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A Cautionary Tale About Contractual Good Faith in Texas

Mark Gergen*

The history of the doctrine of good faith in Texas offers a cautionary tale about legal change. In the last decade, Texas has gone through a revolution and a counter revolution as its supreme court created a new tort for bad faith breach of contract for which emotional and sometimes exemplary damages could be awarded and then struggled to limit the scope and effects of the tort. The new tort of bad faith breach of contract has had explosive effects on insurance litigation in Texas. The battle over the limits of the tort has sharply divided the supreme court, and it has had corrosive effects on the quality and tenor of the court's opinions, which are flimsily reasoned and often acrimonious. Quieter developments in contract law parallel these noisy developments in tort. When the supreme court created the tort of bad faith breach, it also held that the doctrine of good faith could not be used in contract to supplement or alter the express terms of a contract. This Paper traces these developments and argues that both are wrong from their inception.

These developments originate in the same case, English v. Fischer, in which the Texas Supreme Court rejected a compelling good faith argument and stated the general principle that the doctrine of good faith could not be used to supplement or alter the express terms of a contract. In the same case, the concurring opinion states that the doctrine of good faith remains a basis for treating breach of contract as a tort in certain special

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1. See Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 168 (Tex. 1987) (holding that an insurer may be liable in tort for wrongful failure to pay a first-party insurance claim and that exemplary damages are available for egregious behavior).

2. See infra text accompanying notes 56-81.

3. See infra Part III.

4. 660 S.W.2d 521 (Tex. 1983).

5. See id. at 522 ("This concept [of good faith and fair dealing] is contrary to our well-reasoned and long-established adversary system which has served us ably in Texas for almost 150 years.").
relationships. Since *English*, good faith has atrophied as a contract doctrine in Texas. Good faith has been denied what I will show to be its traditional function—allowing courts to redefine contractual obligations when the express terms of a contract have failed to fulfill the parties’ clear expectations or interests. Meanwhile, the tort of bad faith breach has become of dominant importance in litigation involving wrongful denials of first-party insurance claims. This extension of a tort doctrine into contract cases to award emotional and sometimes exemplary damages for breach not only is doctrinally unsound in its inception, elaboration, and later restriction, but it is also bad policy. Sometimes problems in enforcing contracts may justify the award of such damages for breach of contract, but not when other laws such as fee-shifting statutes already improve contract enforcement.

What is in this Paper for non-Texans? The discussion of the costs and benefits of enhanced damages for breach of contract and the explanation of why statutes that allow attorney’s fees and prescribe fixed emotional or exemplary damages for breach of contract are superior to the tort of bad faith breach are of obvious general relevance. So too is the discussion of the traditional role of good faith in contract.

The Texas experience offers deeper lessons. It suggests some dangers in creating new ruptures in the membrane between tort and contract, particularly through doctrines like bad faith breach that have boundaries that are defined in vague and highly subjective terms. Opening the door to tort claims in contract, with their lure of emotional and exemplary damages, creates a crush of claims as plaintiffs and their lawyers attempt to cash in. Trial judges vary in how closely they police the door, and juries sometimes award extraordinary damages in what seem to be run-of-the-mill contract cases. While the Texas appellate courts have policed this particular door between contract and tort fairly closely (they limited the tort to the area of insurance, and only a few cases have upheld large exemplary damage awards when an insurer made what seemed a good faith mistake in denying a claim), the opinions are ill-reasoned because the ways in which the tort’s boundaries are defined defy reasoned analysis. The huge stakes in bad faith cases and its flimsy doctrinal garb make this a particularly volatile area of the law. Small changes in the personnel at the Texas

6. *Id.* at 524 (Spears, J., concurring).
7. See infra Part IV.
8. See infra text accompanying notes 34-54.
9. See infra Part II.
10. See infra note 60.
12. See infra note 54.
Supreme Court have resulted in large and rapid shifts in the law. The crush of bad faith claims and the changing law have obvious institutional costs for litigants and courts in arguing and rearguing claims. Ill-reasoned and seemingly politically driven opinions present a poor spectacle. And, like other revolutions, this one may turn out in the end to have reactionary consequences. It was partly a fear of imposing exemplary damages for breach of implied duties that led the Texas Supreme Court to gut the doctrine of good faith in contract. To protect insurers from spurious bad faith claims, the supreme court recently redefined the standard for appellate review of jury findings of bad faith and imposed a radical new restriction on the recovery of exemplary damages in bad faith cases. These changes eventually may affect other parts of Texas law.

Of Texans, and in particular of the Texas Supreme Court, this Paper makes two requests. First, abolish the tort of bad faith breach of contract or at least restrict the tort to truly opportunistic breach when a promisor intentionally breaches an obligation with no intention to compensate the promisee for her loss. Second, revive the doctrine of good faith in contract.

