GOOD FAITH IN CONTRACT PERFORMANCE: MARKET STREET ASSOCIATES LTD. PARTNERSHIP V. FREY

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Contracts courses are notoriously traditional, with Hadley suing Baxendale\(^1\) year after year and William E. Story, Sr., perpetually promising William E. Story, Jr., $5,000 to refrain from drinking, smoking, swearing, or gambling until he is twenty-one.\(^2\) One of the few modern cases to have broken into the canon — or, I should say, one of the few modern cases to have broken in that does not relate to computers, computer software, or deals in cyberspace — is Judge Posner’s opinion in *Market Street Associates Ltd. Partnership v. Frey*,\(^3\) written in 1991. It is treated as a principal case on performance in good faith in the Fuller and Eisenberg casebook\(^4\) and as an extended squib in Macneil and Gudel.\(^5\) Perhaps more definitive of its having reached the pantheon of contracts cases is its inclusion for substantial discussion in Professor Marvin Chirelstein’s *Concepts and Case Analysis in the Law of Contracts* (that favorite “extra” reading of contracts students),\(^6\) where it is one of only eight cited cases decided since 1990.\(^7\) And I include the case in my own materials.\(^8\) I teach it with care, because it is so clear and so intelligent, but also, I confess, because I think it leaves a lot yet to be said. Even if one accepts the approach the opinion embraces, it does not, in my view, reach the right result, and the approach itself leaves out important considerations recognized elsewhere in Judge Posner’s writings. Indeed, I wonder whether Judge Posner himself would reach the same result were he to have the chance to write the opinion again.

*Market Street Associates*, assignee of J.C. Penney, sued for specific performance of a contract to convey a shopping center owned by General Electric Pension Trust (of which Dale Frey, the named defendant, 

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3 941 F.2d 588 (7th Cir. 1991).


7 See id. at 231–33 (listing cases cited).

was a trustee). Judge Posner’s opinion describes the relevant contract terms very clearly:

In 1968, J.C. Penney Company, the retail chain, entered into a sale and leaseback arrangement with General Electric Pension Trust in order to finance Penney’s growth. Under the arrangement Penney sold properties to the pension trust which the trust then leased back to Penney for a term of 25 years. Paragraph 34 of the lease entitles the lessee to “request Lessor [the pension trust] to finance the costs and expenses of construction of additional Improvements upon the Premises,” provided the amount of the costs and expenses is at least $250,000. Upon receiving the request, the pension trust “agrees to give reasonable consideration to providing the financing of such additional Improvements and Lessor and Lessee shall negotiate in good faith concerning the construction of such Improvements and the financing by Lessor of such costs and expenses.” Paragraph 34 goes on to provide that, should the negotiations fail, the lessee shall be entitled to repurchase the property at a price roughly equal to the price at which Penney sold it to the pension trust in the first place, plus 6 percent a year for each year since the original purchase.9

Market Street Associates claimed that in 1988 it requested financing to build a new store on the premises, was turned down, and therefore was entitled to repurchase the property by the terms of paragraph 34. The pension trust refused to sell, from which, as the case says, we may infer that the property was now worth more than its original price plus accumulated six percent increases.10

Presumably paragraph 34 was written because, once Penney sold the shopping center, it lost the collateral it could mortgage to finance the center’s future development, and, indeed, the underlying facts were that Market Street Associates had tried first to get financing for the project elsewhere but was refused for lack of available security. But the point in dispute was not whether the proposed project qualified for financing under the terms of the contract, nor whether the parties had negotiated in good faith. All there had been was an exchange of letters requesting financing and flatly refusing it. The court (building on the way the parties had framed the case) took it as a given that if the pension trust was wrong for failing even to talk about granting the loan, transfer of the property should follow.11 But the pension trust claimed it was not in the wrong because the extreme consequences of failing to negotiate had not been brought to its attention. So the point ultimately at issue was the legal effect of the fact that Market Street Associates’ request for financing did not refer to paragraph 34, although the general partner who wrote the letters (one Orenstein) knew about

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9 *Mkt. St. Assocs.*, 941 F.2d at 591 (alteration in original).
10 *Id.* at 592.
11 See *id.* at 593.
the paragraph and realized that it was possible that the person at the pension trust to whom he was writing (one Erb) might not have.

