GOOD FAITH AND FAIR DEALING: NEW ISSUES AND NAGGING CONCERNS

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This article explores the applicability of the implied obligation of good faith and fair dealing to real estate transactions. It first traces the history of the doctrine, describes the theories behind it and examines it both in the context of contract negotiations and contract performance. Finally, it discusses a recent case with disturbing implications about the applicability of the doctrine to disclosure obligations of the parties.
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by

William A. Walsh, Jr.*

I. INTRODUCTION

The doctrine of good faith and fair dealing is like the concept of reasonableness -- easy to articulate but difficult to apply with precision. Most lawyers know the doctrine in the context of personal property sales because the Uniform Commercial Code is clear on that issue. The doctrine is often murky, however, when applied to real estate transactions.

The doctrine is further clouded when courts and commentators commingle it with concepts such as disclosure, misrepresentation and fraud. Causes of action founded in contract law converge with those based in tort. With the resulting gumbo of differing legal principles, it is not surprising that courts take a fact specific approach to deciding cases and, in doing so, often reach inconsistent conclusions.

The purpose of this article is to examine some recent cases to attempt to ascertain some bright line rules of engagement for the negotiation, formation and performance of commercial real estate contracts. It will discuss the historical development of the doctrine and summarize what it means today, first in the context of contract negotiations and formation and then in the context of performance. Finally, it will view the doctrine in other contexts and discuss a disturbing case recently decided by the Supreme Court of Arizona.

II. HOW THE DOCTRINE HAS EVOLVED AND WHAT IT MEANS TODAY

A. Historical Development

In American jurisprudence, the doctrine of good faith and fair dealing is relatively new. The first widespread duty of good faith and fair dealing appeared as a statutory obligation in the Uniform Commercial Code (the “UCC”). The UCC was promulgated in 1951 and enacted by the first jurisdiction -- Pennsylvania -- in 1953.1 Between 1954 and 1967 all but one jurisdiction -- Louisiana -- had enacted the UCC, albeit with some minor variations.2 By the end of the 1960s, nearly every jurisdiction had adopted this statutory obligation of good faith and fair dealing for many commercial transactions. The UCC, however, had no applicability to contracts for the

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purchase and sale of real estate or leases of real property, and it was unclear whether and to what extent the common law imposed a duty of good faith and fair dealing.

The first Restatement of Contracts did not recognize an obligation of good faith and fair dealing between parties to a contract. Nonetheless, by the late 1960s, a growing number of jurisdictions began to imply that obligation. Two scholars suggest that a fair amount of case law discussing good faith duties existed before the mid-1960s but no one had yet recognized the decisions as creating a doctrine. Their theory is that academics, judges and lawyers relied on the key numbering system devised by West Publishing Company to group cases that discussed a particular doctrine. West, however, “did not even spot the good faith trend and begin locating the relevant cases together until some time in the 1960s.” The convergence of the UCC’s duty of good faith and West’s identification of a trend in case law imposing good faith duties upon parties to contracts undoubtedly contributed to the recognition of the duty of good faith and fair dealing when the Restatement (Second) of Contracts (the “Second Restatement”) was being drafted.

In 1970, the American Law Institute tentatively adopted a duty of good faith and fair dealing in the Second Restatement. There was some concern, however, over how general or specific and how broad or narrow the duty should be described. Indeed, one drafter explained:

> The trouble with this section, of course, is that it’s very general, very abstract, and it needs specification the worst way [sic], and specification is not to be had. . . . This proposition [of a duty of good faith in contract performance and enforcement] is thoroughly

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3 It is suggested that the obligation of good faith and fair dealing has its underpinnings in Roman law, but that “[d]uring the nineteenth century, the American common law was reluctant to recognize explicitly any generalized duty to act in good faith.” Robert S. Adler & Richard A. Mann, Good Faith: A New Look at an Old Doctrine, 28 AKRON L. REV. 31, 42 (1994). New York courts, however, imposed an implied covenant of good faith and fair dealing in the performance of contracts as far back as 1933. The New York Court of Appeals stated that “[i]n every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing.” Steven J. Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 HARV. L. REV. 369, 379 (quoting Kirke La Shelle Co. v. Paul Armstrong Co., 188 N.E. 163, 167 (N.Y. 1933)).

4 See, e.g., Robert S. Summers, The General Duty of Good Faith—Its Recognition and Conceptualization, 67 CORNELL L. REV. 810, 814 (citing 47 ALI Proceedings 489-491 (1970)). At the May 1970 Meeting of the American Law Institute, where the former version of Section 205 was tentatively adopted, Professor Baucher explained to the second Restatement drafters that “Section 231 [the predecessor to section 205] is entirely new to the Restatement, although is not new to the law.” Id.

5 Summers, supra note 4, at 812. Summers observed that “the courts went beyond the more familiar standards of performance—for example, the specific terms of the agreement, general gap-filler law, course of dealing, and custom and usage—and invoked a general requirement of good faith.” Id. at 813.

6 ROBERT S. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH § 2.2.2.2 at 33 (1995).

7 Id.
acceptable if you define good faith very narrowly; but as you define good faith more broadly, doubts begin to arise.

A significant concern was that if the duty were defined too broadly, it might then be used by courts to rewrite contracts. A proponent who advocated the inclusion of the duty in the Second Restatement argued that the duty of good faith and fair dealing was grounded in the common law and it was not “a novel proposition of the law.”

Finally, in 1971, the Second Restatement was promulgated. The final version that was adopted included Section 205, which recognized the duty of good faith and fair dealing in the performance and enforcement of every contract. In the twenty years following its initial promulgation, Section 205 of the Second Restatement has been adopted by most jurisdictions.

B. Current State of the Doctrine

Although the inclusion of a duty of good faith and fair dealing in the UCC and the Second Restatement has been touted as one of the major advances in contract law, a workable definition or standard has yet to be formulated. The UCC states that “[e]very contract or duty . . . imposes a duty of good faith in its performance or enforcement.” The UCC defines good faith as “honesty in fact in the conduct or transaction concerned.” One scholar has criticized the “honesty in fact” definition as being too narrow. Professor Summers argued that “[h]onesty only rules out dishonesty in its various forms. But good faith, as used by many judges, excludes numerous forms of contractual bad faith besides dishonesty.” He cited as examples actions that

8 Summers, supra note 4, at 813 (quoting the transcript from the 1970 ALI meeting).

9 This concern grew out of observations of post-World War I Germany. The good faith counterpart in the German Civil Code “became, in the days of the great inflation following World War One, a license for judicial remaking of contracts way beyond anything that ever happened in the United States. . . . I suppose if we got to a place where you had 25 percent inflation every month that you would find some judicial activism here too.” Summers, supra note 4, at 815.

10 Summers, supra note 4, at 814.

11 Maine, Virginia and Indiana do not appear to recognize an implied covenant of good faith and fair dealing in most contracts other than those governed by the UCC. Pennsylvania imposes the implied covenant in some but not all contracts. See part IV.A. for a further discussion.


13 UCC § 1-203 (2000).

14 UCC § 1-201(19) (2000). The Official Comments explain that this definition in 1-201(19) is a minimum standard. Within the various articles of the UCC, the drafters anticipated that good faith may require additional defining. The Comments illustrate this point by referring to the definition of good faith that is set forth in Article 2 (Sales), which requires parties to act not only with honesty in fact but also in observance of “reasonable commercial standards of fair dealing in the trade.” See UCC § 1-201(19) (Official Comments) and § 2-103 (1)(b).