I. The Emergence of Bad Faith Breach as a Tort in Texas

Over the last decade in Texas, many contract suits included a claim in tort for emotional and exemplary damages on a theory of bad faith breach. The groundwork for this practice was laid in English, a decision that, ironically, rejects the implied covenant of good faith and fair dealing in contract as a "novel concept" that "would abolish our system of government according to settled rules of law." Although the majority closed the door to good faith as a doctrine to define contractual obligation, Justice Spears in a concurring opinion opened the door to good faith as a tort doctrine regulating performance in some contracts. He stated that Texas courts recognized a duty of good faith and fair dealing that "springs from the relationship, not from the contract" in "special relationships"
involving trust or an imbalance of bargaining power. The emphasis on the element of trust suggests that Justice Spears thought the tort of bad faith breach to be akin to the breach of fiduciary duty, which regularly results in emotional and exemplary damages. As we will see, later Texas cases read Spears's concurring opinion in this way.

Justice Spears was wrong; there was no tort in Texas of bad faith breach of contract. Furthermore, much of the authority he relied upon did not justify the award of emotional and exemplary damages. Justice Spears cited three lines of cases. The first, and most helpful to Justice Spears, involved a liability insurer's duty to settle a claim. In Texas, this duty does sound in tort, but emotional and exemplary damages have not traditionally been awarded for its breach. Thus, the duty could have been grounded in contract with no important substantive change in the law. Even conceding, unwisely I think, that the duty to settle third-party insurance claims lies in tort, it does not follow that bad faith or delay in paying first-party claims or in performing other express obligations should be treated as a tort. The duty to settle third-party claims is more analogous to the typical fiduciary duty—a duty that is usually grounded in tort—because an insurer has the authority to deal with third parties for the benefit of the insured—much like an agent and a principal.

19. English, 660 S.W.2d at 524-25 (Spears, J., concurring).
20. Professor Crespi correctly observes that Justice Spears did not address the issue of exemplary damages in English. Gregory S. Crespi, Good Faith and Bad Faith in Contract Law: Reflections on A Cautionary Tale and Border Wars, 72 Tex. L. Rev. 1277, 1280 (1994). That later cases found a right to exemplary damages for bad faith breach based on English suggests the point was implicit in Spears's argument.
21. English, 660 S.W.2d at 524 (Spears, J., concurring).
22. Id. (citing G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Comm'n App. 1929, holding approved)).
23. Until recently, no Texas case had awarded emotional or exemplary damages for wrongful failure to settle. An insurer's liability traditionally has been limited by the judgment rendered due to its failure to settle within the policy limits. E.g., Hernandez v. Great Am. Ins. Co., 464 S.W.2d 91, 95 (Tex. 1971). Awards of exemplary damages were reversed in two early cases. See Linkenhoger v. American Fidelity & Casualty Co., 152 Tex. 534, 539, 260 S.W.2d 884, 887 (1953) (holding that an insurance company's rejection of offers to settle a personal injury suit against its insured did not constitute gross negligence and thus did not merit an award of exemplary damages), overruled on other grounds by Street v. Honorable Second Court of Appeals, 756 S.W.2d 299 (Tex. 1988); Smith v. Transit Casualty Co., 281 F. Supp. 661, 666 (E.D. Tex. 1968) (declining to award exemplary damages when the insured was not found to be grossly negligent), aff'd, 410 F.2d 210 (5th Cir. 1969). However, these cases left open the possibility of awarding exemplary damages because the decisions were based on a failure to show gross negligence.
24. See G.A. Stowers Furniture Co., 15 S.W.2d at 547 (stating that when an insurance company makes a contract, it assumes the responsibility of an agent).
liability for failure to settle depends on the level of care exercised by an insurer in passing on a settlement offer. In the context of bad faith or delay in paying first-party claims, on the other hand, the care exercised by the insurer is irrelevant. An insurer must pay a first-party claim if a court finds that the risk is covered regardless of how scrupulous the insurer is in reviewing the claim before denial. Another way of expressing this difference is that in the third-party claim case, the rule of good faith regulates the exercise of discretion under a contract—an insurer controls settlement, but it must use that power in good faith and with respect for the interests of the insured. In the first-party claim case, the rule of good faith is a basis for imposing additional sanctions on the breach of a nondiscretionary term of a contract.

The second line of cases cited by Justice Spears involved the duty of an oil and gas lessee or executive rights holder to protect the interests of the lessor or royalty owner in developing mineral property. This duty is expressed in terms of good faith, but it sounds in contract, and emotional and exemplary damages rarely are recovered for its breach. Emotional and exemplary damages are traditionally awarded only if there is an independent tort action such as fraud.

