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ARTICLE

THE REGRESSION OF “GOOD FAITH” IN MARYLAND COMMERCIAL LAW

By: **Lisa D. Sparks, Esq.***

“Good faith,” in the affirmative or as the absence of bad faith, has always been a challenge to define and judge as a matter of conduct, motive, or both. Different tests apply a subjective standard, an objective standard, or even a combination of the two. Some parties may be held to different expectations than others. This determination of good faith has always been fact-driven and somewhat transcendental. Until recently, however, the question invoked a construct of fairness, resting on a two-pronged metric, at least insofar as several key titles of the Maryland Uniform Commercial Code were concerned. Since June 1, 2012, the various Maryland Uniform Commercial Code definitions of good faith have been stripped to the bare, subjective “honesty in fact.”¹ The ramifications of this deviation from the Uniform Law Commission’s² promulgated Uniform Commercial Code (“UCC”) and decades of jurisprudence with consistency among most states have yet to unfold; the bench and bar are just discovering the change. This comment explores how this occurred and what the potential consequences are and also recommends remediation of Maryland’s statutory language to conform to the UCC.

I. A HISTORICAL PERSPECTIVE

The Maryland Uniform Commercial Code was enacted in 1963, with an effective date of February 1, 1964.³ It later became the nine leading titles of the Commercial Law Article, along with ten other non-uniform titles in the recompilation and reorganization of the Annotated Code of Maryland in 1975.⁴ Over time, the Commercial Law Article has expanded to 23 titles in

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¹ H.B. 700, 2012 Leg., 430th Sess. (Md. 2012).

² The Uniform Law Commission is also known as the National Conference of Commissioners on Uniform State Laws.

³ H.B. 671, 1963 Leg., Ch. 538 (Md. 1963).

⁴ 1975 Md. Laws Ch. 49. The current sequence of MUCC titles is: Title 1: General Provisions; Title 2: Sales; Title 2A: Leases; Title 3: Negotiable Instruments; Title 4: Bank Deposits and Collections; Title 5: Letters of Credit; Title 6: Bulk Transfers;

all.⁵ Titles 1-10 are commonly referred to as the Maryland Uniform Commercial Code⁶ (“MUCC”). As is the case with most uniform codes and comprehensive statutory schemes, Title 1 provides general provisions, including definitions, governing the remaining titles.⁷ The definition of good faith in Title 1 was then, as it remains today, “*honesty in fact in the conduct or transaction concerned*.”⁸

As Maryland adopted the Uniform Law Commission’s additions and revisions to various articles, additional definitions for good faith emerged. Titles 2 and 2A, governing the sales and leases of goods, added a separate provision for merchants: “good faith in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”⁹ This notion of commercial standards spread to Titles 3 (Negotiable Instruments) and 4 (Bank Deposits and Collections) in 1996 following Maryland’s adoption of the 1990 UCC revisions, but covered all parties involved as opposed to just merchants.¹⁰ Official comment 4 to UCC section 3-103 explained the significance and intent surrounding the use of this expanded, two-part definition in the title governing negotiable instruments:

Subsection (a)(4) introduces a definition of good faith to apply to Titles 3 and 4. Former Titles 3 and 4 used the definition in Section 1-201(19). The definition in Subsection (a)(4) is consistent with the definitions of good faith applicable to Title 2, 2A, 4, and 4A. The definition requires not only honesty in fact, but also “observance of reasonable commercial standards of fair dealing.”¹¹

Title 7: Documents of Title; Title 8: Investment Securities; and Title 9: Secured Transactions.

⁵ Title 10 is an administrative title, Effective Date and Repealer, for amending Titles 1-9. Titles 11-23 cover a wide range of additional commercial matters, including trade regulation, credit, consumer protection, regulation of certain industries, debt collection, and certain electronic transactions.

⁶ MD. CODE ANN., COM. LAW § 1-101(a) (2013).

⁷ The UCC designates its numbered components as articles. Because the Annotated Code of Maryland is already divided into subject matter articles, the MUCC is broken down into titles. The numbering, however, is nearly identical and the labels “article” and “title” are often used interchangeably in Maryland case law.