The trial court granted summary judgment for the defendant. “The pension trust’s argument, which the district judge bought,” wrote Judge Posner, “is that . . . under the compulsion of the doctrine of good faith, a provision requiring Market Street Associates to remind the pension trust of paragraph 34 should be read into the lease.”12 Beyond dispute, no such notice had been given. By contrast, the Seventh Circuit ruled that “[t]he dispositive question . . . is simply whether Market Street Associates tried to trick the pension trust and succeeded in doing so.”13 As to this, “[t]he essential issue . . . was Orenstein’s state of mind, a type of inquiry that ordinarily cannot be concluded on summary judgment, and could not be here.”14 Accordingly, the case was remanded for trial.15

The question Market Street Associates raises is the application, in the circumstances, of the duty of good faith performance. (Good faith in negotiation, as the case made plain, is quite another matter.16) As to good faith performance, Judge Posner wrote that “[t]he Wisconsin cases (applicable to this diversity matter) are cryptic as to its meaning though emphatic about its existence,”17 a point that contracts scholars would tell you is also true elsewhere.18

Partly, this obscurity reflects the breadth of the doctrine. The duty of good faith arises to qualify all performance obligations, and, of

12 Id. The district judge also thought the same result followed simply as a matter of contract interpretation, but as this conclusion does not seem to have been based on additional evidence of what the parties intended, the Seventh Circuit said, rightly, that the interpretation issue simply comes back to what the words mean when read under the obligation of good faith. See id.
13 Id. at 596.
14 Id. at 597–98.
15 Id. at 598. On remand, Judge Reynolds (this time after hearing testimony) wrote:

While Orenstein initially assumed that the Trust would review the lease . . . , he subsequently recognized that the Trust was not operating under paragraph 34. While Orenstein knew this fact, he did not bring the matter to the Trust’s attention, and continued to write ambiguous letters, until he wished to utilize the purchase option, thereby purchasing the property at a discounted cost. By so doing, this court concludes that Orenstein breached his duty to use good faith . . . .

Mkt. St. Assocs. Ltd. P’ship v. Frey, 817 F. Supp. 784, 788 (E.D. Wis. 1993). When the case came up to the Seventh Circuit a second time, this language was at issue because “plaintiffs complain[ed] that the district court did not make a determination about Orenstein’s state of mind and intent, the specific purpose for which this Court remanded the case.” Mkt. St. Assocs. Ltd. P’ship v. Frey, 21 F.3d 782, 787 (7th Cir. 1994). Whatever the logical accuracy of that complaint, the court, acting through a different panel, affirmed the judgment for the defendants. Id. at 788.
16 Mkt. St. Assocs., 941 F.2d at 594.
17 Id. at 593.
18 See, e.g., Melvin A. Eisenberg, The Duty To Rescue in Contract Law, 71 FORDHAM L. REV. 647, 667–70 (2002) (recasting Market Street Associates as involving a duty to rescue, a doctrine Professor Eisenberg maintains is preferable to “good faith performance” because it is “more specific” and “easier to apply”).
course, the courts have responded to particular situations according to the context presented. Indeed, some lines of cases have become so driven by context that it is not clear whether they represent the overall doctrine; the good faith obligations of employers towards employees, for example, seem to have a life of their own.19

But even if we limit our view to cases of commercial relations between commercial parties, the scope of the duty of good faith performance is vague. Judge Posner’s opinion dealt with that problem by identifying various outer limits of the doctrine and rebounding off them. At its most capacious, he said, the doctrine of good faith invites comparison with the duties of a fiduciary — “required to treat his principal as if the principal were he”20 — but in an ordinary commercial case that would be going too far. “[I]t is unlikely that Wisconsin wishes, in the name of good faith, to make every contract signatory his brother’s keeper, especially when the brother is the immense and sophisticated General Electric Pension Trust . . . .”21 At its most restricted, the doctrine invites comparison of bad faith with the tort of fraud and its emphasis on intentionally harming the other party. But in considering good faith in performance, we are not just considering the general tort obligations we owe everyone; we are dealing with parties who are already linked together. “[C]onduct that might not rise to the level of fraud may nonetheless violate the duty of good faith in dealing with one’s contractual partners . . . .”22 What we are looking for, said Judge Posner, when we are trying to give content to the obligation of good faith, is something between these extremes.23

