Boundaries of Extracompensatory Relief for Abusive Breach of Contract, The

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The Boundaries of Extracompensatory Relief for Abusive Breach of Contract

NICHOLAS J. JOHNSON*

I. INTRODUCTION

The idea of extracompensatory damages for abusive breach of contract presents a fundamental conflict. Contract doctrine aims to facilitate exchanges. Extracompensatory damages are disincentives. These aims are essentially irreconcilable. And traditionally the goal of facilitating exchanges has trumped any interest in punishing bad conduct. But there is a lingering sense that sometimes a proportionate response to bad conduct surrounding breach requires more than the traditional measure of damages.

At the edges of contract doctrine, two notable experiments manifest the sense that some breaches demand more than compensatory damages. One, the failed California experiment with bad faith breach, permitted the plaintiff to collect punitive damages for defendant's "bad faith" denial of the existence of a contract. Criticism of the bad faith breach was rife. Lower

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1. I use "abusive breach" here to capture the various articulations of bad behavior surrounding breach; e.g., bad faith breach, tortious breach, and willful, opportunistic breach. I use "extracompensatory" damages to connote not only punitive damages, but expanded (tort measure) consequential damages of the type that some propose as a better choice than punitive damages. See, e.g., Thomas A. Diamond & Howard Foss, Proposed Standards for Evaluating When the Covenat of Good Faith and Fair Dealing Has Been Violated: A Framework for Resolving the Mystery, 47 HASTINGS L.J. 585, 585-86 (1996).


Courts and commentators seem to have used the terms "tortious breach" and "bad faith breach" interchangeably to describe the decision to award punitive damages for violation of the implied covenant of good faith. See James H. Cook, Comment, Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case, 71 IOWA L. REV. 893, 894 n.12 (1986).

courts had difficulty drawing even rough boundaries around the concept and split over many questions. The California Supreme Court ended the confusion in a 1995 decision scuttling the bad faith breach.

Another experiment, allowing the award of punitive damages against insurance companies for bad conduct breaches, is an enduring exception to the general bar on extracompensatory damages in contract law. The model case is a denial of coverage on some specious pretext.

With the failure of the California experiment, we are tempted by basic tenets of contract doctrine to dismiss the insurance cases as singular aberrations in a doctrine that properly limits recovery for breach to what we loosely call compensatory damages. It is easy to understand the traditional response to breach of contract as a necessary element of our core commitment to making the cost of contracting—viz., the price of breach—certain and predictable. This predictable exit price limits the risk of making promises and encourages trading. Any escalation of damages for bad conduct or otherwise would raise the cost of promise-breaking and thus discourage exchanges. Because it is difficult to harmonize extracompensatory damages with this formula, courts typically refuse to award punitive damages for breach of contract and narrowly limit consequential damages to those that were easily contemplated when the deal was


5. See Robert L. Rancourt, Jr., Note, Freeman & Mills, Inc. v. Belcher Oil Co.: Yes, The Seaman’s Tort is Dead, 27 PAC. L.J. 1405, 1406-07 (1996) (illustrating the disagreement as to whether to expand the concept of bad faith breach to include bad faith assertion of a defense to breach and whether bad faith breach was grounded on the implied covenant of good faith or an expanded view of tort liability).


8. For a representative description of the insurance cases, see Roger C. Henderson, The Tort of Bad Faith in First-Party Insurance Transactions After Two Decades, 37 ARIZ. L. REV. 1153 (describing liability for punitive damages as being triggered by outright refusals to pay, delays, misinterpretation of records or policies for the purpose of defeating coverage, using threats to force unfair settlement, falsely accusing the insured of wrongdoing, etc.). See also Douglas R. Richmond, An Overview of Insurance Bad Faith Law and Litigation, 25 SETON HALL L. REV. 74, 74-76 (1994) (examining insurance bad faith law and litigation in both the third-party and first-party contexts); Chris Michael Kallianos, Comment, Bad Faith Refusal to Pay First-Party Insurance Claims: A Growing Recognition of Extra-Contract Damages, 64 N.C. L. REV. 1421 (1986) (describing factors that should be present in insurance and non-insurance tortious breach cases before extracompensatory damages are assessed).


11. See Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460 (Cal. 1994) (limiting damages to those reasonably foreseeable at the time of contracting encourages exchanges by allowing parties to accurately gauge the risk of contracting at the outset).
Compensatory damages, the argument goes, are as close to optimal as we are likely to get. This tempts us to dismiss the insurance cases as aberrations and to view the California experiment as confirmation that extracompensatory damages are not compatible with contract doctrine.

But have we been too quick to dismiss these experiments with extracompensatory damages? Are the insurance cases really so specialized that they offer no general lessons about responding to abusive breach? Was the California experiment so flawed that nothing useful can be salvaged from it?

This Article shows that a unified analysis of the two efforts yields an insight that delineates our capacity to respond to abusive breach. Considered together, they show that rules punishing abusive breach with extracompensatory relief are indeed viable so long as their impact is limited to subcategories that are conceptually and practically severable from the general pool of transactions. Severability is the core requirement of any workable extracompensatory response to abusive breach. If we respect it, then we can punish subcategories of abusive breach with aggressive disincentives. Failure to respect severability will violate the basic aims of contract doctrine by leaking collateral risk into the general pool of transactions, thus discouraging exchanges.