⁸ MD. CODE ANN., COM. LAW § 1-201(b)(20) (2013); MD. CODE ANN., COM. LAW § 1-201(19) (2002 Repl. Vol.); MD. CODE, Art. 95B, § 1-201(19) (1957).

⁹ MD. CODE ANN., COM. LAW §§ 2-103(1)(b), 2A-103(3) (2002 Repl. Vol.).

¹⁰ 1996 Md. Laws Ch. 91.

¹¹ MD. CODE ANN., COM. LAW § 3-103, cmt. 4 (2002 Repl. Vol.).

Title 4’s definition section was revised to simply relate back to the expanded definition in Title 3 so that the good faith considerations for negotiable instruments and check collection processes were consistent.¹² Title 4A, regarding wire funds transfers, used the same language as Title 3.¹³ Title 8, governing investment securities, also picked up the two-pronged definition of good faith.¹⁴

In a provision of far narrower applicability, section 7-404 provides immunity for bailees who deliver or dispose of goods in accordance with a document of title so long as they acted “in good faith including observance of reasonable commercial standards.”¹⁵ According to this section’s official comment, “[t]he generalized test of good faith and observance of reasonable commercial standards is substituted for the attempt to particularize what constitutes good faith in the . . . old uniform acts.”¹⁶

The net effect of these scattered provisions was that all transactions governed by the MUCC were conducted under a general obligation of subjective good faith.¹⁷ For particular parties and transactions, an objective standard was overlaid, applying a rule-based measure of compliance.¹⁸ It is important to note that Maryland law does not recognize an independent cause of action for breach of the duty of good faith in the MUCC or otherwise.¹⁹ Instead, the prescribed duty of good faith applies in the context of the performance or enforcement of an obligation arising under the MUCC.²⁰

A. MARYLAND’S 2012 LEGISLATION

In 2012, the Maryland General Assembly unanimously adopted various revisions to the MUCC. Many of the amendments were a belated adoption of the Uniform Law Commission’s 2001 revisions to Article 1.²¹ House Bill 700 titled “Commercial Law – Uniform Commercial Code – Revisions to Title 1” stated this purpose:

¹² *Id.* at § 4-104(c).

¹³ *Id.* at § 4A-105(a)(5) cmt. 3.

¹⁴ *Id.* at § 8-102(a)(10).

¹⁵ *Id.* at § 7-404.

¹⁶ *Id.*

¹⁷ MD. CODE ANN., COM. LAW § 1-203 (“Every contract or duty within Titles 1-10 of this article imposes an obligation of good faith in its performance or enhancement.”). This provision has been stylistically edited and moved to § 1-304.

¹⁸ MD. CODE ANN., COM. LAW §§ 2-103(1)(b), 2A-103(3), 3-103(a)(4), 4-104(c), 4A-105, 7-404, 8-102 (2002 Repl. Vol.).

¹⁹ *See* Howard Oaks, Inc. v. Md. Nat’l Bank, 810 F. Supp. 674, 677 (D. Md. 1993).

²⁰ MD. CODE ANN., COM. LAW § 1-304 cmt. 1 (2002 Repl. Vol.).

²¹ *See* U.C.C §§ 1-101 – 1-310 (2001).

[R]evising, updating, reorganizing, and clarifying Title 1 of the Maryland Uniform Commercial Code (MUCC) relating to general provisions applicable to the MUCC; establishing a certain short title; clarifying the transactions to which Title 1 of the MUCC applies; . . . making certain stylistic changes; defining certain terms; altering and repealing certain definitions; making conforming changes to certain provisions of the MUCC; and generally relating to the Maryland Uniform Commercial Code.²²

House Bill 700's reach went far beyond Title 1, however, amending sections of Titles 1, 2, 2A, 3, 4, 4A, 5, 8, and 9.²³

In its original form, as proposed and first read in the House Economic Matters Committee on February 8, 2012, House Bill 700 included this Title 1, § 1-201 definition: "(20) 'Good faith', except as otherwise provided in Title 5 of this article, means honesty in fact and the observance of reasonable commercial standards of fair dealing."²⁴ This revision, bringing an objective component to the general definition governing all titles, save Title 5 by express exclusion, rendered the corresponding definitions scattered throughout the MUCC redundant and unnecessary. Sections 2-103(1)(b), 3-103(a)(4), 4A-105(a)(6), and 8-102(a)(10) were deleted in their entirety and marked with "Reserved" placeholders.²⁵ Sections 2A-103(3) and 4-104(c) were similarly deleted by virtue of their aforementioned reference sections being deleted. House Bill 700, as originally drafted, tracked the Uniform Law Commission's 2001 revisions to Article 1.²⁶

²² H.B. 700, 2012 Leg., 430th Sess. (Md. 2012); *see also* 2012 Md. Laws Ch. 673 (the stated purpose remained the same from proposal through enactment).