The third line of cases involved the duty of a partner or an agent as a fiduciary. This duty is expressed in terms of good faith, it sounds in tort, and exemplary damages may be had for its breach if it is willful or malicious. This third line of cases is not authority for treating bad faith

25. See Kent D. Syverud, The Duty to Settle, 76 VA. L. REV. 1113, 1122 (1990) (noting that insurers are only liable for failing to settle if their conduct departs from an accepted norm).

26. See Beck v. Farmers Ins. Exch., 701 P.2d 795, 799-800 (Utah 1985) (emphasizing the distinction between the third-party context, in which the interests of the insurer and the insured are aligned such that a fiduciary relationship arises and the first-party context, in which their interests are somewhat adversarial).

27. English v. Fischer, 660 S.W.2d 521, 524 (Tex. 1983) (Spears, J., concurring) (citing Schlitter v. Smith, 128 Tex. 628, 101 S.W.2d 543 (1937) and Amoco Prod. Co. v. First Baptist Church, 611 S.W.2d 610 (Tex. 1980)).


29. See, e.g., Pan Am. Petroleum Corp. v. Hardy, 370 S.W.2d 904, 908-09 (Tex. Civ. App.—Waco 1963, writ ref'd n.r.e.) (holding that a fraudulent concealment of drainage justified exemplary damages).

30. English, 660 S.W.2d at 524 (Spears, J., concurring).

31. See Johnson v. Peckham, 132 Tex. 148, 151, 120 S.W.2d 786, 787-88 (1938) (holding that partners in an oil and gas lease are confidential agents and their relationship mandates honesty and good faith); Kinzbach Tool Co. v. Corbett-Wallace Corp., 138 Tex. 565, 571, 160 S.W.2d 509, 512 (1942) (describing the duty of a fiduciary as requiring integrity, fidelity, fair dealing, and good faith).

32. See, e.g., Texas Bank & Trust Co. v. Moore, 595 S.W.2d 502, 510 (Tex. 1980) (awarding exemplary damages for a willful breach of a fiduciary duty); Christopher v. General Computer Sys., Inc., 560 S.W.2d 698, 706-07 (Tex. Civ. App.—Dallas 1977, writ ref'd n.r.e.) (upholding an exemplary damage award for willful diversion of corporate funds to personal use); Morgan v. Arnold, 441 S.W.2d 897, 905 (Tex. Civ. App.—Dallas 1969, writ ref'd n.r.e.) (allowing an award of exemplary
in the performance of contract as a tort generally (or in insurance cases in particular) because Texas courts have limited the duty to traditional fiduciary relationships and close relationships of kinship or friendship.  

33. See, e.g., Thigpen v. Locke, 363 S.W.2d 247, 252-53 (Tex. 1962) (recognizing two distinct categories of fiduciary relationships: "technical fiduciary relationships" like attorney-client relationships and confidential relationships that "arise informally from moral, social, domestic, or purely personal relationships").

34. 673 S.W.2d 180 (Tex. 1984).
35. Id. at 184.
36. Id. at 183.
37. Id. at 184.
38. See Mims v. Beall, 810 S.W.2d 876, 878 (Tex. App.—Texarkana 1991, no writ) (explaining that the decision in Manges was the first to equate a duty of utmost good faith with a fiduciary duty, thereby converting an executive rights holder's ordinary breach of contract to a breach of fiduciary duty warranting exemplary damages).
39. See, e.g., Miller v. Gahagen, 316 S.W.2d 160 (Tex. Civ. App.—Fort Worth 1958, no writ) (holding that the purchaser of a grantor's interest assumed the grantor's obligation to grantees under a written contract and was subject to the contract statute of limitations in an action to recover the amount allegedly due).
40. See, e.g., Kimsey v. Fore, 593 S.W.2d 107, 113-14 (Tex. Civ. App.—Beaumont 1979, writ ref'd n.r.e.) ( awarding the fair market value of the royalty interest); Portwood v. Buckalew, 521 S.W.2d 904, 910 (Tex. Civ. App.—Tyler 1975, writ ref'd n.r.e.) ( awarding a percentage of the overriding royalties and bonuses).
42. 725 S.W.2d 165 (Tex. 1987).
43. Id. at 167-68.
coverage after an accident because an inexperienced attorney had concluded on weak evidence that Arnold had been speeding and was intoxicated at the time of the accident. In reversing summary judgment for the insurer on a bad faith claim, the court relied on Manges and Justice Spears's concurring opinion in English to establish a duty of good faith in contracts involving special relationships, and it relied on an insurance case involving a failure to settle a third-party claim to establish that an insurance contract is such a relationship. Later Texas cases clarify that an insurer commits a tort if it denies a claim without a reasonable basis or without adequate

