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I. INTRODUCTION

Today, virtually all mortgages contain acceleration clauses permitting the mortgagee to accelerate the mortgage indebtedness upon default by the mortgagor as defined in the mortgage loan documentation. Section 8.1 of the new *Restatement (Third) of Property: Mortgages* [hereinafter *Mortgages Restatement*][1]

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1. Section 8.1 provides:

> (a) An acceleration provision is a term in a mortgage, or in the obligation it secures, that empowers the mortgagee upon default by the mortgagor to declare the full mortgage obligation immediately due and payable. An acceleration becomes effective on the date specified in a written notice by the mortgagee to the mortgagor delivered after default.
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> (b) Prior to the date an acceleration becomes effective, the mortgagor may cure the default and reinstate the mortgage obligation by paying or tendering to the mortgagee the amount that is then owing on the mortgage obligation or performing any other duty the mortgagor is obligated to perform under the terms of the mortgage documents.
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> (c) After an acceleration has taken place and subject to Subsection (d), a mortgagor may prevent foreclosure only by paying or tendering to the mortgagee the full accelerated mortgage obligation.
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> (d) A mortgagor may defeat acceleration and reinstate the mortgage obligation by paying or tendering to the mortgagee the amount due and owing at the time of tender in the absence of acceleration and by performing any other duty in default the mortgagor is obligated to perform in the absence of acceleration if:
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> (1) such an action is authorized by statute or the terms of the mortgage documents; or
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> (2) the mortgagee has waived its right to accelerate; or
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> (3) the mortgagee has engaged in fraud, bad faith, or other conduct

endorses the view that these mortgage acceleration provisions are generally enforceable after default in accordance with their terms.[2] Following default and acceleration, the mortgagor may prevent foreclosure only by redeeming the property from the mortgage debt, i.e., "only by paying or tendering to the mortgagee the full accelerated mortgage obligation."[3] Section 8.1(d)(3), however, places certain constraints upon the mortgagee's right to accelerate, permitting the mortgagor to reinstate (after curing any existing defaults) if "the mortgagee has engaged in fraud, bad faith, or other conduct making acceleration unconscionable."[4] This standard has a significant judicial pedigree in mortgage law decisions, but its use of the elusive term "bad faith"—a term often understood in the context of its more honorable twin, "good faith"—creates the potential for uncertainty in the evaluation of disputes over the enforcement of acceleration provisions.

The rhetoric of good faith has played a significant role in judicial opinions addressing challenges to creditor decisions to exercise acceleration clauses following the occurrence of a default by the borrower. Most of these challenges involve a claim by the borrower either that the lender's security or prospects for repayment are not threatened (i.e., that the default poses no actual harm to the lender meriting acceleration of the debt) or that the lender's decision is pretextual or comes as an unfair surprise. For example, consider the following hypothetical: Randolph runs a small plumbing supply business, financed via a $750,000 revolving line of credit (bearing an interest rate of 10%) from Local Bank. Local Bank holds a perfected security interest in all of Randolph's inventory, accounts, and intangibles as well as a recorded mortgage upon Randolph's business premises. Under the terms of the loan documents, Randolph must provide audited financial statements to Local Bank each year by January 14. Under the terms of the loan documents, failure by Randolph to perform any obligation (whether monetary or

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making acceleration unconscionable.

RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 8.1 (1997) [hereinafter MORTGAGES RESTATEMENT].

2. *See id.* § 8.1 cmt. a.

3. *Id.* § 8.1(c).

4. *Id.* § 8.1(d)(3).

nonmonetary) constitutes a default and entitles Local Bank to demand immediate payment of the entire outstanding balance of the line of credit.

Now consider the following scenarios, each involving a variation on the foregoing hypothetical.

Example One (Borrower Insolvency). As of January 15, 1998 (one day late), Randolph has not provided the audited financial statements. Citing Randolph's failure to provide the financial statements on a timely basis, Local Bank demands immediate repayment of the entire credit line. Had Randolph provided the financial statements, they would have shown him to be insolvent.

Example Two (Bank's Mistaken Perception of Insecurity). On January 20, 1998 (six days late), Randolph provides Local Bank with audited financial statements. The statements demonstrate that Randolph has a net worth exceeding the outstanding balance of the credit line, and operating cash flows that are more than sufficient to cover monthly amortization of that outstanding balance. Furthermore, the financial statements indicate that the value of Local Bank's collateral exceeds $1 million. Nevertheless, Smith (the Local Bank loan officer responsible for Randolph's loan) is concerned by rumors that Home Depot will open a new superstore in the area. Smith believes that a new Home Depot would erode Randolph's customer base and render his operations unprofitable. In reality, however, Home Depot has decided not to open a new store in the area; the rumors are the wishful thinking of a local real estate developer. As a consequence of Smith's concerns, Local Bank demands immediate repayment of the entire credit line, citing Randolph's failure to provide the financial statements in a timely fashion as required by the loan agreement.

Example Three (Bank Seeks Increased Interest Rate). On January 20, 1998 (six days late), Randolph provides the audited financial statements. The statements demonstrate that Randolph has a net worth exceeding the outstanding balance of the credit line, and operating cash flows that are more than sufficient to cover monthly amortization of that outstanding balance. Furthermore, the financial statements indicate that the value of Local Bank's collateral exceeds $1 million. Nevertheless, Smith (the Local Bank loan officer responsible for

Randolph's loan) informs Randolph that Local Bank will demand immediate repayment of the entire credit line, based upon Randolph's failure to provide the financial statements in a timely fashion, unless Randolph agrees to increase the contract interest rate to 12.5%. When Randolph refuses, Local Bank demands immediate repayment of the outstanding balance of the credit line, citing Randolph's failure to provide the financial statements in a timely fashion as required by the loan agreement.

Example Four (Bank Makes Change in Lending Policy). In December 1997, Local Bank is acquired by industry giant MEGABank, which retains Local Bank's personnel in their existing positions. MEGABank executives issue a policy directive informing Smith (the loan officer responsible for Randolph's loan) and other former Local Bank personnel that MEGABank policy strongly discourages commercial loans of less than $1 million. Further, the policy directive urges that bank personnel should exercise "all means necessary to call existing loans" smaller than that threshold, and that their success in doing so would be factored into their performance evaluations for purposes of salary, bonus, and promotion decisions. On January 20, 1998 (six days late), Randolph provides the audited financial statements. The statements demonstrate that Randolph has a net worth exceeding the outstanding balance of the credit line, and operating cash flows that are more than sufficient to cover monthly amortization of that outstanding balance. Furthermore, the financial statements indicate that the value of Local Bank's collateral exceeds $1 million. Citing Randolph's failure to provide the financial statements in a timely fashion, MEGABank demands immediate repayment of the outstanding balance of the credit line.

Example Five (The Loan Officer's Animus). On January 20, 1998 (six days late), Randolph provides the audited financial statements. The statements demonstrate that Randolph has a net worth exceeding the outstanding balance of the credit line, and operating cash flows that are more than sufficient to cover monthly amortization of that outstanding balance. Furthermore, the financial statements indicate that the value of Local Bank's collateral exceeds $1 million. On behalf of Local Bank, Smith (the Local Bank loan officer responsible for

Randolph's loan) demands immediate repayment of the outstanding balance of the credit line, citing Randolph's failure to provide the financial statements in a timely fashion as required by the loan agreement. In reality, Smith's decision was motivated by personal animus resulting from a decision in late 1997 by Randolph's son (who was married to Smith's daughter, Jane) to leave Jane and their children for a younger woman.

If Randolph challenges the ability of the Bank to call in his credit line, in which examples (if any) should the court sustain his challenge? Section 8.1 suggests that the Bank's acceleration provision is generally enforceable, and in each example Randolph has violated a term of the loan agreement, thereby apparently triggering the Bank's reserved contractual right to demand full and immediate repayment of the credit line. But would the Bank's decision in any of the examples constitute "bad faith" within the meaning of section 8.1(d)(3), thereby defeating the Bank's reserved contractual right?

Example One, of course, presents no analytical problem. Not only does Randolph's failure to provide the financial statements violate a term of the loan agreement, but Randolph's insolvency places the Bank's decision to call the loan and enforce its remedies beyond reasonable challenge. The Bank's decision would comply with its duty of good faith performance under any conception of that duty. The other four examples, however, present the possibility of significant analytical disagreement because the Bank's prospects for repayment do not appear to be threatened and the Bank's secured position is solid. In Example Two, the Bank officer honestly believes that the Bank's prospects for repayment are threatened, but his belief appears to be mistaken and perhaps even negligent. If so, is the Bank's decision made in "bad faith"? In Examples Three and Four the Bank uses the violation as a basis for acting to protect its general economic interests—to obtain a higher interest rate (in Example Three) or to extract itself from the relationship based upon a change in bank policy (in Example Four). Are these decisions bad faith pretextual surprises or foreseeable good faith exercises of prudent business judgment? In Example Five, the Bank's decision is motivated not by any business concerns, but by the Bank officer's personal animus toward Randolph. Is this decision a bad faith pretextual surprise, or a foreseeable decision authorized by an arms-length bargain?

This Article explores the extent to which courts have struggled to give meaning to "good faith" as a constraint upon a creditor's enforcement of its contractual remedies. Although the *Mortgages Restatement* seeks to introduce certainty and predictability into mortgage law by advocating the free enforcement of acceleration clauses, its use of the elusive "bad faith" standard in section 8.1(d)(3) will compromise its ability to achieve that certainty and predictability. In Part II the Article evaluates section 8.1 and its stated objective of fostering certainty and predictability in the enforcement of mortgage remedies.[5] As Part II explains, the desire for efficiency has caused some to define the term "good faith" by reference to freedom-of-contract rhetoric; under this view, a creditor's decision to accelerate is in "good faith" if (as in the sample hypotheticals) the borrower has breached an objective term of the mortgage and the mortgage expressly reserved the right to accelerate upon that breach.[6]

As described in Part III, however, this freedom-of-contract view is not consistent with the duty of good faith performance and enforcement as that duty has evolved through its incorporation into the *Restatement (Second) of Contracts* and the Uniform Commercial Code. Instead, as Part III explains, the evolving duty of good faith compels a more searching inquiry—one that focuses not only upon whether the creditor honestly believes that the contract authorizes its action, but also upon whether the creditor's action under the circumstances comports with the reasonable, yet unexpressed, expectations of the parties at the time they entered into their bargain.[7]

Part IV explores the impact of the rhetoric of good faith on judicial decisions involving challenges to creditor acceleration decisions. Part IV focuses particularly on the tendency of some courts to use "impairment of security"—sometimes improperly—as a means to inform the parties' expectations about the lender's power to accelerate the maturity of a debt.[8] In Part V the article contrasts the enforcement of acceleration provisions with the enforcement of land use restrictions in the

5. *See infra* notes 12-22 and accompanying text.
6. *See infra* notes 23-26 and accompanying text.
7. *See infra* notes 29-93 and accompanying text.
8. *See infra* notes 94-153 and accompanying text.

law of servitudes, in which courts have struggled with questions about the enforceability of servitudes in the absence of harm.[9] Part V discusses the resolution of this issue in the proposed *Restatement (Third) of Property: Servitudes*, which adopts a "rationality" standard for the enforcement of land use restrictions.[10] Part VI the Article compares the "rationality" and "bad faith" standards and offers some concluding observations, both about the resolution of the hypotheticals introduced above and the possible benefits that may flow from the uncertainty occasioned by section 8.1's "bad faith" standard.[11]

II. SECTION 8.1 AND EFFICIENCY IN MORTGAGE REMEDIES

Section 8.1 specifically governs acceleration decisions pursuant to breaches of "objective" default provisions (e.g., failure to pay installments in a timely fashion, failure to pay taxes, failure to provide insurance), the violation of which can be demonstrated by reference to objectively determinable facts. In contrast, a creditor sometimes may exercise the power to accelerate pursuant to a "subjective" default provision (e.g., acceleration based upon the mortgagee's decision to "deem itself insecure"). With regard to this latter group of acceleration decisions, the standard for enforcement is relatively clear; both mortgage law and the Uniform Commercial Code provide that a creditor may not accelerate pursuant to an insecurity clause unless the creditor honestly believes that its security or prospect of repayment is actually threatened.[12]

One might argue that all acceleration decisions should be governed by that same standard, regardless of the type of default involved. After all, the mortgage transaction (at its core)

9. *See infra* notes 154-84 and accompanying text.

10. *See infra* notes 185-94 and accompanying text.

11. *See infra* notes 195-210 and accompanying text.

12. *See* Jackson v. State Bank, 488 N.W.2d 151, 156 (Iowa 1992) (stating that a mortgagee cannot refuse to advance funds based upon insecurity clause in mortgage note unless mortgagee in good faith believes its security or prospect of repayment is impaired); MORTGAGES RESTATEMENT, *supra* note 1, § 8.1 reporters' note ("Where a mortgage note actually contains [an insecurity clause], the good-faith requirement is applicable."); U.C.C. § 1-208 (1995) ("A term providing that one party or his successor in interest may accelerate payment or performance . . . 'at will' or 'when he deems himself insecure' or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired.").

serves to provide security for the repayment or performance of the borrower's mortgage obligation.[13] In this regard, both "objective" and "subjective" default provisions are motivated by the mortgagee's desire to protect itself against conditions that could threaten the mortgagee's security or its prospects for repayment. As a result, one might articulate the view that a breach of an objective default provision should not justify acceleration by the mortgagee where that breach does not threaten the mortgagee's security or its prospects for repayment, especially if the default is nonmonetary in nature.

At first glance, section 8.1 of the *Mortgages Restatement* rejects this view. The comments to section 8.1 distinguish the violation of an objective default covenant from a subjective default (such as the commission of common law waste or the mortgagee's exercise of an insecurity clause) and suggest that the mortgagee need not demonstrate impairment of the mortgagee's security in order to justify acceleration following an objective default:

> The mortgagee's acceleration based on the mortgagor's commission of common-law waste is permissible only when the waste impairs the mortgagee's security . . . . On the other hand, where the mortgagee's acceleration stems from the mortgagor's violation of specific covenants, impairment of security need not be shown. Thus, for example, if the mortgage requires the mortgagor to care for an improvement in a certain manner, to insure the premises, or to pay real estate taxes, defaults on these covenants are the proper basis for acceleration even though they also constitute waste . . . and do not impair [the mortgagee's] security.[14]

Furthermore, section 8.1 makes no distinctions between monetary objective defaults and nonmonetary objective defaults. As the comments suggest, "acceleration is not only permitted for failure to pay the mortgage debt promptly, but also for defaults in mortgage covenants to pay taxes, to

13. *See* MORTGAGES RESTATEMENT, *supra* note 1, § 1.1 cmt. ("The function of a mortgage is to employ an interest in real estate as security for the performance of some obligation.").

14. *Id.* § 8.1 cmt. a. The comments also explain that section 8.1 permits the general enforcement of "cross-default" provisions, i.e., provisions that permit acceleration of one mortgage debt in the event that a different loan goes into default. *See id.*

maintain insurance, to keep buildings intact, to maintain an adequate financial condition, to avoid the commission of waste, and the like."[15] These comments appear to embrace a strong "freedom-of-contract" view that accelerations based upon objective defaults should be judged in accordance with the terms of the contract and the objective facts (i.e., did the mortgagor sell the land, or fail to provide a financial statement, or fail to pay real estate taxes in violation of the agreement?), without regard to external issues such as impairment of the mortgagee's security or the mortgagor's personal circumstances. The comments justify this view by reference to efficiency, noting that section 8.1 should provide predictability in the enforcement of mortgage remedies and avoid "difficult and time-consuming judicial inquiries into such matters as the degree of mortgagor's negligence, the relative hardship that acceleration imposes, and other subjective concerns."[16]

In section 8.1(d), however, the *Mortgages Restatement* recognizes certain limitations upon the mortgagee's right to accelerate the mortgage debt. Section 8.1(d) permits the mortgagor to defeat acceleration and reinstate the mortgage obligation (by curing any pre-acceleration defaults) if reinstatement is authorized by statute or the mortgage documentation,[17] or if the mortgagee has waived its right to

15. *Id.*

16. *Id.* cmt. e; *see also id.* reporters' note ("This section, in adopting the traditional approach, reflects the view that, in the absence of fault on the part of the mortgagee, relief from acceleration is better dealt with by 'arrearages' statutes or the language of the mortgage documents. This section serves an important policy goal of predictability in mortgage remedies.").

17. *See id.* § 8.1(d)(1). Most conventional residential mortgage documentation contains a contractual reinstatement provision. *See, e.g.*, 2 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 14.3, at 325 (3d ed. 1993) (showing form: Federal National Mortgage Association–Federal Home Loan Mortgage Corporation (FNMA-FHLMC)–Uniform Mortgage–Deed of Trust Covenants–Single Family, ¶ 18). In addition, a number of states have enacted legislation providing certain mortgagors with statutory reinstatement privileges. *See, e.g.*, CAL. CIV. CODE § 2924c (West 1993); COLO. REV. STAT. § 38-38-104(2.5) (1997) (certain nonmonetary defaults only); 735 ILL. COMP. STAT. ANN. 5/15-1602 (West 1992); MINN. STAT. ANN. § 580.30 (West 1988); 41 PA. CONS. STAT. ANN. § 404 (West 1992); UTAH CODE ANN. § 57-1-31(1) (1994). In addition, Chapters 11, 12, and 13 of the Bankruptcy Code provide debtors in possession of mortgaged property with the opportunity to use the plan of reorganization as a means to deaccelerate and reinstate a defaulted mortgage obligation. *See* CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 11.3, at 768, § 12.3, at 900, § 13.2, at 959-61 (1997).

accelerate either in writing or by implication as a result of its conduct.[18] In addition, section 8.1(d)(3) permits the mortgagor to reinstate the debt (again, after curing any defaults) if "the mortgagee has engaged in fraud, bad faith, or other conduct making acceleration unconscionable."[19]

Section 8.1 does not provide a positive definition of the term "bad faith"; thus, the exact extent to which subsection (d)(3) constrains the mortgagee's acceleration decision is unclear. The comments provide some limited guidance, distinguishing between *active misconduct by the mortgagee prior to its acceleration decision* (e.g., a statement that it will not enforce its remedies, or will do so only after a certain period of time) and *the mortgagor's personal circumstances* (e.g., the hardship that acceleration would impose, or the mortgagor's ability to pay). According to the comments, the former might prevent the mortgagee from accelerating legally,[20] but not the latter:

> While mortgagee misconduct of the type described in Subsection (d) is an appropriate basis for relief from acceleration, mortgagor's negligence, mistake, or improvidence are not. This is the case even where the default is caused by circumstances beyond mortgagor's control and where acceleration will cause extreme hardship. . . . Under this Restatement, a mortgagee who is guilty of no misconduct is *ex ante* permitted to rely on its contract acceleration right without being subject to the vagaries of mortgagor's financial and personal situation . . . .[21]

18. *See* MORTGAGES RESTATEMENT, *supra* note 1, § 8.1(d)(2). Most typically, courts have found waiver based upon a mortgagee's consistent pattern of accepting late payments. *See, e.g.*, Miller v. Uhrick, 706 P.2d 739 (Ariz. Ct. App. 1985); Rosselot v. Heimbrock, 561 N.E.2d 555 (Ohio Ct. App. 1988); Fairfield Fin. Group, Inc. v. Gawerc, 814 S.W.2d 204 (Tex. App. 1991).

19. MORTGAGES RESTATEMENT, *supra* note 1, § 8.1(d)(3).

20. The comments provide two examples, Illustrations 16 and 17, in which the mortgagee attempts to accelerate shortly after providing the mortgagor with oral assurances that no acceleration would occur. *See id.* cmt. e, illus. 16 (payment due by Monday, but mortgagee assures mortgagor that no acceleration will take place if mortgagor pays by Friday at 5:00pm); *id.* cmt. e, illus. 17 (mortgagor loses job and cannot pay mortgage installment, but requests time to sell land; mortgagee orally assures mortgagor that it will wait for "a couple of months" before taking any action). In each case, the comments suggest that "estoppel, fraud, or bad faith provide appropriate theories for defeating acceleration." *Id.* cmt. e.

21. *Id.* cmt. e.

The comments reinforce this point, using an example based upon the facts of the landmark New York Court of Appeals decision in *Graf v. Hope Building Corporation*.[22] The comments ex-pressly reject the view expressed by Justice Cardozo (dissenting in *Graf*) that equity justifies relieving the borrower from the consequence of a trivial monetary default triggered by the borrower's own mistake.

What the comments do not make clear is whether section 8.1 distinguishes between (on the one hand) active misconduct by the mortgagee prior to the acceleration decision and (on the other hand) the making of the decision itself in reliance upon an objective default provision. In other words, can a decision to accelerate a mortgage debt, based upon the occurrence of an objective default as specified by the terms of the loan documents, ever constitute "bad faith"? Many courts have concluded that the answer is "no," and that the creditor's reliance upon the terms of the loan documents is sufficient to defeat a claim of bad faith.[23] Courts and commentators often

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22. 171 N.E. 884 (N.Y. 1930). In *Graf*, the mortgagor (a corporation) fell into default because the corporation's bookkeeper made an arithmetical error in preparing the check for the mortgage installment. The bookkeeper discovered the mistake, but could not cure it immediately because the corporation's president had since left the country on business. The mortgagee accelerated the debt, demanded payment of the entire balance (approximately $300,000), and refused to reinstate the mortgage when the mortgagor tendered the correct past due installment. When payment of the accelerated balance did not occur, the mortgagee instituted foreclosure proceedings. In its decision, a 4-3 majority of the New York Court of Appeals upheld the acceleration, enforcing the bargained-for acceleration clause and suggesting that while the mortgagee's conduct was "ungenerous," it did not involve "fraud, bad faith or unconscionable conduct" by the mortgagee so as to justify the court's equitable intervention on the mortgagor's behalf. *Id.* at 885. In dissent, Justice Cardozo argued that the enforcement of acceleration provisions was subject to equitable limitations, and that acceleration was not justified given the trivial nature of the borrower's mistake, the borrower's ability to pay, the mortgagee's awareness of the mistake, and the harm that the borrower would suffer if no relief were granted (by the time of the Court of Appeals decision, of course, the country had entered the Depression and the mortgagor likely had no hope of obtaining financing to satisfy the accelerated mortgage debt). *See id.* at 889 (Cardozo, C.J., dissenting).