²³ H.B. 700, 2012 Leg., 430th Sess. (Md. 2012) (repealing, reenacting, and amending §§ 1-101 – 1208, 2-103, 2-202, 2A-103, 2A-501, 2A-518, 2A-519, 2A-527, 2A-528, 3-103, 4-104, 4A-105, 4A-106, 4A-204, 5-103, 8-102, 9-102).

²⁴ *Id.*

²⁵ MD. CODE ANN., COM. LAW §§ 2-103(1)(b), 3-103(a)(4), 4A-105(a)(6), 8-102(a)(10) (2013).

²⁶ The Uniform Law Commission's Reporter's Notes elaborate on the rationale for consolidating the definition of good faith in Article 1. "Reasons for change. Current UCC section 1-201(19) defines 'good faith' simply as honesty in fact; the definition contains no element of commercial reasonableness. Initially, that definition applied throughout the Code with only one exception. UCC section 2-103(1)(b) provided that 'in this Article' 'good faith in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.' This alternative definition was limited in applicability . . . Over time, however, amendments to the UCC brought the Article 2 concept of good faith (subjective honesty and objective reasonableness) into other Articles. First, Article 2A explicitly incorporated the Article 2 standard. *See* U.C.C. section 2A-103(7). Then, other Articles broadened the applicability of that standard by adopting it for all parties

The Revised Fiscal Policy Note attached to House Bill 700 demonstrates a fundamental misunderstanding of the multiple definitions of good faith, which existed throughout the MUCC prior to the 2012 revisions.²⁷ In the “analysis” portion of the report, a bill summary provides that “[t]he bill alters the definition of good faith to mean honesty in fact in the conduct or transaction concerned.”²⁸ In the “current law” segment, the report cites that “‘Good faith’ is defined as honesty in fact in the conduct or transaction concerned.”²⁹ There is no alteration in that language. Furthermore, no mention is made of the deletion of other sections and definitions of good faith.

Two letters of support, or written testimony, were received by the Economic Matters Committee. Both supporters were responding to the version of House Bill 700 that expanded the definition of good faith to include an objective standard in order to promote fairness and consistency. One letter from the Maryland Commission on Uniform State Laws urged the adoption of the updates presented in House Bill 700 (as well as House Bill 713, affecting Title 9 only³⁰) to make the MUCC “consistent with the most recent revisions of the UCC Articles 1 and 9[,]” especially where the Article 1 updates “have already been enacted by all but a handful of states.”³¹ The testimony makes clear that the Maryland Commission on Uniform State Laws was in favor of the inclusion of an objective standard in the Title 1 definition of good faith, citing that provision specifically and in detail: “Revised Definition of Good Faith – Reasonable commercial standards are added to definition of ‘good faith’, providing an objective and fairer standard for courts to enforce to obligations and duties set forth in the various articles of the UCC.”³²

A second letter supporting adoption was submitted by the Uniform Commercial Code Subcommittee of the Business Law Section of the

rather than just for merchants. *See, e.g.*, U.C.C. sections 3-103(a)(4), 4A-105(a)(6), 8-102(a)(10). . . and of revised sections 2-102(a)(24) (Sept. 1996 draft) and 9-105(a)(18) (Annual Meeting draft). All of these definitions are comprised of two elements - honesty in fact and the observance of reasonable commercial standards of fair dealing. . . . Given this near unanimity, it is appropriate to move the definition of ‘good faith’ to Article 1.” U.C.C. § 1-201 reporter’s notes.

²⁷ H.B. 700, 2012 Leg., 430th Sess. (Md. 2012) (Revised Fiscal and Policy Note).

²⁸ *Id.*

²⁹ *Id.*

³⁰ H.B. 713, 2012 Leg., 430th Sess. (Md. 2012).