The severability insight yields several lessons that enrich our view of damages for abusive breach. First, a general standard of abusive breach exhibits the lowest degree of severability and is not viable because it elevates risk in the entire pool of transactions. Second, we achieve the highest degree of severability (and thus encounter the best opportunities to award extracompensatory damages without leaking collateral risk) in categories that key on the type of transaction rather than the manner of the breach. For example, saying that we will award punitive damages for abusive breach in insurance contracts (keying initially on the type of transaction with abuse determined by violation of some intra-category norm) insulates that risk from the general pool. But saying that we will award punitive damages for willful, opportunistic or bad faith breach (keying exclusively on the manner of the breach) elevates risk in all transactions. Third, we can discern a large category of cases exhibiting a moderate degree of severability where a viable response to abusive breach depends on the process of implementation. In that category, the legislative process has crucial

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12. See RESTATEMENT (SECOND) OF CONTRACTS § 355 cmt. a (1979). Professor Farnsworth contends that the first statement that punitive damages will not be awarded in contract law appeared in a 1909 English case. 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.8, at 192 n.17 (2d Ed. 1998).

advantages over the common law process.

Part II will show how severability is essential to mediating the tension between our commitment to predictability of the cost of contracting and the uncertainty introduced by extracompensatory damages. Parts III and IV will consider what is required to achieve severability. Part V shows that particular types of responses to abusive breach will exhibit differing degrees of severability that control the viability of those responses. Part VI shows that the viability of extracompensatory responses exhibiting moderate degrees of severability depends on the process of implementation—i.e., legislation versus common law.

Finally, it is not my aim to engage substantively the large body of economic analysis arguing against the award of extracompensatory damages in contract law or the numerous economic criticisms of punitive damages generally. My effort here relates to those projects only indirectly, in two respects: first, in the sense that it is indirectly critical of their predominately economic focus, to the exclusion of insights that can be drawn directly from the doctrine; and second, in its assumption throughout that the decision to punish particular subcategories of abusive breach with extracompensatory damages is not just an economic one, but also must take into account social, political, equitable and systemic considerations. However, except for purposes of illustration in Part VI, I do not make any general or particular normative claims favoring extracompensatory damages. My aim is only to show that any efforts to impose extracompensatory damages must operate within the limits that I set out here.

II. A PREDICTABLE EXIT PRICE AND SEVERABILITY

A prime tenet of contract doctrine is certainty and predictability of the cost of contracting. Traditional damages rules permit the promisor to gauge with relative certainty the price of breach—viz., the risk attached to promise-making. As Professor Farnsworth explains, our system of contract remedies “is not directed at compulsion of promisors to prevent breach. Its preoccupation is not with the question: how can promisors be made to keep their promises?” The aim instead is to encourage trading through en...

14. This Article will not engage the question of whether awarding extracompensatory damages is a good idea in any particular case (with one exception used for purposes of illustration in Part VI). Some of the commentators cited herein have argued that extracompensatory damages for breach of contract always are a bad idea from an economic perspective. As suggested below, that is too narrow a perspective. The decision is not just economic, but also must take into account social, political, and equitable considerations. However, except for purposes of illustration in Part VI, I do not attempt to make general or particular normative claims favoring extracompensatory damages. See infra text accompanying notes 66-74 (making the case against the “late-pay scheme” for purposes of illustration).

15. See, e.g., Foley, 765 P.2d at 389. See also Dodge, supra note 13, at 695-98.

16. FARNsworth, supra note 12, § 12.1, at 147.
forceable contracts. One of the primary ways that contract doctrine encourages trading is through a low and predictable cost of promise-making. Remedies for breach of contract provide obvious incentives to promisors. Compensatory damages are not literally compensatory. Non-recoverability of litigation expenses, and limitations on consequential damages, prevent the promisee from recovering fully the benefit of her bargain. But the virtue of our traditional damages rules is that they give the promisor the ability to gauge with relative certainty the cost of contracting—viz., the price of breach. Promisees, we presume, are in a much better position than promisors to predict and insure against the collateral costs of breach.

Alan Schwartz argues that the predictable expectancy measure of damages brings the cost of contracting to its optimal level. Supracompensatory damages, he argues, would turn the contract into a gamble that informed, risk-averse traders always would choose to avoid. The added risk of extracompensatory damages goes directly to the bottom line cost of the trade, causing the promisor to charge too much and the promisee to pay too much for the good or service. Some trades will be deterred altogether.

We see this concern explicitly in the evolution of California's bad faith breach. As the experiment developed, some appellate courts extended the concept of bad faith breach to include not only bad faith denial of existence of a contract, but also bad faith assertion of a defense to breach. Other courts resisted, emphasizing that such expansion of the bad faith breach would inject a large dose of collateral risk into the general pool of transactions.

In DuBarry International, Inc. v. Southwest Forest Industries, Inc.,

17. Id. at 756.
18. Sykes, supra note 9, at 408-09.
19. Id.
20. Unpredictability of the exit price raises the risk of contracting and discourages trading. If parties cannot gauge the fiscal risk of entering into a contract ahead of time, then the trade is more like a gamble. There may be a chance to guess intelligently about the probability of breach, but the price of breach is pure speculation. See, e.g., Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460 (Cal. 1994) (explaining that commercial activity is fostered by limiting contract remedies to damages reasonably foreseeable at the time of contracting).
21. Alan Schwartz argues that generally rational and fully informed parties will prefer merely compensatory damages. Schwartz, supra note 13, at 372. Schwartz might be right about basic incentives and general preferences of traders, but there are other factors to consider. The decision whether to respond to abusive breach with extracompensatory damages requires a social, political, and systemic evaluation of the conduct and its interaction with the doctrine. An analysis like Schwartz's is only part of that normative decision. See, e.g., the discussion of late-pay schemes, infra notes 65-74 and accompanying text.
22. See supra note 14.
the court refused to expand the concept, emphasizing that such expansion would mean that "any party attempting to defend a disputed contract claim would risk, at the very least, exposure to the imposition of tort damages and an expensive and time consuming expansion of the litigation into an inquiry as to the motives and state of mind of the breaching party." This would blur the line between contract and tort, trench on their purposefully different measures of damages, and upset the predictability of commercial transactions.

