Welcome to this podcast on Good Faith brought to you by CALI. I am Professor Scott J. Burnham.

The topic of this podcast is the basic concept of good faith, with a focus on both subjective and objective good faith in the performance of contracts under the common law and the Uniform Commercial Code.

Good faith, sometimes called the covenant of good faith and fair dealing, is an implied term in a party’s obligation of performance in every contract. The word *performance* is emphasized because so far the U.S. has not required good faith in the *negotiation* of contracts. You can imagine some of the problems in that area. For example, if a buyer says during negotiations, “I won’t pay a penny more than $5,000,” when he would happily pay twice that, is he being dishonest? So far, we have ducked those issues.

Both the common law as expressed in Restatement § 205 and in the U.C.C. § 1-304 include an obligation to perform a contract in good faith. But what does it mean? There is a definition in the U.C.C., but even though the U.C.C. is intended to be “uniform,” the definition of good faith is one area where the U.C.C. varies among the jurisdictions.

Here’s a bit of history. In the version of Article 1 that was enacted by the states prior to 2001, the definition was “honesty in fact;” that is, a person had to actually be honest. Now, whether they are honest goes to their motives, which can be difficult to determine. We call this *subjective* good faith because it depends on your state of mind. For example, in the case of *Reid v. Key Bank*, the plaintiff claimed that the bank denied him credit not because he was a credit risk, but because of his race. That type of subjective dishonesty would be hard to prove in the absence of documentary evidence.

At the same time, the version of Article 2 that was enacted at that time had a special rule for merchants which stated that the standard of good faith for *merchants* in goods transactions was both honesty in fact *and* “the observance of reasonable commercial standards of fair dealing.” We call this latter one the *objective* standard because it can more easily be measured. For example, if that definition applied in the *Reid* case, Reid could show that the bank did not act in good faith by putting a banker on the stand to testify that a reasonable banker would have extended him credit.

Now here’s the tricky part. Revised Article 1, which was promulgated in 2001, changed the Article 1 definition in § 1-201(b)(20) to include *both* the subjective and objective standards. Jurisdictions enacting the official text of Revised Article 1 then repealed the rule from Article 2 because it was duplicative. Note that since Article 1 applies throughout the Code, the Article 1 standard became applicable to all parties in goods transactions and not just merchants.

But here comes another complication. States are free to make changes when enacting a uniform law. While all the states have enacted Revised Article 1, a number in doing so retained the old definition of good faith – *subjective* only except for merchants in Article 2 which is objective and subjective. So today you have to carefully check the law of the applicable jurisdiction to see whether it has only the subjective definition – “honesty in fact” – or also contains the objective definition – “the observance of reasonable commercial standards of fair dealing.”

The common law as expressed in the Restatement treats good faith sort of like unconscionability and says we are not going to define it, for to define it might be to limit it and we don't want to limit it. Rather, we will let case law determine where it applies. A number of commentators have attempted to define it. One commentator says it arises when a party tries to recapture forgone opportunities. Another says it arises when a party engages in opportunism, that is, they try to take advantage of the express terms of the agreement. For example, a party might come up with an interpretation that may be contrary to the understanding of the parties but could be supported by a literal reading of the agreement.

Here’s an example of that. In the case of *Billman v. Hensel*, Billman agreed to buy a house from Hensel but only on the condition that he was able to secure a mortgage within 30 days. After 30 days he said, “I didn't secure the mortgage, so I don't have to buy the house.” But did he attempt to find a mortgage? No, he didn't, but he argued that it didn’t say in the contract that he had to try to secure a mortgage, it just said that he didn’t have to buy the house if he didn’t secure one. But the court said there was an implied obligation to make a good faith effort to bring about that event. Another way of putting it is if your performance is conditional, you can't prevent performance of that condition in order to excuse your own performance. So this might be a good example of opportunism – where the argument he makes could be literally supported by the agreement, but it is certainly contrary to the intention of the parties.

An example of where good faith came up in Article 2 is the case of *Neumiller Farms v. Cornett*. It involved a merchant who was a buyer of potatoes. Now this came up under the old Article 1, so as you recall from the previous discussion, the subjective standard applied from Article 1 and the objective standard applied from Article 2. Today, in a jurisdiction that enacted the official text of Revised Article 1, both standards of good faith would apply. By the way, notice that if both standards apply, that means that in order to act in good faith, the person has to be *both* honest and reasonable, so they lack good faith if they're either not honest or not reasonable.

What happened in *Neumiller Farms* is that the contract said that the buyer could reject the potatoes that were tendered if they didn't chip satisfactorily; that is, if they weren’t satisfactory for making potato chips. So he rejected a load of potatoes and said, “They don't chip satisfactorily,” but he also told the seller, “Why should I pay you $2.00 per hundredweight for potatoes when I can buy them on the market for $1.00?” So he was admitting that he was being dishonest – the real reason he rejected the potatoes was because the market price had gone down, not because they didn’t chip satisfactorily. That’s a good example of evidence proving subjective bad faith – lack of honesty.

In addition, the seller had the potatoes tested by an independent expert who proved that they did chip according to industry standards. So that would prove that the buyer had violated the *objective* standard of good faith as well since as he had not observed reasonable commercial standards – a reasonable person in the trade would've accepted those potatoes. So it is clear that he violated both standards, but again a person needs only to have violated one to have acted in bad faith where both standards apply.

One important thing about good faith is that if there is breach of it, it's not an independent claim – it simply buttresses another claim that there was a breach of contract. So in *Billman*, the buyer breached the contract to buy the house and in *Neumiller Farms*, the buyer breached the contract to buy the potatoes. Furthermore, no dire consequences attach to the breach. There was a time in some jurisdictions when bad faith breach was a tort, but that is no longer the case. The one exception might be where there is a “special relationship” between the parties. For example, if an insurance company refuses to cover an insured’s claim in bad faith, that might be a tort in some jurisdictions. But for the most part, bad faith simply supports a claim for breach of contract. There are no punitive damages because of it and there are no attorney's fees. So while it may help to support a breach claim, it doesn't enhance the claim in any way.

This concludes the podcast. At this point, you should be able to identify when good faith is applicable and distinguish between subjective and objective good faith.

I hope you’ve enjoyed this podcast on Good Faith.

Lawdibles are produced and distributed by CALI, The Center for Computer-Assisted Legal Instruction. Find more Lawdibles at www.cali.org/lawdibles. Send your questions and feedback to lawdibles@cali.org. The Lawdibles theme music is “Ask Me No Question” by [Learning Music](http://freemusicarchive.org/music/Learning_Music/). Lawdibles are for educational purposes only. Please seek an attorney if you need legal advice.

CREDIT: Ask Me No Question by Learning Music is licensed under an [Attribution-Noncommercial-Share Alike 3.0 United States License.](http://creativecommons.org/licenses/by-nc-sa/3.0/us/)