Illustration 19 is based precisely upon the facts in *Graf*, and Professor Grant Nelson (who was the principal drafter of section 8.1) has suggested that his objective in section 8.1(d)(3) was to reject Cardozo's view that courts should use equitable powers to rescue the borrower from the consequences of its own negligence or mistake.

23. *See, e.g., In re* Nantahala Village, Inc., 976 F.2d 876, 881-82 (4th Cir. 1992); Terry A. Lambert Plumbing, Inc. v. Western Sec. Bank, 934 F.2d 976, 982-83 (8th

advance efficiency concerns to justify this view and use strong freedom-of-contract rhetoric to inform the meaning of good faith in contract enforcement. One of the more eloquent defenses of this view comes from the Seventh Circuit's decision in *Kham & Nate's Shoes No. 2, Inc. v. First Bank,*[24] in which Judge Easterbrook justifies an extremely narrow view of "good faith" by reference to the need for certainty and predictability in contracting:

> Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of "good faith". Although courts often refer to the obligation of good faith that exists in every contractual relation, this is not an invitation to the court to decide whether one party ought to have exercised privileges expressly reserved in the document. "Good faith" is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties. When the contract is silent, principles of good faith—such as the UCC's standard of honesty in fact . . .—fill the gap. They do not block use of terms that actually appear in the contract.
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> We do not doubt the force of the proverb that the letter killeth, while the spirit giveth life. Literal implementation of unadorned language may destroy the essence of the venture. Few people pass out of childhood without learning fables about genies, whose wickedly literal interpretation of their "masters'" wishes always leads to calamity. Yet knowledge that literal enforcement means some mismatch between the parties' expectation and the outcome does not imply a general duty of "kindness" in performance, or of judicial oversight into whether a party had "good cause" to act as it did. Parties to a contract are not each others' fiduciaries; they are not bound to treat customers with the same consideration reserved for their families. Any attempt to add an overlay of "just cause" . . . to

Cir. 1991); Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990); Van Arnem Co. v. Manufacturers Hanover Leasing Corp., 776 F. Supp. 1220, 1223 (E.D. Mich. 1991); Idaho First Nat'l Bank v. David Steed & Assocs., Inc., 825 P.2d 79, 83 (Idaho 1992); Brown v. Weeres Indus., Inc., 375 N.W.2d 64, 67 (Minn. Ct. App. 1985); Bennco Liquidating Co. v. Ameritrust Co., 621 N.E.2d 760, 762-63 (Ohio Ct. App. 1993).

24. 908 F.2d 1351 (7th Cir. 1990).

> the exercise of contractual privileges would reduce commercial certainty and breed costly litigation.[25]

The judicial efficiencies gained from this view of bad faith are easily seen by considering the introductory hypotheticals in Part I and evaluating how a court would view Randolph's challenges to the Bank's decision to call in his line of credit. Example One (in which Randolph is insolvent), of course, poses no analytical difficulty under any conception of bad faith; Randolph has violated the terms of the loan agreement and his insolvency poses a threat to the Bank's prospects of repayment. Likewise, the Bank's decisions in Examples Two, Three, and Four would not involve "bad faith" under the Easterbrook view. Randolph may argue that he never expected that the Bank would call his loan based upon a technical, six-day default, especially if that action was imprudent (as in Example Two, in which the Bank mistakenly perceives its security is threatened); motivated by a desire to obtain a higher interest rate (as in Example Three); or motivated by a change in Bank lending policies (as in Example Four). Under this view, however, the literal terms of the contract authorize the Bank's action, and the "mismatch" between Randolph's expectations and the Bank's intentions is irrelevant.[26]

Whether courts will interpret section 8.1 in equally sweeping fashion, however, is conjecture. Although the

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25. *Id.* at 1357 (citations omitted). Notably, the Seventh Circuit based its interpretation of "good faith" upon the existing language of UCC section 1-203 which, as discussed in Part III, originally meant only "honesty in fact," i.e., does the actor sincerely believe that its conduct is authorized by the law? *See infra* notes 47-61 and accompanying text. As Part III explains, through the UCC revision process, the principal architects of the UCC have abandoned this narrow conception of good faith in favor of a duty informed by the observance of reasonable commercial standards. *See infra* notes 77-93 and accompanying text.

26. *See Kham & Nate's Shoes*, 908 F.2d at 1357. Exactly how the Bank would fare under Easterbrook's view is unclear in Example Five, in which the Bank's action is motivated by the loan officer's personal animus. Easterbrook's rhetoric suggests that Randolph's acceptance of a provision authorizing acceleration if he failed to provide financial statements makes all other circumstances irrelevant; under this view, the Bank's action would withstand challenge by Randolph. However, it seems dubious to suggest that Randolph, at the time he entered into the loan agreement, would have contemplated that the Bank would act in such an arbitrary and capricious fashion, and courts have often applied the duty of good faith in a fashion that protects the borrower against such pretextual conduct. *See infra* notes 142-53 and accompanying text.

comments to section 8.1 incorporate some relatively strong freedom-of-contract rhetoric, they provide no examples or illustrations involving a "bad faith" challenge to a mortgagee's decision to accelerate based upon a *nonmonetary* objective default provision, nor to a decision involving a clear "mismatch" between the expectations of the mortgagor and the mortgagee. Furthermore, even assuming that section 8.1 advances a freedom-of-contract view akin to that of Easterbrook, section 8.1's use of the term "bad faith"—informed as that term is by the rhetoric associated with its twin "good faith"—creates some uncertainty about how broadly courts will interpret section 8.1(d)(3). Given the historical origins of the term "good faith," that term can be, and often has been, understood by courts to invite *ex post* review of the reasonable expectations of contracting parties and *ex post* judgment that one party's enforcement of the contract did not comport with those reasonable expectations.

Furthermore, this broader conception of good faith performance has obtained significant influence through its adoption in the *Restatement (Second) of Contracts*,[27] and will gain more influence as it continues to be promulgated throughout the Uniform Commercial Code.[28] As a result, it seems likely that some courts will use the broad rhetoric of good faith as a means to evaluate the objective reasonableness of a contracting party's enforcement decisions in marginal cases—a result that may work at odds with the stated objectives of section 8.1. To explain why, Part III of this Article retraces the historical origins of the term "good faith" and the evolution of the duty of good faith performance and enforcement in American commercial law.

III. "GOOD FAITH"—UNDERSTANDING ITS ORIGINS, DEVELOPMENT, AND PARAMETERS

Today, it is generally accepted that a duty of good faith governs the performance and enforcement of promissory notes and credit agreements secured by real or personal property.[29] Never

27. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) [hereinafter CONTRACTS RESTATEMENT]; *see infra* notes 77-83 and accompanying text.

28. *See infra* notes 85, 91 and accompanying text.

29. The enforcement of negotiable promissory notes secured by realty and/or

theless, courts have struggled mightily to give practical substance to this general duty. Does good faith constitute merely a state of mind (i.e., the sincere subjective belief that one is acting in accordance with the law, regardless of the correctness of that belief)? Or does it require adherence to external standards of moral behavior (i.e., actions consistent with behavior one might expect from similarly situated commercial parties)?[30] To provide a framework for understanding why section 8.1 may not produce the certainty and predictability it seeks to achieve, Part III traces the historical origins of the "good faith" concept, its introduction into American law, its incorporation into the Uniform Commercial Code (UCC), and its "restoration" in the *Restatement (Second) of Contracts* and revised UCC.

A. The Origins of Good Faith–Roman and Continental Antecedents

In the Roman law of obligations, the terms *bona fides* and *stricti juris* served to designate the two primary categories of obligations. The *stricti juris* obligation designated the formal agreement, typically made in ritual stipulation;[31] these formal agreements included agreements involving the loan of money, the guarantee, and certain kinds of security.[32] In contrast, the *bona fides* obligation designated the nonritualistic, informal consensual contracts that covered most Roman commercial activity.[33] The different judicial treatment of the stipulation

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personalty is governed by the provisions of the UCC, which from its initial promulgation has provided that "[e]very contract or duty within [the UCC] imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203 (1995). The enforcement of nonnegotiable notes is governed by the common law of contracts, under which courts have (as suggested *infra* notes 77-83 and accompanying text) implied a duty of good faith and fair dealing as manifested in the provisions of the CONTRACTS RESTATEMENT, *supra* note 27.

30. *See* Saul Litvinoff, *Good Faith*, 71 TUL. L. REV. 1645, 1649 (1997) ("It has been said that, in the legal context, good faith has both a psychological and an ethical component.").

31. *See* WILLIAM WARWICK BUCKLAND, A TEXT-BOOK OF ROMAN LAW 413-15 (2d ed. 1950).

32. *See* FREDERICK H. LAWSON, A COMMON LAWYER LOOKS AT THE CIVIL LAW 93-94, 121-22, 126, 137 (1955).

33. *See id.* at 120-21; *see also, e.g.*, E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 669 (1963); Jill Pride Anderson, Comment, *Lender Liability*

and the consensual contracts reflected the normative force that Roman law ascribed to the concept of *bona fides*. Courts strictly interpreted the ritual stipulation to limit the parties' respective obligations to those expressly stated by the parties; the judge retained no discretion in fashioning relief.[34] In determining disputes arising out of the consensual agreements, however, Roman judges found significant flexibility in the concept of *bona fides*:

> In the actions on the consensual contracts, on the other hand, the judge . . . was directed to order the defendant, if unsuccessful, to pay the plaintiff whatever he found to be due *ex fide bona,* that is to say, in accordance with the requirements of good faith; and this cast on the judge . . . the burden of deciding what the defendant ought in good faith to have done, in other words what kind of performance the contract called for. This meant that, in contrast to the stipulation, where all the terms had to be expressed, the parties would be bound not only by the terms they had actually agreed to, but by all the terms that were naturally implied in their agreement.[35]

Thus, under Roman law, *bona fides* was not merely a "tool for interpretation," but a basis for imposing upon contracting parties obligations that were beyond the express terms of their agreement yet consistent with their unexpressed, reasonable expectations.[36]

The influence of the Roman *bona fides* and its incorporation of external standards of reasonable behavior significantly influenced the development of commercial law throughout continental Europe. In France, the first modern civil code required that *all* contracts be performed in good faith,[37]

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for Breach of the Obligation of Good Faith Performance, 36 EMORY L.J. 917, 919 n.10 (1987).

34. *See* LAWSON, *supra* note 32, at 124.

35. *Id.* at 124-25 (citations omitted).

36. *See* Litvinoff, *supra* note 30, at 1652 ("[T]he [*bona fides*] standard had the ability to create an obligation that bound a contracting party to whatever could be expected of a person who acted in such a case with probity and rectitude, an obligation that thus came into existence regardless of any formality at its inception. The Roman *bona fides* allowed the Roman judge great discretion in his determination of that which parties to an informal contract, acting as *boni viri*, or honest men, could expect from each other . . . ." (footnote omitted)).

37. *See* CODE CIVIL [C. CIV.] art. 1134 (Fr.).

rejecting the formal Roman law distinction between *stricti juris* and *bona fides* contracts.[38] Likewise, the Swiss Civil Code provides that all persons are bound to exercise their rights and perform their obligations in accordance with the rules of good faith.[39] Further, the Swiss code draws a direct connection between good faith and abuse of rights, providing that the law does not protect the "manifest abuse" of a right.[40] In this regard the Swiss code suggests that a contracting party acts in bad faith when he or she uses a contractual right "as an instrument to obtain an advantage which lies beyond that which . . . the parties contemplated at the time the contract was entered into."[41] The Dutch code uses a comparable term, prescribing that all contracting parties must conduct themselves and their affairs according to the demands of "reason and equity."[42] Finally, the German Civil Code provides the most striking example of the development of good faith in commercial law. The German Code's duty of good faith (*Treu und Glauben*) incorporates an external standard of reasonableness, prescribing that a party must perform or enforce an agreement in accordance with both the established standards of the community and the confidence bestowed upon her by the other party.[43] German courts have applied this duty of good faith with striking breadth, most notably during the post-war reconstruction period as a basis for rewriting fixed-price

38. *See* Litvinoff, *supra* note 30, at 1653 ("By virtue of that crucial rejection, in French law all contracts, since the enactment of the *Code civil*, have bound the parties to all those attending obligations that, although not made express by them, are prescribed by *equité*, usage, or the law, according to the nature of their contract." (citing 3 TOULLIER, LE DROIT CIVIL FRANÇAIS 391-92 (1833))); *see also* LAWSON, *supra* note 32, at 150 & n.16 ("French authors simply say that the distinction has not been received into their law.").

39. *See* CODE CIVIL SUISSE [CC] art. 2, ¶ 1 (Switz.).

40. *Id*. ¶ 2.

41. Litvinoff, *supra* note 30, at 1661.

42. CIVIL CODE OF THE NETHERLANDS art. 6; *see also* Litvinoff, *supra* note 30, at 1655.

43. *See* § 157 BURGERLICHES GESETZBUCH [BGB] (F.R.G.) (stating that contracts shall be interpreted according to the requirements of good faith, ordinary usage being taken into consideration); *id*. § 242 (stating that the debtor is bound to perform according to the requirements of good faith, ordinary usage being taken into consideration.); *see also* 1 KONRAD ZWEIGERT & HEIN KÖTZ, AN INTRODUCTION TO COMPARATIVE LAW 155-56 (Tony Weir trans., 2d ed. 1987) (noting that the German code, as interpreted by courts, has emphasized "mutuality of social responsibility" and led to the "'moralization' of contractual relations"); Litvinoff, *supra* note 30, at 1654.

contractual obligations that would otherwise have been significantly devalued by hyperinflation.[44]

B. "Good Faith" Comes to America

As Professor Farnsworth has explained, "good faith" as originated in Roman law and developed in continental legal systems had its primary meaning in the context of *good faith performance* of agreements; its primary significance was in implying terms into the agreement consistent with the reasonable unexpressed expectations of the contracting parties.[45] This conception of good faith performance also influenced the development of commercial law in England; Holdsworth described this broad conception of good faith as a central characteristic of English mercantile law:

> [T]he canon law was able to exert this influence upon the development of commercial law [because of] the manner in which the Canon law put into legal form the religious and moral ideas which, at this period, coloured the economic thought of all the nations of Western Europe. . . .
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> . . . [T]he canonist's view that faith should be kept, in whatever form the promise was expressed, helped forward the development of forms of commercial contract . . .; it assisted the legislature to deal adequately with the new forms of fraud and sharp practice rendered possible by a more elaborate organization of commerce; and thus it contributed to enforce those high standards of good faith and fair dealing which are the very life of trade.[46]

By the nineteenth century, however, the scope of "good faith" began to narrow as commercial interests directed judicial attention toward barriers to the free trade of goods and the marketability of commercial paper. As Professor Farnsworth explained:

44. For a discussion of these developments, see Werner F. Ebke & Bettina M. Steinhauer, *The Doctrine of Good Faith in German Contract Law*, *in* GOOD FAITH AND FAULT IN CONTRACT LAW 182-84 (Jack Beatson & Daniel Friedmann eds., 1995) and 2 ZWEIGERT & KÖTZ, *supra* note 43, at 558-63.

45. *See* Farnsworth, *supra* note 33, at 670.

46. 5 SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 80-81 (1966) (footnotes omitted).

> Good faith purchase—not good faith performance—was the concern of the day, and the courts set about the task of defining "good faith" for this purpose. The leading cases involved the test of "good faith" for a holder in due course of a negotiable instrument. In 1801, in *Lawson v. Weston*, Lord Kenyon ruled that the holder need not make diligent inquiry when he takes the instrument, and . . . he introduced the subjective test of actual good faith, the test of "the pure heart and the empty head." In 1824, in *Gill v. Cubitt*, the subjective test was discarded for an objective test that required the holder to exercise the prudence and caution of a reasonable man. . . . But by 1836 *Gill v. Cubitt* had been overruled in England and by the end of the nineteenth century most of the American states had adopted a subjective test for good faith purchase.[47]

Professor Farnsworth noted that this development resulted in two widespread and mistaken assumptions—first, that good faith mattered only in the purchase context; and second, that its meaning was purely subjective and limited to honesty in fact.[48] As a result, Farnsworth suggested, the notion that the duty of good faith performance established an objective standard of commercial behavior gradually faded from view,[49] leading at least one English scholar to express the view, as of the mid-1950s, that there was no general positive duty of good faith performance imposed upon contracting parties.[50]

C. The Adoption of the Uniform Commercial Code

1. The codification of good faith as subjective honesty

As the impetus for a standard commercial code gained momentum, the drafters of the Uniform Commercial Code attempted to challenge the prevailing "misconception" of good faith as mere honesty. From its original promulgation, UCC

47. Farnsworth, *supra* note 33, at 670 (footnotes omitted).

48. "The uniform acts that preceded the [UCC] contain upwards of fifty references to good faith, and not once is that term used in the sense of good faith performance. A subjective test of 'honesty in fact' is used consistently throughout the uniform acts." *Id.* at 670-71.

49. *See id.*

50. *See* Raphael Powell, *Good Faith in Contracts*, 9 CURRENT LEGAL PROBS. 16, 25 (1956) ("[I]n English law there is no overriding general positive duty of good faith imposed on the parties to a contract." (footnote omitted)).

section 1-203 has provided that "[e]very contract or duty [governed by the UCC] imposes an obligation of good faith in its performance or enforcement."[51] As originally proposed, the UCC would have provided a positive definition of the term "good faith" that would have restored the historical duty of good faith performance as informed by external objective standards of conduct. In the original May 1949 draft of the UCC, section 1-201 defined "good faith" as "honesty in fact in the conduct or transaction concerned. Good faith includes good faith toward all prior parties *and observance by a person of the reasonable commercial standards of any business or trade in which he is engaged*."[52] Had this definition survived in the UCC as finally promulgated, the relevant inquiry would have focused explicitly upon a contracting party's conduct and whether it adhered to accepted moral standards within the relevant community[53]—i.e., was the party's conduct consistent with conduct that one might expect from a reasonable commercial actor under the circumstances?[54]

Almost immediately, however, the May 1949 draft encountered opposition from commercial interests alarmed by the potential impact of such a broad conception of the duty of good faith. In September 1950, the Committee on the Proposed Commercial Code of the American Bar Association Section on Corporation, Banking and Business Law released a report

51. *Compare* U.C.C. § 1-203 (Draft May 1949), *quoted in* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 207 (1968), *with* U.C.C. § 1-203 (1995).

52. U.C.C. § 1-201(18) (Draft May 1949) (emphasis added), *quoted in* Summers, *supra* note 51, at 207.

53. *See* Litvinoff, *supra* note 30, at 1649 ("It has been said that, in a legal context, good faith has both a psychological and an ethical component. . . . The latter would consist in conducting oneself according to moral standards, and is designated as *good faith-probity*, or *good faith-honesty*, and is germane to ideas of loyalty and respect for the pledged word." (footnote omitted)).

54. As Farnsworth explained:

> Good faith performance has always required the cooperation of one party where it was necessary in order that the other might secure the expected benefits of the contract. And the standard for determining what cooperation was required has always been an objective standard, based on the decency, fairness or reasonableness of the community and not on the individual's own beliefs as to what might be decent, fair or reasonable. Both common sense and tradition dictate an objective standard for good faith performance.

Farnsworth, *supra* note 33, at 672.

criticizing the proposed "good faith" definition. The Committee, concerned that an "objective" formulation would complicate the appropriate resolution of cases involving good faith purchase, suggested that the term be limited to "honesty in fact in the conduct or transaction concerned and the absence of trickery, deceit or improper purpose."[55] The Committee provided three justifications for its objection: (1) the average person understood "good faith" to mean "honesty;"[56] (2) the phrase "observance of reasonable commercial standards" implied the identification of usages, customs, and practices; however, the determination of exactly *what* usages, customs, and practices control would produce significant litigation;[57] and (3) litigation and judicial definition of "reasonable commercial standards" could have the effect of perpetuating those standards indefinitely, thereby preventing the evolution and development of commercial practices over time.[58] In a political compromise, the drafters deleted the reference to "reasonable commercial standards" in Article 1, inserting that broader definition only in limited contexts (such as Article 2 provisions regarding the conduct of merchants).[59]

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55. Walter D. Malcolm, *The Proposed Commercial Code*, 6 BUS. LAW. 113, 128 (1951).

56. "Although we recognize that there are some court decisions that have added to 'honesty in fact' in the meaning of 'good faith' the requirement to observe some commercial standards of conduct, nevertheless we believe that to the average person and the average lawyer, 'good faith' signifies primarily 'honesty.'" *Id.*

57.

> Assuming, however, that within the term [good faith] there should be added to 'honesty' some meaning of 'commercial decency' the phrase 'observance of reasonable commercial standards' carries with it the implication of usages, customs or practices. If this is true there immediately arises the very difficult problem of *what* usages, customs and practices are those intended to be included in the standard. Any lawyer who has ever attempted to prove what a usage or custom is will immediately recognize how litigious such a standard could grow to be.

Id.

58.