³¹ Letter from Steven N. Leitess, Comm’r, Md. Comm’n on Unif. State Laws, to Del. Brian Feldman, Md. H.D. (Feb. 17, 2012) (on file with the Md. Dep’t of Legislative Servs.).

³² *Id.*

Maryland State Bar Association.³³ This group also pressed for consistency with updates to the UCC.³⁴ This letter's summary of the addition of reasonable commercial standards to the Title 1 good faith definition was identical to the one in the first letter.³⁵ The author of this letter appeared before the committee hearing on February 21, 2012. It is unclear whether he gave testimony, but he did indicate that he was in favor of the legislation.

The only other witness who registered at the February 21, 2012 hearing before the Economic Matters Committee was a representative of the Maryland Bankers Association,³⁶ who indicated by checking a box that his testimony was favorable with amendments.³⁷ An amendment was indeed introduced at some point during this committee hearing.³⁸ The amendment struck the objective, reasonable commercial standards language in the Title 1 good faith definition, essentially reverting back to honesty in fact.³⁹ This amendment did not maintain the status quo, because no effort was made to restore the existing two-part definitions of good faith in Titles 2, 2A, 3, 4, 4A, and 8.⁴⁰ With this single amendment, which was passed by the House of Delegates following a second reading on March 17, 2012, the net effect of House Bill 700 was to strip away the objective standard of good faith in the MUCC.⁴¹ The annotations do not contain legislative history notes to explain the purpose or intent of this revision. Moreover, the published comments in the annotations are in line with the UCC and do not explain Maryland's departure from the uniform language.⁴²

³³ Letter from K. Lee Riley, Jr., Chair, Unif. Commercial Code Subcomm., Bus. Law Section, Md. State Bar Ass'n, to Del. Brian Feldman, Md. H.D. (Feb. 21, 2012) (on file with the Md. Dep't. of Legislative Servs.).

³⁴ *Id.*

³⁵ The inclusion of identical summaries of the proposed Title 1 good faith definition revision by both supporters suggests that the language appeared in the original Fiscal and Policy Note in the bill summary section. The original report is not available in the bill file for comparison or verification.

³⁶ The finance and banking industry is the most likely to oppose the application of an objective standard. See Patricia L. Heatherman, Comment, *Good Faith in Revised Article 3 of the Uniform Commercial Code: Any Change? Should There Be?*, 29 WILLAMETTE L. REV. 567, 590 (1993).

³⁷ *Hearing on H.B. 700 Before the H. Comm. on Econ. Matters*, 2012 Leg., 430th Sess. (Md. 2012) (witness sign-up sheet).

³⁸ ECONOMIC MATTERS COMMITTEE, AMENDMENT TO HOUSE BILL 700, H.B. 700-863493-1, 2012 Leg., 430th Sess. (Md. 2012).

³⁹ *Id.*

⁴⁰ *Id.* Recall that prior to House Bill 700, several titles of the MUCC contained their own definitions of "good faith" including, in some titles, an objective component.

⁴¹ H.B. 700, 2012 Leg., 430th Sess. (Md. 2012) (codified at MD. CODE ANN., COM. LAW § 1-201(b)(20) (2013)).

⁴² See, e.g., MD. CODE ANN., COM. LAW §§ 1-201 cmt. 20, 3-103 cmt. 4, 7-404 cmt. (2013).

II. THE SUBJECTIVE VS. OBJECTIVE DEBATE

The distinction between a pure subjective (honesty in fact) and an objective (compliance with some standard(s)) methodology for good faith determinations is more than just semantics and represents a substantive divergence in applicable law - leading to different outcomes. The debate between these two competing options is not, however, new. Courts have grappled with how best to judge a party’s conduct on a continuum as long as commercial cases have been litigated.⁴³ Indeed, both tests date back to early nineteenth century English cases.⁴⁴ In recent history, the 1990 UCC revisions expanding the definition of good faith in Article 3 sparked a broader conversation in the context of negotiable instruments and good faith’s role in the requirements for a holder in due course.⁴⁵