16 Id. at 204.
are not necessarily dishonest but would not be deemed good faith conduct, such as abuse by a party of its bargaining power, interference with another party’s performance and actions that are arbitrary or that “give another a raw deal.”

Section 205 of the Second Restatement provides that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” The drafters of Section 205, however, did not attempt to define good faith. Instead, they stated that although the meaning of good faith is dependent upon the context in which it is used, good faith “emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.” The drafters conceded that identifying an exhaustive list of bad faith performance was not possible. Nonetheless, they offered the following examples of conduct that might constitute bad faith: evasion of the spirit of the deal or bargain; lack of diligence; intentionally rendering performance that does not conform to the requirements of the contract; abuse of the power to specify express terms; and interference or failure to cooperate with the other party’s performance.

It is important to note that although some jurisdictions impose good faith duties on parties concerning their conduct during contract formation and negotiation, the duty of good faith discussed in the Second Restatement does not apply to negotiations or other pre-contract behavior. The drafters of Section 205 explained that bad faith during contract formation may be sanctioned under other legal doctrines such as fraud, duress or unconscionability. Some tort actions, such as misrepresentation, or quasi-contract actions for unjust enrichment or promissory estoppel, also may lie for bad faith in negotiations.

C. Principal Scholarly Influences on the Evolution and Meaning of the Doctrine

There have been two influential attempts to ascertain the meaning of good faith and to determine what type of conduct the duty mandates. Most courts have relied upon one or both approaches. The following summarizes these two approaches.

1. Professor Summers’ “Excluder” Theory

Professor Summers argued that the concept of good faith lacks inherent meaning. The absence of independent criteria to define good faith suggests that the concept is best understood

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17 Id. at 204-205.
18 Restatement (Second) of Contracts § 205 (1981).
19 Id. § 205 cmt. a.
20 Id. § 205 cmt. d.
21 See id. § 205 cmt. c; see also Burton & Andersen, supra note 6, § 8.2.1, at 330 (stating that “American law imposes no general duty to negotiate a contract in good faith.”)
22 Id.
23 See BURTON & ANDERSEN, supra note 6, § 8.1, at 328.
as the converse of bad faith behavior. Summers explained that the lawyer would more accurately understand the meaning of good faith if, when analyzing a case, the lawyer “does not ask what good faith itself means, but rather asks: what, in the actual or hypothetical situation, does the judge intend to rule out by his use of the phrase?” Once the bad faith conduct has been identified and “excluded,” the lawyer can ascribe the meaning of good faith as the opposite of the proscribed conduct. Moreover, Summers suggests that this approach will improve the likelihood that the lawyer’s understanding of the concept is aligned with the judge’s intended meaning. The rationale is that “judges are more interested in what they are proscribing than in characterizing what is generally allowed.”

2. Professor Burton’s “Foregone Opportunities” Theory

Professor Burton rejects Summer’s thesis that good faith and fair dealing is incapable of being accurately and completely defined other than by use of the excluder theory. Burton argues that good faith performance requires a party to exercise its discretionary contractual rights in such a way as not to attempt to recapture the opportunities it passed up in choosing to enter into the contract in the manner that it did. Burton believes that good faith issues frequently arise either because the express terms of the contract were imperfectly or ambiguously drafted or because the parties executed a long term contract lasting into an uncertain future without adequate foresight. Under those circumstances, the express terms of the contract do not provide sufficient guidance to determine whether the other party’s exercise of discretion constitutes good faith performance.

Burton insists that we must gain a better understanding of the “contractual expectation interest.” He argues that that interest should be analyzed not only in terms of expected benefits accruing to the promisee -- property, services or money -- but also in terms of the expected cost owing from the promisor -- the opportunities that it must necessarily forego by entering into the contract. Burton’s thesis suggests that by entering into a contract the parties create two mutually exclusive worlds -- one that contains all possible contractual opportunities within the parties’ justified expectations at the time the contract was executed, and the other that contains all other present and future opportunities that were foregone when the parties entered into the contract. When the promisor exercises a discretionary right, one must focus on which world the promisor is trying to access to determine accurately if that discretion was exercised in good faith.

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24 Summers states that “[i]n a particular context, the phrase takes on specific meaning but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out.” Summers, supra note 15, at 201.
25 Id. at 200.
26 Id. at 206.
27 See Burton, supra note 3, at 369-370.
28 Id. at 371.
29 Id. at 372.
30 Id.
If the promisor seeks to capture an opportunity that is not inconsistent with the terms of the contract it executed, then the promisor has acted in good faith. On the other hand, if the promisor attempts to recapture one or more opportunities it gave up upon entering into the contract, the promisor can be said to have acted in bad faith by “refus[ing] to pay the expected cost of performance.”31

III. GOOD FAITH AND FAIR DEALING IN CONTRACT FORMATION32

A. Pure Negotiations

The cases generally hold that “pure” negotiations may be broken off at any time for any reason, or for no reason whatsoever, without liability to either party. Pure negotiations are the usual give and take between businesspersons or their agents as they try to determine whether there is a mutually-acceptable bargain to be struck and the essential terms of that bargain. Pure negotiations can be either oral or written although obviously written communications, particularly when prepared by non-lawyers, can often look more like an interim understanding (discussed in more detail below) or even a preliminary agreement than pure negotiations.33

Absent more than pure negotiations, the doctrine of good faith and fair dealing will not operate to require either party to attempt to reach an agreement.34

B. Negotiations Plus

The doctrine begins to have some applicability under the law of some states (not a majority, certainly) when pure negotiations reach the next stage in the deal-making process. For example, if the parties, without reaching agreement on the principal business terms of a transaction, agree to negotiate to attempt to reach a definitive agreement, some states will impose an implied obligation to carry those negotiations forward, in good faith and reasonably, until

31 Id. at 373.


33 This is as good a place as any to address in a very summary manner an issue that could itself form the basis of an entire article. In most states, contracts for the purchase and sale of real estate are required to be written and signed by the parties. This requirement typically is grounded in the statute of frauds (diluted, of course, by its numerous exceptions) or some permutation thereof. Many negotiations, interim understandings, preliminary agreements and the like are oral. By and large, the doctrine of good faith and fair dealing is not dependent upon there being a written agreement to be operative; obviously, however, proof of a written understanding or agreement is easier than is proof of an oral one.

34 See, e.g., Levenson v. L. M. I. Realty Corporation, 31 Mass. App. Ct. 127, 575 N.D.2d 370 (1991). Depending upon the actions of the party that terminates the negotiations, however, a shunted suitor may have a cause of action founded in some other theory of contract law (such as promissory estoppel or unjust enrichment) or tort law (such as fraud or misrepresentation).
substantive agreement is reached or each of the parties acknowledges that no agreement can be reached notwithstanding their diligent efforts to do so.

Another example is where a seller, in anticipation of negotiating a transaction with a prospective purchaser, agrees to remove the property from the market to allow the parties to negotiate a definitive purchase and sale agreement. Further assume that the seller passed up one or more other sales opportunities in reliance upon the purchaser’s agreement to negotiate. Under those situations, some courts would not allow a purchaser that simply has lost interest in the property to unilaterally terminate negotiations.