44. Id. at 166-67.
45. Id. at 167 (citing Manges, 673 S.W.2d at 183 and English v. Fischer, 660 S.W.2d 521, 524 (Tex. 1983) (Spears, J., concurring)).
46. Id. (citing G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544, 548 (Tex. Com'n App. 1929, holding approved)).
47. See Viles v. Security Nat'l Ins. Co., 788 S.W.2d 566, 567 (Tex. 1990) (affirming that a tort action exists for a breach of the duty of good faith and fair dealing if no reasonable basis existed for the claim denial); Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 213 (Tex. 1988) (holding that a tort action exists if a carrier breaches its duty of good faith and fair dealing by refusing to pay a claim without a reasonable basis). Liability exists for denial of a claim without a reasonable basis at the time of denial even though later events prove the claim invalid. See First Tex. Sav. Ass'n v. Reliance Ins. Co., 950 F.2d 1171, 1179 (5th Cir. 1992) (explaining that an insurance carrier's obligations, such as the common law duty of good faith and fair dealing, are imposed independent of duties arising under a policy); Viles, 788 S.W.2d at 567-68 (stating that whether a reasonable basis exists for the denial of an insurance claim should be judged with reference to the facts at the time of the denial); Republic Ins. Co. v. Stoker, 867 S.W.2d 74, 78-79 (Tex. App.—El Paso 1993, writ granted) (concluding that an insurer's denial of a claim can independently establish a breach of the duty of good faith and fair dealing even when it is later discovered that denial of the claim was justified). For a case finding a claim to be valid, but denying liability in tort because the insurer disputed its validity in good faith, see National Union Fire Insurance Co. v. Hudson Energy Co., 780 S.W.2d 417, 427 (Tex. App.—Texarkana 1989) (finding that the insurer's position established a good faith legal controversy justifying litigation of the claim), aff'd, 811 S.W.2d 552 (Tex. 1991).

Lyons v. Millers Casualty Insurance Co., 866 S.W.2d 597 (Tex. 1993), is important because it clarifies the standard for appellate review of a jury's verdict of bad faith. Lyons made a claim for wind damage to a wall under her homeowner's policy. Id. at 598-99. The insurer denied the claim after a contractor hired to evaluate the damage concluded that it was caused by shifting of the foundation, which predated the storm. Id. at 599. There was much evidence to support this assessment. After Lyons complained, Millers hired a second contractor to evaluate the damage, and that contractor agreed with the first. Id. There was physical evidence that the foundation had shifted earlier, and it seemed unlikely that the tree had struck the house, as Lyons had claimed. Id. The Texas Supreme Court reversed the jury's verdict of bad faith. Id. at 599 & n.1. The decision turns on an issue of Texas procedure. Although prior Texas law allowed courts to reverse factual determinations only if there was no evidence in the record to support the jury's verdict, the court restated the standard for appellate review of bad faith determinations. The court reasoned that because under the applicable standard of bad faith an insurer was liable for bad faith only if there was no reasonable basis for denying a claim, an appellate court should have asked whether the "evidence presented, viewed in the light most favorable to the prevailing party . . ., permitted the logical inference that the insurer had no reasonable basis to delay or deny payment of the claim . . . ." Id. at 600. Lyons failed to meet this standard because she offered no evidence that the experts' reports were not objectively prepared or otherwise should have seemed unreliable to the insurer. Id. at 601. A dissenting opinion argued that the no-evidence standard required affirmance because the jury finding that the claim was partially valid, coupled with the evidence supporting that determination, supported a finding of bad faith and therefore
investigation, but the question remains open whether mere negligence in a claim evaluation is bad faith. Commission of the tort can result in an award of emotional damages as well as the usual contractual damages. Exemplary damages are also available. Prior to Transportation Insurance Co. v. Moriel it was not clear whether the standard for awarding exemplary damages exceeded the standard for finding bad faith. In Arnold and later cases, the Texas Supreme Court adopted the usual tort standard for awarding exemplary damages, which requires that a tortfeasor act with malice or with conscious indifference to the victim’s rights. Lower courts applied this was sufficient under the traditional conception of the no-evidence standard. Id. at 604-05 (Doggett, J., dissenting).

48. See Automobile Ins. Co. v. Davila, 805 S.W.2d 897, 904, 903-04 (Tex. App.—Corpus Christi 1991, writ denied) (stating that bad faith includes a “failure by the insurer to determine whether there was a reasonable basis for denying the claim”).

