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Feature

Contract Law II

***1190 STILL KEEPING THE FAITH: THE DUTY OF GOOD FAITH REVISITED**

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The duty of good faith and fair dealing is implied in every contract. The Restatement (Second) Contracts, Section 205 states: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." The Uniform Commercial Code (UCC) also imposes a duty of good faith. UCC Section 1-203 provides: "Every contract or duty within the Act imposes an obligation of good faith in its performance or enforcement." The UCC sets forth the extent of that obligation depending on the status (merchant v nonmerchant, etc.) of the contracting parties.

Despite these general rules imposing implied duties, courts continue to disagree about how the duty of good faith should be applied. Some courts have refused to impose an implied duty of good faith in certain transactions. Even where a duty to act in good faith is recognized, most courts have held that the duty cannot override express contractual provisions. Other cases suggest that the duty imposes obligations on the contracting parties beyond those expressed in the contract.

This article supplements the March 1991 article authored by Gerard Mantese, entitled *The UCC and Keeping the (Good) Faith*. [FN1] We will survey recent cases which attempt to define the obligations imposed by the implied duty of good faith.

GOOD FAITH DEFINED--OBJECTIVE v SUBJECTIVE GOOD FAITH

Restatement's Position

Section 205 of the Restatement (Second) Contracts, quoted above, has been held to impose an objective standard of good faith. [FN2] It is not enough for a contracting party to believe that he or she is acting in good faith. Rather, the contracting party's conduct must be objectively reasonable. Comment d to Section 205 of the Restatement states that good faith is violated "even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty." [FN3]

Comment d also provides examples of bad faith which include "evasion of the spirit of the bargain" and "abuse of a power to specify terms."

UCC's Position

The UCC specifically imposes two distinct duties of good faith depending upon the status of the parties. "Merchants" are held to a higher standard than "nonmerchants." For example, UCC Section 2-103(1)(b) provides: " 'Good faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." [FN4]

On the other hand, with respect nonmerchants, Section 1-201(19) provides: "Good faith means honesty in fact in the conduct

or transaction concerned." Therefore, nonmerchants have an obligation of mere subjective good faith while merchants are also held to an objective standard. [FN5] A nonmerchant can meet its good faith duty if he or she has an honest but unreasonable belief that he or she acting in good faith. [FN6] Merchants on the other hand, must act honestly and reasonably. [FN7] For purposes of Article Two, a merchant is defined as:

[A] person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill. [FN8]

Since the status of the parties under Article 2 of the UCC determines the standard of good faith to which they are held, the parties' status can dictate whether a party's actions violate the implied covenant of good faith.

It should be noted that some court in applying the subjective standard of good faith, have required more than simply *1191 refraining from dishonest behavior. For example, the U.S. Court of Appeals for the Ninth Circuit explained:

This covenant [of good faith and fair dealing] not only "requires each contracting party to refrain from doing anything to injure the right of the other to receive the benefits of the agreement," "but also [imposes] the duty to do everything that the contract presupposes that he will do to accomplish its purpose." [FN9]

It is possible for contracting parties to modify the standard of good faith owed by defining whether the parties are held to an objective or subjective standard. [FN10]

THE DUTY OF GOOD FAITH CANNOT BE WAIVED OR DISCLAIMED

Although contracting parties may be successful in limiting or defining the scope of obligations owed by the duty of good faith, it is widely recognized that the duty cannot be completely waived or bargained away. [FN11] For example, UCC Section 1-102(3) provides:

The effect of provisions of this act may be varied by agreement, except as otherwise provided in this act and except that the **obligations of good faith**, diligence, reasonableness and care prescribed by this act **may not be** disclaimed by agreement **but the parties may by agreement determine the** standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable. [FN12]

Further, with respect to bank deposits and collections, UCC Section 4-103(1) provides: "the parties to the agreement cannot disclaim a bank's responsibility for its lack of good faith or failure to exercise ordinary care or limit the measure of damages for the lack of failure." [FN13] Further, in non-UCC transactions, liability cannot be waived for recklessness, willfulness, and gross negligence. [FN14]

GOOD FAITH REQUIRES THAT A PARTY NOT COMPROMISE THE OTHER PARTY'S RIGHTS

The duty of good faith requires a party to refrain from acting in a way which jeopardizes another party's contractual rights. Comment a to Section 205 of the Restatement (Second) Contracts states that a party performs in good faith if it acts with a "faithfulness to an agreed common purpose and consistency with the justified expectations of the other party." [FN15] The generally recognized duty of good faith and fair dealing is that it "prevents one party to the contract from exercising a judgment conferred by the express terms of agreement in such a manner as to evade the spirit of the transaction or so as to deny the other party the expected benefit of the contract." [FN16]

In a case decided this year, the U.S. District Court for the Eastern District of Pennsylvania cited common examples of

conduct that would violate the duty of good faith:

The obligation to act in good faith in the performance of contractual duties varies somewhat with the context and is impossible to define completely, but it is possible to recognize certain strains of bad faith which include: evasion of the spirit of the bargain; lack of diligence and slacking off; willful rendering of imperfect performance; abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance. [FN17]

In *Uptown Heights Associates Limited Partnership v Seafirst Corp*, [FN18] the Supreme Court of Oregon recently held that good faith "is to be applied in a manner that will effectuate the reasonable contractual expectations of the parties," but that "only the objectively reasonable expectations of [the] parties" will be examined. The Court added that "the party invoking its expressed, written contractual rights does not, merely by so doing, violate its duty of good faith." [FN19]

DISCRETIONARY DUTIES MUST BE EXERCISED IN GOOD FAITH

Since at least 1974, Michigan courts have imposed a duty of good faith in performing discretionary duties. [FN20] A discretionary duty which carries an obligation to act in good faith includes discretion to estimate the amount of taxes and insurance that had to be paid on a mortgage [FN21] and the discretion to continue insurance coverage for laid-off employees. [FN22]