Not only is this an accurate analysis, but it also has the real virtue — for thinking about the problem and for presenting it to students — of grounding the inquiry in the doctrinal universe rather than just restating the general idea of “good faith” in other, equally fluffy, words. Even better, Judge Posner — building on an observation that is plainly true but often forgotten — provided us with a general view of why we are in this middle ground:

It is true that an essential function of contracts is to allocate risk . . . . But contracts do not just allocate risk. They also (or some of them) set in

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19 For an extreme statement of the employment-cases-are-different view, see *Morriss v. Coleman Co.*, 738 P.2d 841 (Kan. 1987), in which the court wrote:

[T]he majority of the court has concluded that the principle of law stated in *Restatement (Second) of Contracts* § 205, that every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement, is overly broad and should not be applicable to employment-at-will contracts.

Id. at 851.

20 *Mkt. St. Assocs.*, 941 F.2d at 593.

21 Id.

22 Id. at 594–95.

23 Id. at 595.
motion a cooperative enterprise, which may to some extent place one party at the other’s mercy. “The parties to a contract are embarked on a cooperative venture, and a minimum of cooperativeness in the event unforeseen problems arise at the performance stage is required even if not an explicit duty of the contract.” [Quoting a prior Judge Posner opinion.] The office of the doctrine of good faith is to forbid the kinds of opportunistic behavior that a mutually dependent, cooperative relationship might enable in the absence of rule.\(^{24}\)

So here is our problem. Contractual relationships are both cooperative and distributive. As performance progresses, we reach issues not directly addressed by the agreed terms. We want to enable cooperation to continue, we want to respect the parties’ allocation of risk as far as it goes, and we do not want to “place one party at the other’s mercy.” On the one side, there is the tort law of fraud to protect the innocent, but we want the contract doctrine to go further than that. On the other side, there is the law of fiduciary obligation, but in the case of ordinary commercial contracts we do not want the law to go that far. How do we further specify the doctrine of good faith in order to decide the actual case?

So far, so good. To this point, *Market Street Associates* offers what seems to me an excellent examination of the doctrine of good faith. But as to its treatment of the work still needed to reach a decision, I am more doubtful. Judge Posner cited a lot of cases, both from his own circuit and from common law “greats” like Cardozo, Hand, and Friendly. But he did not rely on any prior opinion as a precedent to be directly applied to the facts before him. Nor did he use the cases to build an analytical series covering the remaining middle ground. Rather, he offered us a general approach (which the cases were taken to illustrate) and a specific outcome.

Here are Judge Posner’s statements of the general approach: “The concept of the duty of good faith . . . is a stab at approximating the terms the parties would have negotiated had they foreseen the circumstances that have given rise to their dispute. The parties want to minimize the costs of performance. To the extent that a doctrine of good faith designed to do this by reducing defensive expenditures is a reasonable measure to this end, interpolating it into the contract advances the parties’ joint goal.”\(^{25}\) “The contractual duty of good faith is thus not some newfangled bit of welfare-state paternalism or . . . the sediment of an altruistic strain in contract law . . . .”\(^{26}\) “But whether we say that a contract shall be deemed to contain such implied condi-

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\(^{24}\) *Id.* (citation omitted) (quoting AMPAT/Midwest, Inc. v. Ill. Tool Works, Inc., 896 F.2d 1035, 1041 (7th Cir. 1990) (Posner, J.).

\(^{25}\) *Id.*

\(^{26}\) *Id.*
tions as are necessary to make sense of the contract, or that a contract obligates the parties to cooperate in its performance in ‘good faith’ to the extent necessary to carry out the purposes of the contract, comes to much the same thing. They are different ways of formulating the overriding purpose of contract law, which is to give the parties what they would have stipulated for expressly if at the time of making the contract they had had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero.”

And from the last of these general formulations, Judge Posner moved almost immediately to what was (as has already been mentioned) the court’s bottom line: “The dispositive question in the present case is simply whether Market Street Associates tried to trick the pension trust and succeeded in doing so.”