The theme appears again in *Harris v. Atlantic Richfield Co.* There, the court refused to extend the bad faith breach to punish bad faith assertion of defenses, citing the need for predictability of the consequences of breach and the destabilizing effect of a doctrine that had the potential to turn every contract breach into a claim for punitive damages.

Concerns about the loss of predictability substantially influenced the ultimate decision to close the California experiment. In *Freeman & Mills, Inc. v. Belcher Oil*, the California Supreme Court overturned *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, emphasizing that the bad faith breach violated two essential tenets of contract doctrine: certainty and predictability of the cost of contracting, and the traditional emphasis on compensation rather than punishment.

*DuBarry*, *Harris* and *Freeman* take us part-way toward recognizing the importance of severability in fashioning a response to abusive breach. They confirm that a response to abusive breach that exposes virtually any breach to the risk of extracompensatory damages is irreconcilable with the central commitment to a predictable exit price.

But in their overall approach these cases fail to discern the full lesson of severability. Indeed, the severability insight gets lost in the various other rationales the courts offer to support their conclusions. The opinions


There was at least a possibility that the bad faith breach in its original configuration might have operated in harmony with the principle of a predictable exit price. Initially it applied merely to the arguably small and potentially severable set of transactions where one party contended that a deal had been struck and the other unjustifiably denied it. However, extension of the idea to bad faith defenses captured potentially every contested case, leaving traders to gamble on a court's conception of a bad faith defense.

27. Id. at 654.
30. Freeman & Mills, Inc., 900 P.2d at 674-75 (citing Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460 (Cal. 1994), thereby reasoning that parties should be able to gauge ahead of time the fiscal risk of entering into a contract, and thus, damages for breach of contract should be limited to those that can be foreseen at the time the parties enter the contract).
argue, among other things, that extracompensatory damages require policy judgments that only the legislature can make, 33 and that extracompensatory damages discourage efficient breach. 34 Ultimately, there were so many objections to the bad faith breach that the severability lesson was obscured.

The full insight is not apparent until we incorporate the experiment with extracompensatory damages that undeniably has worked. Consider now the insurance cases. These cases award punitive damages for bad conduct accompanying breach 35 and yet they thrive, seemingly in harmony with the core tenet of a generally predictable exit price. Here it seems we have in fact reconciled inexorably conflicting themes.

The explanation is in the character of the cases themselves. The insurance cases create an easily identifiable island of elevated risk that is practically and conceptually severable from the general pool of transactions (where a predictable exit price remains essential). This characteristic (severability) is vital to any extracompensatory response to abusive breach.

The primary evidence of the insurance cases' severability is the absence of indications or even concern that the award of extracompensatory damages in the insurance cases leaks collateral risk into the general pool of transactions. The possibility is not even raised in cases considering punitive damages for an insurer's bad conduct. 36 Compare the concerns raised by courts in the evolution of the California experiment. Recall the DuBarry court's admonition that extending the bad faith breach to cases of bad faith assertion of a defense would upset the certainty of the cost of contracting on which the commercial world relied. 37

As the doctrine has matured, we have seen significant variation and expansion in what courts are willing to deem bad conduct by insurance carriers. 38 Indeed, some now criticize that courts have permitted punitive damages in cases that range well outside the boundaries of any conception of bad conduct. 39 But even here, there is no suggestion that this (arguably unprincipled) intra-category expansion has disrupted general contracting incentives. Compare DuBarry, where the court worried that a moderate

33. As I will discuss in detail in Part VI, the prior notice and potential for more precise delineation of risk that is inherent in the legislative process makes it the preferred mechanism for responding to certain categories of abusive breach.

34. See Freeman & Mills, Inc., 900 P.2d at 669; see also Dodge, supra note 13, at 698.

35. See, e.g., supra note 8 and accompanying text.

36. Criticism of the insurance cases has been wide ranging. See, e.g., James M. Fischer, Should Advice of Counsel Constitute a Defense for Insurer Bad Faith?, 72 TEX. L. REV. 1447 (1994); Cathryn M. Little, Fighting Fire with Fire: "Reverse Bad Faith" in First-Party Litigation Involving Arson and Insurance Fraud, 19 CAMPBELL L. REV. 43 (1996); Ellen Smith Pryor, Comparative Fault and Insurance Bad Faith, 72 TEX. L. REV. 1505 (1994). But no one seriously contends that there is any danger of spillover into the general pool.


38. See, e.g., discussion in Sykes, supra note 9, at 412.

39. Id. at 431.
expansion to encompass a new aspect of bad faith threatened to leak risk into the general pool.\textsuperscript{40}

Consider also the work of commentators critical of elevated liability for breaching insurance carriers. Alan Sykes' thorough-going economic criticism of the insurance cases is one place we might expect to see concerns raised about collateral risk.\textsuperscript{41} Sykes criticizes that there are high error costs (courts, he posits, are not very good at discerning abusive breaches by insurers) and that the approach over-deters denial of claims, thus artificially raising the cost of coverage.\textsuperscript{42} But nothing in Sykes' analysis suggests that the award of punitive damages in the insurance cases raises the cost of contracting in the general pool of transactions.\textsuperscript{43}

The insurance cases endure because they only add risk to a discrete subcategory of easily identifiable transactions. The decisions have produced such a buffer between these cases and the general pool of transactions that even the arguably unprincipled expansion of punitive damages beyond initially perceived categories of bad conduct does not add risk to contracting in the general pool.\textsuperscript{44}

III. UNPACKING SEVERABILITY AND THE RANGE OF SEVERABLE OPTIONS

To this point we can understand severability as a description of the particular characteristics of a demonstrably viable exception to our standard damages formula. Severability accounts for the enduring vitality of the insurance cases. The lack of it helps explain the failure of the California experiment. But to transform severability into a general prescription for abusive breach we must determine what generally is required to achieve it.