C. Interim Understandings

It is not unusual for parties to reach and sometimes document in writing an interim understanding to establish a milepost along the way to executing a definitive agreement. Interim understandings can take several forms -- letters of intent, memoranda of understanding, term sheets and so on. To oversimplify, the more these interim understandings indicate an intent on the part of both parties to be bound, the less likely it will be that a court will allow a party unilaterally and arbitrarily to walk away from the negotiations without liability.

Just because the parties have entered into an interim understanding does not mean the doctrine of good faith and fair dealing will prevent unilateral withdrawal if the parties have clearly and unambiguously documented that that was their intent. It is not enough simply to state that the interim understanding is not binding.

Of course, a problem that frequently arises is that the interim understanding is not drafted by a lawyer, or is drafted by a lawyer under clear and unambiguous instructions from the client not to “kill the deal with legalese.”

35 The word “understanding” was intentionally chosen over the word “agreement” in describing these vehicles so as not to confuse them with legally binding contracts. Some courts will hold certain interim understandings to be binding contracts but even where they are not, the parties to them sometimes will be held to have an obligation to negotiate in good faith to attempt to reduce their understanding to a contract.


37 Here is an example of language that has been used for this purpose: “The provisions of this letter of intent are intended solely to aid the parties as they attempt to negotiate a binding agreement. None of the provisions hereof are or ever will be binding upon the parties. The parties will be contractually bound to each other only upon the full execution of a legally binding definitive agreement and the payment of any consideration referred to therein. Until that time, neither party will have any obligation whatsoever, either express or implied, to negotiate or to continue to negotiate with the other party and either party may unilaterally cease all negotiations without liability.”
Clearly, the existence of an interim understanding during the course of negotiations increases somewhat the likelihood that a party will incur some liability if it jettisons a transaction because it loses interest or finds a party willing to consummate a different transaction on more favorable terms. The root problem in these situations is that either or both parties entered into an interim understanding in good faith and intending to proceed to consummate a transaction and then something changes -- a better offer comes along, the purchaser finds a more attractive property, the seller believes the property is worth more than the asking price, etc. The party that has lost interest in the transaction either stops negotiating or begins taking unreasonable positions in an attempt to underline the negotiations. The transaction dies, and the disappointed party seeks to hold the other party liable.

IV. GOOD FAITH AND FAIR DEALING IN CONTRACT PERFORMANCE

A. Jurisdictions that Disavow an Implied Covenant of Good Faith

Although a majority of jurisdictions impose a duty of good faith and fair dealing in every real estate contract, a few states apply the duty only in very limited contexts. Maine, for example, refuses to impose a duty of good faith upon any contract that is not within the statutory scope of the UCC or within the realm of casualty insurance contracts between an insured and insurer.

Similarly, Indiana does not recognize an implied duty of good faith in contracts other than insurance contracts, contracts involving a fiduciary duty, and employment contracts. In First Federal, for example, the Indiana Supreme Court interpreted a lease provision as prohibiting the tenant from assigning the lease or subleasing the premises without the landlord’s consent where the consent could be withheld by the landlord for any reason at all. The court explained that where the language of the contract is clear and unambiguous and the intent of the parties can be readily ascertained from the contract language, “[i]t is not the province of the court to require a party acting pursuant to a contract to be ‘reasonable,’ ‘fair,’ or show ‘good faith’ cooperation.” Reciting Indiana law governing the transfer of leases, the court explained that absent a provision restricting such transfers, a lease is freely transferable and the tenant is in control. If, however, the lease requires a landlord’s consent before a transfer can be effected, then the landlord is in control. Therefore, if the landlord’s discretion to grant consent is not limited by the terms of the lease, the court will not impose a duty that the landlord cannot unreasonably withhold consent.

In Virginia, the duty of good faith and fair dealing has very limited applicability. The Virginia Supreme Court has held that the duty is not applicable to the valid and binding rights

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41 First Federal 559 N.E.2d at 603.
42 Id.
that the parties create in their contracts. This is true for contracts construed under the common law as well as contracts governed by the UCC. Virginia courts will not use the duty of good faith and fair dealing as a judicial device to rewrite unambiguous contracts or to impose additional duties that the parties did not expressly create. A breach of the duty of good faith and fair dealing imposed by Virginia’s version of the UCC does not give rise to an independent tort action, but may be actionable under a contract cause of action. In insurance contracts, the insurer owes a duty of good faith and fair dealing to a third-party beneficiary. In the employment context, however, there is no implied covenant of good faith and fair dealing in employment relationships that are created pursuant to the employment-at-will doctrine.

Finally, in Pennsylvania, the duty of good faith and fair dealing applies in a limited number of contexts but is not imposed in every contract. For example, a franchisor owes a duty of good faith and fair dealing to its franchisee. Conversely, the duty of good faith will not be imposed on creditors if doing so would alter or abrogate the creditor’s legal rights.

B. Application of Doctrine to Illustrative Real Estate Transactions

As illustrated above, courts are divided as to how and when they impose the doctrine of good faith and fair dealing. Set forth below is a brief discussion of selected cases involving leases, purchase and sale agreements, rights of first refusal, options, installment land contracts and brokerage commission agreements.

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44 See id.
46 In dicta, the Virginia Supreme Court held that a breach of the duty of good faith imposed by the UCC may be actionable under a contract theory of liability but not in tort. See Charles E. Bauer Co. v. NationsBank, 251 Va. 28, 466 S.E. 2d 382 (1996).
47 See Levine v. Selective Insurance Company of America, 250 Va. 282, 462 S.E. 2d 81 (1995). This case may only govern third-party insurance contract claims. For example, Coker v. State Farm Fire and Casualty Co., 45 Va. Cir. 510 (1998), involved a claim by an insured against its insurer asserting that the insurer breached its duty of good faith and fair dealing. The trial court explained that Virginia has recognized a duty of good faith and fair dealing in third-party insurance contracts, but there was no authority recognizing such a duty in first-party contracts. The court never reached a conclusion on the issue because it ruled that the plaintiff’s action was barred by the statute of limitations. Id. Thus, it appears still unsettled whether Virginia would recognize a duty of good faith and fair dealing in first-party insurance contracts.
50 Id.
1. Leases

In a recent case, the Supreme Court of New Mexico drew a distinction between a party’s latitude in granting consent as opposed to agreeing to a contract modification. In *Cafeteria Operators*, a lease severely limited the physical structure and layout of a shopping center. The landlord sought to construct a new building in the shopping center that would require that the tenant consent and the lease be modified. The tenant agreed to consider a proposed lease modification. As plans for the construction progressed, the tenant declined to agree to modify the lease and sued to enjoin the landlord from beginning construction in violation of the lease. In a separate settlement agreement, the tenant agreed to modify the lease only if certain conditions were met. The landlord completed the building and the tenant sued for breach of the lease. The trial court found that the landlord failed to establish its legal right to construct the building and ordered the landlord to demolish the building.

On appeal, the landlord argued that the tenant breached its obligation of good faith and fair dealing when it declined to negotiate the lease modification. The appellate court explained that New Mexico recognizes a duty of good faith and fair dealing in every contract but that that duty does not permit a court to override express contractual terms. When the lease provisions permit a change or modification that is expressly subject to the other party’s consent, that consent may not be unreasonably withheld. In the lease at issue, however, the configuration provision strictly limited the physical structure of the shopping center, and nothing in the lease permitted the landlord to modify the lease with the tenant’s consent or even contemplated a modification of the lease for this purpose. The court explained that “[i]t is one thing to say that where a lease expressly contemplates certain actions that can be taken only with the consent of the other party, then that consent cannot be unreasonably withheld. It is quite another to impose on a party an obligation to negotiate reasonably and in good faith with respect to any change that the other party wishes to make in the contract. We will not make the leap from the first proposition to the second.” The court affirmed the order requiring the landlord to tear down the building.