> More serious still is the possibility that "reasonable commercial standards" could mean usage, customs or practices existing at any particular time. This could have the very bad effect of freezing customs and practices into particular molds and thereby destroy the flexibility absolutely essential to the gradual evolution of commercial practices,—a result which the Code draftsmen certainly would never desire.

Id.

59. *See* Robert Braucher, *The Legislative History of the Uniform Commercial*

As eventually promulgated, then, the original UCC expressed its general duty of good faith in a purely subjective fashion, focusing only upon a party's state of mind in the psychological sense—i.e., does the party sincerely believe (even if that belief is mistaken) that she is acting in accordance with the law?[60] This purely subjective view of good faith fits nicely with the freedom-of-contract view of acceleration enforcement articulated by Easterbrook;[61] presumably, if the loan documents reserve to the lender the right to accelerate based upon an objective default and the objective event of default has taken place, then the lender almost certainly has a sincere belief that its decision to accelerate complies with the law. As such, that decision would appear to satisfy the good faith enforcement standard of UCC section 1-203. As discussed below, however, although this subjective formulation of good faith survives to the present day in Article 1 of the UCC, its impact has been steadily eroded through the UCC revision process in favor of a view that incorporates external standards of commercially reasonable behavior.

2. *Intermission–the UCC, section 1-203, section 1-208, and good faith in the context of acceleration*

Much of the confusion in judicial decisions regarding the duty of good faith as applied to the acceleration of a debt has arisen as a result of confusion regarding the proper relationship between UCC sections 1-203 and 1-208. Therefore, this Article will take a brief detour to elaborate upon the relationship of

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Code, 58 COLUM. L. REV. 798, 812 (1958); Farnsworth, *supra* note 33, at 673-75; Summers, *supra* note 51, at 208-13. In the original official comments, the drafters reemphasized the nature of this compromise and the contextual dichotomy it created:

> "Good faith" whenever it is used in the Code, means at least [honesty in fact in the conduct or transaction concerned]. In certain Articles, by specific provision, additional requirements are made applicable. To illustrate, in the Article on Sales, Section 2-103, good faith is expressly defined as including in the case of a merchant observance of reasonable commercial standards of fair dealing in the trade, so that throughout that Article *wherever a merchant appears in the case an inquiry into his observance of such standards is necessary to determine his good faith*.

U.C.C. § 1-201 cmt. 19 (1962) (emphasis added) (citations omitted).

60. *See* Litvinoff, *supra* note 30, at 1649 ("It has been said that, in a legal context, good faith has both a psychological and an ethical component. The former would consist of a belief that one is acting according to the law . . . .").

61. *See supra* note 25 and accompanying text.

these two provisions. On its face, section 1-203's duty of good faith applies to every contract governed by the UCC; thus, a party must act with good faith to enforce the acceleration provisions of a note or contract governed by the UCC. Nevertheless, it is not clear that this duty, when limited by section 1-201(19)'s subjective definition of "good faith," should provide a significant constraint upon the judgment of an accelerating creditor. As noted above, under the UCC as originally promulgated, the general duty of good faith in performance or enforcement required the creditor only to act with "honesty in fact."[62] As Professor Summers has noted in his work on good faith performance and enforcement of sales contracts, the subjective standard should rule out claims that a party acted in bad faith due to her negligence (e.g., such as by accelerating based upon insecurity when any reasonable person would have concluded that the party's position was secure) or because she openly acted in a fashion inconsistent with the "spirit" of the bargain (e.g., by accelerating based upon an objective default under circumstances outside the expectations of the borrower at the time of the contract).[63]

a. Objective defaults. Consistent with this view, the original UCC subjective duty of good faith *should* present no significant basis for challenge to an acceleration based upon an objective default provision in the credit agreement. Consider the introductory hypotheticals; in each, Randolph committed an objective default (his failure to provide the required financial statements in a timely fashion), the agreement permitted acceleration based upon that default, and the Bank openly invoked that default provision as a basis for accelerating. Thus, in each example, the Bank would have a sincere belief, based upon the language of its written agreement, that the law

62. *See supra* notes 51-61 and accompanying text. Since 1990, however, Article 3 has defined good faith to include not only honesty in fact, but also "the observance of reasonable commercial standards of fair dealing." U.C.C. § 3-103(a)(4) (1990). Further, the pending revision of Article 9 will likely define good faith so as to incorporate "the observance of reasonable commercial standards of fair dealing." U.C.C. § 9-102(23) (Proposed Draft 1997).

63. *See* Summers, *supra* note 51, at 210-12. Summers particularly noted that the subjective standard would not appear to reach "forms of bad faith that do not involve dishonesty, let alone negligence—for example, openly abusing the power to break off negotiations, openly taking unfair advantage of bargaining power, openly acting capriciously or openly undercutting another's performance." *Id.* at 210.

authorized its conduct. Under this view, in each example the Bank would have enforced its rights in "good faith" under section 1-203; thus, application of the original UCC subjective good faith standard should produce decisions that are generally consistent with the Easterbrook "freedom-of-contract" view of acceleration described in Part II.[64]

b. Subjective defaults. In UCC section 1-208, the drafters provided a specific application of the general duty of good faith,

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64. Many decisions interpreting UCC section 1-203 have expressed this strong freedom-of-contract view of good faith. One of the most notable examples is the Minnesota Court of Appeals decision in *Brown v. Weeres Indus.*, 375 N.W.2d 64 (Minn. Ct. App. 1985). In 1982, Weeres Industries, Inc. (Weeres) sold its pontoon boat and water bicycle manufacturing business to Gordon Brown and Clinton Lee, who executed an installment note for a portion of the purchase price and who granted Weeres a security interest in all assets of the business. Brown and Lee also signed a three-year lease for Weeres's existing plant, along with an option to purchase the plant at the conclusion of the lease. The security agreement provided that the collateral would remain at its existing location and would not be removed from that location without prior written consent of Weeres. *See id.* at 65. Approximately two years later, however, Brown and Lee decided that business concerns justified relocating to a different site in the immediate area; accordingly, they communicated to Weeres their intention not to renew the lease. Weeres objected to any relocation and stated that it would accelerate the maturity of the note if Brown and Lee removed the collateral from its existing location.

Brown and Lee filed suit, arguing that Weeres's refusal to consent constituted a bad faith effort to compel Brown and Lee to renew the lease. In the suit, Brown and Lee sought a declaration that they could relocate the collateral without triggering a default and acceleration under the security agreement. *See id.* at 66. The trial court granted summary judgment for Brown and Lee, reasoning that they were current on their note payments, sales and inventory levels had increased (improving Weeres's secured position), and the new site was in the immediate vicinity of the old site; therefore, Weeres had no legitimate basis to feel insecure about its prospects for repayment, and acceleration was improper. *See id.* at 67.

The Minnesota Court of Appeals reversed, however, and remanded the case for entry of summary judgment in favor of Weeres. The court held that the terms of the security agreement did not require Weeres to have a reasonable basis for withholding consent, nor did the duty of good faith require that Weeres provide a reasonable justification for withholding consent. Because Brown and Lee violated the literal terms of the security agreement, Weeres had the right to accelerate the debt, regardless of whether the violation posed a meaningful threat to Weeres' prospects for repayment:

> Under the clear and unambiguous terms of this security agreement, the collateral may not be removed from the leased premises without [Weeres'] prior written consent. The security agreement does not provide that withholding of such consent must be reasonable. Although [Brown and Lee] may have failed to anticipate that they might have to pay off the debt before removal of the collateral, this is insufficient reason to ignore the contract's literal meaning.

Id.

articulated to govern acceleration decisions in which a creditor acts pursuant to an insecurity clause. Section 1-208 provides, in pertinent part:

> A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so *only if he in good faith believes that the prospect of payment or performance is impaired*.[65]

Section 1-208 has resulted in some interpretational quandaries. Does section 1-208 govern all optional acceleration decisions, or only those decisions based specifically upon insecurity or "at will" language in the agreement?[66] Is it sufficient that the creditor honestly believes that its security or likelihood of payment is threatened (even if that belief is mistaken), or must the creditor's belief be reasonable under the circumstances?[67] Litigation under section 1-208 has not produced universal consensus regarding these questions, and the judicial uncertainty is a product of at least two factors: section 1-208's unclear relation to section 1-203, and the commentary of one of the principal UCC drafters in his *ex post* explanations of the purpose of section 1-208.

First, courts have struggled to identify the correct relationship between sections 1-203 and 1-208. If section 1-208 requires only subjective good faith (i.e., the creditor's belief in its insecurity must be honest, but not necessarily reasonable),

65. U.C.C. § 1-208 (1995) (emphasis added). Section 1-208 goes on to provide that "[t]he burden of establishing lack of good faith is on the party against whom the power has been exercised." *Id*.

66. As discussed *infra* in notes 98-118 and accompanying text, some courts have concluded that section 1-208's standard applies to all acceleration decisions that result from a creditor's exercise of its option to accelerate, regardless of the nature of the default. *See, e.g.*, Brown v. AVEMCO Inv. Corp., 603 F.2d 1367 (9th Cir. 1979). In contrast, most courts have concluded that section 1-208 does not apply when the creditor elects to accelerate based upon an objective default. *See, e.g.*, Bowen v. Danna, 637 S.W.2d 560, 564 (Ark. 1982).

67. *See* Susan A. Wegner, Comment, *Section 1-208: "Good Faith" and the Need for a Uniform Standard*, 73 MARQ. L. REV. 639, 639-40 (1990) (discussing the different interpretations of good faith and reviewing cases applying various standards); *see also* Anderson, *supra* note 33; Darlene M. Nowak, Note, *Standards for Insecurity Acceleration Under Section 1-208 of the Uniform Commercial Code: A Proposal for Reform*, 13 MICH. J.L. REFORM 623 (1980).

that would seem to render section 1-208 purely duplicative of section 1-203. After all, section 1-203 already imposes a subjective duty of good faith in the performance and enforcement of *every* contractual obligation. As a result, one might reason that the drafters *must* have intended section 1-208 to apply a *higher* standard to discretionary accelerations or accelerations based upon insecurity. Under this view, accelerations governed by section 1-208 would have to be objectively reasonable.[68] The comments to sections 1-203 and 1-208, however, belie this view. The comments to section 1-203 suggest that the drafters understood section 1-208 merely as an illustrative application of the duty of good faith as expressed in section 1-203.[69] The comments to section 1-208 reinforce this view, suggesting that the drafters added section 1-208 not to create a different good faith standard, but merely to make clear that because of the general duty of good faith expressed in section 1-203, courts should not invalidate agreements permitting acceleration "at will" as illusory promises.[70]

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68. *See, e.g.*, Reid v. Key Bank of S. Me., Inc., 821 F.2d 9, 15 n.2 (1st Cir. 1987) (dictum); *AVEMCO*, 603 F.2d at 1378-80; Sheppard Fed. Credit Union v. Palmer, 408 F.2d 1369, 1371 (5th Cir. 1969); *In re* Martin Specialty Vehicles, Inc., 87 B.R. 752, 765-66 (Bankr. D. Mass. 1988), *rev'd on jurisdictional grounds*, 97 B.R. 721 (D. Mass. 1989); Kupka v. Morey, 541 P.2d 740, 747 (Alaska 1975); Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1032-33 (Colo. Ct. App. 1987); Universal C.I.T. Credit Corp. v. Shepler, 329 N.E.2d 620, 623-24 (Ind. Ct. App. 1975); Black v. Peoples Bank & Trust Co., 437 So. 2d 26, 29-30 (Miss. 1983); Blaine v. G.M.A.C., 370 N.Y.S.2d 323, 327 (Monroe County Ct. 1975); Mitchell v. Ford Motor Credit Co., 688 P.2d 42, 45 n.5 (Okla. 1984); American Bank v. Waco Airmotive, Inc., 818 S.W.2d 163, 171-72 (Tex. App. 1991).

69. In elaborating upon the "good faith" obligation contained in section 1-203, the original comments provided:

> Particular applications of this general principle appear in specific provisions of the Act such as the option to accelerate at will, the right to cure a defective delivery of goods, the duty of a merchant buyer who has rejected goods to effect salvage operations, substituted performance, and failure of presupposed conditions. The concept, however, is broader than any of these illustrations and applies generally . . . to the performance or enforcement of every contract or duty within this Act.

U.C.C. § 1-203 cmt. (1962) (citations omitted).

70. The original comments to section 1-208 provided:

> The increased use of acceleration clauses . . . has led to some confusion in the cases as to the effect to be given to a clause which seemingly grants the power of an acceleration at the whim and caprice of one party. This Section is intended to make clear that despite language which can be so construed and which further might be held to make the agreement void as against public policy or to make the contract illusory or too indefinite for

Accordingly, it seems doubtful that section 1-208 "ratcheted up" the standard to which a creditor should be held in accelerating at will or based upon insecurity. As originally promulgated, the combined language of sections 1-201(19) and 1-208 only required that the creditor honestly believe that its security or prospect for repayment was threatened, even if that belief was mistaken or unfounded.[71]

Nevertheless, the notion that the original section 1-208 did "ratchet up" the standard received a boost from the scholarship of Grant Gilmore, one of the principal drafters of Article 9. In his treatise on secured transactions, Gilmore argued that section 1-208 required that acceleration based upon insecurity must be *objectively* reasonable:

> The cases are quite clear that the insecurity clause will not be allowed to operate as a charter of irresponsibility. A "reasonable man" rule emerges from the cases. The creditor has the right to accelerate if, under all the circumstances, a reasonable man, motivated by good faith, would have done so. . . . The Code adopts such a rule in §1-208 . . . .[72]

Under Gilmore's view, a party could accelerate for insecurity only if that decision was both objectively reasonable and subjectively honest. Lest he be misunderstood, Gilmore went on

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> enforcement, the clause means that the option is to be exercised only in the good faith belief that the prospect of payment or performance is impaired.

U.C.C. § 1-208 cmt. (1962).

71. A significant number of courts have interpreted section 1-208 in precisely this way. *See, e.g.*, Farmers Coop. Elevator, Inc. v. State Bank, 236 N.W.2d 674, 678 (Iowa 1975) ("The [debtor] has not adduced substantial proof that the Bank's concern about the security of its loans, whether or not reasonable, was not genuine . . . ."); Van Horn v. Van De Wol, Inc., 497 P.2d 252, 254 (Wash. Ct. App. 1972) ("[N]egligence is irrelevant to good faith. The standard is what the plaintiff actually knew, or believed he knew, not what he could or should have known."); *see also, e.g.*, Klingbiel v. Commercial Credit Corp., 439 F.2d 1303, 1308 & n.12 (10th Cir. 1971); Paine Webber Jackson & Curtis, Inc. v. Winters, 539 A.2d 595, 598 n.1 (Conn. App. Ct. 1988); Quest v. Barnett Bank, 397 So. 2d 1020, 1022 (Fla. Dist. Ct. App. 1981); Ginn v. Citizens & S. Nat'l Bank, 243 S.E.2d 528, 530 (Ga. Ct. App. 1978); Van Bibber v. Norris, 419 N.E.2d 115, 124 (Ind. 1981); Jackson v. State Bank, 488 N.W.2d 151, 156 (Iowa 1992); Karner v. Willis, 700 P.2d 582, 584 (Kan. Ct. App.), *aff'd*, 710 P.2d 21 (Kan. 1985); Fort Knox Nat'l Bank v. Gustafson, 385 S.W.2d 196, 200 (Ky. Ct. App. 1964); J. R. Hale Contracting Co. v. United N.M. Bank, 799 P.2d 581, 591 (N.M. 1990).

72. 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 43.4, at 1197 (1965).

to elaborate this point while discussing the proper allocation of the burden of proof:

> One court has suggested that the burden [of proving good faith] should be on the creditor on the ground that "a pure state of mind" on the creditor's part is involved. That however, seems to be an inaccurate statement. The creditor's state of mind is clear enough—he decided to accelerate—and the question under the "reasonable man" rule . . . is *whether he had a right to feel that way*. Presumably under the Code's burden of proof rule, a debtor's testimony that he knew of no reason why the creditor should have felt insecure, unimpeached on cross-examination or unrebutted by the creditor would get him to the jury.[73]

Gilmore's interpretation of section 1-208 appears unfaithful both to the statutory language of the 1962 Code and the history surrounding the excision of the objective reasonableness standard from the May 1949 draft.[74] Nevertheless, Gilmore's interpretation of section 1-208 gained favor in subsequent judicial decisions.[75] Indeed, as discussed in Part IV, Gilmore's view even led the Ninth Circuit to conclude that the "good faith" standard required objective reasonableness even for

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73. *Id.* at 1198 (emphasis added) (footnote omitted).

74. One might defend this view of section 1-208 more narrowly by arguing that even under a subjective standard of good faith, the trier of fact legitimately may consider the reasonableness of a creditor's action in evaluating the creditor's credibility, i.e., whether that party's allegedly honest belief of insecurity was sincere. *See, e.g.*, *Hale Contracting*, 799 P.2d at 591 ("Even under a subjective test of good faith the trier of fact may evaluate the credibility of a creditor's claim and in doing so may take into account the reasonableness of that claim."); Farnsworth, *supra* note 33, at 672 (same). The language of Gilmore's treatise, however, reflects that Gilmore clearly viewed section 1-208 as establishing an objective reasonableness standard.

75. *See, e.g.*, Reid v. Key Bank, 821 F.2d 9, 15 n.2 (1st Cir. 1987) (dictum, citing GILMORE); Brown v. AVEMCO Inv. Corp., 603 F.2d 1367, 1378-1380 (9th Cir. 1979); Sheppard Fed. Credit Union v. Palmer, 408 F.2d 1369, 1371 n.2 (5th Cir. 1969) (quoting GILMORE); *In re* Martin Specialty Vehicles, Inc., 87 B.R. 752, 765-66 (Bankr. D. Mass. 1988), *rev'd on jurisdictional grounds*, 97 B.R. 721 (D. Mass. 1989); Kupka v. Morey, 541 P.2d 740, 747 (Alaska 1975); Richards Eng'rs, Inc. v. Spanel, 745 P.2d 1031, 1033 (Colo. Ct. App. 1987) (quoting GILMORE); Black v. Peoples Bank & Trust Co., 437 So. 2d 26, 29-30 (Miss. 1983) (quoting GILMORE); Blaine v. G.M.A.C., 370 N.Y.S.2d 323, 327 (Monroe County Ct. 1975); Mitchell v. Ford Motor Credit Co., 688 P.2d 42, 45 n.5 (Okla. 1984) (citing GILMORE); American Bank v. Waco Airmotive, Inc., 818 S.W.2d 163, 171-72 (Tex. App. 1991).

accelerations based upon objective defaults (although section 1-208, on its face, does not purport to govern such decisions).[76]

D. *The Duty of "Good Faith" Stages a Rally–The* Restatement (Second) of Contracts

Over the decades following the promulgation of the UCC, a number of leading scholars offered pointed criticism of the decision to excise the objective reasonableness standard from the May 1949 draft. Professor Allen Farnsworth decried the decision as one that "enfeebled" the duty of good faith and rendered it devoid of meaningful force.[77] Professor Robert Summers argued that the Code's definition of good faith distorted the proper understanding of good faith performance;[78] further, he argued that good faith could not be defined meaningfully only in terms of honesty.[79] These criticisms informed the deliberations of the American Law Institute, then engaged in the early stages of work on the *Restatement (Second) of Contracts* [hereinafter *Contracts Restatement*]. When eventually promulgated, the *Contracts Restatement* reflected the influence of the criticisms of Farnsworth, Summers and others in section 205, which provided that "[e]very contract

76. *See AVEMCO*, 603 F.2d at 1378-80 (9th Cir. 1979); *see also infra* notes 98-118 and accompanying text.

77. *See* Farnsworth, *supra* note 33, at 673-74 ("The demise of the single, unitary definition of good faith [including reference to reasonable commercial standards] . . . . was one of the major casualties during the drafting of the Code. The American Bar Association section recognized this and suggested that if the definition of good faith were limited to honesty in fact, the general obligation of good faith could be eliminated as unnecessary. Although not eliminated, it was so enfeebled that it could scarcely qualify at this point as an 'overriding' or 'super-eminent' principle." (footnote omitted)).

78. *See* Summers, *supra* note 51, at 215 ("In sum, the Code's definitions restrictively distort the doctrine of good faith. . . . If an obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition. Courts should be left free, under the aegis of a statutory green light, to deal with any and all significant forms of contractual bad faith, familiar and unfamiliar.").

79. *See id.* at 205-06 ("Even if it were conceded that conduct must be subjectively immoral before it can constitute bad faith, it still would not follow that dishonesty is the only form of contractual bad faith. Thus when a man openly and straightforwardly gives another a 'raw deal,' he does not necessarily act dishonestly. That is, he does not undertake to mislead or deceive. . . . Such conduct is not dishonest. But it may well be thought immoral, and it is certainly commercial bad faith. In truth, good faith cannot be defined in terms of honesty." (footnote omitted)).

imposes upon each party *a duty of good faith and fair dealing* in its performance and its enforcement."[80]

Section 205 revived the historical conception of a duty of good faith performance that encompassed external objective standards of reasonable behavior.[81] Rather than attempt to define the term "good faith" positively, however, Section 205 left to the judiciary the task of identifying conduct that breached the reasonable expectations of a contracting party:

> The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness.[82]

Moreover, the comments strongly articulated the view that fair dealing required not only honesty but also reasonableness in the enforcement of contractual claims:

> The obligation [of good faith] is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an

80. CONTRACTS RESTATEMENT, *supra* note 27, § 205 (emphasis added).

81. *See* Friedrich K. Juenger, *Listening to Law Professors Talk About Good Faith: Some Afterthoughts*, 69 TUL. L. REV. 1253, 1253 (1995) ("[T]he concept of good faith was smuggled into the Commercial Code by Karl Llewellyn, who had found it in Germany. Having succeeded in putting good faith into the [UCC], Llewellyn promptly covered up the traces of the concept's Teutonic origin. Untainted by residues of foreign soil, it sprouted roots and grew beyond the U.C.C.'s confines. In his capacity as Reporter for the *Restatement (Second) of Contracts*, Professor Farnsworth found a larger field of cultivation for this transplant." (footnotes omitted)).