Although in Michigan the breach of the duty of good faith does not provide an independent cause *1192 of action in tort, [FN23] the U.S. District Court for the Eastern District of Michigan in *Paradata Computer Networks, Inc v Telebit Corp*, [FN24] explained: "Michigan courts will recognize an action for breach of an implied covenant of good faith and fair dealing where 'a party to a contract makes the manner of its performance a manner of its own discretion.'" [FN25]

In many instances, a contracting party can reserve unrestricted discretion. In interpreting Illinois law, in *Metro Communications Co v Ameritech Mobile Communications, Inc*, [FN26] the Sixth Circuit Court of Appeals held that a contract provision in which Ameritech reserved the right to compete permitted it to enter into a contract with the plaintiff's competitors at better terms than those offered to the plaintiff. The court held that the duty of good faith did not restrict Ameritech's right to compete:

In essence, the plaintiffs are arguing that although Ameritech has a right to compete, that right has limits and should not be so broad that it makes their contracts so uncompetitive that they are useless. But the implied covenant of good faith is a construction aid that helps a court determine the intent of the parties; it cannot be used to add terms to the contract when there is no evidence that the parties intended that those terms be included. In this case, Ameritech's right to compete is unrestricted. As the district court stated, "Plaintiffs are attempting to read an implied restricted competition clause into an express right to compete clause." [FN27]

In *Maida v Retirement & Health Services Corp*, [FN28] a contract for the sale of property between the Archbishop of the Archdiocese of Detroit and a developer of a retirement facility contained provisions which permitted either party to terminate the sale "in its sole discretion." The U.S. District Court for the Eastern District of Michigan held: "The Court is persuaded that the right of termination reserved by the parties under the terms of the Agreement is not subject to an additional, implied duty of good faith." [FN29] The Sixth Circuit Court of Appeals affirmed the district court without "decid[ing] whether the Archbishop was bound to exercise his discretion in good faith because we find no evidence that he failed to do so in any event." [FN30]

In a case decided in 1997 by the Washington Court of Appeals, *Goodyear Tire & Rubber Co v Whiteman Tire, Inc*, [FN31] the court held that the duty of good faith and fair dealing did not prevent Goodyear from exercising its express contractual right to establish its own outlets and to sell tires in the dealer's trade area, despite oral assurances by the company that "it

would not solicit customers or interfere in the dealer's general market area so long as Whiteman adequately serviced its customers." [FN32] Stating that the duty of good faith and fair dealing only applies to discretionary duties, the court held:

... the contract provision reserving Goodyear's right to sell in Whiteman's trade area is not stated by reference to a certain context. It is unconditional, and, does not call for the exercise of discretion and the consequent implied covenant to exercise that discretion in good faith. It was not reasonable for Whiteman to rely on Goodyear's assurances directly contrary to the language of the contract, especially in light of the additional provision that the contract completely expressed the obligations of the parties. [FN33]

Even where sole discretion is reserved under the contract, a contracting party must allow the other party to enjoy the fruits of the contract, and must act honestly and avoid pretext.

Two months ago, in *Locke v Warner Bros Inc*, [FN34] actress and director, Sondra Locke and Warner Brothers studios entered into an agreement under which Locke would submit proposals for movies to Warner Brothers. In turn, the studio promised to produce and allow Locke to direct those of her projects which the studio approved at its "creative discretion." Locke was also guaranteed minimum payments under the contract. After the studio rejected all of Locke's proposals, but made all guaranteed payments under the agreement, Locke sued for breach of contract.

The studio sought summary judgment claiming that the duty of good faith could not alter its sole creative discretion and also because it fulfilled all of its express obligations by making all of the guaranteed payments provided for under the contract. Locke presented evidence that Warner Brothers "categorically refus[ed] to work with her, irrespective of the merits of her proposals." She also argued that the studio had no intent to approve her projects, but had entered into the contract to get Locke to settle another lawsuit with her former love interest, Clint Eastwood.

The trial court summarily dismissed Locke's good faith claim, but the California Court of Appeals, in an August 1997 decision, reversed:

While Warner was entitled to reject Locke's proposals based on its subjective dissatisfaction, the evidence calls into question whether Warner had an honest or good faith dissatisfaction with Locke's proposals, or whether it merely went through the motions of purporting to "consider" her projects.

* * *

The Locke/Warner agreement did not give Warner the express right to refrain from working with Locke. Rather, the agreement gave Warner discretion with respect to developing Locke's projects. The implied covenant of good faith and fair dealing obligated Warner to exercise that discretion honestly and in good faith.

In sum, the Warner/Locke agreement contained an implied covenant of good faith and fair dealing, that neither party would frustrate the other party's right to receive the benefits of the contract. Whether Warner violated the implied covenant and breached the contract by categorically refusing to work with Locke is a question for the trier of fact. [FN35]

Further, the California Court of Appeals held that simply paying all of the guaranteed payments under the contract did not relieve Warner Brothers of its duty of good faith:

Merely because Warner paid Locke the guaranteed compensation under the agreement does not establish Warner fulfilled its contractual obligation. As pointed out by Locke, the value in the subject development deal was not merely the guaranteed payments under *1193 the agreement, but also the opportunity to direct and produce films and earn additional sums, and most importantly, the opportunity to promote and enhance a career.

Unquestionably, Warner was entitled to reject Locke's work based on its subjective judgment, and its creative decision in that regard is not subject to being second-guessed by a court. However, bearing in mind the requirement that subjective

dissatisfaction must be an honestly held dissatisfaction, the evidence raises a triable issue as to whether Warner breached its agreement with Locke by not considering her proposals on their merits. [FN36]

CAN THE DUTY OF GOOD FAITH VARY THE EXPRESS TERMS OF A CONTRACT?

It is commonly held that the implied duty of good faith and fair dealing cannot alter or override express terms of a contract. [FN37] The duty of good faith "does [not] require a party to ignore, forego or waive its express contractual rights." [FN38] This point may seem to conflict with court rulings that say that a party, in exercising its rights, cannot harm the other party's contractual expectations.