One reason the insurance cases are easily severable is that they arise from a peculiar, highly regulated commercial subculture.\textsuperscript{45} This makes them amenable to an enhanced damages rule governing an easily segregated class of actors. The regulatory structure and barriers to entry ensure

\textsuperscript{40} See DuBarry Int'l, Inc., 282 Cal. Rptr. at 192.

\textsuperscript{41} Alan Sykes argues that supracompensatory damages are ill-advised in the insurance cases because judges are not very good at identifying true cases of opportunistic breach and thus over-apply the remedy to the detriment of all involved. Sykes, supra note 9, at 420.

\textsuperscript{42} See id. at 424-28.

\textsuperscript{43} See generally id.

\textsuperscript{44} This is not surprising. We know it certainly is possible to create severable categories of elevated risk in contract law. Witness for example the treatment of usury loans. Rules penalizing these transactions elevate risk in a variety of ways. In some jurisdictions the usurious lender forfeits both interest and principle as punishment for lending above the usury rate. See, e.g., In re Estate of Dane, 390 N.Y.S.2d 249 (App. Div. 1976). This tends to confirm that it is possible to apply risk elevating rules to discrete categories of activity, without introducing uncertainty into the general pool.

\textsuperscript{45} For a discussion on the nature of the insurance industry, see ERIC MILLS HOLMES & MARK S. RHODES, HOLMES'S APPLEMAN ON INSURANCE, 2d (Eric Mills Holmes ed., 1996) and JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE (1981).
that general traders will not fall into this class inadvertently. But is an overarching regulatory structure crucial to achieving severability?

The best indications are that such a structure is not essential. While the bad faith breach and the insurance cases are the most notable examples, there are other more obscure experiments with extracompensatory damages in contract law. These efforts suggest that severability can be achieved outside the context of a regulated industry. Moreover, they show that severability has been tacitly respected in the common law for decades.

Historically, punitive damages have been awarded in cases of abusive breach of contract by public utilities and marriage promisors. These efforts are mere relics today, with both sets of cases removed from the ambit of common law doctrine. It is difficult to discern what, if any, broad theoretical influences fueled common law courts to allow the exceptional remedy of punitive damages in these peculiar cases. But it is evident that both sets of cases were, like the insurance cases, highly severable, keying on the type of transaction rather than the manner of the breach.

Other signals supporting the severability theme and confirming that a background regulatory structure is not a prerequisite appear in the modern doctrine of several states. At least four states currently allow punitive damages where the breach of contract occurs in the context of a special relationship. Indeed, one scholar treats the insurance cases as just another in a list of special relationships where breach can result in extracompensatory damages. The other relationships “include [ ] carrier and passenger, innkeeper and guest, physician and patient, and attorney


47. There is little indication that the judges in the public utility and marriage promisor abusive breach cases were consciously attempting to reconcile the risk elevating disincentives of punitive damages with the risk minimizing incentives of traditional damages. See id.

48. William Dodge describes these cases in detail. Id. at 640-41.

In California, we also find special cases where extracompensatory damages for breach are keyed on the characteristics of the transaction. See, e.g., Rogoff v. Grabowski, 246 Cal. Rptr. 185, 189-91 (Cl. App. 1988) (remanding to determine whether the plaintiff stated a statutory cause of action under California Public Utilities Code); Commercial Cotton Co. v. United Cal. Bank, 209 Cal. Rptr. 551, 554 (Cl. App. 1985) (finding that the relationship of bank to depositor was quasi-fiduciary, therefore bank could not reasonably claim non-existent legal defenses to its negligent disbursement of the plaintiff’s funds); Wallis v. Superior Court, 207 Cal. Rptr. 123, 129-30 (Cl. App. 1984) (finding recovery in tort against an employer that breached its agreement to pay its employee severance pay on the ground that the parties shared a relationship analogous to that of a disability insurer and insured). It is suggested that the overruling of Seaman’s Direct Buying Serv. v. Standard Oil Co., 686 P.2d 1158 (Cal. 1984), casts doubt on the vitality of these cases. See Price v. Wells Fargo Bank, 261 Cal. Rptr. 735, 741 (Cl. App. 1989) (suggesting that Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988), signals the end of the “quasi-fiduciary” category of cases).

49. Dodge, supra note 13, at 648. In describing the peculiar and compelling characteristics of the insurance cases, courts generally emphasize the special relationship between the insurer and the insured.
These special category cases, both early and current, suggest that an overarching regulatory structure is not vital to severability. More importantly, they reveal its core requirement.

IV. THE CORE OF SEVERABILITY

There is a lesson in what the special category cases do not attempt. They do not attempt to sanction abusive breach through a general standard—e.g., opportunistic breach—that overhangs every transaction. Risk attached primarily to such generally described bad conduct inevitably leaks into the general pool. Under such a standard, every trader in every trade runs some chance of having his conduct deemed opportunistic.

Like the insurance cases, the special category cases key on the type of transaction rather than the manner of the breach. It is transaction type that signals elevated risk. Defining the category this way isolates risk so clearly that traders in the general pool can ignore it. Keying on transaction type rather than the manner of the breach seems essential to minimizing collateral risk. Traders in the targeted category have prior notice of elevated risk. Traders operating outside these areas are free to contract and breach without fear that the manner of their breach will escalate damages. This maintains predictability of the cost of trading in the general pool of transactions.