49. The two leading lower court cases on the standard of reasonableness are State Farm Lloyds, Inc. v. Polasek, 847 S.W.2d 279, 283-88 (Tex. App.—San Antonio 1992, writ denied), and State Farm Fire & Casualty Co. v. Simmons, 857 S.W.2d 126, 133-37 (Tex. App.—Beaumont 1993, writ denied). The cases differ on the question of whether mere negligence in evaluating a claim is bad faith. Both involve claims for fire damage in which there was some circumstantial evidence of arson by the insured. Polasek holds that an insurer is not liable so long as a claim is reasonably in doubt even if a reasonable insurer would have paid the claim. Polasek, 847 S.W.2d at 286. Simmons holds that even though a claim is in doubt, an insurer may be liable for bad faith if there is evidence that a reasonable insurer would have paid the claim. Simmons, 857 S.W.2d at 132-35. The tests produce different results if there is some evidence to justify denying a claim, but the weight of the evidence goes the other way. Lyons does not really resolve this conflict. The majority stated that it applied the no reasonable basis test because that was the formulation on which the case had been tried below. See Lyons, 866 S.W.2d at 600 n.2 (adhering to the Aranda formulation of the bad faith test).

50. Arnold, 725 S.W.2d at 168.

51. 879 S.W.2d 10 (Tex. 1994).

52. Arnold, 725 S.W.2d at 168; see Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 215 (Tex. 1988) (confirming that exemplary damages may be awarded for breach of the duty of good faith and fair dealing under the same criteria used to allow exemplary damages in other tort actions); cf. Chitsey v. National Lloyds Ins. Co., 738 S.W.2d 641, 643-44 (Tex. 1987) (holding that exemplary damages could not be awarded because a jury found that the insurer had not been grossly negligent in valuing the loss from a fire).

53. See Trenholm v. Ratcliff, 646 S.W.2d 927, 933 (Tex. 1983) (holding that conscious indifference to a real estate purchaser's rights was sufficient to award exemplary damages); Ware v. Paxton, 359 S.W.2d 897, 898-99 (Tex. 1962) (indicating that to justify an award of exemplary damages, the defendant's conduct must be not only unlawful, but also wanton and malicious); Bennett v. Howard, 141 Tex. 101, 108, 170 S.W.2d 709, 712 (1943) (deciding that exemplary damages are available if “the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons affected by it” (emphasis in original)). The current jury charge states that exemplary damages may be imposed if the defendant acts with “heedless” or “reckless” indifference to the plaintiff’s rights, which is defined as “such an entire want of care as to indicate that the act or omission in question was the result of conscious indifference to the rights, welfare, or safety of persons affected by it.” State Farm Mut. Auto. Ins. Co. v. Zubiate, 808 S.W.2d 590, 599 (Tex. App.—El Paso 1991, writ denied). The standard is different from that usually employed in a contractual context, in which acting to profit oneself at the expense of another is not thought to be malicious. See Clements v. Withers, 437 S.W.2d 818, 822 (Tex. 1969) (holding that liability may arise for the tortious interference with an existing contract despite the interfering party’s motive to save money, but that actual malice is still required to support an award of exemplary damages).
standard with different severity. Some cases permitted juries to award exemplary damages even though an insurer had an apparently plausible basis for denying a claim if there was evidence of bias or dilatory investigation.54 These cases seem to assume that the standard for exemplary damages is the same as that of bad faith. Other cases gave insurers the benefit of the doubt and did not permit juries to award exemplary damages if a claim honestly seemed in doubt.55 *Moriel* establishes a high standard for the award of exemplary damages: An insurer must have known or had reason to know that the claim denial threatened serious harm to the insured that was qualitatively different from the usual harm from breach of contract.56 The case also held that the anxiety and mental anguish that the jury found substantial was not such an injury.57

54. Nationwide Mut. Ins. Co. v. Crowe, 857 S.W.2d 644, 648 (Tex. App.—Houston [14th Dist.]) (awarding exemplary damages for a denial of a claim for death benefits under a workers' compensation policy even though the Industrial Accident Board had concluded on the same factual record as was before the insurer that the decedent's heart attack was not work related), *vacated pursuant to settlement*, 863 S.W.2d 462 (Tex. 1993); Nicolau v. State Farm Lloyds, 869 S.W.2d 543, 551 (Tex. App.—Corpus Christi 1993, writ granted) (awarding exemplary damages for the denial of a claim for foundation damage that the insured attributed to a plumbing leak despite reputable studies, accepted by the expert employed to investigate the claim, indicating that plumbing leaks could not cause such damage); Commonwealth Lloyd's Ins. Co. v. Thomas, 825 S.W.2d 135, 138–40 (Tex. App.—Dallas 1992) (upholding a jury award of exemplary damages, even though there was physical and circumstantial evidence of arson, because there was doubt about the arson evidence and there was exculpatory evidence to which the insurer may have given too little weight), *vacated pursuant to settlement*, 843 S.W.2d 486 (Tex. 1993). In *State Farm Mutual Automobile Insurance Co. v. Zubiate*, the court upheld a jury award of exemplary damages despite the fact that a Mexican police report stated and the wrecker testified that the accident occurred 98 miles from the United States border, a factor that would justify denial of a claim for accident insurance under a policy provision limiting coverage to accidents within 25 miles of the border. *Zubiate*, 808 S.W.2d at 597–98. The award was upheld because the insurer failed to conduct an on-site investigation, which would have disclosed that the accident site was within 25 miles of the border, but 98 miles from the claimant's port of entry. *Id.* at 594–95. The Texas experience belies Kenneth Abraham's claim that most bad faith cases involve "repeated attempts by the insured to furnish satisfactory evidence of coverage, and stubborn, vengeful, or blind refusals by insurers to reconsider the denial of payment." KENNETH S. ABRAHAM. DISTRIBUTING RISK 186 (1986).