A 1996 case dealing with these issues is *Vylene Enterprises, Inc v Naugles, Inc*, [FN39] which involved a dispute over a franchise agreement. The franchisee restaurant began to experience financial difficulties toward the end of a 10-year lease. Shortly before the end of the lease, the franchisee paid its past-due rent and notified the franchisor of its intent to exercise a provision extending the franchise agreement, providing for an eight-year extension "on terms and conditions to be negotiated." [FN40] A month later, the franchisor opened a competing company-owned restaurant within a mile and a half of the plaintiff's restaurant. The Ninth Circuit Court of Appeals held that although the franchisor reserved its right to compete with the plaintiff/franchisee, the franchisor breached its duty of good faith and fair dealing by establishing the competing restaurant, which offered a new menu with smaller portions at lower prices. The court held:

Vylene [the plaintiff/franchisee] did not have any rights to exclusive territory under the terms of the franchise agreement, and we do not impliedly read any such rights into the contract. However, Naugles' construction of a competing restaurant within a mile and a half of Vylene's restaurant was a breach of the covenant of good faith and fair dealing. The bad faith character of the move becomes clear when one considers that building the competing restaurant had the potential to not only hurt Vylene, but also to reduce Naugles' royalties from Vylene's operations. [FN41]

Thus, although the franchisor in *Vylene* had a contractual right to compete, its actions in compromising its own royalties appeared to be spiteful and vindictive and were therefore a breach of the duty of good faith and fair dealing.

Since the duty of good faith cannot override express contractual terms, certain agreements by their terms do not require the exercise of good faith. In *Uptown Heights*, supra, the bank did not breach its duty of good faith by foreclosing a loan when the borrower failed to make timely payments where the loan agreement permitted the bank to foreclose "for any default" of the borrower. [FN42]

Similarly, in *Check Reporting Services, Inc v Michigan Nat Bank-Lansing*, [FN43] the Michigan Court of Appeals held that the duty of good faith does not prevent a bank from calling in a demand note and accelerating the maturity of a loan without any advance notice. The court relied on the comment to UCC Section 1-208 (imposing a duty of good faith on the right to accelerate payment or require collateral) which states: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason." Therefore, the court held that the nature of a demand note is such that they can be terminated at-will, and the creditor is not burdened with the obligations of the duty of good faith in calling in such a note or in accelerating payment. [FN44]

A demand note, however, does not override a party's good faith obligations owed pursuant to other agreements between the parties or where there is a "consistent and uninterrupted" course of performance between parties. [FN45] The 1997 case of *Coddon v Youngkrantz*, [FN46] involved a land contract where the parties' course of performance indicated that the purchaser was occasionally late making payments, and the vendor accepted such late payments, together with interest. However, one time when the purchaser made a payment seven days late, the vendor refused to accept the payment, and instead took possession of the property. The court held that the vendors conduct breached the duty of good faith: "[The

vendor's] act of refusing payment appears to be an attempt to create a default, violating the implied covenant of good faith and fair dealing that was part of the parties' contract." [FN47]

Likewise, "the right to terminate the contract at will does not vitiate a party's expectations while the contract remains in force." [FN48] In *Becks Office Furniture and Supplies, Inc v Haworth, Inc*, [FN49] the U.S. Court of Appeals for the Tenth Circuit held that even though a contract may be terminable at will by either party, the parties still have a duty to perform in good faith all obligations undertaken before termination. The case involved a manufacturer's decision to terminate one of its dealers. Before electing to terminate the dealer, Haworth, the manufacturer, began giving preference to CCG, a nondealer. The contract, which permitted Haworth to compete with its dealers, contained a provision stating, "whenever possible, [Haworth will] include dealer participation as a serving dealer on these projects." [FN50] The contract also included vague assurances "to make readily available to [the dealer] the tools that will help you be successful." [FN51] A jury returned in favor of the plaintiff-dealer, and the Court of Appeals affirmed:

While the terms in the written dealer agreement themselves may not have given rise to enforceable obligations with regard to Haworth's duty to help Becks win project sales in its territory, or to prefer it to nondealers, or to award it dealer service fees, the jury was entitled to find consistent implied terms creating these obligations.

* * *

Substantial evidence also supports the jury's finding that Haworth breached the implied covenant of good faith and fair dealing in the manner it preferred CCG, a nondealer, to Becks, and in the manner it failed to *1194 support Becks' efforts to win the projects on which it claims lost profits. Even if the at-will exception to enforcing the implied covenant extends beyond employment contracts, it is still inapplicable in this context, where the claimed breach is not Becks' termination, but actions Haworth took before it terminated Becks. [FN52]

Even where a contract is terminable at will, some courts have held that parties must act in good faith in terminating the agreement. In *Cherick Distributors, Inc v Polar Corporation*, [FN53] the Massachusetts Appeals Court upheld a jury verdict that awarded damages to a distributor for wrongful termination of the distributorship agreement. There, a manufacturer terminated a contract after it learned that one of its distributors planned a meeting with other distributors to form an association to negotiate with the manufacturer. The court held that the manufacturer's termination of Cherick, the organizing distributor, on the eve of the meeting was a breach of good faith:

The evidence revealed that Polar terminated its unwritten distributorship agreement with Cherick upon discovering that Cherick's president, Richard Corey, had written a letter to other Polar distributors urging them to attend a meeting to discuss the possibility of forming an association to negotiate with Polar. As its reason for termination, Polar initially cited Cherick's expired letter of credit, which had expired a year and one-half earlier. However Polar's vice president admitted that the letter of credit issue was a pretext. The termination of Cherick's contract was to take effect upon only four days' notice, on the eve of the distributors' scheduled meeting.