V. DEGREES OF SEVERABILITY

We know that severability is achievable with rules that key on the characteristics of the transaction and difficult to achieve through standards that focus purely on the manner of the breach. But how should we map the possibilities? Are we facing a constellation of random opportunities to respond to abusive breach? Or can we impose more structure on the severability insight?

Let us first establish a fixed point that represents the lowest degree of severability and the least viable response to abusive breach. It is represented by the recommendation from William Dodge's recent economic critique, The Case for Punitive Damages in Contract Law, favoring the award of punitive damages for abusive breach of contract.51 I raise this point here not to criticize the proposal substantively (it is a response to the numerous economic criticisms of punitive damages for breach of contract and I am sympathetic to much of it). Rather, I use its ultimate prescription to illustrate the most extreme version of the mistake we make by failing to

50. Id.
51. See generally id.
respect severability and how easy that mistake is to make.

Ultimately, Dodge contends that punitive damages ought to be available for any willful, opportunistic breach. In essence, Dodge proposes a general standard of abusive breach that allows us to ask in every case whether the manner of the breach warrants the award of punitive damages. This proposal exhibits an extremely low degree of severability. As a reference point, it helps us to position the California experiment and the insurance cases, and ultimately will help us to discern and position a category of difficult cases where severability depends largely on the process of implementation (i.e., legislation versus common law development).

Recall our discussion of the California experiment. The nebulous bad faith standard, combined with the myriad open questions left by the court in Seaman's, introduced into California contract doctrine a broad-ranging notion of abusive breach. The broad trigger "bad faith"—that is, conduct that violates accepted notions of business ethics—potentially captured a great deal and gave little guidance about what conduct was safe from the risk of punitive damages.

This was particularly true after some California courts expanded the bad faith breach to include bad faith assertion of a defense to contract liability. That failure prevented the concept of bad faith breach from working in harmony with the paramount goals of reliability and predictability of the cost of contracting. Appended to post breach activity like the assertion of defenses, it cast a shadow over all contested transactions and threatened to discourage contracting by raising generally the cost of promise breaking.

Compare the Dodge proposal. Bad faith denial of the existence of the contract and bad faith assertion of a defense are both narrower, less amor-

52. Id. at 699.
53. Id. at 633-34.
54. See, e.g., Rancourt, supra note 5, at 1426 (showing disagreement over whether it is grounded in tort or the implied covenant of good faith and fair dealing; whether it applied just to denial of contract or bad faith denial of liability; whether a special relationship like in the insurance cases was necessary).
56. Responding to the question "under what circumstances will a breach of the implied covenant of good faith and fair dealing in a commercial contract give rise to an action in tort," the court in Seaman's asserted that it was unnecessary to decide this broad question. "It is sufficient to recognize that a party to a contract may incur tort remedies when in addition to breaching the contract, it seeks to shield itself from liability by denying in bad faith and without probable cause, that the contract exists." Seaman's, 686 P.2d at 1167.
phous standards than Dodge's willful, opportunistic breach. Under the
Dodge formulation no promisor can guarantee going in that a subsequent
breach will not result in an award of punitive damages. All traders in all
contracts must account for this possibility in pricing, and, given the diffi-
culty of pricing the risk, some trades will not occur. In degrees of sever-
ability, we find the Dodge proposal at the extreme low end, followed by
the California experiment. At the other end of the spectrum, the insurance
cases and the special category cases exhibit high severability.

We have then a suggestion of a continuum; a non-severable and non-
viable general standard of abusive breach at one end (the Dodge proposal)
and a highly severable subcategory at the other (the insurance cases). They
are distinguished primarily by their triggers. The mistake of the Dodge
proposal is to key on the manner of breach -- e.g., willful, opportunistic. The
entire universe of contract breaches is exposed to that designation. The
proposal injects collateral risk into the entire pool. On the other hand,
viable rules will respect severability by keying on the characteristics of the
transaction (e.g., insurance, marriage and public utility contracts) thus fil-

59. See Dodge, supra note 13, at 652.

60. At a more general level, this criticism is a familiar one. Considering the elusive question of
what comprises a violation of the implied covenant of good faith, Professor Summers argued that the
concept was so broad that it was nearly empty of substance. To give it meaning Summers created
subcategories of bad conduct that were "excluded" from the range of good faith performance and fur-
ther defined those categories with descriptive anecdotes. See Robert S. Summers, The General Duty of

Summers' attempt to give substance to the idea of good faith responds to the same problem that
afflicts the Dodge proposal. Like the implied covenant of good faith, a general standard punishing
willful, opportunistic breach is hopelessly broad and generates tremendous uncertainty about what
conduct will run afoul of the standard. See also Diamond & Foss, supra note 1, at 590-91.

61. Dodge acknowledges this criticism at the end of his article and offers a short response. His
rule, he contends, would not inject significant new risk or instability into trades because the promisor
can negotiate for a release from the promisee. Dodge, supra note 13, at 697. However this is two steps
too late. The value of a predictable exit price under current doctrine is that it drives promisor's think-
ing before he commits to the deal. It drives his pricing and ultimate willingness to make a promise at
all. The possibility of negotiating a release after the breach has occurred does nothing to affect this ex
ante calculation. And it would be an odd transaction indeed that incorporated an agreement ex ante that
set damages for promisor's willful, opportunistic breach. This is clear when we consider the range of
language we have used to characterize this type of breach. See, e.g., Dold v. Outrigger Hotel, 501 P.2d
368, 372 (Haw. 1972) (allowing the award of punitive damages "where the contract is breached in a
wanton or reckless manner as to result in a tortious injury"). See also Schwartz, supra note 13, at 369.

