation was “very uneconomical,” but after said date of cessation no steps were taken to obtain more economical equipment. The toasting oven was intentionally broken down, then partially rebuilt, then completely dismantled in the summer of 1969 and, thereafter, defendant used the space for a computer room. It appears, without dispute, that defendant indicated to plaintiff at different times that the former would resume bread crumb production if the contract price of 6 cents per pound be changed to 7 cents, and also that, after the crumb making machinery was dismantled, defendant sold the raw materials used in making crumbs to animal food manufacturers.

Special Term denied plaintiff’s motion for summary judgment on the issue of liability and turned down defendant’s counter-request for a summary judgment of dismissal. From the Appellate Division’s order of affirmance, by a divided court, both parties appeal.

Defendant contends that the contract did not require defendant to manufacture bread crumbs, but merely to sell those it did, and, since none were produced after the demise of the oven, there was no duty to then deliver and, consequently from then on, no liability on its part. Agreements to sell all the goods or services a party may produce or perform to another party are commonly referred to as “output” contracts, and they usually serve a useful commercial purpose in minimizing the burdens of product marketing. The Uniform Commercial Code rejects the ideas that an output contract is lacking in mutuality or that it is unenforceable because of indefiniteness in that a quantity for the term is not specified. Official Comment 2 to section 2-306 states in part: “Under this Article, a contract for output . . . is not too indefinite since it is held to mean the actual good faith output . . . of the particular party. Nor does such a contract lack mutuality of obligation since, under this section, the party who will determine quantity is required to operate his plant or conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his output . . . will approximate a reasonably foreseeable figure.”

The real issue in this case is whether the agreement carries with it an implication that defendant was obligated to continue to manufacture bread crumbs for the full term. Section 2-306 of the Uniform Commercial Code, entitled “Output, Requirements and Exclusive Dealings” provides:

- (1) A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.
- (2) A lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale. (Emphasis supplied.)

The Official Comment thereunder reads in part: “Subsection (2), on exclusive dealing, makes explicit the commercial rule embodied in this Act under which the parties to such contracts are held to have impliedly, even when not expressly, bound themselves to use reasonable diligence as well as good faith in their performance of the contract. . . . An exclusive dealing agreement brings into play all of the good faith aspects of the output and requirement

problems of subsection (1). It also raises questions of insecurity and right to adequate assurance under this Article.”

Section 2-306 is consistent with prior New York case law. Every contract of this type imposes an obligation of good faith in its performance. Under the Uniform Commercial Code, the commercial background and intent must be read into the language of any agreement and good faith is demanded in the performance of that agreement, and, under the decisions relating to output contracts, it is clearly the general rule that good faith cessation of production terminates any further obligations thereunder and excuses further performance by the party discontinuing production.

This is not a situation where defendant ceased its main operation of bread baking. Rather, defendant contends in a conclusory fashion that it was “uneconomical” or “economically not feasible” for it to continue to make bread crumbs. Although plaintiff observed in his motion papers that defendant claimed it was not economically feasible to make the crumbs, plaintiff did not admit that as a fact. In any event, “economic feasibility,” an expression subject to many interpretations, would not be a precise or reliable test.

There are present here intertwined questions of fact, whether defendant performed in good faith and whether it stopped its manufacture of bread crumbs in good faith, neither of which can be resolved properly on this record. The seller’s duty to remain in crumb production is a matter calling for a close scrutiny of its motives, confined here by the papers to financial reasons. It is undisputed that defendant leveled its crumb making machinery only after plaintiff refused to agree to a price higher than that specified in the agreement and that it then sold the raw materials to manufacturers of animal food. There are before us no componential figures indicating the actual cost of the finished bread crumbs to defendant, statements as to the profits derived or the losses sustained, or data specifying the net or gross return realized from the animal food transactions.

The parties by their contract gave the right of cancellation to either by providing for a six months’ notice to the other. The apparent purpose of such a stipulation was to provide an opportunity to either the seller or buyer to conclude their dealings in the event that the transactions were not as profitable or advantageous as desired or expected, or for any other reason. Correspondingly, such a notice would also furnish the receiver of it a chance to secure another outlet or source of supply, as the case might be. Short of such a cancellation, defendant was expected to continue to perform in good faith and could cease production of the bread crumbs, a single facet of its operation, only in good faith. Obviously, a bankruptcy or genuine imperiling of the very existence of its entire business caused by the production of the crumbs

would warrant cessation of production of that item; the yield of less profit from its sale than expected would not. Since bread crumbs were but a part of defendant's enterprise and since there was a contractual right of cancellation, good faith required continued production until cancellation, even if there be no profit. In circumstances such as these and without more, defendant would be justified, in good faith, in ceasing production of the single item prior to cancellation only if its losses from continuance would be more than trivial, which, overall, is a question of fact.

The order of the Appellate Division should be affirmed, without costs.

### Notes and Questions

1. There was more in the official comments of the UCC section on requirements and outputs contracts that might have been relevant to *Feld*. Consider this in Comment 2: "Reasonable elasticity in the requirements is expressly envisaged by the section and good faith variations from prior requirements are permitted *even when the variation may be such as to result in discontinuance*. A shut-down by a requirements buyer for lack of orders might be permissible when a shut-down merely to curtail losses would not be. The essential test is whether the party is acting in good faith." Did the court not mention this because of an important difference between requirements contracts and output contracts? What would that be?
2. Did you notice in the Official Comment about exclusive dealings that it defines "best efforts" in § 2-306(2) as "reasonable effort and due diligence"? What do you make of that given our discussion after *Wood* above?
3. Is the ultimate determination about good faith a question of law for the judge or a question of fact for the factfinder? Are the good faith cases you read so far consistent in answering this question?
4. As a contract drafting note, it is important to be aware of Comment 3 associated with § 2-306: "If an estimate of output or requirements is included in the agreement, no quantity unreasonably disproportionate to it may be tendered or demanded. Any minimum or maximum set by the agreement shows a clear limit on the intended elasticity. In a similar fashion, the agreed estimate is to be regarded as a center around which the parties intend the variation to occur." Then again, if you have covered the *Columbia Nitrogen Corp.* case in your interpretation materials, it is worth thinking through how this provision reflects on that case.