55. See Automobile Ins. Co. v. Davila, 805 S.W.2d 897, 908–10 (Tex. App.—Corpus Christi 1991, writ denied) (finding insufficient evidence to support an award of exemplary damages based on conscious indifference by the insurer); National Union Fire Ins. Co. v. Hudson Energy Co., 780 S.W.2d 417, 427 (Tex. App.—Texarkana 1989) (holding that an insurer's refusal to pay was justified because there was a legitimate interpretive question), *aff'd*, 811 S.W.2d 552 (Tex. 1991); cf. National Fire Ins. Co. v. Valero Energy Corp., 777 S.W.2d 501, 511 (Tex. App.—Corpus Christi 1989, writ denied) (reversing an award of exemplary damages because the jury was not asked to find intentional misconduct).


57. *Id.* at 26. The fact that the court remanded the case qualifies this holding and suggests that *Moriel* established a colorable claim of sufficient mental anguish from nonpayment of the claim. Justice Doggett argued in a concurrence that remanding was a cynical gesture because it would be impossible for Moriel to make a case for exemplary damages under the new standard. *Id.* at 35 (Doggett, J., concurring).
With one exception,\footnote{58} Texas appellate courts have refused to extend the tort beyond the areas of insurance and executive rights agreements.\footnote{59} Claims of bad faith in employment, franchise, and other relations have prevailed at the trial level often with enormous damage awards only to be reversed on appeal.\footnote{60} Occasional dissents have urged extension of the tort

58. \textit{Houston Cable TV, Inc. v. Inwood West Civic Association}, 839 S.W.2d 497 (Tex. App.—Houston [14th Dist.] 1992), vacated pursuant to settlement, 860 S.W.2d 72 (Tex. 1993), extended the tort to contracts between a cable television company and neighborhood civic associations on the theory that the company's status as a public service enterprise created the requisite special relationship. \textit{Id.} at 504. The facts of the case suggest a different theory of liability akin to that in \textit{Seaman's Direct Buying Service, Inc. v. Standard Oil Co.}, 686 P.2d 1158 (Cal. 1984), which allows tort remedies for breach of contract when a defendant denies in bad faith and without probable cause that the contract exists. \textit{Id.} at 1167. Houston Cable had promised to pay the civic associations 2\% to 3\% of its gross revenues if they persuaded their members to allow the company to lay cable lines through the neighborhood. Once the company controlled the market, it stopped payment by falsely claiming that federal law forbade such payments. \textit{Houston Cable TV,} 839 S.W.2d at 504. \textit{Seaman's} holds that such bad faith denial of an obligation under a contract is a tort even without a special relationship. \textit{Seaman's}, 686 P.2d at 1167. Later California cases undercut \textit{Seaman's}. \textit{See, e.g., Malmstrom v. Kaiser Aluminum \& Chem. Corp.}, 231 Cal. Rptr. 820, 832 (Ct. App. 1986) (holding that an at-will employee cannot raise the \textit{Seaman's} rule); \textit{Quigley v. Pet, Inc.}, 208 Cal. Rptr. 394, 401 (Ct. App. 1984) (stressing that the \textit{Seaman's} rule does not apply absent a special relationship). Therefore, a claim based on this theory probably would not succeed in California today.