62. The California experiment made essentially the same mistake. See supra text accompanying
notes 15-44.

63. Traders must not be subjected to enhanced damages without warning. Within the category of
abusive activity, elevated risk is what we seek. But in the general pool our goal must be to maintain the
incentives that traditional contract damages provide. To do this we must give notice and then sever the
category deemed abusive from the general pool. A general common law standard of abusive breach
prevents this. It invites judges to evolve the standard to include new categories of activity. Nearly any
trade might provide the case through which a judge applies the general theory to create another cate-
gory of elevated risk. This possibility injects new risk into the entire pool.
With the insurance cases and the Dodge proposal as extremes on a continuum, another question appears. Is it just a general standard of abusive breach—one that overhangs every trade—that is scuttled by its failure to respect severability? The original rendition of the California experiment (which we can fairly position several steps inside the Dodge proposal) suggests that there are other possibilities and problems between the extremes.

Consider now a mid-range of cases where we key on the manner of the breach, not generally, but with specificity. Is it possible to sever and punish particular abusive practices and still avoid collateral risk in the general pool? The next Part takes up this question and the problems it presents.

VI. THE IMPORTANCE OF PROCESS AT MID-RANGE

Imagine a mid-range of cases consisting of a peculiar, abusive rendition of a common and typically immaterial type of breach. Here, we cannot key on transaction type because the conduct is pervasive. Instead, we are forced to focus on the manner of the breach—the very focus that we concluded defeats severability in the case of a general standard of abusive breach. But these mid-range cases present a different opportunity. We would not characterize the violation with broad manner-of-breach designations like willful, opportunistic or bad faith breach. Rather we would key on peculiar, explicitly designated acts. Might this allow us to create here the same type of *ex ante* signal of elevated risk that we achieve by keying on transaction type? The challenge is to create and seal off the category through a sufficiently narrow and detailed description of prohibited activity. True, any trader might trip this type of standard. Thus, it poses a greater danger of collateral risk than rules keying on transaction type. But if the violation is narrowly and precisely defined, it is possible that we still can signal the risk *ex ante* sufficiently to create only a *de minimus* level of collateral risk in the general pool.

However, achieving this precision poses a new problem: the uncertainty inherent in the evolution of a common law rule prevents the precise

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64. The California experiment was problematic because, at best, it hinged on the vague concept of bad faith. Guided merely by a mildly embellished rendition of bad faith, courts were not guided to protect any general categories of breach or any particular transactions.

65. The range of risk is obviously broader here. For example, for a rule keying on transaction type, traders will be able to determine quite easily that they are not engaged in a contract for provision of insurance protection. That single, easy determination is sufficient to insulate them from the elevated risk attached to the insurance cases. However, under a standard punishing late-pay schemes, as defined *infra* in text accompanying notes 66-67, traders are in danger of making decisions throughout the transaction that will trigger exposure to punitive damages. At mid-range, traders still can achieve a good degree of certainty that their conduct will not be deemed abusive, but they must be aware throughout the life-span of the deal that their conduct might trigger a claim for extracompensatory damages.
designation of prohibited conduct that is essential in these mid-range cases and becomes a significant source of collateral risk. For these mid-range cases, the legislative process offers a better chance of developing an extracompensatory response to abusive breach with minimal collateral risk.

For a concrete illustration, consider a pervasive form of buyer's breach that I call the late-pay scheme. Professional money managers have raised it to an art form.\(^6\) It is simply the practice of dragging out payment to vendors beyond the agreed payment date, and to the boundaries of vendors' tolerance. In its abusive form, it is an intentional, continuing exploitation of the remedial inefficiencies of the legal system that enriches its most successful practitioners by millions of unbargained-for dollars per year.\(^6\) In the European Community, calls to "outlaw" it appeared in the financial press resulting in legislation aimed at stopping it.\(^6\)

The case against the scheme is straightforward.\(^6\) It is an attack on the

66. Treasury managers call the practice "payment timing optimization." The scheme is complex enough that treasury management consultants do "brisk business showing companies how to increase cash by stretching vendor payments." Richard H. Gamble, Taking Advantage of Suppliers, 7 TREASURY & RISK MGMT., Jan.-Feb. 1997, at 33.

67. The following passage illustrates typical late-pay practices and the advantages they afford to corporations.

The Chief Financial Officer of a $500 million East Coast apparel manufacturer and importer cut $250,000 from his company's annual interest costs last year by helping himself to an interest free loan. How did he do it? Simple. He essentially borrowed from his vendors by delaying his company's payment of their bills. But because he was subtle in his approach and resisted stretching the bill paying as much as he could, many of those vendors have never even felt his hand in their pockets.

More brazen in the approach is the treasurer of a $700 million maker of consumer products who routinely makes vendors wait an additional 11 or 12 days for the money they are owed. Several of them have howled. But for this treasurer, it's worth the noise because the short-term cash reaped from the delaying tactics has allowed him to reduce some debt carrying a 7% coupon. That savings on interest payments means an additional $1 million annually flows to his company's bottom line.

Id.

68. The Late Payment of Commercial Debts (Interest) Act, 1998, c 20 (U.K.), 11 June 1998, gives promisees a statutory right of interest and requires large firms to report the level of their late payments. See also Barbara Roche, Why We Must Outlaw Late Payment, TIMES OF LONDON, June 22 1997, available at LEXIS, News Library, Times File.

69. There are very few reported cases where plaintiffs have sought damages for the loss caused by the late-pay scheme. With so little litigation over the issue, one might conclude that the market has adjusted to the practice—that vendors generally adjust prices to account for the costs imposed by the scheme.