82. CONTRACTS RESTATEMENT, *supra* note 27, § 205 cmt. a. The absence of a positive definition of good faith clearly reflects the influence of Professor Summers' work arguing that good faith is properly understood as an "excluder," that is, as a way to describe conduct thought to be undertaken in bad faith. *See generally* Summers, *supra* note 51.

Likewise, comment d to section 205 reinforced the idea that a court should evaluate a party's good faith performance based upon an objective standard:

> [F]air dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: 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.

CONTRACTS RESTATEMENT, *supra* note 27, § 205 cmt. d.

> interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason. . . . Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract.[83]

E. The Post-Section 205 Era

Section 205 rejected the purely subjective view of good faith performance articulated in UCC Article 1, in favor of a broader conception of good faith performance that is consistent with its origins—including the notion that good faith does not permit a party to abuse rights bestowed upon it by a contract so as to defeat the reasonable expectations of the other contracting party. Despite this change, section 205 appears not to have encountered widespread opposition at the time of its consideration or promulgation.[84] Indeed, section 205's implicit criticism of the more limited UCC duty of good faith appears to have had the effect ultimately desired by its adherents; as the

83. CONTRACTS RESTATEMENT, *supra* note 27, § 205 cmt. e.

84. When this provision was initially discussed and tentatively approved at the May 1970 meeting of the American Law Institute, Professor Braucher (the Reporter at the time) felt obliged to defend the definition of "good faith" against criticism that it was an "attempt . . . to write the Sermon on the Mount into the Restatement of Contracts." Robert S. Summers, *The General Duty of Good Faith–Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 814 (1982) (quoting 47 A.L.I. PROC. 489 (1970). Evidently worried about criticism that the broad standard would invite judicial activism, Braucher was "amazed" when his presentation produced no comment from the floor. *Id.* at 815.

As discussed *infra* in note 85 and accompanying text, Articles 3, 4, and 4A were revised in 1990 to broaden the definition of good faith within those articles to include "the observance of reasonable commercial standards of fair dealing." Although this objective standard does not appear to have generated the significant objections it did in the 1950s, it was not without controversy. At least six states—Alabama, Idaho, Louisiana, Missouri, Tennessee, and Utah—either refused to adopt the broader definition or subsequently removed the objective component of that definition. *See* ALA. CODE § 7-3-103(a)(4) (Supp. 1996); IDAHO CODE § 28-3-103(1)(d) (1995); LA. REV. STAT. ANN. § 10:3-103(a) (West 1998) (altogether omitting any definition of good faith in Article 3, thereby incorporating the purely subjective definition from Article 1); MO. REV. STAT. 400.3-103(a)(4) (Supp. 1998); TENN. CODE ANN. § 47-3-103(a) (1996) (altogether omitting any definition of good faith in Article 3, thereby incorporating the purely subjective definition from Article 1); UTAH CODE ANN. § 70A-3-103(1)(d) (1997).

UCC revision process has progressed during the 1980s, the revisers consistently have broadened the UCC's statutory good faith definition throughout the other Articles. Revisions of Articles 3, 4, and 4A incorporated an "objective reasonableness" standard of good faith in 1990; revision of Article 8 in 1995 accomplished the same.[85]

Nevertheless, after section 205's promulgation, some critics expressed concern that section 205 described the duty of good faith between contracting parties in rhetorical terms that were too general and invited too much judicial intervention. Many of these critics argued that the scope of the duty of good faith could be defended normatively only by notions of economic efficiency; several expressed concern that unless its parameters were properly restrained, a broad duty of good faith performance would invite unwarranted judicial activism that would result in uncertainty, litigation, and undesirable costs for contracting parties.[86] Indeed, in the years following the promulgation of section 205, litigation arose in a wide variety of contexts involving claims of bad faith: disputes involving the

85. *See, e.g.*, U.C.C. § 3-103(a)(4) (1990) ("'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing."); U.C.C. § 4-104(c) (1990) (incorporating Article 3's definition of good faith into Article 4); U.C.C. § 4A-105(a)(6) (1990) (using identical definition as in Article 3); U.C.C. § 8-102(a)(10) (1995) ("'Good faith,' for purposes of the obligation of good faith in the performance or enforcement of contracts or duties within [Article 8], means honesty in fact and the observance of reasonable commercial standards of fair dealing.").

86. Most of these critics articulated a view of the good faith performance requirement informed by efficiency concerns. For example, Professor Clayton Gillette worried that

> [a]n expansive definition of good faith, however, may also serve as a source of *uncertainty* if it permits judicial modification of legal rules relied on in the parties' contractual arrangements. The costs of entering into a transaction are reduced to the extent that the parties are certain of the consequences of contract terms and can predict who will bear specific risks. Existence of a broad principle, judicially applied and not capable of disclaimer by bargaining, introduces an element of uncertainty that is likely to increase risks and raise costs at the contract formation stage.

Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619, 651. Likewise, Professor Steven Burton argued that "[t]raditional legal analysis supplies no tools for balancing the relative capacities of the parties to protect themselves" by securing more explicit contractual promises, and thus the duty of good faith had to be informed by economic analysis and its role in "enhanc[ing] economic efficiency by reducing the costs of contracting." Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 392-93 (1980) (footnote omitted).

interpretation of sales contracts, landlord-tenant disputes, lender liability disputes, and numerous others.[87] Perhaps more alarmingly for defendants, plaintiffs seeking to vindicate their rights in these cases creatively framed their causes of action and sought remedies (such as punitive damages) typically unavailable in contract disputes. Neither *Contracts Restatement* section 205 nor UCC section 1-203 specify a precise remedy when one party breaches its duty of good faith performance; instead, the drafters of those respective provisions argued that the appropriate remedy should vary with the context of the dispute.[88] In the face of this silence, aggrieved parties sought relief based not only upon breach of contract, but also breach of fiduciary duty, duress, and (borrowing from cases recognizing causes of action against insurers who acted in bad faith in dealing with their insureds) the "independent" tort of breach of the duty of good faith and fair dealing.[89]

Concerned that judicial decisions recognizing bad faith performance as a "tort" were beyond the bounds intended by section 1-203, the Permanent Editorial Board for the UCC [hereinafter PEB] promulgated new commentary designed to clarify the consequences of bad faith in the performance or enforcement of contracts. In *PEB Commentary No. 10*. the PEB rejected the tort of "commercial bad faith":

> This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, *constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power*. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.[90]

87. *See, e.g.*, Pacific First Bank v. New Morgan Park Corp., 876 P.2d 761 (Or. 1994) (discussing bad faith in context of lease agreements).

88. *See* CONTRACTS RESTATEMENT, *supra* note 27, § 205 cmt. a ("The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.").

89. Many of these decisions are noted in Patricia A. Milon, Recent Development, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?*, 40 VAND. L. REV. 1197 (1987) and Anderson, *supra* note 33.

90. PEB COMMENTARY NO. 10 (Feb. 10, 1994); *see* U.C.C. § 1-203 cmt. (1995).

Although *PEB Commentary No. 10* articulates a limited view of the scope of the aggrieved party's remedy for contractual bad faith performance, its real significance lies in the sweeping language it uses to describe the proper understanding of the UCC duty of good faith enforcement. It is worth noting that *PEB Commentary No. 10* arose in response to concerns about the unwarranted increase of litigation involving claims of "bad faith." The PEB might have responded to this litigation boomlet by articulating freedom-of-contract rhetoric; instead, the PEB did precisely the opposite, describing the UCC duty of good faith in broad terms, thus reflecting the full evolution of a duty of good faith performance defined by external standards of behavior:

> The concept of Agreement permeates the entirety of the Code. . . . The "agreement of the parties" cannot be read off the face of a document, but must be discerned against the background of actual commercial practice. Not only does the Code recognize "the reasonable practices and standards of the commercial community . . . [as] an appropriate source of legal obligation," but it also rejects the "premise that the language used [by the parties] has the meaning attributable to [it] by rules of construction existing in the law rather than the meaning which arises out of the commercial context in which it was used." The correct perspective on the meaning of good faith performance and enforcement is the Agreement of the parties. The critical question is, "Has 'X' acted in good faith with respect to the performance or enforcement of some right or duty under the terms of the Agreement?" *It is therefore wrong to conclude that as long as the agreement allows a party to do something, it is under all terms and conditions permissible.* Such a conclusion overlooks completely the distinction between merely performing or enforcing a right or duty under an agreement on the one hand and, on the other hand, doing so in a way that recognizes that the agreement should be interpreted in a manner consistent with the reasonable expectations of the parties in the light of the commercial conditions existing in the context under scrutiny. The latter is the correct approach.[91]

91. *Id.* (emphasis added) (some alterations in original) (quoting Amy H. Kastely, *Stock Equipment for the Bargain in Fact: Trade Usage, "Express Terms," and Consistency Under Section 1-205 of the Uniform Commercial Code*, 64 N.C. L. REV.

PEB Commentary No. 10 is significant for several reasons. First, it reflects the UCC's near-total rejection of the purely subjective understanding of good faith as "honesty in fact." With the July 1998 promulgation of the revised Article 9—which also incorporates the commercial reasonableness standard[92]—the UCC now consistently defines the term "good faith" in a fashion that evaluates a party's performance and enforcement by reference not only to honesty but also to reasonable commercial standards of good faith and fair dealing. Second, and more significantly, *PEB Commentary No. 10* disclaims the Easterbrook absolute freedom-of-contract view of "good faith," overtly rejecting the notion that a court can always evaluate a party's good faith performance or enforcement by reference only to the four corners of a written agreement.[93] Instead, *PEB Commentary No. 10* plainly compels courts to interpret agreements in a fashion that respects the reasonable unexpressed expectations of a contracting party.

IV. THE RHETORIC OF GOOD FAITH IN THE COURTS—OF GOOD INTENTIONS AND (SOMETIMES) QUESTIONABLE DECISIONS

As articulated in *Contracts Restatement* section 205 and *PEB Commentary No. 10*, the duty of good faith compels a court to inquire into whether a creditor's decision to accelerate based upon the occurrence of an objective default comports with the reasonable expectations of the borrower at the time that the parties entered into the security agreement. As a result, a court faced with a challenge to a creditor's acceleration decision must inquire whether a reasonable borrower would have appreciated, at the time she executed the loan documents, the likelihood that the lender would decide to accelerate the loan under the circumstances that have now transpired. If the answer to that inquiry is "yes," then the creditor's decision cannot come as an

777, 780 (1986) and U.C.C. § 2-202 cmt. 1(b) (1995)).

92. *See* U.C.C. § 9-102(a)(43) (1998) ("'Good faith' means honesty in fact and the observance of reasonable commercial standards of fair dealing.").

93. *See* DENNIS M. PATTERSON, GOOD FAITH AND LENDER LIABILITY 35 (1989) ("Limiting the 'agreement of the parties' to the written words alone cramps the contextual character of the [UCC] concept of Agreement. Meaning is wider than words alone.").

unfair surprise to the borrower,[94] and a court should sustain the credi-tor's acceleration as good faith enforcement of the security agreement.

Such a sweeping conception of good faith obviously vests significant trust in the ability of judges to appreciate the context of the transaction at issue in a consistent fashion and to ascertain correctly any unexpressed yet reasonable expectations of the contracting parties. As is always true when the law leaves it to judges to make decisions using such a malleable standard, sometimes this trust is misplaced. In some cases, courts fail to ascertain correctly the reasonable unexpressed expectations of the contracting parties because of a philosophical perspective that simply denies the possibility that a party's unexpressed expectations could be reasonable.[95] In other cases, courts push the standard beyond its proper limits, ascribing "bad faith" to enforcement decisions that doubtless could have been expected by a reasonable borrower. In order to highlight the tensions present when courts attempt to identify the "reasonable" expectations of lenders and borrowers, Part IV of this Article discusses several notable decisions interpreting the UCC duty of good faith—first evaluating the extent to

94. In his book on good faith in the lender liability context, Professor Dennis Patterson properly recognized the contextual nature of this inquiry:

> Good faith means lack of surprise, an equation consistent with the traditional contract law notion that the reasonable expectations of the parties is the fundamental interest to be protected by the courts. To accomplish this, . . . the law must reflect the commercial reality that businesspersons frequently employ express terms in their agreements which, when read against the commercial background against which the parties enter into their agreements, do not mean what they say; further, the expectations of the parties, which are expressed in their language, cannot be understood except by reference to that background out of which those expectations are forged. . . .
>
> Llewellyn's vision [of the concept of "agreement" as expressed in the UCC] is very much like the hermeneutic circle. To understand the Agreement of the parties one must look at their language. To understand the language one must investigate the commercial background of its use. The expectations of the parties are created both by their language and the circumstances surrounding formation. To understand any single element requires an understanding of the totality.

Id. at 33-35 (footnotes omitted).

95. Judge Easterbrook's rhetoric in *Kham & Nate's Shoes* appears to fall into this category, as it denies the relevance of good faith altogether when a particular enforcement decision is authorized by the literal terms of a written instrument. *See supra* note 25 and accompanying text.

which courts have used the concept of impairment of security to inform this inquiry,[96] and then the extent to which the courts have used (or misused) the duty of good faith as a shield against pretextual actions by creditors.[97]

A. Good Faith and Security Impairment

1. The AVEMCO *case and its progeny*

Although *Mortgages Restatement* section 8.1 generally adopts the view that security impairment is not necessary when a creditor seeks to accelerate the maturity of a debt based upon an objective default, a significant number of decisions have adopted a view that makes the absence of security impairment relevant to the court's evaluation of the creditor's good faith. Perhaps the most notorious decision adopting this view is the Ninth Circuit's opinion in *Brown v. AVEMCO Investment Corporation*.[98] In September 1972, Robert Herriford executed a promissory note payable to AVEMCO Investment Corp., secured by a lien upon Herriford's airplane. The security agreement permitted AVEMCO to accelerate the debt if the plane was sold, leased, or encumbered without AVEMCO's prior written consent.[99] In July 1973, Herriford entered a lease/purchase agreement with three other parties (the "Buyers"), under which each of the Buyers agreed to pay hourly rentals for use of the plane and to contribute one-fourth of the amount necessary to retire the AVEMCO debt; in exchange, the Buyers received an option to purchase a one-fourth interest in the plane for one dollar upon satisfaction of the AVEMCO debt.[100]

96. *See infra* notes 98-141 and accompanying text.

97. *See infra* notes 142-53 and accompanying text.

98. 603 F.2d 1367 (9th Cir. 1979).

99. *See id.* at 1369. The security agreement also contained a clause permitting AVEMCO to accelerate the maturity of the note if it "deem[s] itself insecure." *Id.*

100. *See id.* The Buyers became co-insured parties along with Herriford on the insurance covering the plane, and AVEMCO apparently received a copy of the policy listing the Buyers as co-insureds. Based upon this fact, the court could have concluded that since AVEMCO had knowledge of Herriford's breach of the security agreement in 1973, AVEMCO had waived its right to accelerate based upon this objective default by waiting until July 1975 to accelerate the debt and repossess the plane. As discussed in the text, however, the Ninth Circuit did not treat this as a waiver case.

For the next two years, the loan remained current. In July 1975, the Buyers opted to exercise their purchase option and tendered payment to AVEMCO in satisfaction of what the Buyers believed to be the correct balance of the debt. AVEMCO refused this tender, indicating that the actual balance was higher; further, AVEMCO accelerated the loan based upon Herriford's leasing the plane in violation of the security agreement.[101] The Buyers objected, notifying AVEMCO in writing that the tendered funds were in escrow and were available to AVEMCO upon presentation of the satisfied note and security agreement. Shortly thereafter, AVEMCO repossessed the plane and eventually sold it in September 1975 for a total of $7,000—more than the existing balance of the debt.[102]

The Buyers filed an action against AVEMCO in the United States District Court for the District of Montana, alleging that AVEMCO's acceleration of the debt and repossession of the plane were wrongful, constituted a conversion of the Buyers' interest in the plane, and breached AVEMCO's duty of good faith under the UCC. The Buyers essentially advanced a "no harm, no foul" argument, noting that the lease did not seriously threaten AVEMCO's security in any meaningful respect; Herriford and the Buyers had continued to pay the note on a timely basis, the plane's value far exceeded the balance of the debt, and the Buyers could not acquire ownership of the plane without paying off AVEMCO in full.[103] The Buyers thus argued that no reasonable lender in AVEMCO's position would have accelerated the loan as a consequence of the lease, which constituted at best a technical default. Accordingly, the Buyers asked the court to instruct the jury, consistent with UCC section 1-208, that AVEMCO could accelerate the loan only if it believed in good faith that the lease actually impaired AVEMCO's security interest in the plane.[104] The district court refused and instructed the jury that AVEMCO's enforcement of

101. *See id*. According to the opinion, the discrepancy between the parties' respective payoff amounts was a function of AVEMCO's claim that it was entitled to reimbursement for sums advanced for insurance pursuant to the terms of the security agreement.

102. *See id*.

103. *See id*. at 1369-72.

104. *See id*. at 1371-72.

the acceleration clause was valid if the jury found even a "technical breach of a lease without consent" in violation of the security agreement.[105] The jury returned a verdict for AVEMCO, and the district court entered judgment upon that verdict.

Applying Texas law,[106] the Ninth Circuit reversed the judgment and remanded for a new trial. The Ninth Circuit acknowledged several state court decisions holding that UCC section 1-208—and its requirement that the creditor must in good faith believe that its security is impaired when accelerating based upon insecurity[107]—does not apply to acceleration based upon objective defaults.[108] The Ninth Circuit concluded, however, that section 1-208 applies whenever a secured party exercises its discretion to accelerate a secured debt, even in the event of an objective default such as Herriford's lease to the Buyers:

> According to its language, § 1.208 applies when a party in interest may accelerate payment "at will" or "when he deems himself insecure" or "in words of similar import." Here the agreement provided that AVEMCO may, *at its option*, accelerate payment when the debtor leases without consent or when AVEMCO deems itself insecure or when various other contingencies occur. The agreement does not require immediate, automatic acceleration upon one of these events but further ties acceleration to the option of AVEMCO. Section 1.208 applies the Code's good faith concept to such acceleration and provides that the creditor has power to exercise the option "only if he in good faith believes that the prospect of payment or performance is impaired."[109]

The Ninth Circuit conceded that objective and subjective defaults were different, noting that objective defaults (such as

105. *Id.* at 1372-73, 1375-76.

106. The parties had specified that Texas law would govern the interpretation of the security agreement. *See id.* at 1369. Under UCC section 1-105(1), parties are free to include forum choice clauses in their contracts, and such clauses are enforceable so long as the state chosen bears a "reasonable relationship" to the subject of the transaction.

107. *See supra* notes 65-76 and accompanying text.

108. As discussed *supra* in notes 23 and 64 and accompanying text, the majority of courts have interpreted section 1-208 in a fashion inconsistent with the Ninth Circuit's interpretation in *AVEMCO*.

109. *AVEMCO*, 603 F.2d at 1378.

Herriford's lease) are generally within the control of the debtor, whereas a creditor's feelings of insecurity are not, leaving the debtor more subject to the "whim and caprice" of the creditor.[110] Based upon this distinction, the Ninth Circuit conceded that one might read section 1-208 to apply only to acceleration based upon insecurity, because that type of acceleration was more likely to subject the debtor to the "uncontrolled will of the creditor."[111] The Ninth Circuit rejected this view, however, noting that the facts strongly suggested the possibility that AVEMCO had accelerated "from an inequitable desire to take advantage of a technical default."[112] Based upon their view that the UCC drafters did not intend to leave debtors defenseless against such creditor abuse, the Ninth Circuit concluded that section 1-208 governed all situations in which a secured creditor exercises its discretion to accelerate the maturity of a secured debt:

> While [the insecurity] clause may be the primary focus of § 1.208, this court does not believe it is the only focus. Abuse is possible with "due-on-lease" acceleration as well. The "option" to accelerate based on a lease, like the one based on feelings of insecurity, could be used by AVEMCO as a sword for commercial gain rather than as a shield against security impairment. Section 1.208, growing from and incorporating equitable principles, defines "good faith" in acceleration to provide protection from such abuse.[113]

The Ninth Circuit thus reversed the district court and remanded for a new trial addressing whether AVEMCO's decision was reasonable under the circumstances.[114]

The *AVEMCO* decision is not unique as an example of a court's willingness to undertake *ex post* review of the reasonableness of a creditor's acceleration decision. A

110. *See id*. at 1378-79; U.C.C. § 1-208 cmt. ("The increased use of acceleration clauses . . . has led to some confusion in the cases as to the effect to be given to a clause which seemingly grants the power of an acceleration at the whim and caprice of one party. This Section is intended to make clear that . . . [such an] option is to be exercised only in the good faith belief that the prospect of payment or performance is impaired.").

111. *AVEMCO*, 603 F.2d at 1378-79.

112. *Id*. at 1379.

113. *Id*.