Whether a landlord must act reasonably in deciding whether to consent to assignments or subleases varies from state to state. In a growing number of jurisdictions, however, consent cannot be unreasonably withheld unless the language expressly and unambiguously grants that right to the landlord. In Connecticut, for example, a landlord who has discretion to withhold consent to lease assignments must exercise its discretion in such a way that is consistent with the duty of good faith and fair dealing. In *Warner*, the tenant sought to sell its business and assign its lease during the fourth year of a five year lease. The lease provided that the tenant could not

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52 *Id.* at 438.
53 *Id.* at 439.
54 *Id.* at 440.
55 *Id.* at 440.
assign the lease “without the prior written consent of Landlord.” The landlord refused to grant consent unless the parties renegotiated the rental. The Connecticut Supreme Court held that a landlord may not unreasonably withhold its consent to the proposed lease assignment and that the landlord’s refusal to grant consent in this case was unreasonable.

When Warner was decided in 1989, Alabama, Florida, Illinois, and Ohio had imposed the duty of good faith to prevent landlords from unreasonably withholding consent to lease assignments absent clear and unambiguous lease language to the contrary. California and Oregon have now also adopted this rule. As discussed previously, a landlord in Indiana, however, appears to have an unfettered right to withhold consent.

Next, in Carma Developers, a lease provision permitted the landlord to terminate the lease upon receiving the tenant’s notice to sublease the premises. Additionally, the lease provision permitted the landlord to enter into a new lease with the tenant’s prospective sublessee, and to exclude the tenant from sharing in any profits earned as a result of the sublease. The trial court concluded that “a reasonableness standard must be read into the termination and recapture clause of the lease . . . .” and held that the landlord breached that implied reasonableness term and the implied duty of good faith.

Reversing the trial court, the California Supreme Court held that the termination clause expressly permitted the landlord to act in the manner that it did. The court explained that the duty of good faith is imposed in every contract, and it is not necessary that a party breach a specific provision of the contract to have breached the implied duty of good faith. The duty can be breached by dishonest conduct or by honest but objectively unreasonable conduct. The duty of good faith is imposed “to protect the express covenants and promises, not to protect some general public policy interest not generally tied to the contract’s purpose.” The greatest challenge is to determine whether the conduct at issue, although not prohibited by the lease, is contrary to the justifiable expectations of the parties when they entered the contract. Here, the court concluded that the landlord’s conduct was entirely within the contemplation of the parties.

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57 Id. at 1140 n.1.
58 Id. at 1140-1141.
63 Carma Developers (California) Inc. v. Marathon Development California, 826 P.2d 710 (Cal. 1992)
64 Pacific First Bank v. New Morgan Park Corp., 876 P.2d 761 (Or. 1994).
67 Id. at 712.
68 Id. at 727.
when they entered into the lease.\[^{69}\] Therefore, the landlord’s termination of the lease was not a breach of the duty of good faith and fair dealing.

Finally, a tenant in Utah was held to have breached the duty of good faith and fair dealing when it changed the use of its leased premises from a grocery store to a warehouse box store.\[^{70}\] The lease (the “Olympus Hills lease”) permitted the tenant to use the premises as “a supermarket, drug store and pharmacy or any other lawful retail selling business not directly in conflict or competition with another major tenant in the shopping center.”\[^{71}\] The tenant entered a second lease in a different shopping center located within two miles of the Olympus Hills premises. The tenant sought to assign the Olympus Hills lease to REI, a national sporting goods chain, but the landlord would only consent to an assignment to a tenant who would use the premises as a grocery store. Unable to assign the lease, the tenant converted the Olympus Hills premises to a warehouse “big box” type of store that sold discounted goods and other convenience items. The tenant relocated its grocery store from the Olympus Hills premises to the new premises.

The landlord sued the tenant for breach of the duty of good faith claiming that the warehouse box store was a “sham operation designed to improperly freeze the space in Olympus Hills and to force customers to [the tenant’s] new location.”\[^{72}\] The landlord argued that the lease required the tenant to select a reasonable use for the leased space. The appellate court affirmed the jury verdict that the tenant breached its duty of good faith and fair dealing. Notwithstanding the fact that the lease permitted the tenant to operate any lawful retail sales business, the court concluded that reasonable minds could differ as to whether the tenant exercised its discretion for reasons beyond the risks assumed by the landlord in the lease or inconsistent with the landlord’s reasonable expectations.\[^{73}\]

The dissent criticized the court’s decision as having used judicial fiat to create a better deal for the landlord than it made for itself.\[^{74}\] The dissent noted that the only restrictions on the tenant’s use of the premises were that the use had to be some sort of retail sales business and that it could not directly compete with the business of any of the other tenants in the shopping center. The dissenting justice believed that, as a matter of law, the implied covenant of good faith and fair dealing could not create a duty that overrides or is inconsistent with the express terms of a contract. Moreover, the dissent opined that the duty cannot require a party vested with a contract right to exercise it in a way that contradicts that party’s legitimate self-interest.\[^{75}\] If the landlord’s

\[^{69}\] Id. at 728. The court stated that “it was certainly within the reasonable expectations of the parties that [the landlord] might terminate the lease upon a proposed transfer in order to claim for itself appreciated rental value of the premises.” Id.

\[^{70}\] Olympus Hills Shopping Center Ltd. v. Smith’s Food & Drug Centers, 889 P.2d 445 (Utah Ct. App. 1995).

\[^{71}\] Id. at 457.

\[^{72}\] Id. at 451.

\[^{73}\] Id. at 451.

\[^{74}\] See id. at 462 (Bench, J., dissenting).

\[^{75}\] Id. at 463.
expectation upon entering into the lease was to require the tenant to operate a specific business -- a grocery store -- with a certain customer volume, the dissent believed that it should have written such provisions into the lease. The lease that the parties executed did not contain such provisions, and the dissent believed that the court should not rewrite the lease simply because the landlord was dissatisfied with its bargain.\footnote{Id. at 466.}

2. Purchase and Sale Agreements

Agreements for the purchase and sale of the real estate are often contingent on the occurrence of certain events. The duty of good faith and fair dealing can play a significant role in determining the consequences of the nonoccurrence of a contractual condition precedent. Generally, if a party’s obligation is subject to a condition precedent, that party need not perform unless either the condition has been satisfied or waived. If the party whose performance is subject to a condition precedent controls the events that will lead to the occurrence or nonoccurrence of that condition, then that party must act consistently with the duty of good faith and fair dealing. This could serve as a policing mechanism so that, if a party causes in bad faith the condition not to be satisfied, then that party’s performance obligation becomes due immediately.