But the idea that it is just factored in to the contract suggests a more level playing field than has been proved. For small to medium sized local vendors competing against one another for accounts of national corporations, it is false to suggest that the late-pay pattern of breach is factored in to the contract price. The British Late Payment Act explicitly recognizes the potential imbalance of bargaining power where the promisee is a small vendor. See also Janet Stites, Prospectus: Small Technology-Based Companies Constantly Face the Problem of Getting Big Customers to Pay Their Bills on Time, N.Y. TIMES, Oct. 5, 1998, at C4.

Moreover, as a matter of process, if we accept that the market has factored in the pattern of late-payment, how are we to respond to litigated cases under the current rules? Are we to ignore the express language governing payment terms in favor of defendant's arguments that implicit in plaintiff's sale
structure of contract law. The schemer exploits the interface between con-
tract rules and contract remedies and is successful only because of the costs
the legal system imposes on those seeking relief for broken promises.

In other contexts, we have responded aggressively to thwart similar
types of abuse. Examples of this are civil abuse of process and Rule 11
sanctions under the Federal Rules of Civil Procedure. Those tools recog-
nize that the open door policy of our legal system empowers plaintiffs to
impose unjustified costs on defendants. They restrain this power by raising
the threat that the abusive plaintiff will be penalized for invoking the legal
process merely to exploit its inherent costs.

In the late-pay scheme, putative defendants exploit the same inherent
costs. The only real difference is the timing. The putative late-pay defen-
dant exploits the high costs of justice before litigation begins. He captures
unbargained-for benefits with the expectation that transaction costs will
make it inefficient for anyone to stop him.

There are three basic renditions of the late pay scheme. The most
clearly abusive (class one) is the scenario where goods or services are ren-
dered in installments under a long term contract, and the buyer employs a
premeditated plan or system with the explicit aim of skimming unbar-
gained-for value from the deal. Here the scheme is manifestly intentional
and continuing. The class one late-pay schemer aims to maintain the rela-
tionship in the future even while siphoning unearned value from it through

price was compensation for the intentional and continuing late-pay breach that plaintiff knew would
occur? There are too many things wrong with such a view. First, it pushes us to evaluate subjective
intention while ignoring the objective indicators of intent. Second, it suggests that we should counten-
cance abuse of the remedial structure (exploitations of its inefficiencies) so long as the targets of that
exploitation (at least those with sufficient market power to protect themselves) have adapted. Finally, it
counsels against attempts to improve the doctrine.

The argument is also problematic where the target is an organization with layers of relatively
transient decision-makers. It is harder here for the experiences and expectations of the point person to
filter up reliably to everyone who will make a decision contingent on the observable promises that form
the contract.

Moreover, it is just as likely that the targets of the late-pay scheme realize plainly that there are
no cost effective legal responses available to them. To the degree that damages are viewed as merely
the total amount overdue factored by the pre-judgement rate of interest, it is understandable that very
few putative plaintiffs have pursued formal legal action where the late-pay scheme is defendant's only
violation.

Again, one is tempted to say that the problem is a small one that gets just about the amount of
attention from the legal system that it deserves. Indeed, we commonly accept that in the case of sellers
of services, and less so for goods, there will be a bin of residual immaterial breach that is not cost
effective to pursue. But this is of course an incomplete view of the practice. When we incorporate the
total levels by which practitioners of the scheme are unjustly enriched through the scheme, it cannot be
dismissed as inconsequential.

70. Our general interest in removing errors and inefficiencies from the structure is a traditional
motivation for legal change that prescribes an aggressive response here.

71. A perfect mechanism would screen out warrantless cases at the outset. Unless we sacrifice the
ideal of equal access to law, the open door structure seems to be the best available option.

72. See, e.g., the mechanisms described in Gamble, supra note 66 and accompanying text.
repetitive breaches. The class one scheme is the most easily identifiable and easiest to police.

More complicated, and more difficult to classify as abusive, is late payment in the repetitive contract (class two), *i.e.* late payment in separate, similar contracts for goods or services delivered over a period of time.\(^3\) The most difficult to classify as abusive is the isolated late payment (class three). Isolated late payment is a common occurrence that overhangs virtually every transaction. A rule that penalized it would violate our principle aim by making the exit price of virtually any trade highly uncertain.

A plausible goal is a rule that penalizes class one late-pay scheme with extracompensatory damages, and ensures that class two and class three late payers are exempt.\(^4\) This is viable as a legislative enterprise. Pursued through the common law it is much harder and maybe impossible.

The main concern is notice, and it breaks into two parts. If awarded through the common law, extracompensatory relief will surprise the first defendant. He will not have anticipated it and will not have priced it into the deal.\(^5\) This is a general risk posed by the fact that common law judges have the power to recognize new causes of action. But given the general bar on extracompensatory damages for breach of contract, this risk is *de minimus.*\(^6\)

The important notice problem occurs after the first case, in the form of uncertainty about how far the new cause of action will extend. The first common law case warns traders that the exit price of trades is now indeterminately higher. They are uncertain about whether this risk actually will bite or how costly it will be. The fact that the rule will evolve through the common law process is *itself* a significant source of risk. On any day in any court, a common law rule penalizing class one late payment might expand to other classes or to entirely new categories of aggressive commercial activity.\(^7\) That possibility of extracompensatory damages attach-

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\(^3\) One example is the provision of temporary staff at buyer’s request.

\(^4\) We might decide to lump class two late-pays with either class one or class three. I think it is cleaner to place class two and class three together.

\(^5\) This is a general risk all traders face from the general knowledge that the law might change.