* * *

The jury could have found that the abrupt termination of Cherick's distributorship agreement, coinciding as it did with the planned meeting of Polar distributors, was calculated to put Cherick out of business and thereby discourage other distributors from meeting. By the same token, the jury could have rejected Polar's assertion that the short notice period was for the purpose of protecting Polar's customers. The evidence indicated that the four-day notice left Cherick with no time to secure another supplier make adjustments in its equipment and warehouse, and maintain its staff. Accordingly, there was adequate support for the jury's finding that four days' notice was unreasonable and that it constituted a breach of the covenant of good

faith and fair dealing. [FN54]

In a case decided earlier this year, *Sons of Thunder, Inc v Borden, Inc*, [FN55] the Supreme Court of New Jersey held that even though the jury determined that a contracting party was not in breach of a termination clause of a contract, it was permitted to find that the contracting party was still in breach of its duty of good faith and fair dealing in exercising its rights to terminate the contract. There, the plaintiff along with its owner and related entities were engaged in the business of clam fishing, and had a long course of dealing with Borden. In fact, with Borden's assistance in obtaining financing, the plaintiff purchased a boat exclusively for the use of performing a contract with Borden. A one-page written contract between the parties provided:

The term of this contract shall be for a period of one (1) year, after which this contract shall automatically be renewed for a period up to five years. Either party may cancel this contract by giving prior notice of said cancellation in writing Ninety (90) days prior to the effective cancellation date. [FN56]

The contract also specified a minimum amount of clams that Borden would purchase from the plaintiff each week at the market rate. Borden never met the required minimum. Testimony was offered which suggested that "the intention of the parties was that either party could terminate the contract at the end of the first year upon 90 days notice, and if the contract was not terminated, the parties were locked in for five years." [FN57] There was also evidence that Borden intended the agreement to be a long-term contract. However, after Borden's management and business plans had changed, and the overall demand for clams began to decline, Borden decided to terminate the contract pursuant to the 90-day requirement, but it did so before the five-year expiration date.

The jury returned a special verdict that Borden did not breach the termination provision of the contract. However, the jury found that Borden breached its duty of good faith and fair dealing in terminating the agreement, and it awarded the plaintiff one year of profits under the contract, \$412,000, for the breach of the duty of good faith. [FN58]

The trial court refused to enter a judgment notwithstanding the verdict because there was evidence of lack of good faith. For example, the plaintiff submitted evidence that at a time when one of the plaintiff's ships was out of commission, Borden extended an advance against future receivables. Borden had agreed to advance these funds without interest, and not to hold the plaintiff's president personally liable. Before terminating the contract, Borden increased the rate at which the advance would be paid back, and it began charging interest. Borden also required the plaintiff to restructure some of its loans and related companies.

The appellate court vacated the judgment, reasoning that an implied covenant of good faith and fair dealing could not override or eliminate Borden's express right to terminate the contract on 90 days notice. [FN59]

In 1997, the state's highest court overruled the appellate court and reinstated the jury's verdict. Noting that "[t]he obligation to perform in good faith exists in every contract, including those contracts that contain express and unambiguous provisions permitting either party to terminate the contract without cause," the New Jersey Supreme Court held:

When all [of the] relationships [between Borden and the plaintiff, its owner, and its related entities] are viewed together, there is sufficient evidence for the jury's conclusion that Borden breached its duty to perform the contract in good faith. In reaching that conclusion, we consider only Borden's performance during the contractual period, including the conduct surrounding the termination of the contract. We do not consider Borden's dealings following the termination of the contract because they are irrelevant to whether Borden performed the contract in good faith.

The New Jersey Supreme Court also noted that the jury verdict was supported by the evidence which demonstrated that:

- Borden was aware of the plaintiff's loans;
- The plaintiff had guaranteed loans of its related entities;
- *1195 • The plaintiff relied on income from Borden to repay the loans;
- New management for Borden told the plaintiff's owner that it did not intend to honor the contract;
- Borden continuously breached the contract by never buying the required amount, and
- Eventually Borden stopped buying clams from the plaintiff.

Yet, despite knowing the "desperate financial straits" [FN60] of the plaintiff and its related entities, Borden pressured the plaintiff to obtain financing to pay back the advance. Finally, the Supreme Court held that the assessment of one year's worth of profits was appropriate where a buyer breaches the implied covenant of good faith and fair dealing.

In *Conoco Inc v Inman Oil Company, Inc*, [FN61] discussed in *The UCC and Keeping the (Good) Faith* (Mich BJ March 1991), the court held that a distributor's actions in stealing a customer away from its distributor violated the duty of good faith. Inman Oil, a distributor of petroleum and non-petroleum products, entered into a Jobber Franchise Agreement with Conoco. After the parties entered into the contract, Conoco began selling oil directly to Inman's best long-term customer, at prices lower than Inman could purchase from Conoco. The court held that this conduct violated the duty of good faith:

This implied covenant imposes upon each party the duty to do nothing destructive of the other party's right to enjoy the fruits of the contract and to do everything that the contract presupposes they will do to accomplish its purpose. Together with the express provision, found in each of the serial [Agreements] between the parties, that Conoco would promote the success of Inman Oil, the implied obligation of good faith and fair dealing represented Conoco's promise not to engage in activities harmful to Inman Oil.... [FN62]

ASSUMED AND ONGOING OBLIGATIONS OF THE DUTY OF GOOD FAITH

Even where a contracting party has the right to terminate a contract at will, if it assumes obligations in addition to those in the contract, it must perform those additional obligations in good faith. In *Travel Services Network, Inc v Presidential Financial Corp of Massachusetts*, [FN63] the U.S. District Court for the District of Connecticut held in 1997, that a borrower stated a claim for breach of the implied covenant of good faith and fair dealing, even though the borrower waived its rights to any notice of termination, because the bank had willfully responded falsely to inquiries about its intent to restrict or terminate the borrower's line of credit. The court noted that the plaintiff was not employing the duty of good faith to modify the lender's right to terminate because the lender "has not identified any contractual basis for a right to respond falsely to direct inquiries." Further, the court held:

TSN [the borrower] does not argue that Presidential [the lender] was obligated to respond to its inquiries, but maintains that when Presidential chose to respond, Presidential became obligated to respond honestly. The Court agrees that dishonesty in these circumstances would violate the implied covenant of goodfaith. [FN64]

In Michigan, the duty of good faith may give rise to a cause of action akin to fraudulent omission, where one party acquires material information after the contract was consummated but fails to disclose it to the other party. In *Lawyers Title Ins v First Federal Savings Bank*, [FN65] a title insurance company sued a mortgagee-bank, First Federal, after the title company, which issued an insurance policy, discovered that the mortgagor did not have title to the property, and that the title documents had been forged. First Federal had previously demanded indemnity from Lawyers Title, which then filed this declaratory action

claiming that it was not liable for indemnification because, at the time that the policy was issued, First Federal had knowledge or information of a defect in the title which it failed to disclose.