59. A federal case, \textit{Schmueser v. Burk Burnett Bank}, 937 F.2d 1025 (5th Cir. 1991), interpreting Texas law, extends the tort in a truly radical fashion. The case holds that any breach of the duty of good faith under the Uniform Commercial Code is tortious even without a special relationship of trust or confidence. \textit{Id.} at 1031-32. The case involved a claim by a homeseller against a bank for wrongful failure to pay on a letter of credit established by the buyer to provide security in the purchase of the home. An earlier declaratory judgment action against the bank to collect on the letter of credit barred contract claims. \textit{Id.} at 1029. The court found no claim under the Deceptive Trade Practices Act, TEX. BUS. \& COM. CODE ANN. § 17.45-63 (Vernon 1987), because the homeseller was not a consumer, \textit{Schmueser}, 937 F.2d at 1028-29, but it allowed the good faith claim to proceed. \textit{Id.} at 1031-32. This reasoning would make claims of dishonesty in any contract covered by Article 1 of the UCC and, presumably, any failure by a merchant in a sale or lease of goods to perform in accordance with reasonable commercial standards sound in tort. \textit{Section 2-103(b)} defines good faith for merchants in sales of goods as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." U.C.C. § 2-103(1)(b) (1993). The same definition applies under Article 2A, which covers leases of goods. \textit{See id.} § 2A-103(3). \textit{Schmueser rests on a simple fallacy; just because the tort director the standard of care in terms of good faith does not mean that all duties defined in those terms sound in tort. The concept of good faith runs throughout the law; it would hardly do to unthinking to sweep all of these areas into tort.}

60. \textit{See, e.g., Crim Truck \& Tractor Co. v. Navistar Int'l Transp. Corp.}, 823 S.W.2d 591, 596-97 (Tex. 1992) (upholding the reversal of a breach of fiduciary duty verdict); \textit{Day \& Zimmerman, Inc. v. Hatridge}, 831 S.W.2d 65, 67-72 (Tex. App.—Texarkana 1992, writ denied) (reversing a $64,000 judgment for the plaintiff in a wrongful discharge case); \textit{Adolph Coors Co. v. Rodriguez}, 780 S.W.2d 477, 478-79 (Tex. App.—Corpus Christi 1989, writ denied) (reversing a judgment for plaintiff of over $14,000,000 for breach of a distributorship contract); City of San Antonio v. Forgy, 769 S.W.2d 293, 298 (Tex. App.—San Antonio 1989, writ denied) (reversing the trial court judgment for a plaintiff contractor of $341,744.64 plus interest in an action against a municipality over a contract to drill a water well); \textit{Transcontinental Gas Pipe Line Corp. v. American Nat'l Petroleum Co.}, 763 S.W.2d 809, 811, 826-27 (Tex. App.—Texarkana 1988) (reducing a judgment of nearly $22,000,000 for a tortious interference with a contract by roughly 95\% through reversal of various verdicts), rev'd on other grounds, 798 S.W.2d 274 (Tex. 1990).
to no avail. Claims by borrowers and loan guarantors against banks on this theory have been rebuffed, as have claims of bad faith termination or other mistreatment by employees and franchisees or distributors. Courts have also held that the tort does not extend to contracts between a city and a contractor. In the area of oil and gas, the tort has not been extended to cover mineral leases, joint operating agreements, development contracts, and mineral purchase contracts.

Changes in the Texas Supreme Court may best explain the failure to extend the tort. The crucial change in the court seems to have occurred in 1991. Prior to 1991, plaintiffs almost always won on bad faith and related statutory claims; from 1991 on they almost always have lost. Prior to 1991, a divided court extended the tort to workers’ compensation on facts

61. See, e.g., Crim Truck & Tractor Co., 823 S.W.2d at 597, 599-600 (Mauzy, Doggett, & Gammage, JJ., dissenting) (accusing the majority of "abandon[ing] motor vehicle dealers and other small businesses across the state to the whims of powerful franchisors" and reviewing in detail evidence of a franchisor’s superior bargaining power and exclusive control); Lumpkin v. H & C Communications, Inc., 755 S.W.2d 538, 540 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (Levy, J., dissenting) (advocating the repudiation of "the harsh ‘at will’ doctrine" and urging the adoption of the implied covenant of good faith and fair dealing in the employment relationship).


64. E.g., Crim Truck & Tractor Co., 823 S.W.2d at 596 n.8; Adolph Coors Co., 780 S.W.2d at 481.

65. E.g., City of San Antonio v. Forgy, 769 S.W.2d 293, 295-98 (Tex. App.—San Antonio 1989, writ denied).

66. See, e.g., Texas Oil & Gas Corp. v. Hagen, 31 Tex. Sup. Ct. J. 140, 141-42 (Dec. 16, 1987) (stating that a mineral lease does not impose a higher duty than reasonableness on the parties to the contract), withdrawn pursuant to settlement, 760 S.W.2d 960 (Tex. 1988); Hurd Enters., Ltd. v. Bruni, 828 S.W.2d 101, 108-12 (Tex. App.—San Antonio 1992, writ denied) (holding that, absent a confidential relationship, there is no duty of good faith and fair dealing implied in a mineral lease contract).


that suggested the carriers had not acted too unreasonably,\(^{70}\) found a statutory claim for exemplary damages for bad faith in claims processing by a highly imaginative reading of the relevant statutes,\(^{71}\) and disassociated the tort claim from contract to establish that a claim for bad faith in claims processing might stand even though the insurer turns out to have a valid contractual ground for denying coverage.\(^{72}\) The plaintiffs lost in only one important case during this period and by only one vote.\(^{73}\)