For example, assume that a purchase and sale agreement is contingent upon the purchaser securing acceptable financing. When the purchaser fails to obtain financing, a critical question often centers on the purchaser’s efforts and whether they were made in good faith. In one case involving the purchase of a single family residence, the financing condition required the purchaser to use reasonable diligence to obtain a loan.\footnote{See Century 21 Mary Carr & Associates, Inc. v. Jones, 418 S.E.2d 435 (Ga. Ct. App. 1992).} A lender approved the purchaser’s loan application on the condition that it pay its outstanding credit card balance. The purchaser’s bank account had sufficient funds to cover the debt amount; however, the purchaser claimed that the money in the account belonged to her boyfriend. The trial court held that the purchaser’s efforts to obtain financing were reasonable and the purchaser did not breach the duty of good faith and fair dealing by refusing to use the funds in the bank account to pay off the credit debt.\footnote{Id.}

In another case, a purchaser was held not to have breached the duty of good faith implied in a financing condition when it refused to apply for a loan from other lenders after the first lender rejected its application because of environmental problems that existed on the property.\footnote{See Barber v. Jacobs, 753 A.2d 430 (Conn. App. Ct. 2000).} In Barber, the lender withdrew its approval of the loan application after the purchaser’s counsel discovered that there were inland wetlands irregularities and disclosed that information to the bank. The seller argued that the purchaser breached its duty of good faith implied in the financing condition by refusing to apply for the loan at another institution. The purchaser’s
counsel concluded that the inland wetlands irregularities could not be resolved easily and that the environmental issues would pose similar problems on loan applications to other lenders. The purchaser considered the purchase agreement to be terminated because it could not obtain a loan. The court held that because the environmental problems would not have been easily resolved and other lenders likely would have rejected the purchaser’s loan applications, good faith did not require the purchaser to apply to other lenders after the first application was rejected.

In Utah, when a purchase and sale agreement is conditioned upon the purchaser obtaining financing, the seller may be required to begin performing its contractual obligations before the purchaser’s financing application has been approved. If the seller refuses to perform until after the purchaser has obtained financing, the seller may be in jeopardy of breaching the duty of good faith. In *Huber*, the agreement required the purchaser to qualify for a loan within sixty days of the date that the agreement was executed. If the purchaser failed to qualify within that period, either party could terminate the agreement. The property had been used previously as a gas station and the parties were concerned about potential environmental problems related to the underground storage tanks that remained on the property. The seller agreed to obtain the necessary environmental clearances and remove all contamination, to remove the storage tanks and to fill the holes caused by the removal. The purchaser agreed to contribute $4,000.00 toward the clean-up, which would be credited against the purchase price.

The purchaser did not qualify for the loan within sixty days and the seller refused to remove the underground storage tanks. Claiming that the seller acted in bad faith by refusing to perform its obligations until after the purchaser qualified for a loan, the purchaser sued claiming the seller breached the duty of good faith. The trial court found that the seller’s bad faith conduct prevented the purchaser from qualifying because applying for the loan would have been futile until the property was cleaned up and inspected.

The Utah appellate court concluded that there was no express term in the contract that required the purchaser to qualify for the loan before the seller had to begin removing the tanks. Absent an express term stating the order of performance, “the law implies a covenant and condition that the related obligations be performed concurrently.” The court explained that the seller’s right to delay the removal of the storage tanks would have arisen only if the purchaser

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80 There were clearing and ground disturbances that violated the regulations enforced by the town’s inland wetlands and watercourses agency and a letter from the agency informed the sellers that there were unauthorized activities on their property. *Id.* at 431-433.

81 *Id.* at 434.

82 *See* PDQ Lube Center, Inc. v. Huber, 949 P.2d 792 (Utah Ct. App. 1997).

83 *Id.* at 795.

84 *Id.* at 796-98.

85 *Id.* at 796.

86 *Id.* at 798.
failed to perform, but the purchaser had not. It had begun its efforts to secure financing within a week of the date on which the contract was executed.\textsuperscript{87} Therefore, the seller’s refusal to remove the underground storage tanks was held to be a breach of the duty of good faith.

Some purchase and sale agreements may be conditioned upon other events. For example, if the purchaser is purchasing the property as part of a larger development scheme, it may make one agreement contingent upon the closing on the purchase of an adjacent or other piece of property. In one case, the purchaser executed a purchase agreement that was contingent upon the purchaser’s “ability to purchase and close on the [other] property as well as proceed with the construction of the warehouse.”\textsuperscript{88} The agreement gave the purchaser the sole discretion to determine its ability to purchase the other property. Eventually, the purchaser decided not to pursue the warehouse development plan or to purchase the other property, and so it terminated the contract. The seller sued for breach of contract seeking damages and specific performance. The court explained that although the contract condition imposed no duty on the purchaser to ensure the occurrence of the other transaction, a court will impose a duty of good faith on the purchaser to put forth reasonable efforts to bring about that other transaction.\textsuperscript{89}

Termination clauses in purchase and sale agreements provide the parties with a remedy that is exercisable if the specific conditions are not satisfied. Case law differs by jurisdiction, however, on the issue of whether the exercise of a termination right is subject to the duty of good faith and fair dealing. In Ohio, for example, a duty of good faith is implied in a provision that permits a party to terminate an agreement if a condition precedent is not satisfied.\textsuperscript{90} In Meridia, a purchase agreement permitted the purchaser to inspect the property and improvements to determine whether they were suitable for the purchaser’s intended use and whether environmental problems existed. If the purchaser objected to the condition of the property or improvements, the purchaser could declare the agreement null and void after giving notice to the seller.\textsuperscript{91} After inspecting the premises, the purchaser found that there was insufficient parking, and the square footage of the building was insufficient for the purchaser’s intended use -- to construct an ambulatory surgery center. Additionally, the elevators were not large enough to hold a hospital gurney.\textsuperscript{92} Because of these deficiencies, the purchaser terminated the agreement. The seller sued, alleging that the purchaser’s termination was based on reasons unrelated to its dissatisfaction with the building.\textsuperscript{93} The court held that a duty of good faith is imposed upon the party with the discretion to terminate an agreement based upon its satisfaction with the building and “the canceling party may only do so because of genuine dissatisfaction.”\textsuperscript{94} Based on the

\textsuperscript{87} Id. at 798-99.
\textsuperscript{89} Id. at 1373.
\textsuperscript{91} Id. at *1.
\textsuperscript{92} Id. at *1.
\textsuperscript{93} Id. at *5.
\textsuperscript{94} Id.
evidence presented, the court concluded that the purchaser’s dissatisfaction was genuine and it did not breach the duty of good faith.

In New Jersey, a party may terminate an agreement pursuant to an express contractual right to do so, so long as it continues to perform until the actual moment that the termination takes effect. In Atlantic City Racing Assoc., the purchase agreement permitted the purchaser to inspect the property to determine that it was suitable for its intended uses and to determine if there were any title, environmental, zoning or other problems. The purchaser had the right to terminate the purchase agreement during the inspection period. The purchaser gave two notices of its intent to terminate and each time the seller extended the inspection period. The purchaser gave a third and final notice to terminate based on title issues that remained unresolved to its satisfaction. The seller argued that the purchaser’s termination was in bad faith and asserted that the true reason the purchaser terminated the contract was because it had not obtained certain concessions from the state of New Jersey.

Although there is a duty of good faith and fair dealing in every contract under New Jersey law, nothing supported the seller’s assertion that the purchaser breached that duty. The court explained that “where the contractual right to terminate is express and unambiguous, the motive of the terminating party is irrelevant.” The court further reasoned that the seller should not have been surprised by the termination because the purchaser had given notice of intent to terminate three times and its reasons for terminating were expressly contemplated by the contract. The purchaser performed fully up until the point at which its termination took effect and it terminated the contract pursuant to an express contract right; therefore there was no breach of the duty of good faith.