The connection between this general method and this specific conclusion seems unclear. Judge Posner’s own explanation of why “tried to trick” was the “dispositive” standard was that “this would be the type of opportunist behavior in an ongoing contractual relationship that would violate the duty of good faith performance however the duty is formulated.” But the trial judge did not deny that intentional trickery would be bad faith; what he claimed was that the duty went further, requiring the lessee (regardless of motive) to remind the lessor of paragraph 34 as a precondition to later claiming rights under it. To justify the Seventh Circuit’s reversal, it is not enough to allow that the duty of good faith goes as far as Judge Posner specified; one has to show that it goes no further. More is needed.

Suppose we try to fill in the missing reasoning; suppose we try, as Judge Posner said we should, “to give the parties what they would have stipulated for expressly.” What language would the parties have drafted ex ante to cover explicitly the situation that arose? Presumably the contract would still include paragraph 34 as it was written, providing for the lessee to ask the lessor to provide financing for improvements; requiring the lessor to give fair consideration to the request and negotiate in good faith over it; and including a stipulation to the effect that if the negotiations failed, the lessee would be entitled to repurchase the property at the original sales price plus six percent per year. As to whether the lessee would have to give the lessor notice of the lessee’s right to repurchase at a time that would allow the lessor to consider that possible outcome as part of its decision whether to provide the requested financing, there are three possibilities: yes, no, and

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27 Id. at 596.
28 Id.
29 Id.
30 Id.
maybe. These possibilities might be formulated as contractual provisions as follows:

Alternative (1) — have to notify: “Lessee shall be entitled to exercise said right to repurchase only if it has notified Lessor of its possible intent to exercise that right and has given Lessor a reasonable time to consider, in light of this notice, whether to provide financing as requested.”

Alternative (2) — do not have to notify: “Lessee shall be entitled to exercise said right to repurchase regardless of whether Lessor was aware of Lessee’s right or was notified of it by Lessee prior to the failure of negotiations over providing financing as requested.”

Alternative (3) — might have to notify: “Lessee shall be entitled to exercise said right to repurchase unless Lessor was unaware of that right when it refused to provide financing as requested and Lessor’s failure to be aware of said right resulted at least in part from Lessee’s tricky behavior.”

Now, it seems to me perfectly clear that if we imagine the parties actually drafting the contract, they would not use the third alternative. The sensible lessor might want the first clause as a protection against its own future carelessness, and the sensible lessee might want the second clause because it can only help make its rights more absolute; but neither side would negotiate for, or accept, the third clause because its operation depends on difficult-to-ascertain, otherwise-extraneous facts. It makes the rights of each party subject to the vagaries of determining what the lessor knew, what the lessee did, and in particular whether what the lessee did was “tricky.” Moreover, at least if the contract is being drafted with the participation of lawyers (and is it likely that we would get to a paragraph 34 if it were not?), the parties ought to take into account the substantial defect of the third alternative that, if litigation becomes necessary, a full trial will very likely be needed to resolve the relevant issues, whereas the effect of either of the other clauses can likely be resolved on summary judgment. Judge Posner’s statement that, under his approach — which is to say, under alternative 3 — “[t]he essential issue bearing on Market Street Associates’ good faith was Orenstein’s state of mind, a type of inquiry that ordinarily cannot be concluded on summary judgment,”31 is almost reason enough to say that the parties, ex ante, would not want to adopt his result.

It is perhaps a closer question whether the parties would choose clause (1), making notice an absolute prerequisite to the lessee’s right of repurchase, or clause (2), dispensing with notice altogether. What was the purpose of this right to repurchase, contingent as it was on the