114. *See id*. at 1380.

significant number of decisions involving real or personal property collateral have used the rhetoric of good faith to shield the borrower against acceleration under circumstances that neither impaired the lender's security nor threatened its prospects for repayment. For example:

- The Texas Court of Appeals nullified the acceleration of a purchase money mortgage debt and enjoined the foreclosure of that mortgage—even though the mortgagor had failed to pay installments on a timely basis during a title dispute with the seller/mortgagee—on the ground that the circumstances demonstrated no meaningful threat to the mortgagee's security or prospects for repayment.[115]

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115. *See* Davis v. Pletcher, 727 S.W.2d 29 (Tex. App. 1987). On July 1, 1977, Davis purchased what he believed was at least 670 acres of land from the Pletchers, executing a $210,000 promissory note and deed of trust. The Pletchers' deed expressly covenanted title to at least 670 acres of land, but required Davis to provide the Pletchers with certain notice within five years from the date of the deed to trigger any liability on this covenant. *See id.* at 33. Near the end of this period, a dispute arose over the parcel's acreage. On June 30, 1982, Davis' attorney sent a mailgram to the Pletchers, notifying them of a shortage of 41 acres, but did not send a certified survey until July 5, 1982. The Pletchers responded that the five-year period specified in the deed had passed without a valid objection by Davis, that no adjustment in the price was due, and that they expected Davis to make the regularly scheduled installment on August 1, 1982. Davis did not pay this installment to the Pletchers; instead, Davis sued for a declaration that the Pletchers had breached the deed covenant, and attempted to pay the mortgage installment into the court. On August 31, 1982, the Pletchers accelerated the maturity of the note and thereafter filed a counterclaim seeking to foreclose the deed of trust. *See id.* at 31-32.

The trial court granted summary judgment for the Pletchers, holding (a) that Davis' failure to provide the Pletchers with a certified survey prior to July 1, 1982, deprived Davis of any recourse under the deed covenants and (b) that the Pletchers legally had accelerated the maturity of the note based upon Davis' monetary default. The Texas Court of Appeals reversed, however, concluding that Davis provided sufficient notice to place the Pletchers in breach of the covenant. As the court recognized, Davis' remedy for this breach was still independent of his obligation to make his mortgage payments. Nevertheless, the court held that the acceleration of the debt was a nullity, relying primarily upon the court's equitable power to protect Davis as mortgagor from the Pletchers' unreasonable actions:

> Davis' attempted tender to the court registry clearly showed an ability and willingness to pay the annual installment payment upon determination of the amount of set off, if any, he is entitled to take. We can see no threat to the security of the debt which called for exercise of the option to accelerate. Nor can we find anything indicating that the security for the debt was in any way threatened.

Id. at 36. Perhaps not surprisingly, the court's opinion relies upon earlier Texas decisions—*Parker v. Mazur*, 13 S.W.2d 174 (Tex. App. 1928) and *Bischoff v. Rearick*, 232 S.W.2d 174 (Tex. App. 1950)—that the Ninth Circuit also relied upon in its decision interpreting Texas law in *AVEMCO*. *See AVEMCO*, 603 F.2d at 1376.

- A Florida bankruptcy court enjoined a national motel franchisor from accelerating a $200 million credit line secured by mortgages on various motel properties—despite the borrower's failure to provide the mortgagee with audited financial statements as required in the loan agreement—because the breach did not impair the mortgagee's security or its prospects for repayment and because acceleration would have placed the borrower in default on more than $220 million of other loans.[116]
- The Utah Supreme Court applied UCC section 1-208 to reinstate a mortgage note accelerated for default in payment, because there was "little doubt" that the mortgagee would be paid and the mortgagee had no good faith reason to believe that its security was threatened.[117]

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116. *See In re* Prime Motor Inns, Inc., 131 B.R. 233 (Bankr. S.D. Fla. 1991). Prime Motor Inns (PMI) agreed to advance up to $200 million to Northeast Hotel Associates and other affiliated entities (Borrowers), secured by mortgages on various motel properties owned by Borrowers. The loan agreement required that Borrowers had to provide PMI with financial statements on a timely basis each year, and permitted acceleration in the event of default. In late 1990, the Borrowers defaulted when their accountants filed for bankruptcy and ceased operating, preventing the Borrowers from providing the necessary financial statements to PMI on a timely basis. When PMI (operating under Chapter 11 bankruptcy protection) threatened acceleration, the Borrowers sought an injunction and the bankruptcy court granted that injunction, citing *AVEMCO* for the proposition that acceleration would be inequitable under the circumstances:

> [E]quity precludes [PMI] from accelerating the loan. The breach which gave rise to [PMI's] right to accelerate did not impair [PMI's] security or ability to recover on the loan. [PMI's] economic risk is not increased merely because [Borrowers] are unable to provide audited financial statements timely. In contrast, [Borrowers] may suffer extreme and irrevocable hardship because a default under the Loan Agreement may trigger the acceleration of the repayment of $222,840,000 to other lenders under other loan agreements. In sum, acceleration of the loan in this case would be unjust in light of the harm that would accrue to [Borrowers] and the fact that [their] default is merely a technical one which does not put [PMI] at risk.

Id. at 236 (footnote omitted).

117. *See* Williamson v. Wanlass, 545 P.2d 1145 (Utah 1976). In 1971, Lorna and George Wanlass purchased a farm from Don and Catherine Williamson, who retained a purchase money note and second mortgage to secure the $20,000 balance of the purchase price. The Wanlasses made monthly payments under the note for two years, though it appears that many of these payments were untimely. When the Williamsons did not receive the Wanlass's July 1973 payment, the Williamsons accelerated the maturity of the note. Mr. Wanlass then tendered a check for the July installment, along with an explanation that the original payment had been lost in the mails. The Williamsons refused this tender and sued to collect the accelerated balance. The trial court entered a judgment in favor of the Williamsons, but the Supreme Court of Utah

- Furthermore, the Ninth Circuit—faced with an opportunity to limit or reject its earlier *AVEMCO* decision—instead reaffirmed the view that section 1-208 governs accelerations pursuant to objective defaults and requires that such decisions be supported by "objective business-related considerations."[118]

2. *Reflecting on the* AVEMCO *decision*

Numerous courts and commentators have roundly criticized the *AVEMCO* decision, and the decision merits most of that criticism. The court's interpretation of section 1-208 as

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reversed and reinstated the note. *See id.* at 1146, 1149.

The court should have decided the case on simple waiver or estoppel grounds; the evidence indicated that the Williamsons had routinely accepted late payments and had not communicated clearly to the Wanlasses that timely payment was expected in the future. *See id.* at 1146-47. The court proceeded, however, to invoke UCC section 1-208 to justify its decision. Although the default was an objective monetary default, the court held that section 1-208

> seems to recognize that acceleration is a harsh remedy which should be allowed only if there is some reasonable justification for doing so, such as a good faith belief that the prospect of payment is impaired. There was no such showing made in this case. From the fact that the plaintiffs had a second mortgage on this extensive property, there can be little doubt that the note would be paid, principal and interest.

Id. at 1149.

118. United States v. Grayson, 879 F.2d 620 (9th Cir. 1989). The U.S. Department of Commerce Economic Development Agency (EDA) loaned $2 million to Univox-California, Inc. (Univox), guaranteed by Univox's president John L. Grayson and his wife Dorothy. When Univox defaulted by failing to make any installment payments after July 1985, EDA accelerated the maturity of the loan in February 1986, demanded payment from the Graysons under their guaranty, and eventually filed suit against the Graysons to enforce their guaranty obligations. The Graysons objected that the responsible EDA official did not accelerate the loan based upon a good faith belief that EDA's prospects of repayment were impaired, but instead accelerated the loan in order to receive a bonus under the EDA's new incentive plan for collections officials. *See id.* at 623. Accordingly, the Graysons argued that EDA's acceleration violated section 1-208.

The district court granted EDA's motion for summary judgment, and the Ninth Circuit affirmed. Rather than rely upon the existence of the payment default, however, the Ninth Circuit reaffirmed its statement in *AVEMCO* that section 1-208 governs all optional accelerations, even those based upon objective monetary defaults. *See id.* at 623 n.3 (citing *AVEMCO*, 603 F.2d at 1378-90). Evaluating the surrounding circumstances, the court found that Univox had not cured its monetary defaults during an 11-month period, and that Univox's own financial statements projected net losses of $3.5 million for 1995. *See id.* at 623. As a result, the court concluded that EDA's decision to accelerate "was supported by objective business-related considerations," rendering it "irrelevant" that the EDA official may also have been motivated by the desire to collect a performance bonus. *Id.* at 623 n.4.

incorporating a duty of good faith informed by objective reasonableness is questionable because, as discussed in Part III, there is a strong textual argument that the then-existing duty of good faith articulated in UCC Article 1 required only the creditor's subjective belief that its security was threatened.[119] Furthermore, the foundation laid by the *AVEMCO* court as a basis for this interpretation of section 1-208 is profoundly weak in several important respects.

First, the Ninth Circuit placed an unjustified level of importance upon the fact that the acceleration was not automatic but was instead at AVEMCO's option. This distinction is absurd. Essentially all acceleration decisions are optional in the sense that the *AVEMCO* court uses that term; no prudent mortgage lender specifies that acceleration is automatic upon default. Certainly, the UCC drafters were capable of appreciating that acceleration provisions in commercial documentation are nearly universally exercisable at the creditor's option.[120] Had the drafters originally intended that *all* accelerations be objectively reasonable, they could have said so in language far more sweeping than section 1-208, which specifies accelerations "at will" or based upon "insecurity."

Second, the Ninth Circuit ignored obvious and less objectionable alternative theories of relief. The facts suggested that AVEMCO knew that the Buyers had acquired an interest in the plane—the Buyers were listed as co-insureds with Herriford on the insurance policy covering the plane, a fact known to AVEMCO—and AVEMCO nonetheless accepted debt service payments from the Buyers without objection for two years. As such, the court easily might have ruled that AVEMCO had waived its ability to declare a default based upon the lease, thereby obviating any need to inquire into the reasonableness of AVEMCO's decision.[121]

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119. *See supra* notes 62-76 and accompanying text.

120. *See* MORTGAGES RESTATEMENT, *supra* note 1, § 8.1 cmt. a ("While such automatic acceleration provisions may be effective, a mortgagee is well-advised to avoid their use because they circumscribe the mortgagee's discretion in dealing with mortgagor default and may have a variety of unintended consequences for both parties.").

121. As discussed *supra* in note 18, there is no serious dissent from the position articulated in section 8.1(d)(2) that the mortgagee's conduct or failure to act may

Finally, the *AVEMCO* decision makes for poor commercial policy, subjecting the lender to the risk of after-the-fact liability based upon expert testimony (or worse, the judge's own sense of fairness) that a reasonable lender would not have accelerated despite the occurrence of an objective default as defined in the loan documents. To the extent that the *AVEMCO* standard incorporates impairment of security as a necessary condition of the acceleration decision and requires that the decision be objectively reasonable, *AVEMCO* implicitly places upon the lender a duty of care in exercising its contract remedies that goes beyond the notion of enforcing one's remedies in a fashion that is not opportunistic and does not cause unfair surprise to the other contracting party.

Nevertheless, although one can properly argue that the Ninth Circuit reached the wrong conclusion, one cannot properly criticize the decision for *asking the wrong question*. Indeed, the evolving duty of good faith seems to compel the scope of the Ninth Circuit's inquiry in *AVEMCO*. The court encountered a situation in which a creditor invoked an acceleration clause that on its face served a clearly legitimate protective purpose; the circumstances, however, did not appear to present the threat of harm that the provision was designed to protect against. The evolving duty of good faith articulated in *PEB Commentary No. 10* rejects the view that just because the written document permits the creditor to act, the creditor's decision to act is thereby permissible without further inquiry.[122] *PEB Commentary No. 10* suggests that other factors are relevant to the inquiry: Would a reasonable lender have acted similarly in similar circumstances? Has this particular lender acted similarly with respect to other borrowers in similar circumstances? To the extent that there exists evidence suggesting that the answer to these questions is "no," the evolving duty of good faith compels the court to inquire whether acceleration in the absence of actual harm was within the reasonable, yet unexpressed, expectations of the borrower.

As a result, decisions like *AVEMCO* cannot be terribly surprising, for at the margin the rhetoric of good faith invites

result in a waiver of the right to accelerate. In contrast, as this Article reflects, there is significant disagreement as to the proper bounds of the obligation of good faith.

122. *See* PEB COMMENTARY NO. 10, *supra* note 90.

courts to look to the nature of the underlying transaction in order to inform the underlying expectations of the parties. In this regard, the nature of the mortgage transaction—in which the mortgagee receives an interest in property for the primary purpose of securing a debt—provides the context for identifying those underlying expectations. As discussed below, in property law and in mortgages law, courts have consistently—although perhaps not always correctly—looked to the concept of security impairment as a basis for identifying the parties' reasonable expectations.

a. The "due-on-sale" phenomenon. The rhetoric of good faith influenced mortgage law most vividly in the battle over the validity of "due-on-sale" and "due-on-encumbrance" clauses prior to the federal preemption occasioned by the Garn-St. Germain Act.[123] During the 1970s, mortgage lenders often refused to consent to a proposed transfer by a mortgagor unless the mortgagor and proposed transferee agreed to an upward adjustment of the mortgage interest rate. Mortgagors objected to such conduct, arguing that the due-on-sale clause served only to protect the security of the mortgagee's interest in the property itself, i.e., as security for the mortgagor's indebtedness. Mortgage lenders argued that these decisions constituted a legitimate exercise of the rights granted by a due-on-sale clause, as such decisions allowed lenders to adjust their loan portfolios in line with prevailing interest rates. In litigation, the courts typically framed the question in terms of the parties' justified expectations: Would acceleration based upon interest rate concerns, in the absence of a threat to the lender's security, be consistent with the mortgagor's unexpressed expectations? Or would acceleration based upon interest rate concerns instead be a "hidden purpose, not within the contemplation of the parties when they signed the agreement?"[124]

A number of state courts upheld attempts by mortgage lenders to use due-on-sale clauses in this fashion, holding that if the agreement prohibited sale without the lender's consent, there was no inequity in conditioning the lender's consent upon

123. 12 U.S.C. § 1701j-3 (1994).

124. Tierce v. APS Co., 382 So. 2d 485, 488 (Ala. 1979) (Torbert, C.J., dissenting from denial of application for rehearing).

the mortgagor/transferee's agreement to pay a higher interest rate.[125] A significant number of decisions refused to sanction such conduct, however, and instead held that a lender's refusal to consent to a transfer was unreasonable and unenforceable (despite the technical violation of the mortgage agreement) if the transfer posed no demonstrable threat to the mortgagee's security or prospects for repayment.[126] The opinion of the Florida Court of Appeals in *First Federal Savings & Loan Ass'n v. Lockwood*[127] provides a classic example of a court using the rhetoric of good faith to prevent what the court considered an "inequitable" acceleration:

> Florida courts recognize that a lender has the right to accelerate a mortgage when the violation of the acceleration provision goes to the impairment of the lender's security. They require that the lender in a foreclosure action bear the burden of demonstrating legitimate grounds for refusal to accept the transferee. By so doing, our courts protect borrowers by providing them with equitable defenses to inequitable accelerations by lenders. This approach is based on the historical purpose of acceleration clauses, which is to protect the security of lenders.
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> . . . [T]he sole purpose set out by First Federal [in the mortgage] deals with the protection of its security. There is no mention anywhere in the mortgage instrument that rising interest rates will subvert the stated intent and serve to justify First Federal's attempt to gain a commercial advantage.[128]

125. *See, e.g.*, *Tierce*, 382 So. 2d at 487-88; Malouff v. Midland Fed. Sav. & Loan Ass'n, 509 P.2d 1240, 1244-45 (Colo. 1973); Baker v. Loves Park Sav. & Loan Ass'n, 333 N.E.2d 1, 4-5 (Ill. 1975); Stith v. Hudson City Sav. Inst., 313 N.Y.S.2d 804, 808-10 (1970); Crockett v. First Fed. Sav. & Loan, 224 S.E.2d 580, 586-88 (N.C. 1976); Gunther v. White, 489 S.W.2d 529, 531-32 (Tenn. 1973).

126. *See, e.g.*, Patton v. First Fed. Sav. & Loan Ass'n, 578 P.2d 152, 156-58 (Ariz. 1978); Tucker v. Pulaski Fed. Sav. & Loan, 481 S.W.2d 725, 728-31 (Ark. 1972); Wellenkamp v. Bank of Am., 582 P.2d 970, 973-77 (Cal. 1978); Tucker v. Lassen Sav. & Loan Ass'n, 526 P.2d 1169, 1173-75 (Cal. 1974); First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156, 158-59 (Fla. Dist. Ct. App. 1980); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 250 N.W.2d 804, 807-09 (Mich. Ct. App. 1977); Sanders v. Hicks, 317 So. 2d 61 (Miss. 1975), *overruled by* First Nat'l Bank v. Caruthers, 443 So. 2d 861, 864 (1983); Fidelity Land Dev. Corp. v. Rieder & Sons Bldg. & Dev. Co., 377 A.2d 691, 694-95 (N.J. Super. Ct. App. Div. 1977); Continental Fed. Sav. & Loan Ass'n v. Fetter, 564 P.2d 1013, 1017-19 (Okla. 1977); Bellingham First Fed. Sav. & Loan Ass'n v. Garrison, 553 P.2d 1090, 1091-92 (Wash. 1976).

127. 385 So. 2d 156 (Fla. Dist. Ct. App. 1980).

128. *Id.* at 159 (citation omitted) (footnote omitted).

Likewise, the California Supreme Court decision in *Wellenkamp v. Bank of America*,[129] which essentially triggered the eventual adoption of the Garn-St. Germain Act, refused to permit the blanket enforcement of due-on-sale clauses despite acknowledging that they could serve the lender's business purpose:

> Although we recognize that lenders face increasing costs of doing business and must pay increasing amounts to depositors for the use of their funds in making long-term real estate loans as a result of inflation and a competitive money market, we believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against impairment to the lender's security that is shown to result from a transfer of title. Economic risks such as those caused by an inflationary economy are among the general risks inherent in every lending transaction. They are neither unforeseeable nor unforeseen. Lenders who provide funds for long-term real estate loans should and do, as a matter of business necessity, take into account their projections of future economic conditions when they initially determine the rate of payment and the interest on these long term loans. . . . [I]t would be unjust to place the burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property through the automatic enforcement of a due-on clause by the lender.[130]

Today, of course, the Garn-St. Germain Act preempts state laws limiting the enforceability of due-on-sale clauses, and years of commerce under the shadow of Garn-St. Germain has reshaped the parties' expectations regarding the use of objective default clauses as a hedge against the higher costs of borrowing as interest rates rise. Nevertheless, the history of how the due-on-sale clause fared in state courts prior to Garn-St. Germain reflects the strong tendency of judges to view enforcement of mortgage remedies in a context informed by the nature of the mortgage as a security device.

b. Casualty and partial condemnation. Mortgage law has also seen the rhetoric of good faith influence the disputes over

129. 582 P.2d 970 (Cal. 1978).
130. *Id.* at 976 (footnotes omitted).

the proper disposition of a monetary award for the partial condemnation of the mortgaged premises or the insurance proceeds from an insured casualty to the mortgaged premises. Following a casualty or partial condemnation, the mortgagee may wish to apply the condemnation award or insurance proceeds toward satisfaction of the underlying debt; in contrast, the mortgagor may insist upon use of those monies to rebuild or restore the premises.[131] Courts have split as to the proper resolution of such disputes. A significant number of decisions have upheld the mortgagee's right to apply such funds against the mortgage debt, regardless of the circumstances.[132] Another significant body of decisions, however, has placed equitable limitations upon the mortgagee's dominion and control over such funds. In the condemnation context, numerous cases permit the mortgagee to collect the award from a partial taking only to the extent that the mortgagee can demonstrate that the taking has impaired its security;[133] the *Mortgages Restatement*

131. Following a total condemnation, of course, restoration of the mortgaged premises is impossible, and all authorities generally recognize the mortgagee's right to apply the award against the mortgage debt. *See, e.g.*, Morgan v. Willman, 1 S.W.2d 193, 198-200 (Mo. 1927); 1 Nelson & Whitman, *supra* note 17, § 4.12, at 175.

132. With regard to condemnation, see, e.g., *In re Wolf*, 77 B.R. 51, 56 (Bankr. E.D. Va. 1987); *City of Chicago v. Salinger*, 52 N.E.2d 184, 188 (Ill. 1943); *In re Forman*, 240 N.Y.S. 718, 719-20 (Sup. Ct. 1930); 1 NELSON & WHITMAN, *supra* note 17, § 4.12, at 175-76.

With regard to casualty insurance, see, for example, *First Nat'l Bank v. Martin*, 7 N.E.2d 637, 637 (Ill. App. Ct. 1937); *Giberson v. First Fed. Sav. & Loan Ass'n*, 329 N.W.2d 9, 11-13 (Iowa 1983); *General G.M.C. Sales, Inc. v. Passarella*, 481 A.2d 307, 312 (N.J. Super. Ct. App. Div. 1984); *Savarese v. Ohio Farmers' Ins. Co.*, 182 N.E. 665, 667-68 (N.Y. 1932); *Montgomery v. First Nat'l Bank*, 508 P.2d 428, 434-35 (Or. 1973); *English v. Fischer*, 660 S.W.2d 521, 522-23 (Tex. 1983); 1 NELSON & WHITMAN, *supra* note 17, § 4.15, at 186 & n.2.

133. *See, e.g.*, Swanson v. United States, 156 F.2d 442, 450 (9th Cir. 1946); People *ex rel.* Dep't of Transp. v. Redwood Baseline, Ltd., 149 Cal. Rptr. 11, 16-17 (Ct. App. 1978); Harwell v. Georgia Power Co., 298 S.E.2d 498, 498 (Ga. 1983); First W. Fin. Corp. v. Vegas Continental, 692 P.2d 1279, 1281 (Nev. 1984); State *ex rel.* Comm'r of Transp. v. Kastner, 433 A.2d 448, 449 (N.J. Super. Ct. Law Div. 1981); Buell Realty Note Collection Trust v. Central Oak Inv. Co., 483 S.W.2d 24, 26 (Tex. App. 1972).