The U.S. District Court for the Eastern District of Michigan stated that "parties to a contract have a continuing obligation to act in good faith and must disclose subsequently acquired information if suppression of such information would render previously conveyed representations untrue or misleading." [FN66] However, the court granted summary judgment to First Federal because First Federal did not apply for the title policy and was not the title holder. Thus, First Federal presumably did not owe a contractual duty of good faith. The court also held that First Federal made no affirmative representations to Lawyers Title, and that Lawyers Title did not rely on First Federal's failure to disclose subsequently learned information:

The fact is that Lawyers Title failed to detect the forged documents in its title search, even though it physically examined the documents and itself had actual knowledge of possible title defects before it issued the policy.... Lawyers Title seems to be saying that if First Federal had only told it that they were dealing with a crook at the outset, it would have looked at the title documents more carefully. However, nothing in the terms of the mortgage title insurance policy requires that an insured investigate a borrower in this way. The purpose of mortgage title insurance is to make the insurer the guarantor of its own title search. In this case, Lawyers Title insured First Federal against the possibility of a forgery and it must now make good on its promise. [FN67]

IS THERE A DUTY TO NEGOTIATE IN GOOD FAITH?

Generally, courts will not impose a duty upon noncontracting parties to enter into a contract or to sit down at the bargaining table and negotiate in good faith. [FN68] Therefore, a party can refuse to enter a contract for a good reason, a bad reason, no reason, and even a bad faith reason, excepting, of course, actions which violate statutory or constitutional guarantees against discrimination. For example, in *State Bank of Standish v Curry*, [FN69] the Court of Appeals held that a bank does not have a duty of good faith to issue a loan:

The first allegation we must address is the Currys' claim that "the bank, in its business relationship over the years with counter-plaintiffs, had a duty of good faith performance and fair dealing which it breached" by refusing to extend an operating loan in 1986. The Currys cite MCL Sec 440.1203; MSA Sec 19.1203 as authority under which such a duty should be imposed upon the bank, but a bank's decision to not issue a new loan to a customer, in the absence of an agreement or commitment, does not fall within the purview of the Uniform Commercial Code. Nor are we willing to impose such a duty on the bank merely because it had issued loans to the Currys in years past. The Currys have referred us to no cases holding to the contrary and, consequently, we find that the trial court properly granted summary disposition of this count of the counterclaim. [FN70]

However, courts appear to impose a duty to negotiate in good faith for a renewal of *1196 a contract where there is an undertaking or commitment to do so. In *Vylene Enterprises, Inc v Naugles, Inc*, supra, the Ninth Circuit Court of Appeals held that a franchisor negotiated the renewal of a contract in bad faith. Although an express provision providing for renewal of the franchise agreement "on terms and conditions to be negotiated" was too vague to be enforceable, the court also held that the provision obligated the parties "to negotiate in good faith concerning the terms and conditions of a renewal." [FN71] The franchisor breached its duty to negotiate in good faith when it offered a new and different agreement with conditions that were unreasonable.

In *K-Mart Corp v Davis*, [FN72] the court held that "preliminary negotiations can indeed create a duty to deal in good faith." Also, this year, in *Flight Systems, Inc v Electronic Data Systems Corp* [FN73] (EDS), the U.S. Court of Appeals for the Third Circuit held that, under Pennsylvania law, a plaintiff can recover for the breach of the duty to negotiate in good faith where both parties manifest an intention to be bound by an agreement to negotiate in good faith. In that case, EDS contacted

Flight Systems about the possibility of renting space in Flight Systems' office building, and it forwarded a proposed five-year lease. Flight Systems subsequently took the property off the market. Intensive negotiations followed.

Although the parties appeared to be close to finalizing an agreement, they never executed the lease. Instead, EDS decided not to lease the property because it was unsuccessful in obtaining business in the Harrisburg, Pennsylvania area. Flight Systems claimed that it was never aware of the contingency. The district court dismissed the complaint for failure to state a claim. The Court of Appeals reversed, holding:

We conclude that Flight Systems has alleged sufficient facts to survive the motion to dismiss. Flight Systems contends that it agreed to remove the property at 505 Fishing Creek Road from the rental market while negotiating a lease agreement with EDS according to explicit terms set forth in the letter dated April 20, 1995 from EDS' broker on the understanding that a final agreement would be reached by July 1, 1995. Thus, Flight Systems has alleged it agreed to negotiate a lease for specific property on specific terms within a specific time, and it conferred consideration on EDS by removing the property from the market for the duration of that period. Flight Systems argues that EDS manifested its intention to be bound by establishing terms for a lease ... and engaging in intensive negotiations in the following two months to finalize the lease agreement... Finally, Flight Systems alleges that EDS acted in bad faith by concealing from Flight Systems that it did not intend to execute the lease if it could not obtain additional business in the Harrisburg area. These allegations are sufficient to state a cause of action. [FN74]

Similarly, in *Tan v Allwaste, Inc.*, [FN75] the parties entered into a letter of intent containing a purchase price for the sale of a business, Geotrack, owned by the plaintiffs. The purchase of the company was contingent on the buyer's "satisfactory review" of the business' financial statements. When Allwaste learned that Geotrack had not paid payroll and withholding taxes for some time, Allwaste decided not to proceed with the acquisition. The plaintiffs claimed that Allwaste made no demands at all but simply backed out of the deal. Noting that the letter of intent "required Allwaste to negotiate the closing of the deal in 'good faith,'" the U.S. District Court for the Northern District of Illinois held that the plaintiff submitted enough evidence to proceed to the jury:

[A] party's self-interested behavior is not considered bad faith.... Rather, plaintiffs must show Allwaste insisted unreasonably on terms not contained in the letter of intent or that Allwaste attempted to alter terms already agreed upon.... While Allwaste is entitled to pursue its self-interest in the course of negotiations, it cannot simply refuse to negotiate in the face of an agreement to negotiate in goodfaith. Since a reasonable jury could find that Allwaste ended negotiations for reasons unrelated to any demand, misrepresentation, omission, or information from Geotrack, a jury could also conclude that Allwaste acted in bad faith. [FN76]

In *Venture Associates Corp v Zenith Data Systems Corp.*, [FN77] Zenith and Venture began negotiations for the sale of one of Zenith's divisions. Zenith submitted a letter to Venture agreeing to the acquisition of the purchase of the business "in principle." After six months of bargaining, Zenith demanded that the purchaser, Venture, meet additional conditions not contained in the preliminary agreement. For example, Zenith demanded third-party guarantees because Venture did not produce financial information, and it also demanded that Venture agree to certain post-closing adjustments. Venture claimed that these additional demands were a breach of the duty of good faith.