31 Id. at 597–98.
lessor’s not providing further financing? It seems unlikely that it was included simply as a lottery ticket, a gamble on the future of the real estate market that the lessee might hope to win. Perhaps it was included to give the lessee a way to retrieve a mortgageable interest if the lessor failed to fund needed improvements. Perhaps it was included to give the lessor an incentive to make the loan. Requiring the lessee to give notice would be consistent with either of these purposes and would indeed further the second. As to costs, because the contract has a term of twenty-five years, there is a fair chance that personnel will change and no one on either side will actually remember the intricacies of the contract when a problem arises; there will have to be some search effort. But as the lessee itself has to know of paragraph 34 in order to assert its rights, there are no additional search costs involved in requiring it to notify the other side, and the actual cost of notification is trivial. Requiring both sides to do their own search seems more expensive. Finally, given the long time span for performance and the trivial cost of notification, it would more likely raise questions of trustworthiness during the negotiations for the lessee to negotiate for the right not to notify than for the lessor to ask for the right to be reminded. In short, if the role of the court is to give the parties what they would have stipulated had they addressed the matter, it seems that hypothetical clause (1) is the right one. But this clause, in effect, incorporates the trial judge’s view of the matter. In other words, if we follow out Judge Posner’s statement of the proper approach to questions of good faith, it seems that the result of the case should have been the opposite of what he concluded; he should have affirmed rather than reversed.32

What is going on?

If, with Judge Posner, we start from the proposition that the doctrine of good faith is bounded on one side by intentional tort obligations and on the other side by fiduciary duties, the terrain left in the middle is very large. In it, we will find cases that are close to the tort boundary, although not quite actionable unless the parties are in a contractual relationship. These are cases, for example, in which bad faith is found in a party’s deliberate use of some power it has to undercut the benefit that would in due course come to the other party from the relationship. A traditional example is Patterson v. Meyerhofer,33 in which Meyerhofer, having agreed to buy from Patterson real estate

32 I should note that, although framed in different terms, Professor Chirelstein’s discussion suggests the parties might reject clause (3) in favor of clause (2). See CHIRELSTEIN, supra note 6, at 119–20.
that she knew he was going to first buy at auction, went to the auction herself and bought it directly, thus preventing him from earning the potential profit. A little further from the tort boundary we will see cases in which, regardless of motive, bad faith is found in one party’s failure to make an effort needed to bring forth a benefit assigned to the other party. If, for example, a sale of real estate is subject to the buyer’s getting financing on stated terms, it is an actionable violation of the duty of good faith for the buyer not to apply to at least some banks or mortgage companies that might provide it.34 Closer to the fiduciary end of the scale we will see cases in which the court tries to even up the risks and benefits of the relationship while sticking fairly close to the commercial understanding (if not the language) of the parties’ deal. Some of these are U.C.C. cases,35 but probably the most famous case in this category is Judge Cardozo’s common law opinion in Wood v. Lucy, Lady Duff-Gordon.36 There, the court implied an obligation for an agent to use best efforts to promote his client’s wares in exchange for being given an exclusive license to be paid for by a sharing of revenues. Finally, still within the realm of commercial contracts but right up against the fiduciary boundary, we will find cases in which courts treat the in-fact relationship of the parties as being something of a marriage, with the benefits and vicissitudes of the marketplace to be shared between them.37

At points Judge Posner seemed to recognize the breadth of this continuum, or at least he discussed, without objection, cases that exemplify many points on it.38 But he also clearly rejected the portion of this continuum that comes closest to resembling the law of fiduciaries: “[E]ven after you have signed a contract, you are not obliged to become an altruist toward the other party.”39 What appears then to have happened, if we reconstruct the force field of the opinion, is that Judge Posner’s rejection of the point closest to the law of fiduciaries drove him to conclude that the correct stance was the point closest to the law of torts — the point that requires a bad, even if not tortious, intent. In other words, Judge Posner seemed to be saying that because we do not want to treat the parties as being in a sharing relationship, the only ground for relief is if one party tried to “trick” the other.

36 118 N.E. 214 (N.Y. 1917).
37 See, e.g., Parev Prods. Co. v. I. Rokeach & Sons, Inc., 124 F.2d 147 (2d Cir. 1941).
38 See Mt. St. Assocs., 941 F.2d at 596 (citing cases in which some positive cooperation was required in order to establish benefit for the other party, a case in which a requirements contract was interpreted not to place a large risk on one party, and Wood v. Lucy, Lady Duff-Gordon).
39 Id. at 594.
Whatever its force as a rhetorical trope, this analysis-by-ricochet does not logically follow. Because there are possibilities intermediate between sharing and intentional undercutting, the denial of the one does not suffice to establish the other. Because the trial judge chose one of these intermediate possibilities, imposing an obligation on one party without regard to motive in order to facilitate the other party’s knowing performance, that logical lacuna matters. Because the hypothetical-bargain methodology that Judge Posner suggested also does not produce his result, some further force must be at work.