\(^6\) Paradoxically if courts acknowledge the importance of severability, it empowers and perhaps encourages them to create sub-categories of elevated risk. This itself, may be enough to increase traders’ perception of the risk of contracting. It is easy to imagine that moving from a regime where the generally controlling rule is compensatory damages only, to one where extracompensatory damages are authorized in discrete severable sub-categories (even where that discretion is exercised rarely) will change traders’ perceptions of the cost of promise-making to at least a small degree. However, that is not much different from the current state of affairs. Traders in most jurisdictions operated in the shadow of precedent that confirms the possibility of punitive damages for breach of contract in amorphously defined egregious cases where the court also can push the breach into the category of tort. *See Restatement (Second) of Contracts § 355 (1981)* (stating that punitive damages are recoverable if “the conduct constituting the breach is also a tort for which punitive damages are recoverable”).

\(^7\) The evolution of the California experiment is a good example of this. Consider the message sent by the conflicting opinions in *DuBarry International, Inc. v. Southwest Forest Industries, Inc.*, 282
ing unpredictably to done deals without notice injects unacceptable risk into the entire pool of transactions; it prevents us from awarding extra-compensatory damages in harmony with the prime tenant of a predictable exit price.\textsuperscript{78}

If we are to key on the manner of the breach with particularity sufficient to sever the category from the general pool, we must ensure that the boundaries hold. To avoid collateral risk, the offense must be defined with certainty, reliably into the future, with adequate notice before the rule expands to capture new circumstances.\textsuperscript{79}

Legislation is more likely to achieve this for reasons inherent in the process.\textsuperscript{80} The inherent fluidity of common law rules invites porous, evolving boundaries and thus expanding risk—precisely the collateral risk that we must avoid. After the first common law case awarding extra-compensatory damages, given the uncertainty of its life-span and vigor, direct and collateral risk to traders engaged in similar activity rises dramatically; the ability of traders to assess the boundaries of this new risk is minimal until the doctrine matures.

Legislation can produce immediately something much closer to a mature structure for levying extra-compensatory damages in discrete cases.\textsuperscript{81} In addition to pre-implementation notice that is vital to severability, the legislative process can fix more solid boundaries around the proscribed

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  \item Cal. Rptr. 181 (Ct. App. 1991) (determining that Seaman's could only extend to bad faith denial of a contract's existence, not a party's bad faith denial of liability under a contract) and Multiplex Insur. Agency, Inc. v. Cal. Life Insur. Co., 235 Cal. Rptr. 12 (Ct. App. 1987) (concluding that bad faith denial of liability under a contract was enough for punitive damages to attach).
  \item Witness the California experiment, which initially keyed on fairly discrete activity—bad faith denial of the existence of the contract—and expanded to include activity—bad faith assertion of defenses—that introduced uncertainty to a much larger category of activity. See supra text accompanying notes 14-34.
  \item One arguable drawback of course is that traders will be able to come right to the line safely, but this is the cost of minimizing collateral risk. A common law rule on the other hand, would not permit such a close approach. The uncertainty of what the next judge will do with a common law rule cautions the risks averse to give the activity wide berth; that is it over-deters, which also means it leaks collateral risk.
  \item The legislative process might not produce better substantive rules. Indeed they might be worse. But this merely underscores the fact that at middle-degrees of severability (i.e., rules keying on peculiar styles of breach) process is paramount. For example, legislators might be more prone than judges to make war on "abusive" commercial practices. They might decide to punish a variety of discrete practices that they deem abusive breach. So long as they fashion adequate initial boundaries, the pre-enforcement notice and non-retroactivity of the process will insulate the general pool of transactions from risk.
  \item In countless categories of cases a clear legislative statement will cause courts to defer to legislative schemes as mature structures that permit little room for interpretation. See, for example, the variety of cases stemming from Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984). See generally, NORMAN SINGER, SUTHERLAND STATUTORY CONSTRUCTION (5th ed. 1994). Whether this is purely a function of judicial philosophy or not, the point remains that the legislative process allows development of a mature regulatory scheme more quickly than does the common law process.
\end{itemize}
conduct. There will be uncertainty, but dramatically less than would appear through the slow and unpredictable process of common law evolution. The long lead time, pre-enforcement notice and non-retroactivity inherent in legislative rules allows traders to rely upon an established boundary between class one and class two/three late pays, without fear that theirs will be the case where a common law judge breaks the seal.

We find then at mid-range that severability is degraded by the common law process. The capacity of any category to expand through the common law process generates the collateral risk that we must avoid. If we choose to award extracompensatory damages at mid-range, we also must choose the legislative mechanism.

VII. CONCLUSION

Any response to bad faith breach must occur in harmony with the core commitment to a predictable exit price. The lesson from the failure of the California experiment and the vitality of the insurance cases, is that we can pitch an extracompensatory response to abusive breach in harmony with this core commitment so long as that response is limited to discrete and severable categories of breach.

Extracompensatory damages rules that key on the type of transaction rather than the manner of the breach exhibit the highest degree of severability and thus the highest degree of viability. Broad standards that key on the manner of the breach, generally described, exhibit a low degree of severability and the lowest degree of viability. Rules that key explicitly and precisely defined types of breach achieve a moderate degree of severability and are viable when pursued through legislation.

We will likely continue to debate what constitutes abusive breach as a normative matter. But in practical terms, we cannot develop viable responses to categories of abusive breach without considering and respecting severability.

82. A rough example of the virtues of legislative process are usury laws. The relatively bright line boundaries governing usury permit general lending transactions to continue unimpaired by the threat of elevated damages. See, e.g., In re Estate of Dane, 390 N.Y.S.2d 249 (App. Div. 1976) (holding the usurious lender forfeits both interest and principle as punishment for lending above the usury rate). Contrast the tangled web of common law rules that attach additional risk to contracts with minors. See discussion in Pettit v. Liston, 191 P. 660 (Or. 1920).

83. This of course assumes an adequate job of legislation to design the boundaries and minimize ambiguity. It also assumes a strong legislative message about the systemic importance of the boundary, sufficient to discourage activist judges.