3. Rights of First Refusal and Options

The duty of good faith and fair dealing also applies to rights of first refusal and option agreements. Where a right of first refusal requires the holder of that right to match every term of an offer, a property owner does not breach the duty of good faith and fair dealing when it rejects

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96 Id. at 500.
97 Id. at 501.
98 Id. at 510.
99 Id.
100 Moreover, the seller misconstrued a recent New Jersey case that held that a party may, indeed, breach the implied duty of good faith when it exercises an express and unconditional termination right. Id. at 511 (citing Sons of Thunder, Inc. v. Borden, Inc., 690 A.2d 575 (N.J. 1997)). In Sons of Thunder, the court explained the buyer breached its duty of good faith and fair dealing because of its performance leading up to the contract termination not because it terminated the contract. The buyer had promised to purchase a minimum amount of clams from the seller and the buyer had failed to do so. There was other evidence of bad faith performance. The buyer’s termination of the contract pursuant to its express contractual right was not a violation of the duty of good faith.
the right-holder’s offer that does not match exactly the terms of the third party offer. In Stevens, Foren and Stevens were owners of adjacent properties. They had entered into an easement agreement and Foren granted Stevens a right of first refusal that provided that, if Stevens exercised the right, it had to match every term of the third-party offer. Subsequently, Foren entered into a purchase agreement with a buyer subject to Stevens’ right of first refusal. The terms of the purchase agreement required the buyer to complete construction of a home on the property within 18 months. It also required the buyer to make monthly installments of principal and interest and followed by a balloon payment of the outstanding principal balance at the end of five years. Upon reviewing the terms of the offer, Stevens expressed its intent to exercise its first refusal right but it did not agree to construct the home or to the payment terms. Foren and the buyer subsequently amended their purchase agreement to prohibit the payment of any principal during the first five years, the buyer being permitted only to make monthly payments of interest. Foren then presented the amended agreement to Stevens who accepted the payment terms, but continued to object to constructing a home. Foren rejected Stevens’ offer, and consummated the sale with the third party buyer.

Stevens sued, alleging a breach of the duty of good faith and fair dealing. Stevens argued that the requirement to build a residence was not within the parties’ contemplation when they entered the right of first refusal agreement. The court explained that although the duty of good faith applies to every contract, a party does not necessarily breach that duty when it invokes an express contract right. The right of first refusal required Stevens to match all terms of the offer -- whatever those terms turned out to be. Based on the express language of the first refusal right, the court held that the legitimate expectations of the parties could not have “encompass[ed] anything other than full latitude on Foren’s part to negotiate a sale on whatever terms it might choose.”

With respect to option agreements, an option holder’s conduct likewise is subject to the duty of good faith and if it breaches this duty, the option holder may be precluded from any contractual remedy when the owner of the land fails to honor the option. In one case, for example, a landlord granted its tenant an option to purchase the property at any time during the first two years of the lease for $650,000 and during the next three years for $675,000. When the landlord decided to sell the premises, the tenant expressed an interest in purchasing the land and the building, but the negotiations stalled. Subsequently, the landlord received an offer from one prospective purchaser to purchase the premises for $665,000. The landlord received a second offer from a different purchaser to create a real estate trust in which the landlord and the purchaser would each own a fifty percent beneficial interest. The landlord notified the tenant of the first offer. A principal of the tenant told the landlord that the offer was not bona fide and told

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102 Id. at 1009-1010.
103 Id. at 1010.
104 Id. at 1012.
the offeror that it would not permit the offeror to purchase the premises. Finally, the tenant told
the landlord that it would purchase the premises and led the landlord to believe the purchase
price would be $665,000 or $650,000. After the landlord rejected the first offer, the tenant said
that it would not purchase the property because the principals could not agree on a price. The
landlord accepted the second offer.

Subsequently, the property increased substantially in value and the tenant sought damages
for breach of the lease provisions that granted it a right of first refusal and an option to purchase.
The court rejected the tenant’s claim. The court concluded that the tenant had breached the lease
by violating the duty of good faith and fair dealing based on its conduct relating to the exercise of
its preemptive purchase rights. A party who has violated the duty of good faith and fair
dealing is barred from obtaining relief for the effects that are the result of its own breach.

4. Installment Land Sales Contracts

A buyer under an installment land sale contract can be exposed to substantial risks of
losing the property under contract as well as losing all of the payments it has made to the date of
the forfeiture. The duty of good faith and fair dealing is one theory that has been used to protect
the buyer’s interest in these transactions. When the purchaser under an installment land sales
contract is seeking partners to enter a joint venture, the duty of good faith requires the seller to
cooperate with the purchaser’s efforts to recruit partners. In one case, a purchaser was given
five years to close the deal so that it could find partners or joint venturers to develop the property.
The purchaser made monthly payments on the contract during the five-year period. The
purchaser attracted numerous prospective partners who were interested in the development
opportunity. Principals of the seller, however, prevented two potential partners from entering the
property and dissuaded others from developing the property. Three prospective partners
indicated that they were ready to enter into a joint venture arrangement and probably would have
done so if the seller had not interfered so extensively. The purchaser failed to enter into the joint
venture, ceased paying the monthly installments and sued for breach of contract. The trial court
held that the purchaser breached the contract and that the seller was entitled to retain all the
money that had been paid.

The appellate court reversed, concluding that the seller breached its duty of good faith by
denying the purchaser and its prospective partners access to the property and by actively
dissuading them from entering into an agreement to develop the property. The seller argued that
even if it breached the duty of good faith, under the contract the purchaser was entitled only to
damages if seller’s title was unmarketable or the seller defaulted in the closing; therefore, the
buyer was not entitled to any damages in this case. The court rejected this argument and

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106 Id. at 913-914.
107 Id. at 914.
108 See, e.g., BGW Development Corp. v. Mount Kisco Lodge No. 1552 of the Benevolent and Protective
109 Id. at 58-59.
explained that a seller who breaches an installment land sale agreement in bad faith cannot rely upon the limitation of damages clause. Instead, the purchaser is entitled to recover the loss of its bargain and other reasonable expenses. The loss-of-bargain damages is calculated as the difference between the market value of the property on the date of the breach and the amount unpaid on the contract price.\footnote{Id. at 60.}

If an installment land sale contract contains a prepayment restriction and the purchaser wishes to assign the contract and pay the outstanding balance, a seller may refuse to accept the prepayment without violating the duty of good faith.\footnote{See, e.g., Carey v. Lincoln Loan Co., 998 P.2d 724 (Or. Ct. App. 2000).} Prepayment restrictions are designed to provide the seller under an installment land sale contract with a fixed income (including interest) for a given period of time and minimum tax consequences. A purchaser under a contract that contains a prepayment restriction has no right to prepay unless the seller consents or the contract expressly permits prepayment.\footnote{Id. at 731.} Although a landlord’s consent to an assignment of a lease cannot be unreasonably withheld under Oregon law, the consent to prepayment serves an entirely different purpose and may be withheld if the installment land sale contract does not expressly permit prepayment.\footnote{Id. at 732-33.}