These considerations lead me to suggest that, although Judge Posner put the matter largely in economic and party-bargain terms, the opinion was driven more than it appears by his sense of the possibilities and flaws of the legal process. The only textual support for this suggestion is the statement he made at one point that “[i]t would be quixotic as well as presumptuous for judges to undertake through contract law to raise the ethical standards of the nation’s business people.” Admittedly, that statement is ambiguous. It might be read simply to say that judges should try to give the parties what they (and not the judges) would have wanted. But it might also be read as evincing a fear that if judges (perhaps especially trial judges) are not restrained, they will not be very good at creating implied terms; even if appellate courts tell them to aim only to give the parties what they would have wanted, judges’ natural tendency will be to state a higher standard. Or, to put the matter more particularly, perhaps Judge Posner favored the reading of the obligation of good faith nearest to intentional tort — the outlaw-tricky-behavior reading — because he thought it would yield the best results overall when implemented by the courts.

The point is not simply that Judge Posner may have generalized, that he might have been concerned with the proper scope of good faith in the run of cases and not just in the particular instance he faced. The claim that business people do not expect from each other actions that facilitate each other’s required performances, and only expect their partners not to be “tricky,” is not always wrong, but in the view recognized by many prior cases it is wrong often enough that we ought not ground a doctrine on it.

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40 I should, however, report that Professor James White seems to approve of Judge Posner’s analysis of good faith in these terms, although discussing opinions other than Market Street Associates. James J. White, Good Faith and the Cooperative Antagonist, 54 SMU L. REV. 679, 693–94 (2001).

41 Mkt. St. Assocs., 941 F.2d at 595.

42 See, for example, 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.6 (3d ed. 2004), and the cases cited therein.
Rather, the point is that Judge Posner’s statement might rest on the proposition that policing really smelly behavior is the most that judges can reliably and usefully do — on an assessment, that is, of judicial capabilities rather than of actual commercial practice. That claim, in turn, might come from a belief that, all things considered, trial judges are usually better at understanding interpersonal human relations than they are at decoding the workings of commercial relationships, so that their creation of implied terms in the latter situations will be unreliable. Or it might come from a belief that it is better to set the default rule of good faith at a minimal level in order to put pressure on commercial parties to specify their expectations up front, rather than to have them rely on the judges after the fact, because even if the judges are competent, the parties are more competent. Or it might come from both of these beliefs. These claims would support the result in Market Street Associates, although whether Judge Posner, or the panel, thought about them must remain a matter of speculation.

In a recent article, The Law and Economics of Contract Interpretation, Judge Posner — perhaps I should say, Scholar Posner — addresses these themes at substantial length and with considerable subtlety. While Market Street Associates is cited, it is not specifically discussed, and direct extrapolation from the article to the case is not possible. Nonetheless, the article is notable for rejecting the view (which Scholar Posner identifies as “formalist” or “textualist”) that judges should always put pressure on parties to specify the terms of their deals, instead embracing an analysis that weighs the transaction costs and possible error costs of after-the-fact gap filling against what may often be the greater negotiation and drafting costs of specifying the proper treatment of low-probability situations ex ante. And while the article is uncertain about the ability of American courts to continue to attract senior practitioners to judgeships, it is also notable for its emphasis on the degree to which American judges (in contrast to those in many other countries) do have substantial practical, and often commercial, experience.

To me, these points suggest a more welcoming attitude towards the idea that judges should be in the business of furnishing the terms needed for smooth and useful cooperation between contractual parties than the opinion in Market Street Associates Ltd. Partnership v. Frey suggests. Because no specific precedent closely bound the court in that case, there would appear to be no reason (other than that time runs in

44 Id. at 1604 n.53.
45 See id. at 1584.
46 See id. at 1611–12.
only one direction) that Judge Posner then could not borrow from Scholar Posner now. Or, in other words, perhaps if he had to do it over again, Judge Posner would write an opinion that would affirm, rather than reverse, the trial judge. Or if not that, perhaps he would at least discuss the case in terms of what judges can best do, rather than in terms of what parties might have bargained.