Courts have also disagreed over the question whether the mortgagor may waive the protections of this rule. *Compare* Pima County v. INA/Oldfather 4.7 Acres Trust #2292, 700 P.2d 877, 879-80 (Ariz. Ct. App. 1984) (upholding contractual allocation of award to mortgagee), *with* Sessler v. Arshak Corp., 464 So. 2d 612, 612-13 (Fla. Dist. Ct. App. 1985) (limiting mortgagee recovery to extent of security impairment, notwithstanding contractual provisions allocating award to mortgagee), *and* First W. Fin. Corp. v. Vegas Continental, 692 P.2d 1279, 1281 (Nev. 1984) (same).

adopts this view absent an effective waiver by the mortgagor.[134] In the casu-alty insurance context, there is likewise modern support for the view that the mortgagee must make insurance proceeds available for restoration if restoration is practical and will not impair the mortgagee's security;[135] the *Mortgages Restatement* also adopts this view.[136] The most notable such decision, the California decision in *Schoolcraft v. Ross*,[137] strongly incorporates the rhetoric of good faith:

> "In every contract there is an implied covenant of good faith and fair dealing that neither party will do anything which injures the right of the other to receive the benefits of the agreement." . . .
>
> . . . .
>
> [T]he purpose of a deed of trust is that the borrower will have the use of funds loaned on specific terms and the lender will have the right to a specified repayment that is secured by

134. Section 4.7(b) provides in pertinent part:

> Unless the mortgage effectively provides the contrary, if restoration of the loss or damage . . . is reasonably feasible within the remaining term of the mortgage with the funds received by the mortgagee, together with any additional funds made available by the mortgagor, and if after restoration the real estate's value will equal or exceed its value at the time the mortgage was made, the mortgagee holds the funds received subject to a duty to apply them, at the mortgagor's request and upon reasonable conditions, toward restoration.

MORTGAGES RESTATEMENT, *supra* note 1, § 4.7(b). The comments to section 4.7 demonstrate significant ambivalence regarding whether the mortgagor's waiver of this right should be enforceable, and clearly open the door for a court to take into account the rhetoric of good faith in interpreting the parties' underlying expectations:

> It is common to find mortgage clauses that purport to give the mortgagee the right to casualty insurance and eminent domain awards without mentioning any corresponding duty to permit use of the funds for restoration of the premises, or that expressly negate any such duty. While such a provision may be construed to preclude the mortgagor's right to use of the funds for restoration under Subsection (b), it may also be disregarded by the courts. For example, in jurisdictions following the Restatement, Second, of Contracts the provision might be considered unenforceable on the ground that . . . enforcement would violate the mortgagee's duty of good faith and fair dealing.

Id. cmt. e (citation omitted).

135. *See, e.g.*, Schoolcraft v. Ross, 146 Cal. Rptr. 57, 59-60 (Ct. App. 1978); Cottman Co. v. Continental Trust Co., 182 A. 551, 554-55 (Md. 1936) (personal property collateral); Miller v. Van Kampen, 397 N.W.2d 253, 254-25 (Mich. Ct. App. 1986) (installment land contract); Starkman v. Sigmond, 446 A.2d 1249, 1253-56 (N.J. Super. Ct. Ch. Div. 1982); 1 NELSON & WHITMAN, *supra* note 17, § 4.15, at 186-88.

136. *See supra* note 132 and accompanying text.

137. 146 Cal. Rptr. 57 (Ct. App. 1978).

> the deed of trust. The lender does not have the right to unilaterally cut off the borrower's right to use the loaned funds unless he can show that his security is impaired.
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> Here there is no evidence that the security was impaired by the fire nor is there any evidence that plaintiffs were unwilling or unable to continue making payments on the property.[138]

c. Transfer of tenant's leasehold interest. Outside the context of mortgage law, property law has struggled to resolve a comparable issue in the landlord-tenant context: Under what circumstances may the landlord exercise its contractual right to withhold consent to a tenant's transfer of the leasehold? When market rental rates boomed in certain areas in the 1980s, landlords often withheld consent to a proposed assignment or sublease unless the tenant and transferee agreed to pay a higher rent. This practice resulted in a series of cases addressing whether the landlord could in good faith withhold consent solely to obtain a higher rental, i.e., when the proposed transfer did not threaten the security of the landlord's interest or the landlord's prospects for payment of the original stated rent. Traditionally, of course, the landlord could enforce a no-transfer restriction contained in a lease and thereby refuse consent to transfer for any reason, or for no reason at all—consistent with the notion that the landlord's freedom of conveyancing gave the landlord an absolute right to select her tenants.[139] Recently, however, some courts have refused to permit a landlord to withhold consent to a proposed transfer solely to capture the bonus value present in the lease, absent a freely-negotiated absolute right to withhold consent.[140] In these

138. *Schoolcraft*, 146 Cal. Rptr. at 59-60 (quoting Brown v. Superior Ct., 212 P.2d 878, 881 (Ca. 1949)) (citations omitted). The court's reasoning is all the more striking in light of the evidence, which suggested that the mortgagee's conduct was motivated by the fact that she was "old and sick and needed the money immediately to take care of her medical needs." *Id.* at 60.

139. *See, e.g.*, First Fed. Sav. Bank v. Key Mkts., Inc., 559 N.E.2d 600, 602-04 (Ind. 1990); Jacobs v. Klawans, 169 A.2d 677-79 (Md. 1961), *overruled by* Julian v. Christopher, 575 A.2d 735 (Md. 1990); Gruman v. Investors Diversified Servs., Inc., 78 N.W.2d 377, 379-82 (Minn. 1956); Abrahamson v. Brett, 21 P.2d 229, 232 (Or. 1933); Reynolds v. McCullough, 739 S.W.2d 424, 429 (Tex. App. 1987); B & R Oil Co. v. Ray's Mobile Homes, Inc., 422 A.2d 1267, 1267-68 (Vt. 1980).

140. *See, e.g.*, Homa-Goff Interiors, Inc. v. Cowden, 350 So. 2d 1035, 1037-38 (Ala. 1977); Hendrickson v. Freericks, 620 P.2d 205, 211 (Alaska 1980); Tucson Med. Ctr. v. Zoslow, 712 P.2d 459, 461 (Ariz. Ct. App. 1985); Warmack v. Merchants Nat'l

opinions, the rhetoric of good faith often plays a significant role, as is evident in the California decision in *Kendall v. Ernest Pestana, Inc.*:

> "[T]here has been an increased recognition of and emphasis on the duty of good faith and fair dealing inherent in every contract." Thus, "[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. . . ." "[W]here a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing." Here the lessor retains the discretionary power to approve or disapprove an assignee proposed by the other party to the contract; this discretionary power should therefore be exercised in accordance with commercially reasonable standards. . . .
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> . . . .
>
> . . . [It is not] reasonable to deny consent "in order that the landlord may charge a higher rent than originally contracted for." This is because the lessor's desire for a better bargain than contracted for has nothing to do with the permissible purposes of the [no-transfer clause]—to protect the lessor's interest in the preservation of the property and the performance of the lease covenants. "'The clause is for the protection of the landlord *in its ownership and operation of the particular property*—not for its general economic protection.'"[141]

Bank, 612 S.W.2d 733, 735 (Ark. 1981); Kendall v. Ernest Pestana, Inc., 709 P.2d 837, 843-49 (Cal. 1985); Basnett v. Vista Village Mobile Home Park, 699 P.2d 1343, 1346-47 (Colo. Ct. App. 1984), *rev'd on other grounds*, 731 P.2d 700 (Colo. 1987); 1010 Potomac Assocs. v. Grocery Mfrs. of Am., Inc., 485 A.2d 199, 208-10 (D.C. 1984); Fernandez v. Vazquez, 397 So. 2d 1171, 1173-74 (Fla. Dist. Ct. App. 1981); Funk v. Funk, 633 P.2d 586, 588-89 (Idaho 1981); Jack Frost Sales, Inc. v. Harris Trust & Sav. Bank, 433 N.E.2d 941, 949 (Ill. App. Ct. 1982); Julian v. Christopher, 575 A.2d 735, 736-39 (Md. 1990); Newman v. Hinky Dinky Omaha-Lincoln, Inc. 427 N.W.2d 50, 53-55 (Neb. 1988); Ringwood Assocs., Ltd. v. Jack's of Route 23, Inc., 379 A.2d 508, 512 (N.J. Super. Ct. Law Div. 1977); Boss Barbara, Inc. v. Newbill, 638 P.2d 1084, 1085-86 (N.M. 1982); Ernst Home Center, Inc. v. Sato, 910 P.2d 486, 492-94 (Wash. Ct. App. 1996).

141. *Kendall*, 709 P.2d at 844-45 (quoting Cohen v. Ratinoff, 195 Cal. Rptr. 84 (Ct. App. 1983); California Lettuce Growers, Inc. v. Union Sugar Co., 289 P.2d 785 (Cal. 1955); Universal Sales Corp. v. California Press Mfg. Co., 128 P.2d 665 (Cal. 1942); Schweiso v. Williams, 198 Cal. Rprt. 238 (Ct. App. 1984); *Ringwood Assocs.*, 379 A.2d at 512).

B. *Good Faith as a Shield Against Pretextual Conduct*

In *AVEMCO*, the Ninth Circuit articulated the concern that a creditor might use its discretion to accelerate a debt as a "sword for commercial gain rather than a shield against security impairment."[142] The Ninth Circuit determined that this concern justified scrutiny of the reasonableness of all acceleration decisions. More appropriately, most courts have not pushed the duty of good faith so far and instead would permit an inquiry into the objective reasonableness of an acceleration decision only when there is evidence that the creditor's decision was pretextual and opportunistic in nature. Although this view of good faith doubtless comports more closely with the view articulated in *PEB Commentary No. 10* than the *AVEMCO* view, it does not assure that the court will not make mistakes in evaluating the underlying facts of any given dispute.

The potential for well-intended, yet misguided, decisions is demonstrated by the recent decision of the Mississippi Supreme Court in *Peoples Bank & Trust Co. v. Cermack*,[143] a decision driven in significant part by the court's confusion over the proper relationship between UCC sections 1-203 and 1-208.[144] Container Engineering Corp. and its president, Jerry Cermack, had maintained a borrowing relationship with Peoples Bank & Trust Company since 1973. In 1987, Cermack sought additional financing for Container in an attempt to obtain a new account. The bank agreed to restructure the existing debt of Cermack and Container, and to advance an additional $25,000 in credit; in conjunction with this restructuring, Container agreed not to incur additional debt without the prior consent of the bank.[145]

On March 31, 1988, Container purchased two new trucks on credit without obtaining the bank's prior approval. The bank discovered Container's purchase in July 1988; rather than declaring an immediate default, however, the bank opted to wait and see whether the purchase would negatively affect Container's cash flow. After reviewing the next quarter's financial reports, the bank determined that Container's cash

142. Brown v. AVEMCO Inv. Corp., 603 F.2d 1367, 1379 (9th Cir. 1979).
143. 658 So. 2d 1352 (Miss. 1995).
144. *See supra* notes 62-76 and accompanying text.
145. *See Cermack*, 658 So. 2d at 1355.

flow position had deteriorated. The bank thus accelerated the maturity of the outstanding debts to Container and Cermack and demanded repayment of the $176,543.54 balance. When Cermack was unable to obtain financing from the SBA or other banks, Cermack entered into a lease/purchase arrangement for its business facility in order to generate the funds necessary to retire the bank's debt.[146]

Shortly thereafter, Cermack and Container filed suit against the bank alleging (among other claims) that the bank had breached its duty of good faith in accelerating the maturity of the debt. Cermack argued that the bank's acceleration violated the bank's duty of good faith under UCC section 1-208, as there was no reasonable basis to question the security of the bank's position or the ability of Cermack and Container to repay the debt. The trial court instructed the jury that the bank's decision to accelerate had to be objectively reasonable under section 1-208, and the jury returned a verdict in favor of Cermack and Container. The Supreme Court of Mississippi, however, reversed, holding that

> [Section 1-208] is inapplicable to situations where a creditor, under the terms of its contract with the debtor, has accelerated its debtor's outstanding obligations after the occurrence of an event that was in the complete control of the debtor, i.e., where the creditor accelerates indebtedness because the debtor fails to comply with the terms and conditions contained in the promissory note, deed of trust or loan agreement.[147]

As Cermack had breached the loan agreement by incurring the debt to purchase the trucks—an objective default within his control—the court's rationale would seem to foreclose any possibility that section 1-208 would require the court to evaluate the objective reasonableness of the bank's action.[148] However, the court left the door open for such an evaluation *based upon the bank's delay in accelerating the loan*:

146. *See id.* at 1356.

147. *Id.* at 1358 (citation omitted).

148. Furthermore, as discussed *supra* in notes 62-76 and accompanying text, there is a strong textual argument that section 1-208 merely restates the general good faith duty contained in section 1-203, such that the Bank's good faith in accelerating would be determined based upon its subjective belief that its security was threatened—not the reasonableness of that belief.

> Peoples Bank did not immediately accelerate Cermack's indebtedness upon learning of Cermack's breach of the loan agreement. Instead, Peoples Bank waited approximately two months after learning of Cermack's breach before accelerating Cermack's outstanding indebtedness. Therefore, it could be argued that this delay . . . indicated that Peoples Bank accelerated the outstanding debt not because of the breach, but because Peoples Bank deemed itself "insecure."[149]

The court held that if the bank did accelerate Cermack's indebtedness based upon insecurity and not due to the incurrence of additional debt, then section 1-208 would govern the bank's decision to accelerate the debt and Cermack could demonstrate that the bank's decision was objectively unreasonable.[150] Thus, because the bank's delay permitted an inference of pretext, the court remanded the case for further proceedings.

Like the Mississippi court in *Cermack*, other courts have used the rhetoric of good faith to sustain challenges to acceleration decisions ostensibly based upon objective defaults when the borrower has presented evidence that suggested the possibility of pretextual action by the creditor. For example, a Massachusetts bankruptcy court awarded damages against Bank of Boston–Western Massachusetts for wrongfully accelerating an installment note for nonpayment of interest, on the ground that the bank could have covered the installments using funds from the borrower's operating account but chose instead to accelerate because it had discovered that one of the borrower's shareholders had ties to organized crime.[151]

149. *Cermack*, 658 So. 2d at 1358.

150. *See id.*

151. *See In re* Martin Specialty Vehicles, Inc., 87 B.R. 752 (Bankr. D. Mass. 1988), *rev'd on jurisdictional grounds,* 97 B.R. 721 (D. Mass. 1989). Martin Specialty Vehicles (MSV) was a small business engaged in van conversion. The Bank floorplanned its vehicles pursuant to a promissory note that was facially payable on demand, but the parties had orally agreed that MSV would pay the note via installments. While negotiating with the Bank for a $50,000 credit line unconnected with the purchase and sale of vehicles, MSV did not pay installments of interest under the floorplan note; at all times, however, MSV had sufficient funds on deposit with the Bank to cover these installments. Without prior notice to MSV, the Bank padlocked MSV's plant, accelerated the floorplan note and demanded its full repayment, allegedly on account of the arrearage in interest payments. *See id.* at 759. MSV never reopened its doors; the Bank repossessed and sold all of MSV's tangible

Likewise, the Fifth Circuit reversed summary judgment in favor of the FDIC as successor to RepublicBank Spring Branch, which had accelerated the maturity of a $250,000 line of credit due to borrower's failure to provide financial statements as required by the security agreement, on the ground that the record permitted an inference that the Bank's insistence upon the financial statement was pretextual.[152]

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assets.

Prior to filing for bankruptcy, MSV sued the Bank alleging, *inter alia*, conversion of its property (based on the absence of an actionable default) and estoppel. MSV argued that it was not in material default under the floorplan agreement, because the Bank had the right to withdraw funds from MSV's operating account to satisfy the interest installments in question, because the operating account had contained sufficient funds to cover the interest arrearage, and because the Bank had charged MSV's account for installments on the floorplan note in the past. *See id.* at 760, 763. MSV argued that the Bank's action was in bad faith because the arrearage was a pretext for its real concern—that one of MSV's shareholders, Felix Tranghese, was known by reputation as a member of organized crime in the Springfield, Massachusetts area. Indeed, the evidence showed that during discussions with MSV following the padlocking, the Bank informed MSV that "in order for the company to reopen, it must make up all arrearages on loans and take Tranghese's name off any loan" and that "Tranghese's interest as a stockholder would have to be terminated." *Id.* at 760. The court held that the Bank's acceleration breached the Bank's duty of good faith in enforcing the provisions of its security agreement. The court concluded that the Bank had acted dishonestly and thus in subjective bad faith; the court also characterized the Bank's decision to accelerate the floorplan note and foreclose upon MSV's assets as "irrational[]" and "unfair[]" and thus in objective bad faith, regardless of the Bank's honesty or motives. *Id.* at 767. This latter conclusion appears to have been based upon the court's view that "the one month's arrearage in interest . . . would not be a material breach giving right to acceleration, in view of the fact that the Bank had the right to withdraw the funds from MSV's account." *Id.* at 763.

152. *See* Texas Refrigeration Supply, Inc. v. FDIC, 953 F.2d 975 (5th Cir. 1992). Texas Refrigeration Supply (TRS) maintained this line of credit from the Bank, secured by the inventory of TRS. The note evidencing this line of credit required TRS to provide the Bank with a monthly financial statement, but TRS failed to provide these financial statements (allegedly because of a computer problem). The Bank accelerated the maturity of the note, and when TRS failed to make immediate payment, repossessed and sold the inventory for $20,000 (despite the collateral's fair market value of at least $200,000). *See id.* at 978, 981-82. TRS then sued the Bank for breach of contract, wrongful acceleration, and breach of the duty of good faith.

Trial occurred after FDIC had succeeded to the Bank's position under the loan documents, and the district court granted summary judgment for FDIC on the ground that TRS's affirmative claims and contract defenses were barred by the *D'Oench, Duhme* doctrine. The Fifth Circuit reversed, concluding that "[o]bligations about timely acceleration and the disposal of collateral are implicit in every promissory note," are not "secret" or "unwritten" obligations, and thus could be enforced against the FDIC as successor to the Bank. *Id.* at 981. The court then remanded the case for a determination regarding whether the Bank accelerated the maturity of the note and whether it did so in bad faith. Noting that good faith is "betrayed by '[c]ircumstances which tend to show that the holder has exercised his option to accelerate, not for

In terms of commercial policy, the *Cermack* result is simply abysmal. The court's decision to treat the creditor's delay as evidence of creditor pretext is plainly counterintuitive and provides precisely the wrong incentives to lenders faced with potential problem loans. As compared to the two-year delay in *AVEMCO*—a gap which legitimately suggests the possibility of pretext by the lender—the two-month delay in *Cermack* seems more readily explained as the action of a prudent lender that wanted to avoid precipitous and possibly unwarranted collection efforts. Institutional lenders typically have formal or informal policies that "build in" some short delay prior to the institution of formal recovery proceedings. These policies doubtless reflect what in many cases is prudent business practice; such a delay enables the lender to evaluate the situation, make a carefully considered judgment about the borrower's prospects, and thereby avoid precipitous decisions. The costs associated with formal recovery and bankruptcy proceedings are significant enough that lenders have a built-in incentive to take the time necessary to attempt to work with their borrowers to avoid these costs. This circumspection appears to explain the conduct of Peoples Bank in *Cermack*; rather than declare a default immediately upon learning about the new debt, the bank instead waited to see whether the new debt in fact would have a deleterious effect upon Container's cash flow. As a policy matter, commercial law should *encourage*

purposes of preserving his debt or preserving the security therefor, but for the purpose of coercing the maker to pay the then balance remaining unpaid on the note,' *id*. (quoting Davis v. Pletcher, 727 S.W.2d 29, 35-36 (Tex. App. 1987)), the court held that the Bank's conduct was susceptible of two interpretations:

> The condition of the $250,000 loan that required the debtor to give the bank monthly financial statements is clearly intended to allow the bank to monitor the borrower's financial well-being. . . . Two possible implications flow from the record before us. First, it could be that the bank decided to demand the financial statement . . . because of legitimate misgivings about the financial state of TRS. On the other hand, the trier of fact could also infer that the bank knew that the default was simply due to a temporary technical problem, but was nevertheless requiring strict compliance to create an excuse to accelerate.

Id. at 982. Although the Fifth Circuit's rhetoric of good faith is not as sweeping as that of the Ninth Circuit in *AVEMCO*, the opinion uses enough language of "reasonableness"—such as the suggestion that the bank's misgivings about its debtor's financial state should be "legitimate"—that the opinion seems to leave the door open for the trial court to conclude, on remand, that the existence of a technical default does not by itself reasonably or rationally justify acceleration of the debt.

that sort of circumspection,[153] but the court's reasoning in *Cermack* provides precisely the opposite incentive. To the extent that *Cermack* permits the borrower to recast the creditor's circumspection as a *de facto* waiver of an objective default, it encourages creditors to act immediately and without reflection—a result that often leads to bad decisions and the costs that flow from them.

Again, however, it is important to separate *the scope of the court's inquiry* in *Cermack* from *the court's ultimate conclusion*. Although one can criticize the merits of the *Cermack* court's conclusion to treat a two-month delay as evidence of pretext, the nature of the court's inquiry was both appropriate and consistent with the conception of good faith expressed in *PEB Commentary No. 10*. If a creditor's action is in fact pretextual or opportunistic, that action may not comport with the reasonable unexpressed expectations of the borrower and thus could violate the duty of good faith performance expressed in *Contracts Restatement* section 205 and UCC section 1-203.