The purely subjective approach, i.e., honesty in fact, translates roughly to a proscription on intentional misrepresentation. Others have characterized this as the “pure heart and empty head” or even “innocent simpleton” test.⁴⁶ At one time, the subjective test was considered the majority rule because of its applicability across the entire UCC and because some states had declined to adopt the 1990 revisions to Article 3 that borrowed an objective prong from Article 2’s heightened obligations for merchants.⁴⁷

The objective standard, which is always coupled with the subjective standard, is reminiscent of negligence, in that, it introduces a test of reasonableness.⁴⁸ Moreover, the benchmark of “commercial standards” is flexible to meet the spectrum of parties and transactions to which it is

⁴³ See, e.g., *Price v. Neal*, (1762) 97 Eng. Rep. 871, 873 (K.B.); 3 Burrow. 1354, 1356-7 (“He denied it to be a payment by mistake: and insisted that it was rather owing to the negligence of the plaintiff; who should have inquired and satisfied himself ‘whether the bill was really drawn upon him by Sutton, or not.’ Here is no fraud in the defendant; who is stated ‘to have acted innocently and bona fide, without the least privity or suspicion of the forgery; and to have paid the whole value for the bills.’ . . . Here was no fraud: no wrong. It was incumbent upon the plaintiff, to be satisfied ‘that the bill drawn upon him was the drawer’s hand,’ before he accepted or paid it: but it was not incumbent upon the defendant, to inquire into it”); see also *State Sec. Check Cashing, Inc. v. Am. Gen. Fin. Servs.*, 409 Md. 81, 93-94, 972 A.2d 882, 889-890 (2009) (examining the obligations of a check cashing facility who later asserts holder in due course status).

⁴⁴ *Gill v. Cubitt*, (1824) 107 Eng. Rep. 806 (K.B.) (objective standard); *Lawson v. Weston*, (1801) 170 Eng. Rep. 640, 641 (subjective standard).

⁴⁵ See generally Heatherman, *supra* note 37, at 569 (discussing the expansion of good faith in Article 3 of UCC); see also U.C.C. §3-103(a)(4) (1990).

⁴⁶ Heatherman, *supra* note 37, at 569.

⁴⁷ *Id.* at 590.

⁴⁸ *Id.* at 584.

intended to apply, much like a tort duty.⁴⁹ The drafters of the UCC took care, however, to reject the notion that they intended for a negligence standard to apply:

Although fair dealing is a broad term that must be defined in context, it is clear that it is concerned with the fairness of conduct rather than the care with which an act is performed. Failure to exercise ordinary care in conducting a transaction is an entirely different concept than failure to deal fairly in conducting the transaction. Both fair dealing and ordinary care, . . . are to be judged in the light of reasonable commercial standards, but those standards in each case are directed to different aspects of commercial conduct.⁵⁰

The goal of a combined subjective-objective standard of good faith is to balance the protection of innocent parties with the temptation to be willfully ignorant. In specifying commercial standards, which are only reasonable, the UCC drafters have artfully avoided creating too high a standard that reflects best practices or the most possible fairness. Moderating the test with reasonableness also allows adjustment to the relevant parties and their respective levels of sophistication.

III. RAMIFICATIONS OF THE CURRENT LAW

Maryland is now one of only a few states without the two-pronged subjective-objective definition of good faith in its enactment of UCC Article 1.⁵¹ This undermines the essential purpose of uniform laws, which is to establish as much consistency among states as possible. This is especially important for commercial law matters which often stretch across state borders and may invoke the laws of multiple jurisdictions within the same dispute. Contract drafters, including lenders and merchant sellers who tend to require their own forms and terms, may be enticed to insert choice of law

⁴⁹ *Id.* at 585; *see also* U.C.C. § 3-103(a)(7) (1990) (adding a definition for ordinary care for those engaged in business: “observance of reasonable commercial standards, prevailing in the area in which the person is located with respect to which the person is engaged . . .”).

⁵⁰ U.C.C. § 3-103 cmt 4 (2002); *see also State Sec. Check Cashing, Inc.*, 409 Md. at 95, 976 A.2d at 890 (instructing that reasonable commercial standards of fair dealing are about fairness and not negligence).

⁵¹ Missouri has yet to adopt any of the 2001 revisions to UCC Article 1. A few additional states have enacted non-uniform provisions. For example, Florida has maintained subjective good faith for non-merchants in Article 2A only. *See* FLA. STAT. §§ 672.103(1)(b), 680.1031(1)(a) (2010).

provisions utilizing Maryland law, which holds them to the lowest standards. Forum shopping is also a possibility.