The court held that Zenith did not breach its preliminary agreement to negotiate in good faith by breaking off contract negotiations after six months of bargaining. The plaintiff had failed to furnish third-party guarantees (after the plaintiff did not produce financial information) and failed to agree to post-closing adjustments. The court rejected the plaintiff's argument that Zenith had no right to demand these additional conditions:

This argument overlooks the difference between an agreement to negotiate a contract and the contract to be thrashed out in those negotiations. The agreement to negotiate does not contain the terms of the final agreement. Otherwise it would be the

final agreement. A preliminary agreement might contain closed terms (terms as to which a final agreement had been reached) as well as open terms, and be preliminary solely by virtue of having some open terms. The parties would be bound by the closed terms. There were no such terms here. [FN78]

The court also noted that where a breach of the duty to negotiate in good faith exists, "[d]amages for breach of an agreement to negotiate may be, although they are unlikely to be, the same as the damages for breach of the final contract that the parties would have signed had it not been for the defendant's bad faith." But, the court recognized that the nonbreaching party is entitled to reliance damages--i.e., "the expenses he incurred in being misled." [FN79]

The Seventh Circuit Court of Appeals in *Venture* also recognized that a duty to negotiate in good faith is a viable claim, but it cautioned against enlarging such a duty:

***1197** The process of negotiating multimillion dollar transactions, like the performance of a complex commercial contract, often is costly and time-consuming. The parties may want assurance that their investment in time and money and effort will not be wiped out by the other party's foot dragging or change of heart or taking advantage of a vulnerable position created by the negotiation.... [T]he notion of a legally enforceable duty to negotiate in good faith toward the formation of a contract rests on somewhat shaky foundations. [FN80]

In an August 1997 decision in *Media Sport & Arts v Kinney Shoes Corp*, [FN81] the U.S. District Court for the Southern District of New York held that whether the parties "formed a preliminary agreement, to negotiate toward a final agreement" was a question of fact. Accordingly, the court also held that whether Kinney Shoes breached an implied duty of good faith and fair dealing by refusing to execute a final agreement and by refusing to negotiate after a certain date was a question of fact:

[A] jury might conclude that defendant's actions stonewalled [the plaintiff's] efforts to conclude the deal and represented bad faith conduct.... On the other hand, a jury could conclude that [no preliminary agreement to negotiate] was formed, and thus that no contract existed in which a covenant of good faith could be implied. [FN82]

Similarly, in *SNC, Ltd v Kamine Engineering and Mechanical Contracting Co, Inc*, [FN83] the court held that questions of fact precluded summary judgment regarding whether the parties reached a binding preliminary contract giving rise to the duty to negotiate in good faith.

EMPLOYMENT CONTRACTS

In Michigan, the courts continue to hold that there is no implied covenant of good faith and fair dealing in employment relationships. In *Hammond v United of Oakland, Inc*, [FN84] the Michigan Court of Appeals held:

This Court has been unwilling to recognize a cause of action for breach of an implied covenant of good faith and fair dealing in cases involving at-will employment relationships. Moreover, contrary to the trial court's holding, we have refused to recognize the cause of action in cases involving just cause employment relationships as well. Accordingly, to the extent that the trial court held that plaintiff properly stated a cause of action for breach of the covenant of good faith, we reverse. [FN85]

Some courts in other states have recently recognized the duty of good faith and fair dealing in employment contracts. For example, in *EEOC v Chestnut Hills Hospital*, [FN86] the U.S. District Court for the Eastern District of Pennsylvania held that the duty of good faith was inherent in every contract, including those for at-will employment. In *Shelton v Oscar Mayer Foods Corp*, [FN87] the South Carolina Court of Appeals held that a former employee can recover for a breach of the duty of good faith and fair dealing of an at-will employment agreement where the agreement was modified by a subsequent course of performance, arguably creating just-cause employment. The court held:

[W]e find no authoritative case law holding the implied covenant of good faith and fair dealing is not applicable to

employment contracts that alter the employee's at-will status. If, therefore, the jury finds the handbook issued to Shelton created an employment contract that altered his at-will status, then the question of whether Louis Rich breached an implied covenant of good faith and fair dealing based on an employment contract is for the jury to decide. [FN88]

Shelton was further upheld in an August 1997 decision in the case of Prescott v Farmers Telephone Cooperative, Inc. [FN89] There, the South Carolina Court of Appeals reversed a trial court which granted summary judgment of a claim based on good faith and fair dealing in an employment contract. Similarly, earlier this year, in Acri v Varian Associates, Inc, [FN90] the U.S. Court of Appeals for the Ninth Circuit reversed a trial court which granted summary judgment on a claim alleging breach of the duty of good faith of an "implied" just-cause employment contract. In Acri, an employee handbook stated that all employment was at-will. Nevertheless, the court held that a triable issue of fact existed whether the employer breached the covenant by terminating the employee for poor performance, in a manner inconsistent with the provisions of the employee handbook:

Varian's policy manual includes a set of progressive discipline procedures, but those procedures were not followed in Acri's case ... [T]his failure to follow company policy creates a triable issue of fact whether Acri was terminated in good faith. [FN91]

PLEADING AND PROOF REQUIREMENTS

Adherence to the duty of good faith is normally a question of fact for the jury that should not be resolved by summary disposition. [FN92] Many of the cases discussed above, including Venture Associates v Zenith Systems, supra, precluded summary dismissal because of the existence of issues of fact. "Usually the question of whether a party has acted in good faith is one for the jury, but summary judgment may be proper if the plaintiff cannot offer any evidence suggesting bad faith." [FN93] In a similar context, the U.S. District Court for the Eastern District of Michigan has held:

While a defendant may have a legitimate business motivation for his actions, he may have an improper purpose as well. Thus, this Court will not apply a per se rule, but instead will look to all of the facts to determine whether there is a genuine issue of material fact regarding an improper act or motive of defendants. [FN94]

Of course, where the law does not recognize a duty of good faith, such as in the context of at-will employment contracts, [FN95] summary dismissal may be appropriate on the pleadings.