153. See, for example, the approach of the Ohio Court of Appeals in *Metropolitan Life Insurance Co. v. Triskett Illinois, Inc.*, 646 N.E.2d 528 (Ohio Ct. App. 1994). Triskett owned a commercial office park subject to a $5.4 million nonrecourse mortgage held by Metropolitan. When Triskett encountered significant erosion in its tenant base, Triskett was unable to service the debt and fell into default on its mortgage note installments in August 1990. Over the ensuing six months, Triskett made several workout proposals to Metropolitan, including one plan for "net cash flow" payments until Triskett could restore its tenant base and another to list the property for sale. Metropolitan insisted, repeatedly and in writing, that it would only consider modifying the loan once Triskett brought the loan current by making the past due installments. After nearly seven months, when Triskett had not brought the loan current, Metropolitan accelerated the balance of the debt and instituted foreclosure proceedings. Triskett counterclaimed that Metropolitan failed to enforce its mortgage agreement in good faith. The trial court entered summary judgment for Metropolitan, and the Ohio Court of Appeals affirmed. The court rejected Triskett's argument that Metropolitan acted in bad faith in obtaining the *ex parte* appointment of a receiver, noting that "the decision of a lender in an arm's-length commercial transaction to enforce its contractual rights does not constitute an act of bad faith." *Id.* at 534. Further, the court rejected Triskett's complaint about Metropolitan's delay in its enforcement, noting that "Triskett's contention that Metlife breached its implied duty of good faith by engaging in protracted negotiations which misled Triskett into anticipating a workout is obviated by the correspondence between the parties, which reflects Metlife's insistence, from the outset, that Triskett either bring the loan current or face legal action." *Id.*

V. "RATIONALITY" AND THE *RESTATEMENT (THIRD) OF PROPERTY—SERVITUDES*: A DIFFERENT PARADIGM?

The debris left in the wake of the academic and judicial debates about the proper scope of good faith provokes the question of whether mortgage law should search for a different standard—one without the baggage attendant to the term "good faith"—to constrain the mortgage lender's right to accelerate the mortgage debt. In this regard, it is useful to note that property law has faced a similar question (i.e., how to measure the "reasonableness" of contract enforcement) in the law governing the enforcement of restrictive covenants and equitable servitudes. Courts faced with challenges to servitude enforcement have articulated the tension in familiar terms. Should an equitable servitude be enforced against a successor landowner if it is reasonable on its face, without the need to demonstrate actual harm? Or must enforcement of a servitude be reasonable under the circumstances, i.e., must the challenged use threaten the holder of the servitude with the harm against which the servitude was designed to protect her? The law of equitable servitudes provides a useful contrast, because although courts have struggled with the proper resolution of this tension, they have often done so without using the duty of good faith as an explicit basis for informing their analysis. Accordingly, the law of equitable servitudes, especially as reflected in the new *Restatement (Third) of Property—Servitudes*,[154] provides by analogy an alternative standard for the limitation upon a mortgagee's power to accelerate the maturity of a debt.

The vast majority of covenants and servitudes are of the "objective" variety (e.g., "the land may be used only for a single-family residence" or "any house must contain at least 3,000 square feet of living area"), such that the holder need not exercise discretion in determining whether the covenant was violated.[155] One could analogize such covenants to the typical objec

154. *See infra* notes 185-91 and accompanying text.

155. In comparison, some covenants are "subjective" covenants that require the exercise of discretion by the party charged with enforcement (e.g., a covenant requiring that any house's architecture must be consistent with the surrounding neighborhood). Where, for example, an architectural review covenant provides vague standards for its enforcement (or no standards at all), courts have implied a duty to act in good faith in approving plans, and have refused to enforce decisions that were

tive default covenant in the modern mortgage or security agreement, and for each covenant, the same interpretive question arises regarding its enforcement. Can an objective use restriction be enforced according to its terms without regard to the existence of actual harm, or should the absence of harm prevent enforcement of that restriction? The positions underlying these respective views are demonstrated in *Nahrstedt v. Lakeside Village Condominium Ass'n.*[156]

A. Factual Background

In January 1988, Natore Nahrstedt purchased and occupied a unit in the Lakeside Village Condominiums in Culver City, California. The recorded covenants, conditions and restrictions (CCRs) for Lakeside Village provided that "[n]o animals (which shall mean dogs and cats), livestock, reptiles or poultry shall be kept in any unit except that usual and ordinary domestic fish and birds . . . may be kept as household pets within any unit . . . ."[157] Notwithstanding the CCRs, Nahrstedt owned and kept three cats in her unit. Shortly after Nahrstedt moved in, the Lakeside Village Condominium Association (Association) learned about her cats,[158] demanded that she remove them, and fined her for violating the CCRs.[159] Nahrstedt sued the Association seeking a declaration that the pet restriction was unreasonable and thus unenforceable against her under California Civil Code section 1354, on the ground that her cats posed no threat to the peace, quiet, and safety of her neighbors.[160] The Associa

arbitrary or capricious. *See, e.g.*, Rhue v. Cheyenne Homes, Inc., 449 P.2d 361, 363 (Colo. 1969); ROBERT G. NATELSON, LAW OF PROPERTY OWNERS ASSOCIATIONS § 4.7, at 154 (1989).

156. 11 Cal. Rptr. 2d 299 (Ct. App. 1992) [hereinafter *Nahrstedt I*], *vacated and rev'd*, 878 P.2d 1275 (Cal. 1994) [hereinafter *Nahrstedt II*].

157. *Nahrstedt I*, 11 Cal. Rptr. 2d at 301.

158. Ms. Nahrstedt alleged that agents of the Association discovered the cats by peering through her windows and entering her unit without permission.

159. *See Nahrstedt II*, 878 P.2d at 1278. The Association initially assessed to Nahrstedt a fine of $25/month, which progressively increased to $500/month when Nahrstedt continually refused to remove the cats. *See Nahrstedt I*, 11 Cal. Rptr. 2d at 301-02.

160. *See Nahrstedt II*, 878 P.2d at 1278-79. In pertinent part, section 1354 provides: "The covenants and restrictions in the declaration shall be enforceable equitable servitudes, *unless unreasonable*, and shall inure to the benefit of and bind all owners of separate interests in the development." CAL. CIV. CODE § 1354(a) (West

tion demurred, arguing that the pet restriction was reasonable and enforceable as a matter of law because it furthered the collective well-being of residents within the development. The trial court sustained the Association's demurrer and dismissed Nahrstedt's complaint.[161]

B. Nahrstedt I *and the "Reasonable as Applied" Standard*

A majority of the California Court of Appeals reversed the trial court's judgment of dismissal and ordered the trial court to vacate its order sustaining the Association's demurrer (*Nahrstedt I*). Ignoring decisions in other states upholding condominium regulations that limited residents' ability to maintain pets,[162] the majority in *Nahrstedt I* rejected the Association's defense that the pet restriction was facially reasonable and thus enforceable under section 1354. The majority, clearly troubled by a per se ban on pets regardless of harm, determined that existing California precedent permitted enforcement of covenants under section 1354 only where enforcement of those covenants was reasonable under the particular circumstances.[163]

In particular, the majority felt constrained by two previous decisions, *Bernardo Villas Management Corp. Number Two v. Black*[164] and *Portola Hills Community Ass'n v. James*.[165] In *Bernardo Villas*, apartment managers sued a resident to enforce a recorded restriction that prevented residents from parking trucks, except for temporary loading or unloading. The managers had fined the resident in question over $2,000 for violating this restriction by parking his new pickup truck—which he used only for personal transportation—in his assigned carport space. The court refused to permit the managers to recover the unpaid fines, concluding that the

Supp. 1998) (emphasis added).

161. *See Nahrstedt II*, 878 P.2d at 1279.

162. *See* Wilshire Condo. Ass'n v. Kohlbrand, 368 So. 2d 629 (Fla. Dist. Ct. App. 1979) (upholding regulation that prevented condominium residents from replacing pets who died); Dulaney Towers Maintenance Corp. v. O'Brey, 418 A.2d 1233 (Md. Ct. Spec. App. 1980) (upholding restriction that permitted only one pet).

163. *See Nahrstedt I*, 11 Cal Rptr. 2d at 306-37.

164. 235 Cal. Rptr. 509 (Ct. App. 1987), *overruled by Nahrstedt II*, 878 P.2d at 1289.

165. 5 Cal. Rptr. 2d 580 (Ct. App. 1992), *overruled by Nahrstedt II*, 878 P.2d at 1289.

restriction violated section 1354 as applied to "clean noncommercial pickup trucks" and that "the parking of such vehicles in condominium carports was not aesthetically unpleasant to reasonable persons and did not interfere with other owners' use and enjoyment of their property."[166] In *Portola Hills*, the dispute involved an attempt by the community association to enforce a recorded per se restriction on satellite dishes against a resident who had installed a dish in his backyard. The trial court dismissed the community association's complaint, and the court of appeals affirmed, noting that

> [the satellite] dish is not visible to other residents or the public. With that established, the question becomes whether the ban against a satellite dish that cannot be seen promotes any legitimate goal of the association. It clearly does not. Accordingly, the restriction is unreasonable as a matter of law.[167]

Based upon these precedents, the majority in *Nahrstedt I* concluded that section 1354 permitted enforcement of covenants only if the covenants were reasonable as applied to the specific factual circumstances presented by a dispute.[168] The court thus concluded that Nahrstedt's complaint could not be deemed insufficient as a matter of law, because it alleged that the cats did not disturb her neighbors[169] and because the record contained no findings of fact suggesting that her cats posed any

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166. *Bernardo Villas*, 235 Cal. Rptr. at 510.

167. *Portola Hills*, 5 Cal. Rptr. 2d at 583.

168. *See Nahrstedt I*, 11 Cal. Rptr. 2d at 307. The *Nahrstedt I* court stated:

> The question of whether the pet restriction at issue in the case before us is an enforceable equitable servitude . . . is a mixed issue of law and fact which can only be resolved in the context of the particular circumstances of this case. In *Portola Hills* and *Bernardo Villas*, the courts did not address the question of law (i.e., the reasonableness of the restrictions being challenged), until the question of fact (the circumstances of the particular homeowners who were challenging the restrictions) was determined.

Id. (citations omitted).

169. Nahrstedt's complaint alleged that her cats "are not a nuisance, are clean, are kept inside her unit and have not been the object of complaints by any of her close neighbors." *Id*. at 302.

threat or disturbance.[170] The court thus returned the case to the trial court for an evidentiary hearing.

C. Nahrstedt II *and the "Reasonable on Its Face" Standard*

In a six to one decision, the California Supreme Court reversed and reinstated the dismissal of Nahrstedt's complaint (*Nahrstedt II*). Expressly disapproving of *Bernardo Villas* and *Portola Hills*, the *Nahrstedt II* court adopted a "facially reasonable" standard for the enforcement of covenants. The majority argued that section 1354's proviso that a covenant is "enforceable . . . *unless unreasonable*" meant that a recorded use restriction was clothed with a presumption of reasonableness that rendered it enforceable unless the person challenging it proves it to be unreasonable.[171] To inform the statutorily undefined term "unreasonable," the majority looked to background principles of the law of equitable servitudes. Noting the contractual nature of private land use restrictions, the majority suggested that "[w]hen landowners express the intention to limit land use, 'that intention should be carried out.'"[172] Based upon this strong "freedom-of-contract" view, the court thus concluded that "when enforcing equitable servitudes, courts are generally disinclined to question the wisdom of agreed-to restrictions"[173] and should freely enforce such a restriction unless it violates public policy (such as restrictive covenants based upon race, ethnicity, sex, religion or disability);[174] is arbitrary (meaning that it "bear[s] no rational relationship to the protection, preservation, operation or purpose of the affected land"[175]); or imposes burdens on the

170. "[T]he enforceability of the pet restriction will be decided in the trial court after the taking of evidence as to the relevant circumstances of this case." *Id.* at 307. In contrast, the dissenting judge would have sustained the demurrer, because "[t]he courts should leave the enforcement of covenants and restrictions to the homeowners associations unless there are constitutional principles at stake, enforcement is arbitrary, or the association fails to follow its own procedures." *Id.* at 312 (Hinz, J., dissenting).

171. *Nahrstedt II*, 878 P.2d 1275, 1286 (Cal. 1994) (quoting CAL. CIV. CODE § 1354, subd. (a) (West Supp. 1998)).

172. *Id.* (quoting Hannula v. Hacienda Homes, Inc., 211 P.2d 302 (Cal. 1949)).

173. *Id.*

174. *See id.*

175. *Id.*

affected land that are disproportionate to the restriction's beneficial effects.[176]

According to the majority in *Nahrstedt II*, these principles compelled the conclusion that courts must give significant deference to the judgment of homeowners associations in enforcing and administering servitude regimes, in order to achieve "the stability and predictability so essential to the success of a shared ownership housing development."[177] The majority feared that if homeowners associations had to justify enforcement of recorded restrictions on a case-by-case basis, a variety of adverse consequences would follow: nonenforcement would frustrate the bargained-and-paid-for expectations of unit purchasers;[178] associations might refuse to enforce covenants for fear of litigation challenging the enforcement decision;[179] developers might be discouraged from developing affordable housing alternatives such as condominiums;[180] unit purchasers might bear costly increases in legal fees to enable associations to defend their enforcement decisions;[181] and

176. *See id.* at 1287.

177. *Id.*

178.

> [G]iving deference to use restrictions contained in a condominium project's originating documents protects the general expectations of condominium owners 'that restrictions in place at the time they purchase their units will be enforceable.' . . . [This] also protects buyers who have paid a premium for condominium units in reliance on a particular restrictive scheme.

Id. at 1284 (quoting Note, *Judicial Review of Condominium Rulemaking*, 94 HARV. L. REV. 647, 653 (1981)).

179.

> [The presumption of validity] provides substantial assurance to prospective condominium purchasers that they may rely with confidence on the promises embodied in the project's recorded CC & R's. . . . When courts treat recorded use restrictions as presumptively valid, and place on the challenger the burden of proving the restriction 'unreasonable' under the deferential standards applicable to equitable servitudes, associations can proceed to enforce reasonable restrictive covenants without fear that their actions will embroil them in costly and prolonged legal proceedings.

Id. at 1288.

180. "[G]iving deference to use restrictions contained in a condominium project's originating documents . . . encourages the development of shared ownership housing—generally a less costly alternative to single-dwelling ownership—by attracting buyers who prefer a stable, planned environment." *Id.* at 1284.

181. *See id.* at 1288. The *Nahrstedt II* court states that:

> When courts accord a presumption of validity to . . . recorded use restrictions and measure them against deferential standards of equitable

nonenforcement might disrupt harmony between neighbors within the common interest development.[182] Accordingly, the majority concluded that covenants should be freely enforced as long as those covenants were facially reasonable, without the need for proof of actual harm.[183] Evaluating the challenged pet restriction on its face, the *Nahrstedt II* majority concluded as a matter of law that the restriction "is not arbitrary, but is rationally related to health, sanitation and noise concerns legitimately held by residents of a high-density condominium project."[184]

D. Synthesizing the Debate: The Restatement (Third) of Property: Servitudes.

For the past decade, the American Law Institute has attempted to modernize and restate the law governing equitable servitudes. The product of this effort, the proposed *Restatement (Third) of Property: Servitudes* [hereinafter *Servitudes Restatement*] directly addresses the proper resolution of the "on its face or as applied" dilemma manifested in the *Nahrstedt* litigation.

The *Servitudes Restatement* draws the traditional distinction between direct restraints on alienation (e.g., a covenant forbidding the sale of a unit without the association's

> servitude law, it discourages lawsuits by owners of individual units seeking personal exemptions from the restrictions. This . . . protects all owners in the planned development from unanticipated increases in association fees to fund the defense of legal challenges to recorded restrictions.

Id.

182. *See id.* at 1288-89. The *Nahrstedt II* court states that:

> [Case-by-case enforcement] would impose great strain on the social fabric of the common interest development. It would frustrate owners who had purchased their units in reliance on the CC & R's. It would put the owners and the homeowners association in the difficult and divisive position of deciding whether particular CC & R's should be applied to a particular owner. . . . Homeowners' associations are ill-equipped to make such investigations, and any decision they might make in a particular case could be divisive or subject to claims of partiality.

Id.

183. "Under the holding we adopt today, the reasonableness or unreasonableness of a condominium use restriction . . . is to be determined *not* by reference to facts that are specific to the objecting homeowner, but by reference to the common interest development as a whole." *Id.* at 1290.

184. *Id.*

consent) and indirect restraints on alienation (e.g., the pet restriction in *Nahrstedt*). The *Servitudes Restatement* concludes that a direct restraint is enforceable only if it is reasonable as applied to the specific circumstances of the dispute, i.e., only if the "utility of the restraint [outweighs] the injurious consequences of enforcing the restraint."[185] The comments justify the adoption of this standard by reference to the same "commercial reasonableness" standard (informed by the rhetoric of good faith) that courts have applied to govern a landlord's discretion to withhold consent to a tenant's proposed assignment or subletting.[186] By invoking the rationale of *Kendall v. Ernest Pestana, Inc.* and its progeny,[187] the *Servitudes Restatement* thus requires evaluation of direct restraints on a case-by-case basis, giving due consideration to the individual consequences that would flow from enforcing the restriction.[188]

In contrast, the *Servitudes Restatement* requires a much less demanding standard of review for indirect restraints on alienation such as the pet restriction in *Nahrstedt*. Section 3.5 provides:

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185. RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 3.4 (Tentative Draft No. 2, 1991) (hereinafter SERVITUDES RESTATEMENT).

186. The SERVITUDES RESTATEMENT explains:

> Traditionally, the interests of a landlord were regarded as strong enough to justify absolute prohibitions on transfer of the tenant's interest without consent of the landlord, and the landlord was permitted to withhold consent arbitrarily. Modern law restricts the landlord's power, regarding the restraint on alienation as unjustified unless the landlord can withhold consent only for reasons related to protection of the landlord's rent and reversionary interests, at least in the absence of an explicit agreement that the landlord can withhold consent for other reasons. To the extent that the landlord-tenant rule was applied to [common interest ownership], the same evolution in the consent rule should take place.

Id. § 3.4 cmt. d.

187. *See supra* note 140 and accompanying text.

188. This is not to suggest, however, that section 3.4 would require an *ad hoc*, case-by-case evaluation of enforcement of all conceivable forms of direct restraints. For example, the comments to section 3.4 clearly suggest that certain rights of first refusal—for example, a restraint that granted the association a preemptive right to purchase a unit from its owner by matching any binding offer received by that owner—are reasonable under section 3.4's balancing test, unless exercised for an illegitimate purpose (e.g., for racially exclusionary reasons). *See* SERVITUDES RESTATEMENT, *supra* note 185, § 3.4 cmt. f.

> A servitude is not invalid because it indirectly restrains alienation by limiting the use that can be made of property, by reducing the amount realizable by the owner on sale or other transfer of the property, or by otherwise reducing the value of the property, unless there is *no rational justification* for the servitude.[189]

The *Servitudes Restatement* thus contemplates only facial review of objective covenants such as the pet restriction in *Nahrstedt*, the truck ban in *Bernardo Villas*, or the satellite dish prohibition in *Portola Hills*.[190] As the Reporter's Note explains, this decision reflected a deliberate choice designed to promote certainty and predictability in administering servitude regimes:

> [Section 3.5's "rationality" standard] reflects the approach of this Restatement, which is to give effect to the intentions of the parties unless there is a substantial reason to disregard them. In the realm of direct restraints on alienation, the restraints clearly interfere with operation of the free market economy, and the reasonableness test has been elaborated through many cases. However, in the realm of arrangements challenged as indirect restraints on alienation, it is much less clear that [they] interfere with free functioning of the market in land. It is more likely that a mushy "reasonableness" standard will interfere with the market by introducing a substantial element of doubt into the process of forming transactions. The "lacking in rational justification" standard provides substantially more guidance to parties in negotiating the financial terms of land sales, while protecting land resources from irrationally created servitudes.[191]

In evaluating objective covenants, then, the *Servitudes Restatement* embraces a "rationality" standard or facial reasonableness standard comparable to the one articulated in *Nahrstedt II*—a standard that involves no judicial inquiry into whether the specific breach of the covenant has produced actual harm.

189. *Id*. § 3.5 (emphasis added).
190. The reporters' note to section 3.5 explicitly rejects the rationale of *Bernardo Villas* by name. *See id.* § 3.5, reporter's note.
191. *Id*.