5. Brokerage Agreements

A broker’s right to receive its commission is also protected by the doctrine of good faith and fair dealing. In California, when a prospective purchaser and a broker enter into a brokerage agreement, the purchaser may be liable to pay the commission even though it never technically purchases the property at issue.\footnote{See, e.g., R.J. Kuhl Corp. v. Sullivan, 17 Cal. Rptr. 2d 425 (1993).} In R.J. Kuhl Corp., the broker located a piece of property (the “Sacramento Savings property”) that suited the needs of Sullivan, the purchaser. Although the Sacramento Savings property was a larger parcel than Sullivan desired, he decided that he could keep half of the land and sell the other half. During the negotiations over the Sacramento Savings property, Sullivan was also negotiating to sell a different piece of property to another purchaser, Khachaturian, so he could use the proceeds towards the purchase of the Sacramento Savings Property. Subsequently, Sullivan agreed to assign his rights in the purchase and sale contract for the Sacramento Savings property to Khachaturian and Khachaturian agreed, in turn, to grant a one-year option to Sullivan for the half of the Sacramento Savings property that Sullivan wanted. After the sale between Sacramento Savings and Khachaturian closed, Sullivan’s attorney informed the broker that the sale between Sacramento Savings and Sullivan had not consummated and that Sullivan owed no commission.\footnote{Id. at 429.} Later, Sullivan and Khachaturian terminated the option agreement in exchange for Khachaturian’s promise to indemnify Sullivan for any claims that may arise relating to their transaction. Khachaturian sold

\footnote{Id. at 60.} \footnote{See, e.g., Carey v. Lincoln Loan Co., 998 P.2d 724 (Or. Ct. App. 2000).} \footnote{Id. at 731.} \footnote{Id. at 732-33.} \footnote{See, e.g., R.J. Kuhl Corp. v. Sullivan, 17 Cal. Rptr. 2d 425 (1993).} \footnote{Id. at 429. The brokerage commission was contingent upon the consummation of the sale.
the property that had been under option to a third party. The broker sued Sullivan claiming it had
breached its contract by refusing to pay the commission even though the sale never
consummated.

The appellate court held that Sullivan breached the duty of good faith. As a result of the
breach, the nonoccurrence of the condition precedent to the broker’s right to receive the
commission -- the failure to consummate the sale -- was excused. Consequently, Sullivan’s duty
to pay the commission was unconditional and due immediately.\footnote{Id. at 434. The court explained that it was not going to permit Sullivan to evade its obligation to pay the commission by elevating form over substance. Indeed, “Sullivan could not have defeated Kuhl’s right to a full commission claim if he had consummated the purchase and then sold the property to Khachaturian for the purchase price plus the option and indemnity. This is effectively what happened in this case.”}

C. A Distinction between Conventional and Modern Applications of the Doctrine of
Good Faith

The conventional application of the duty of good faith and fair dealing is a policing
mechanism only to protect the parties’ reasonable expectations and intentions that existed at the
time they entered into the contract. The courts should use good faith and fair dealing to protect
these expectations and intentions only in cases where the circumstances have changed
dramatically such that one of the parties could exercise its discretionary right to injure the other
party based on a risk that the other party had not assumed. Those are the types of cases in which
most would agree that one party is not acting in good faith. One scholar has suggested that,
indeed, this is an optimal application of the duty of good faith and fair dealing.\footnote{See, e.g., Burton, supra note 3, at 392-95.} Where the
parties do not expect the contractual circumstances to change, it is economically efficient for
them to remain silent and rely on a gap-filling rule like the duty of good faith and fair dealing to
protect their contractual expectations. The parties can save the transactional costs that they
would otherwise expend to identify the various events that could arise and to negotiate how they
would resolve them.\footnote{Id.} Accordingly, the duty of good faith and fair dealing should be invoked
by the courts to protect against one party taking advantage of a dramatic change in circumstances
to the other party’s detriment where such action was not within either of the parties’ reasonable
expectation when they formed the contract. This application of the duty of good faith and fair
dealing prevents the party who has a discretionary right from exercising it in an extortionate way.
The cornerstone of an appropriate and economically efficient application of good faith and fair
dealing is to protect the parties contractual expectations.

A modern variant of the application of good faith and fair dealing seems to be developing
in a way that is divergent from these conventional principles. Some courts are invoking the duty
to reallocate risks \textit{ex post} in spite of the fact that the parties expressly allocated those risks in a
particular (and different) way in their contract. In doing this, these courts seem to be blurring the

116 Id. at 434. The court explained that it was not going to permit Sullivan to evade its obligation to pay the commission by elevating form over substance. Indeed, “Sullivan could not have defeated Kuhl’s right to a full commission claim if he had consummated the purchase and then sold the property to Khachaturian for the purchase price plus the option and indemnity. This is effectively what happened in this case.”

117 See, e.g., Burton, supra note 3, at 392-95.

118 Id.
critical, albeit sometimes fine, distinction between contract and tort principles. When interpreting Section 205 of the Second Restatement, courts should be cognizant of the fact that it is a contractual doctrine and should not be used to vindicate some public policy or achieve some social or moral objective.

When the parties allocate risks in a particular way and the express terms of the contract demonstrate that the parties have granted one party a discretionary right, that party should not be in jeopardy of breaching a duty of good faith and fair dealing if, in the course of ordinary business circumstances, it exercises the discretionary right to its benefit, and incidentally to the other party’s disadvantage. The policing mechanism in this situation should be the marketplace. If the actors in a given market find this type of behavior unacceptable, then it will be difficult for this actor to find a transaction partner willing to deal with it. There is a distinction between this situation -- where the marketplace polices transactional behavior -- and the situation discussed above -- where the courts police the behavior. That distinction centers on the circumstances in which the party with the discretionary right chooses to exercise it. If the circumstances surrounding the contract have changed and the party with a discretionary right now seeks to exercise the right in a way that is antithetical to what any of the parties did (subjective intent) and should have (objective intent) anticipated (reasonable expectations) at the time they entered the contract, it is probably appropriate for the court to apply the duty of good faith and fair dealing to police the conduct of the discretion-exercising actor. If, on the other hand, the circumstances have changed and the party with a discretionary right seeks to exercise it in a way that was or should have been within the other party’s contemplation it can reasonably be said that the injured party assumed the risk that the other party would exercise its discretionary right to advance its own self-interest. This type of behavior should be governed by marketplace, and whether the market will tolerate it is a constraint the actor ought to consider when it decides how to exercise an express discretionary right.

One example where a court misapplied the duty of good faith and fair dealing is Market Street Associates, L.P. v. Frey. The parties entered into a sale-leaseback agreement. The ground lease provided that if the lessee wished to build improvements on the land it must first ask the lessor to finance the project. If the lessor refused, then the lessee could repurchase the property at a price calculated under a formula set forth in the buyout provision. The lessee wanted to lease some property to a subtenant, but it needed to construct a building on the property first. The lessee notified the lessor that it wanted to purchase the leased property, but the lessor said it would sell the property for a price that was significantly higher than the price calculated under the buyout formula. Accordingly, the lessee believed the lessor did not intend to negotiate a sale of the land. The lessee then asked the lessor to finance the two-million-dollar-

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119 One court explained “the distinction between tort and contract is well grounded in common law, and divergent objectives underline the remedies created in the two areas. Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate ‘social policy.’ The covenant of good faith and fair dealing was developed in the contract arena and is aimed at making effective the agreement’s promises.” Carma Developers (California), Inc. v. Marathon Development California, 826 P.2d 710 (Cal. 1992).