The inconsistencies between certain MUCC provisions and the explanatory annotations will cause confusion among judges and practitioners attempting to utilize, argue, and enforce these provisions.⁵² Of most concern is the lengthy comment about the expansion of the definition of good faith following section 1-201.⁵³ While the text remains just “honesty in fact,” the comment erroneously explains, in part:

Thus, the definition of “good faith” in this section merely confirms what has been the case for a number of years as Articles of the UCC have been amended or revised – the obligation of “good faith,” applicable in each Article, is to be interpreted in the context of all Articles except for Article 5 as including both the subjective element of honesty in fact *and the objective element of the observance of reasonable commercial standards of fair dealing*. As a result, both the subjective and objective elements are part of the standard of “good faith,” whether that obligation is specifically referenced in another Article of the Code (other than Article 5) or is provided by this Article.⁵⁴

Additionally, upon reliance on a revised Title 1 definition, section 7-404 was revised to remove the expanded subjective-objective description of good faith.⁵⁵ The official comment now inexplicably reads, “This section uses the test of good faith, as defined in Section 1-201, to continue the policy of former 7-404. Good faith now means ‘honesty in fact and the observance of reasonable commercial standards of fair dealing.’”⁵⁶ Thus, the policy of section 7-404 has been changed without an accurate explanation or rationale.

Only a handful of published cases have addressed MUCC issues and mentioned good faith since the revisions went into effect on June 1, 2012.⁵⁷ None have hinged on a determination of good faith for their outcomes. Over time, however, good faith issues will be litigated and courts will be left without the benefit of precedent to guide their analysis of good faith issues,

⁵² See *supra* note 44.

⁵³ MD. CODE ANN., COM. LAW § 1-201 cmt. 20 (2013).

⁵⁴ *Id.* (emphasis added).

⁵⁵ *Id.* at § 7-404 cmt. (2013).

⁵⁶ *Id.*

⁵⁷ See *Great Am. Ins. Co. v. Nextday Network Hardware Corp.*, 73 F. Supp.3d 636 (D. Md. 2014); *Thompkins v. Mountaineer Inv., LLC*, 439 Md. 118, 94 A.3d 61 (2014).

likely leading to inconsistent outcomes and a tangled web of confused case law.

An anticipated area where this change in definition, and therefore standards of conduct, will have some impact is the establishment of holder in due course status. The exercise of good faith is a key requirement for holder in due course status.⁵⁸ In the current market, banks and check cashing facilities are the most likely players to assert holder in due course status as to instruments because few people negotiate promissory notes and checks otherwise. Under the prior good faith definition in MUCC section 3-103, which required, in addition to honesty in fact, “observance of reasonable commercial standards of fair dealing,” these institutions were expected to act and inquire according to what a reasonable party in their position would do.⁵⁹ Now, banks and check cashing institutions are treated the same as consumers and other unsophisticated parties, held to no higher expectations of fairness notwithstanding their superior knowledge, skill and access to information.⁶⁰ This regression of banks’ obligations is further illustrated in the context of shifting losses where there has been negligence under MUCC section 3-406.⁶¹ In practice, that rule precludes a negligent customer from asserting an alteration or forgery against his bank to obtain a re-credit, but only if the bank paid the instrument, took it for value or took it for collection *in good faith*. If the bank does not exercise good faith, it cannot enforce the preclusion.⁶² Where good faith is as simple as “honesty in fact,” unfortunately, the bank will almost always be found to have exercised it.

⁵⁸ MD. CODE ANN., COM. LAW § 3-302(a)(2)(ii) (2013).

⁵⁹ MD. CODE ANN., COM. LAW §3-103 (2002 Repl. Vol.).

⁶⁰ See *In re Nieves*, 648 F.3d 232, 239-240 (4th Cir. 2011) (“We therefore arrive at the conclusion that the objective good-faith standard probes what the transferee knew or should have known, taking into consideration the customary practices of the industry in which the transferee operates” (internal citation omitted)).

⁶¹ MD. CODE ANN., COM. LAW § 3-406(a) (2013).

⁶² *Id.*