E. Comparing the Two Restatements–The Rhetoric of "Rationality" and Section 8.1

The "reasonable on its face/reasonable under the circumstances" debate in servitude enforcement mirrors the debate in judicial decisions reviewing the enforcement of mortgage acceleration clauses. As a result, the "rationality" or "facial reasonableness" standard of the *Servitudes Restatement* provides a potential alternative standard for enforcement of mortgage acceleration clauses, or perhaps a means for informing the proper interpretation of the "bad faith" constraint upon the creditor's enforcement authority under *Mortgages Restatement* section 8.1. As noted above, the *Servitudes Restatement* exalts efficiency concerns to justify its "rationality" standard for the review of objective covenants. These same efficiency concerns also motivated section 8.1; the comments emphasize the need to promote predictability in mortgage remedies and to avoid "difficult and time-consuming judicial inquiries into such matters as the degree of mortgagor's negligence, the relative hardship that acceleration imposes, and other subjective concerns."[192]

The application of a rationality standard would have dramatic consequences for the analysis of mortgage acceleration decisions in marginal cases. Under a rationality standard, the circumstances surrounding the acceleration decision and the consequences that acceleration might impose upon the borrower become totally irrelevant. The rational basis for an objective default provision (i.e., the potential harm that a particular default *could* impose on the mortgagee) and the benefits of certainty and predictability achieved by across-the-board enforcement are deemed to outweigh harms that individual borrowers might suffer as a consequence of decisions that may in reality be imprudent or inconsistent with the reasonable yet unexpressed expectations of the borrower.[193] A

192. MORTGAGES RESTATEMENT, *supra* note 1, § 8.1 cmt. e.

193. Indeed, the Garn-St. Germain Act's preemption of state law limiting the enforceability of due-on-sale clauses, *see* 12 U.S.C. § 1701j-3 (1994), reflects this philosophy precisely. In Congress's judgment, the "rationality" of due-on-sale clauses (i.e., the risk that a transfer *might* result in the impairment of the mortgagee's security) and the benefits achieved by blanket enforcement (i.e., no litigation and the enhanced solvency of financial institutions engaged in mortgage lending) were deemed to outweigh the costs imposed upon individual borrowers who did not anticipate that

rationality standard would thus dictate enforcement of acceleration decisions in essentially all cases; any common objective default provision appearing in standard mortgage documentation easily passes rational-basis scrutiny. Consider, for example, the Bank's decision to call in Randolph's credit line in the hypotheticals in Part I. Randolph could hardly characterize the requirement to provide financial statements as irrational; his failure to provide such statements could leave the Bank with insufficient information to make informed judgments about the enforcement of its rights under the loan documents. Under the rationality standard, Randolph's failure to provide the statements in a timely fashion would certainly justify Bank's decision in Example One (Randolph is insolvent), Example Two (Bank mistakenly believes itself insecure), Example Three (Bank seeks higher interest rate), and Example Four (Bank changes its lending policy). Further, Randolph's violation arguably would justify the Bank's decision in Example Five (Bank officer accelerates based upon animus toward Randolph), as under a rationality standard, there would be no occasion or need for the court to evaluate the reasonableness of the Bank's decision under the particular circumstances.[194] As a result, one might argue that a rationality standard would have captured more precisely section 8.1's stated efficiency goals than the "bad faith" standard actually used in section 8.1(d)(3). A rationality standard would carry the appeal of certainty and predictability (i.e., no evaluation of Randolph's financial condition or the adequacy of Bank's security), while leaving

the clause would be enforced against them in the context of a "nonthreatening" transfer.

194. The *Servitudes Restatement* does not provide specific examples or illustrations as to how it would treat someone enforcing a concededly rational servitude for wholly personal reasons. Suppose, for example, that Mrs. Nahrstedt's neighbors chose to enforce the pet restrictions not because of concerns about her cats, but in order to retaliate against her for her attempts to persuade condominium residents to vote in opposition to the association's plans to renovate common facilities, or (even more tangentially) because Mrs. Nahrstedt's son was arrested on suspicion of drug possession. The rationality standard of section 3.5 seems to suggest that the court should enforce the servitude, but it seems likely that given an egregious set of facts, a court likely might place an overarching duty of good faith upon the enforcement of the servitude and refuse to permit pretextual enforcement. *Cf.* Building Monitoring Sys., Inc. v. Paxton, 905 P.2d 1215 (Utah 1995) (tenant may raise retaliatory eviction as affirmative defense to landlord's summary action for possession of leased premises).

commercial borrowers free to bargain for "reasonable" constraints upon the lender's discretion (e.g., a provision requiring that a decision to accelerate be based upon a reasonable belief that the lender's security or prospects for repayment are impaired).

VI. REFLECTING ON THE FUTURE IMPACT OF SECTION 8.1—SOME CONCLUDING VIEWS

While the comments in each Restatement offer similar efficiency rationales, the Restatement provisions themselves still use differing terms—"rationality" versus "bad faith"—that have traditionally carried quite different rhetorical force. Thus, while the rationality standard of the *Servitudes Restatement* provides an intriguing perspective on the enforcement of mortgage acceleration clauses, section 8.1(d)(3) of the *Mortgages Restatement* still incorporates the term "bad faith" as one of the operative constraint upon the enforcement of those clauses. As a result, courts seeking to interpret section 8.1 will have to address the appropriate scope of the evolving duty of good faith manifested in *Contracts Restatement* section 205 and throughout the revised UCC. As this Article has explained, the conception of good faith expressed in those enactments dictates that courts cannot pay perfunctory homage to the literal terms of a written document in unthinking fashion. Instead, this broader conception of good faith mandates that courts interpret written agreements "in a manner consistent with the reasonable expectations of the parties in the light of the commercial conditions existing in the context under scrutiny."[195] To the extent that this standard obligates the court to identify the unexpressed reasonable expectations of the parties, how should we expect courts to articulate those expectations in the context of a creditor's decision to accelerate a mortgage debt following an objective default?

One approach would be to conceptualize good faith in a narrow fashion that perhaps would come closest to the "rationality" standard of the *Servitudes Restatement*. Under this view, a creditor would be acting in good faith in

195. PEB COMMENTARY NO. 10, *supra* note 90; *see also supra* note 90 and accompanying text.

accelerating a mortgage debt for breach of an objective default as long as the creditor makes that decision *for any business-related reason*. This view, held by Professor Nelson (the principal drafter of section 8.1)[196] assumes that the mortgagor and mortgagee have a shared understanding that objective default provisions rationally serve to protect the mortgagee *against all potential business risks that the mortgagee believes it might face* if it were to continue the mortgagor-mortgagee relationship unchanged.

Returning to the introductory hypotheticals,[197] under this approach the Bank lawfully could call in Randolph's line of credit in Examples One through Four. In Example One, of course, in which Randolph is insolvent, the Bank's decision is defensible under any view of good faith. In Example Two, the Bank mistakenly (if negligently) believes that its prospect for repayment is threatened; in Example Three, the Bank seeks a higher interest rate than what prevailed at the time of the original loan agreement; in Example Four, the Bank has made a policy judgment to no longer seek or maintain lending relationships with small borrowers. In each example, the Bank's motivation is business-related, as it seeks to promote the Bank's general economic interest. Thus, each of those acceleration decisions would withstand challenge under section 8.1. Under this view, the Bank legally could not accelerate only in Example Five, where the Bank officer acts out of animus toward Randolph. This conduct would constitute bad faith enforcement by the Bank, as the reasonable parties to the mortgage transaction would not expect that the Bank would enforce that provision for reasons completely unrelated to the Bank's business interests.

At the opposite extreme, one might conceptualize good faith so broadly as to adopt a standard comparable to that of *AVEMCO*, thereby permitting a creditor to accelerate only when there exists a threat to the creditor's security or prospect

196. Neither the comments nor the reporters' note expressly articulate this formulation of the "bad faith" standard. In our numerous discussions on this subject, however, Professor Nelson has articulated that he believes a creditor would act in good faith if the creditor acted for any business justification, unless that stated business justification violated existing federal or state law (e.g., antidiscrimination laws, antitrust laws, unfair or deceptive trade practices statutes).

197. *See supra* Part I.

of repayment.[198] This view supposes that the mortgagor and mortgagee have a shared understanding that objective default provisions serve to protect the mortgagee against the risk that the mortgagor cannot repay the loan and that the mortgagee's security may be insufficient to permit full satisfaction of the mortgage debt. Under this view, then, the mortgagor would expect the mortgagee to exercise its remedies only when the mortgagee's security or prospects for payment are actually threatened; absent that threat, the mortgagee's action to accelerate the mortgage debt would constitute bad faith enforcement. Under this conception of bad faith, the Bank could not lawfully call in Randolph's line of credit in Examples Two through Five. In Example Two, the Bank's belief in its insecurity is unfounded (and perhaps negligent), and its prospects for repayment are not threatened. In Example Three (Bank seeks higher interest rate) and Example Four (Bank changes its lending policy), the Bank's actions are motivated by business reasons completely unrelated to Randolph's ability to pay and the value of the collateral relative to the mortgage debt. Likewise, in Example Five, the Bank's action arises from animus toward Randolph and his family, not from concerns regarding the loan itself.

If those were the only two options, I would concur with Professor Nelson that the "any-business-reason" standard is plainly preferable. The *AVEMCO* conception of bad faith does not comport with the tenor of the comments to section 8.1, which reject the notion that the mortgagee must show impairment of security to enforce an acceleration based upon an objective event of default. The *AVEMCO* view would not produce the certainty and predictability in mortgage remedies that section 8.1 seeks to attain, as it would invite potential second-guessing of the lender's business judgment.[199] Second, the *AVEMCO* standard comes close to establishing a duty of care on the part of the lender in making enforcement decisions,

198. *See supra* notes 98-118 and accompanying text.

199. Of particular concern is the likelihood that such litigation often would arise in adversary proceedings in the bankruptcy courts, where the presence of a creditor's deep pocket (and the potential recovery for unsecured creditors in a lender liability action or an equitable subordination claim) might cause the bankruptcy judge to engage in more critical or searching review of the creditor's decision than a court would have given that same decision at the time it was made.

further blurring the line between tort and contract. Third, and most significantly, "good faith" is properly informed by the commercial context surrounding the transaction in question, and *AVEMCO* simply fails to take account of those contexts—such as the enforcement of due-on-sale clauses—in which reasonable parties clearly understand that the lender may accelerate regardless of security impairment.[200]

Upon reflection, however, I do not believe either of these two views provides a satisfactory explanation for how section 8.1(d)(3) should serve to constrain a creditor's enforcement of its remedies. To say that the "any-business-reason" standard is better than *AVEMCO* is not to suggest that it is the correct standard. The "any-business-reason" standard of bad faith assumes that the reasonable mortgagor and mortgagee understand when they enter the mortgage transaction that *any* business reason will permit the mortgagee to enforce *any* objective default provision—even if the reason and the default provision bear no apparent or implicit relationship to each other. In other words, the "any-business-reason" conception of bad faith appears to require the assumption that in the commercial context, a mortgagor *can have no unexpressed, yet reasonable, expectations* regarding the mortgagee's power to exercise its objective default remedies.

On the margin, that assumption seems implausible. Suppose (in another variant on the introductory hypothetical) that the Bank threatens to call in Randolph's credit line, based upon a six-day delay in providing financial statements, unless Randolph agrees to buy out his brother-in-law (who does own a 20% stake in the business, but who makes no day-to-day management decisions and has no control over company funds), who Smith and other bank officers believe has an alcohol problem. Is it clear that a reasonable borrower in Randolph's position could or should have anticipated that the Bank would attempt to call in his loan, at a time when there was no apparent threat to the Bank's security or its prospects for repayment, in order to influence the composition of the ownership of the business? I think the correct answer is "no," and courts have used the rhetoric of good faith to strike down

200. *See supra* notes 124-130 and accompanying text.

such creditor enforcement decisions in comparable marginal circumstances.[201]

Likewise, consider Example Four, in which the Bank called Randolph's loan to further implement its change in lending policy. It seems dubious to suggest that Randolph reasonably could have anticipated that Local Bank would be acquired by a larger financial institution like MegaBank; that MegaBank would decide to no longer enter business relationships with small borrowers; and that MegaBank would direct its officials to exercise technical defaults to extract MegaBank from existing relationships with small borrowers like Randolph. As such, the fact that Randolph did not anticipate such a change in Bank lending policy—and thus did not bargain for an express constraint on the Bank's authority to exercise its remedies under those circumstances—does not suggest that Randolph and the Bank possess a shared understanding that Bank could call in Randolph's credit line under those circumstances.[202] The court's task in such a case is to ascertain what Randolph and the Bank *would have agreed to had they anticipated those circumstances*.[203]

Furthermore, it seems even more dubious to suggest that Randolph reasonably could have anticipated the Bank's conduct

201. *See, e.g.*, *In re* Martin Specialty Vehicles, Inc., 87 B.R. 752 (Bankr. D. Mass. 1988), *rev'd on jurisdictional grounds*, 97 B.R. 721 (D. Mass. 1989) (striking down creditor enforcement decision where acceleration motivated by desire to force out borrower's shareholder who had ties to organized crime); *cf.* State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 66, 685-861 (Tex. App. 1984) (striking down creditor enforcement decision where threat of acceleration motivated by desire to prevent former CEO from resuming control of the borrower's business operations). Helen Davis Chaitman, one of the leading commentators in the lender liability field, articulated this as Commandment IV in *The Ten Commandments for Avoiding Lender Liability*: "Thou Shalt Not Run Thy Borrower's Business." Helen Davis Chaitman, *The Ten Commandments for Avoiding Lender Liability (Annotated)* (7th ed. 1988), *available in* WESTLAW at 468 PLI/Comm 783, 818. These decisions and warning reflect an understanding that the lender will not exercise default remedies in a fashion that constitutes an unwarranted interference with the borrower's own business judgment—yet this understanding would be "unexpressed" in the language of the typical mortgage or security agreement.

202. Courts have recognized as much in comparable situations. *See, e.g.*, First Nat'l Bank v. Sylvester, 554 N.E.2d 1063, 1068-70 (Ill. Ct. App. 1990) (denying summary judgment to lender that refused to extend credit to enable borrower to perform profitable construction job; decision not in good faith if lender's decision was based upon policy decision to no longer make construction loans).

203. *See* PEB COMMENTARY NO. 10, *supra* note 90; RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 91-93 (4th ed. 1992).

if the Bank had not exercised those same default remedies (i.e., acceleration based upon failure to provide financial statements) on other commercial loans for which the prospect for repayment remained secure. In other words, even if Randolph appreciated the risk of this scenario, he reasonably could have expected the Bank to treat his loan in a fashion consistent with the treatment customarily extended to other Bank customers. In my view, a decision to uphold the enforcement of the acceleration decision in Example Four would be to "virtually 'read the doctrine of good faith (or of implied contractual obligations and limitations) out of existence'"[204]—a view that one cannot reconcile with *PEB Commentary No. 10*. I would thus characterize the Bank's decision to call in Randolph's line of credit in Example Four as bad faith enforcement of its reserved rights.

I am less certain about the application of the "any-business-reason" standard to Example Three, in which the Bank threatens to call in Randolph's credit line unless he agrees to an increase in interest rates. On the one hand, one can argue with great force that the Garn Act's preemption of state restrictions upon the enforceability of due-on-sale clauses[205] has reshaped reasonable commercial expectations of the parties to mortgage transactions, such that now all reasonable parties understand that the mortgagee may exercise objective default provisions to protect itself against the economic risks posed by interest rate fluctuations. Under that view, the Bank's decision to exercise its remedies in Example Three would constitute a good faith enforcement of its default remedies. Were I the judge in Example Three, I would conclude that the Bank acted in good faith and uphold the Bank's decision on this basis.

On the other hand, it is not necessarily self-evident that all commercial borrowers would equate the consequences of a due-on-sale clause (which motivated the Garn Act) and a requirement to provide financial statements. Further, cases such as *Kendall*[206] and *Schoolcraft*[207] demonstrate the historical

204. Big Horn Coal Co. v. Commonwealth Edison Co., 852 F.2d 1259, 1268 (10th Cir. 1988) (quoting Tymshare, Inc. v. Covell, 727 F.2d 1145, 1153-54 (D.C. Cir. 1984)).

205. *See supra* notes 124-30 and accompanying text.

206. Kendall v. Ernest Pestana, Inc., 709 P.2d 837 (Cal. 1985).

207. Schoolcraft v. Ross, 146 Cal. Rptr. 57 (Ct. App. 1978).

willingness of courts to use the rhetoric of good faith to strike down attempts to exercise contract rights for "unanticipated" or "opportunistic" economic advantage. If the future brings a return of sharply rising interest rates, I expect that we will experience another cycle of "due-on" litigation—and if past is prologue, the rhetoric of good faith will produce judicial division over the appropriateness of those acceleration decisions.

As a proponent of the "any-business-reason" standard of bad faith, Professor Nelson doubtless would turn this uncertainty against me. To the extent that mortgages law values certainty and predictability, how can mortgages law subject the mortgagee to the risk of such *ad hoc* judicial decisionmaking—especially when we know some courts (witness *AVEMCO* and *Cermack*) will apply the duty of good faith to reach incorrect decisions that accord insufficient respect to the lender's business judgment? If we assume that interpretation of the parties' agreement should be informed by efficiency concerns,[208] I am sympathetic; but I am also unconvinced that a less absolute and more moderate "bad faith" standard will produce greater inefficiency than the more absolute "any-business-reason" standard. In fact, to some extent, the very certainty and predictability of the "any-business-reason" standard is its most significant shortcoming. While a less absolute bad faith standard introduces some measure of unpredictability, that unpredictability does not have only negative effects.

At the margin, uncertainty can have positive effects by meaningfully tempering creditor enforcement decisions. The overwhelming majority of acceleration decisions are "no-brainers" based upon serious monetary defaults, insolvent borrowers, and/or obvious threats to the lender's security. In the context of those decisions, the constraining effect that

208. There are, of course, well-founded competing views on this point. *See, e.g.*, DENNIS M. PATTERSON, GOOD FAITH AND LENDER LIABILITY 155 (1989) ("Arguments over meaning are not reducible to questions of Pareto optimality, wealth maximization or efficiency. Interpretive arguments are dialogical contestations over the point of law. The point of law is a function of questions about reasons (e.g., 'Why does this rule exist?'; 'What is the purpose of this regulation?'). The fallacy of economic models of argumentation is the belief of their proponents that questions of meaning (and truth) are susceptible of solution by resort to methodological means. Truth is not the product of method. Truth is a socially-created artifact. Llewellyn understood this. His understanding is in the Code. We should not ignore this truth.").

uncertainty will have on creditor enforcement decisions is negligible or nonexistent. For example, the risk of a challenge to the Bank's decision to call in Randolph's line of credit in Example One (where Randolph is insolvent) would not register on the Bank's decisionmaking scale—or, even if it did register, it would not change the Bank's decision. The prudence of the Bank's decision, and the fact that the decision comports with the reasonable expectations of each contracting party, is self-evident.

At the margin, however, the prudence of an acceleration decision—or whether the decision comports with the likely expectations of the borrower—may not be self-evident. As in Example Two, there may exist readily discoverable evidence that the creditor's security is not impaired and its prospect of repayment is not threatened. As in Example Four, the circumstances under which the lender is exercising its reserved remedies may be ones that could not have been reasonably anticipated by the borrower at the time of the original loan agreement. As with any collection effort, the creditor's decision to accelerate in these marginal cases will impose significant consequences on the borrower in terms of its ability to maintain operations both in the short and long terms. In close cases—cases where a neutral observer might choose not to accelerate based upon a lack of security impairment, or because the borrower likely would not have anticipated enforcement under the circumstances—a more moderate conception of good faith will probably produce some judicial mistakes (i.e., cases like *AVEMCO* in which the court incorrectly ascertains the parties' reasonable expectations), but the uncertainty associated with those mistakes should also have an *in terrorem* effect upon creditor decisionmaking.

In turn, this should have two beneficial effects. First, creditors will respond at the level of documenting transactions, by bargaining to obtain greater enforcement latitude in instances where that latitude is necessary to protect their legitimate business concerns.[209] To the extent that this reduces

209. For example, consider what transpired following the decision in Kendall v. Ernest Pestana, Inc., 709 P.2d 837 (Cal. 1985), discussed *supra* in notes 139-41 and accompanying text. The lease in *Kendall* was silent as to the question of whether the landlord could withhold consent to an assignment or sublease in order to capture

the likelihood that legitimate expectations remain unexpressed, it should reduce the risk of courts imposing unwarranted costs by overextending the duty of good faith. Second, creditors will respond at the level of enforcing agreements by making more careful decisions; the prudent creditor will exercise more careful judgment in evaluating its secured position and will ensure that its enforcement decisions treat similarly situated borrowers in similar fashion.[210] On the margin, this circumspection should produce better decisions. In this regard, a broader conception of good faith—and the occasional damage award against the AVEMCOs of the world—should serve to improve lender decisionmaking about the monitoring and enforcement of loans to a greater extent than might be expected under a pure "freedom-of-contract" or "any-business-reason" view.

Which view is actually more efficient, of course, is an empirical question for which there is no clear answer. Until we have that clear answer, we can expect the debate over the proper application of the duty of good faith to continue—and we can expect less certainty and predictability than section 8.1 may have hoped for.

lease bonus value. As a result, the court concluded that the tenant would not have reasonably expected the landlord to withhold consent in order to renegotiate the stated rent or to capture the bonus value inherent in the lease. Following *Kendall*, landlords inserted clauses into their leases specifically authorizing the landlord to withhold consent unless the tenant agreed to pay some or all of the increased rental value of the premises to the landlord. Courts upheld those provisions in the face of challenges by tenants, as they should have—clearly, no tenant signing such a lease could legitimately claim unfair surprise or disappointed expectations if the landlord used the provision as a means to recapture bonus value. *See* Carma Developers (Cal.), Inc. v. Marathon Dev. Cal., Inc., 826 P.2d 710, 727-29 (Cal. 1992) (stating that a landlord did not breach duty of good faith and fair dealing in enforcing specific, bargained-for provision allocating lease bonus value).

210. Indeed, this is precisely how the lending industry responded to the "lender liability boomlet," as reflected by the proliferation of books, manuals, and presentations designed to help lenders plan for avoiding lender liability claims. *See, e.g.*, GERALD L. BLANCHARD, LENDER LIABILITY: LAW, PRACTICE AND PREVENTION (1989); MARK E. BUDNITZ, THE LAW OF LENDER LIABILITY (rev. ed. 1994); PETER M. EDELSTEIN, THE LENDER LIABILITY DESKBOOK (1992).