120 21 F.3d 782 (7th Cir. 1994).
project, but the lessor rejected the request because it did not finance projects under ten million dollars. The lessee told the lessor that it intended to seek other financing. One month after the lessee stated that it would seek alternate financing, it decided to exercise its buyout right. Upon receiving this notice, the lessor offered to negotiate the financing needed for the improvement. The lessee, however, refused to negotiate claiming that it had made other commitments. The lessor refused to convey the property and the lessee sued for specific performance. The trial court concluded that the lessee had breached its duty of good faith and fair dealing because, in all of its correspondence with the lessor, the lessee never mentioned specifically that it was exercising the buyout right until the last letter it sent to the lessor.

The Seventh Circuit explained that the good faith inquiry in this case centered on the conversations and correspondence that occurred during the four-month period leading up to the lessee’s exercise of its buyout right. Reviewing all the correspondence, the court said that the lessee did not mention that it was operating under the buyout section of the lease until after the lessee received the lessor’s rejection of its financing proposal. The court found that once the lessor received the lessee’s letter stating that it was seeking other financing, the lessor thought the matter was closed. It was not until the lessee’s last letter, in which the lessee decided to exercise its buyout right, that “the trap was sprung,” according to the court. The court stated that once the lessee realized that the lessor had not reviewed the lease and was not operating under the buyout provision, the lessee breached the duty of good faith by not specifically referencing the buyout provision in its letters regarding the project financing.

This case is a stark example of a court misapplying the duty of good faith and fair dealing and imposing social morals on two sophisticated transactional parties. The lessor was a General Electric Pension Trust and the lessee was a real estate development partnership. They entered a ground lease that expressly granted the lessee a right to repurchase the property in the event that financing negotiations did not materialize into an agreement. The lessee had sixty days after the financing was rejected to give notice of its intent to exercise the buyout right. The lessor rejected the lessee’s proposal for financing on August 10, 1988 and the lessee notified the lessor on September 27, 1988 that it was exercising its buyout right. The ground lease was very clear concerning the buyout rights and how they could be exercised. It might have been a considerate gesture for the lessee to draw the lessor’s attention specifically to the buyout provision. To hold, however, that the lessee breached the duty of good faith by remaining silent about the buyout provision, and that the lessee was intentionally tricking, springing a trap on or keeping the lessor in the blind seems to go beyond the contractual realm of the duty of good faith and fair dealing.

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121 Id. at 787.

122 Id. at 787-788. “By remaining silent about paragraph 34 [the buyout provision], the district court determined that [the lessee] intended to trick the [lessor], thus violating the duty of good faith in performing the contract. . . . [T]he failure to mention paragraph 34 specifically or describe its consequences was intentionally designed to keep the [lessor] blind and stupid. . . .” Id. at 788.

123 See id. at 783.

124 See id. at 784 n.3 (setting forth the language of the buyout provision).
Courts sometimes commingle the implied obligation of good faith and fair dealing with other concepts in the law, such as disclosure obligations of the parties. One of the more disturbing in this line of cases is the recent opinion of the Supreme Court of Arizona in *Lombardo v. Albu*.

Sellers of a residential property filed suit against the purchaser’s agent after the sale failed to close because of the inability of the purchaser to obtain the required financing. At the time the contract was entered into, the subject residence was on the verge of being foreclosed upon by the sellers’ mortgagee. Unbeknownst to the sellers, the purchaser’s husband had experienced substantial financial difficulty, including a bankruptcy filing and the existence of Internal Revenue Service liens. The defendant agent had knowledge of those facts before the purchase and sale agreement was signed but did not disclose it to the sellers.

The court held that, because the purchaser had a legal obligation to disclose her and her husband’s unfavorable financial condition to the sellers, the purchaser’s agent was similarly obligated to do so. The court found that that obligation was grounded in the implied covenant of good faith and fair dealing:

> The buyer and seller, of course, have legal duties to each other arising out of their contractual relationship. This includes the covenant of good faith and fair dealing. Buyers and sellers must deal fairly with each other. And, the buyer and seller have duties to each other to disclose facts that are material to the transaction.

The agent argued that she could not disclose the financial condition of her principal but instead was obligated to keep that information confidential. The court rejected that argument, however, and in doing so stated the following:

> The fallacy in this argument . . . is that the client herself has a duty to the seller to disclose facts critical to her ability to perform. Thus, the financial wherewithal of the buyer to perform the contract is not confidential information.

The court held that because the purchaser had an obligation to disclose information about her financial status and that of her husband, her agent had the same disclosure obligation.

It should be noted that this case came to the Arizona Supreme Court on an appeal of a trial court’s granting of a motion for summary judgment and, as a result, all facts were viewed in the light most favorable to the purchaser’s agent, the party against whom the motion was granted. In addition, there was discussion in the opinion of the regulations governing the licensure of real estate agents and the impact, if any, of those regulations on the case at hand. Finally, there was no discussion of the fact that it was the purchaser’s husband – not the purchaser – who had the unfavorable credit history.

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126 *Id.* at 3 (emphasis added).
127 *Id.*
Nevertheless, the holding of the Supreme Court of Arizona is troubling. What are the bounds of one party’s disclosure obligations to the other? If the financial condition of a party is not a matter of sufficient sensitivity that it may be kept confidential, what information is? Does this disclosure obligation extend not only to the condition of the parties to the contract but also to the condition of the property that is the subject of the contract?128

VI. CONCLUSION

The implied covenant of good faith and fair dealing is not susceptible of bright line rules. State law differs on whether and when the doctrine applies, and courts and commentators have struggled to describe and apply a doctrine that is inherently imprecise.

Notwithstanding the lack of consistency or specificity in its application, the doctrine is always lurking throughout the shelf life of real estate contracts -- from negotiation to preliminary agreement to final agreement to performance to contract modification. While a party should be able to avoid liability under this doctrine by acting reasonably and not in bad faith, the fact that the implied obligation is affirmative in nature requires, in many circumstances, that a party do more than simply avoid acting in bad faith.

A lesson one learns anew from the cases and commentaries discussed above is the importance of drafting precision. In the commercial context, courts generally will enforce the intent of the parties as evidenced by the literal provisions of their agreements. But the language of those agreements must be clear and unambiguous to avoid the unintended application of the implied covenant of good faith and fair dealing in a manner the parties never intended.

For example, if it is the intent of the parties to a non-binding letter of intent that either party may unilaterally elect to cease negotiations, the letter of intent should say just that. Problems arise under letters of intent or other interim understandings that provide no express language defining the obligation of the parties to attempt to reach a definitive agreement. Absent that language, a party who wishes unilaterally to cease negotiations and move on to another transaction runs the risk that a court will find that that party breached an implied obligation to negotiate in good faith.

A similar situation is encountered in a purchase and sale agreement where a purchaser bargains for a due diligence period and the right to terminate the agreement without penalty prior to the end of that period. If the purchaser wishes to have an unrestricted right to terminate for any reason or for no reason whatsoever, the purchase and sale agreement should so provide in clear and unambiguous terms. Otherwise, if the agreement simply gives the purchaser the right to perform the tests and analyses of the property one would typically expect to commission, and assuming the results of those tests and analyses are consistent with the purchaser’s justifiable

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expectations in entering into the agreement, a court may not allow that purchaser to terminate the agreement for purely subjective reasons or for no reason at all.

Finally, as the recent decision of the Supreme Court of Arizona in *Lombardo* demonstrates, the law is unclear as to what parties to a transaction and their agents must disclose. That decision is particularly troubling in the rough and tumble world of commercial real estate where the doctrine of *caveat emptor* is generally thought to be alive and well. While it may remain so in many states, in others the lurking obligation to disclose facts the other party might or might not otherwise discover is troubling.