*1198 CONCLUSION

A complete, universally applicable description of the implied duty of good faith and fair dealing is impossible. One reason is that the duty varies depending on the context and the status of the parties. Cases which discuss the duty approach it very differently. Some courts view the duty as a catch-all obligation to keep contracting parties fair and honest in their dealings. Other courts take a narrower approach. Courts have also demonstrated a reluctance to overrule jury verdicts. As shown, the duty of good faith continues to have viability and can be a powerful weapon in a wronged party's arsenal of legal theories.

[FNaa1]. Note 1. Gerard Mantese is a partner in the firm of Mantese Miller and Mantese, P.L.L.C., in Troy, where he focuses his practice in complex business litigation, real estate litigation and domestic relations work. He co-teaches pretrial skills as an adjunct professor at Wayne State University, and lectures on negotiating techniques and strategies. In 1993, he was named Outstanding Young Lawyer by the State Bar of Michigan's Young Lawyers Section.

[FNaa1]. Note 1. Marc L. Newman is an associate at Mantese Miller and Mantese, P.L.L.C. in Troy. He is a 1994 graduate of the University of Michigan Law School and concentrates his practice in commercial and general litigation.

[FN1]. Michigan Bar Journal, March 1991 at page 270.

[FN2]. See, e.g., *US Natl Bank of Oregon v Boge*, 814 P2d 1082, 1091, 311 Or 550 (1990) ("the common law standard of good faith is an 'objective' one that considers the reasonable expectations of the parties.") (and cases cited therein).

[FN3]. Restatement (Second) Contracts, § 205, comment d.

[FN4]. UCC 2-103(1)(b) (emphasis added). It can be argued that the duty of objective good faith arises only under Article 2, sale of goods, since this provision falls within Article 2.

[FN5]. See, e.g., *Wateska First Natl Bank v Ruda*, 135 Ill2d 140, 156-157, 552 NE2d 775, 781 (1990).

[FN6]. See, e.g., *Michigan National Bank v Metro Institutional Food Service, Inc*, 198 MichApp 236, 241, 497 NW2d 225 (1993) (Good faith under the UCC is "evaluated according to a subjective test rather than an objective 'reasonably prudent person' standard").

[FN7]. *Venture Associates v Zenith Systems Corp*, 96 F3d 275, 280 (7th Cir1996); *Hass v Montgomery Ward and Co*, 812 F2d 1015, 1017 (6th Cir1987).

[FN8]. UCC 2-104(1).

[FN9]. *Los Angeles Memorial Coliseum Comm'n v NFL*, 791 F2d 1356, 1361 (9th Cir1986), cert den 484 US 826 108 S Ct 92, 98 LEd2d 53 (1987) (citations omitted).

[FN10]. *Barlett Bank & Trust Co v McJunkins*, 497 NE2d 398, 147 IllApp3d 52 (1st Dist 1986); UCC 1-102(3).

[FN11]. Cf. *Lincoln Park Federal Savings & Loan v Carrane*, 192 IllApp3d 188, 192-93, 548 NE2d 636, 639-40 (1st Dist1989).

[FN12]. UCC 1-102 (emphasis added).

[FN13]. See also *Stanek v Natl Bank of Detroit*, 171 MichApp 734, 738-739, 430 NW2d 819 (1988) ("this section of the Uniform Commercial Code [voids] exculpatory clauses on bank forms.")

[FN14]. *Shelby Mutual v Grand Rapids*, 6 MichApp 95, 148 NW2d 260 (1967).

[FN15]. See also *Banque Nationale de Paris, SA v Insurance Co of North America*, 896 FSupp 163, 165 (SDNY 1995).

[FN16]. *Amecks, Inc v Southwestern Bell Telephone Company*, 937 SW2d 240, 243 (MoCtApp1997).

[FN17]. *City of Rome v Glanton*, 958 FSupp 1026, 1038 (EDPenn1997).

[FN18]. 320 Or 638, 891 P2d 639 (1995).

[FN19]. *Id.*, at 645.

[FN20]. *Burkhardt v City National Bank of Detroit*, 57 MichApp 649, 652, 226 NW2d 678 (1975).

[FN21]. *Id.*

[FN22]. *Sims v Buena Vista School Dist*, 138 MichApp 426, 360 NW2d 211 (1984).

[FN23]. *Van Arnem Co v Manufacturers Hanover Leasing Corp*, 776 FSupp 1220 (EDMich1991); *Hass v Montgomery Ward and Co*, 812 F2d 1015, 1017 (6th Cir1987) ("an action in tort will not arise for breach of contract unless the action in tort would arise independent of the existence of a contract"); *Quail Ridge Associates v Chemical Bank*, 162 A2d 917, 558 NYS2d 655, 657 (3 Dept 1990), appeal dismissed 564 NE2d 674, 76 NY2d 936, 563 NYS2d 64 (1990).

[FN24]. *Paradata Computer Networks, Inc v Telebit Corp*, 830 FSupp 1001 (EDMich1993).

[FN25]. *Id.*, at 1005 (quoting *Burkhardt*, supra, 57 MichApp 649, 652 (1975)).

[FN26]. 984 F2d 739 (6th Cir1993) (citations omitted).

[FN27]. *Id.*, at 743 (citations omitted.)

[FN28]. 795 FSupp 210 (EDMich1992), aff'd 36 F3d 1097 (6th Cir1994).

[FN29]. *Id.*, at 215.

[FN30]. 36 F3d 1097, 1994 WL 614521, 5 (6th Cir1994).

[FN31]. 935 P2d 628, 86 WashApp 732 (1997).

[FN32]. *Id.*, at 631.

[FN33]. *Id.*, at 633 (citations omitted.)

[FN34]. 1997 WL 525252 (CalApp 2 Dist August 26, 1997).

[FN35]. *Id.*, at 6-8.

[FN36]. *Id.*, at 6.

[FN37]. *Eastway & Blevins Agency v Citizens Ins Co of America*, 206 MichApp 299, 302, 520 NW2d 640 (1994); *Maida v Retirement and Health Services Corp*, 795 FSupp 210, 213 (EDMich1992), aff'd 36 F3d 1097 (6th Cir1994); *General Aviation, Inc v Cessna Aircraft Co*, 915 F2d 1038, 1041 (6th Cir1990).

[FN38]. *Van Arnem Co v Manufacturers Hanover Leasing Corp*, 776 FSupp 1220, 1223 (EDMich1991).

[FN39]. 90 F3d 1472 (9th Cir1996).

[FN40]. *Id.*, at 1476.

[FN41]. *Id.*, at 1477.

[FN42]. 320 Or at 647-48, 891 P2d at 644-45.

[FN43]. 191 MichApp 614, 478 NW2d 893 (1991), lv app den 440 Mich 887, 487 NW2d 469 (1992).

[FN44]. See also *Larson v Vermillion State Bank*, 1997 WL 469747, 3 (MinnApp1997) ("Minnesota law does not subject a lender to a duty of good faith, separate from the express terms of a loan agreement, in calling due a demand note.")

[FN45]. *KMC Co, Inc v Irving Trust*, 757 F2d 752 (6th Cir1985).

[FN46]. 562 NW2d 39 (MinnCtApp1997).

[FN47]. *Id.*, at 43.

[FN48]. *Becks Office Furniture and Supplies, Inc v Haworth, Inc*, 94 F3d 655, 1996 WL 466673 (10th Cir1996).

[FN49]. 94 F3d 655, 1996 WL 466673 (10th Cir1996) (unpublished opinion).

[FN50]. *Id.*, at 1.

[FN51]. *Id.*

[FN52]. *Id.*, at 4 (references to the record omitted).

[FN53]. 669 NE2d 218, 41 Mass AppCt 125 (1996), review denied 672 NE2d 538 (1996).

[FN54]. *Id.*, at 220 (footnote omitted).

[FN55]. 690 A2d 575, 148 NJ 396 (1997).

[FN56]. *Id.*, at 578.

[FN57]. *Id.*, at 409.

[FN58]. The jury in *Sons of Thunder* also awarded a total of \$362,292 for Borden's failure to purchase minimum requirements imposed by the contract.

[FN59]. 666 A2d 54, 285 NJ Super 27 (1995), rev'd 690 A2d 575, 148 NJ 396 (1997).

[FN60]. *Id.*, at 425.

[FN61]. 774 F2d 895 (8th Cir1985), appeal after remand 815 F2d 514 (1987).

[FN62]. *Id.*, at 908-909 (citations omitted).

[FN63]. 959 FSupp 135 (DConn1997).

[FN64]. *Id.*, at 144.

[FN65]. 744 FSupp 778, 787 (EDMich1990).

[FN66]. *Id.*, at 787.

[FN67]. *Id.*, at 787.

[FN68]. See e.g., *Cobb-Alvarez v Union Pacific Corp.*, 962 FSupp 1049 (NDIll1997) (interpreting Illinois law).

[FN69]. 190 MichApp 616, 476 NW2d 635 (1991), rev'd on other grounds Mich 76, 500 NW2d 104 (1993).

[FN70]. *Id.*, at 622.

[FN71]. *Id.*, at 1476.

[FN72]. 756 FSupp 62, 69 (DPR1991).

[FN73]. 112 F3d 124 (3rd Cir1997).

[FN74]. *Id.*, at 130-131.

[FN75]. 1997 WL 337207 (NDIll1997).

[FN76]. *Id.*, at 4.

[FN77]. 96 F3d 275 (7th Cir1996) (opinion by J. Posner).

[FN78]. *Id.*, at 279.

[FN79]. *Id.*, at 278.

[FN80]. *Id.*, at 278.

[FN81]. 1997 WL 473968 (SDNY August 20, 1997).

[FN82]. *Id.*, at 13.

[FN83]. 655 NYS2d 47 (1997).

[FN84]. *Hammond v United of Oakland, Inc.*, 193 MichApp 146, 483 NW2d 652 (1992).

[FN85]. *Id.*, at 152 (citations omitted).

[FN86]. 874 FSupp 92, 96 (EDPa1995).

[FN87]. 459 SE2d 851, 319 SC 81 (SC CtApp1995), aff'd 481 SE2d 706 (1997).

[FN88]. *Id.*, at 857 (citations omitted.)

[FN89]. 1997 WL 542289 (SCApp1997).

[FN90]. 1997 WL 52540 (9th Cir August 25, 1997).

[FN91]. *Id.*, at 2.

[FN92]. *Karibian v Paletta*, 122 MichApp 353, 359, 332 NW2d 484 (1983). See also *Pemberton v Dharmani*, 207 MichApp 522, 529, n 1, 525 NW2d 497 (1994).

[FN93]. *Maida v Retirement and Health Services Corp*, 36 F3d 1097 (6th Cir1994) (unpublished opinion).

[FN94]. *Liberty Heating & Cooling, Inc v Builders Square, Inc*, 788 FSupp 1438 (EDMich1992) appeal dismissed 968 F2d 1215 (6th Cir1992)).

[FN95]. *Hammond*, supra (summary disposition granted pursuant to MCR 2.116(C)(8) because employment at-will carried no implied duty of good faith.) See also *Check Reporting Service*, supra (summary disposition granted pursuant to MCR 2.116(C)(8) because duty of good faith did not apply to demand instruments.)

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