From 1991 on, a divided court has held the tort does not extend to franchising relationships,\(^{74}\) has strengthened the standard for appellate review of bad faith determinations,\(^{75}\) has refused to extend the tort to cover claims adjusters,\(^{76}\) has changed the standard for exemplary damages

\(^{70}\) In Aranda v. Insurance Co. of North America, 748 S.W.2d 210 (Tex. 1988), two workers' compensation carriers could not agree which was liable for an employment-related injury that could have been sustained in one or both of two positions; therefore, they petitioned the Industrial Accident Board to determine their liability. The decision was five to four. Justices Spears, Robertson, Kilgarlin, Ray, and Mauzy were in the majority. Justices Phillips, Culver, Wallace, and Gonzalez were in dissent.

\(^{71}\) For a discussion of Vail v. Texas Farm Bureau Mutual Insurance Co., 754 S.W.2d 129 (Tex. 1988), see infra note 123. The decision was six to two. Justices Spears, Robertson, Kilgarlin, Ray, Wallace, and Mauzy were in the majority. Justices Culver and Gonzalez were in dissent. Justice Phillips added a dissent on the motion for rehearing.

\(^{72}\) See Viles v. Security Nat'l Ins. Co., 788 S.W.2d 566, 568 (Tex. 1990) (Hecht, J., concurring). The reasoning and not the result is remarkable in Viles. The insurer claimed a defense based on a policy term that required submission of a sworn proof of loss within 91 days of the accident. The insurer had notice of the claim and had already rejected it before the 91 days lapsed. \(\text{Id. at 566-67}\). The concurring opinion argued that the insurer waived the policy defense as a matter of law on these facts. \(\text{Id. at 568-69}\). The decision was five to four. Justices Doggett, Spears, Ray, Hightower, and Mauzy were in the majority. Justices Hecht, Phillips, Gonzalez, and Cook concurred.

\(^{73}\) Murray v. San Jacinto Agency, 800 S.W.2d 826 (Tex. 1990), held that the statute of limitations on a bad faith claim ran from the time the claim was first denied. \(\text{Id. at 828-29}\). Justices Gonzalez, Phillips, Cook, Hightower, and Hecht were in the majority. Justices Spears, Ray, Mauzy, and Doggett were in dissent. I do not count Chitsey v. National Lloyds Insurance Co., 738 S.W.2d 641 (Tex. 1987), as an important case. The Chitsey court held that a claim of unfair practices under Texas Insurance Code Article 21.21 \(\text{A}\) required a showing of a pattern of unfair practices in handling claims. \(\text{Id. at 643}\). This aspect of the case was quickly made irrelevant by Vail, which created a right of action for unfair claims handling practices when frequency could not be shown through \(\text{§ 16 of Article 21.21}\). Vail, 754 S.W.2d at 134. The Chitsey court also upheld an appellate reversal of a jury award of exemplary damages because the jury had not been instructed to find gross negligence. Chitsey, 738 S.W.2d at 643-44.

\(^{74}\) Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 596 (Tex. 1992). The decision was six to three; Justices Cornyn, Phillips, Gonzalez, Cook, Hightower, and Hecht were in the majority, and Justices Mauzy, Doggett, and Gammage were in dissent.

\(^{75}\) See Lyons v. Millers Casualty Ins. Co., 866 S.W.2d 597, 600-01 (Tex. 1993). The decision was six to three, with Justices Cornyn, Phillips, Gonzalez, Hecht, Enoch, and Spector in the majority and Justices Doggett, Hightower, and Gammage in dissent. National Union Fire Insurance Co. v. Dominguez, 873 S.W.2d 373 (Tex. 1994), follows Lyons closely reviewing the factual basis for a jury determination of bad faith. \(\text{Id. at 378}\).

\(^{76}\) Natividad v. Alexis, Inc., 875 S.W.2d 695, 696 (Tex. 1994). The decision was five to four, with Justices Gonzalez, Phillips, Hecht, Cornyn, and Enoch in the majority and Justices Gammage, Hightower, Doggett, and Spector in dissent.
in a way that makes them virtually impossible to recover in a bad faith case,\textsuperscript{77} has denied injured claimants a statutory cause of action for bad faith in handling a liability claim,\textsuperscript{78} and has reversed a jury determination of bad faith in handling a liability claim while questioning whether the tort even covered mishandling of liability claims.\textsuperscript{79} The plaintiff won only one case, holding that the tort extended to wrongful cancellation of a policy.\textsuperscript{80}

\textit{McClendon v. Ingersoll-Rand Co.}\textsuperscript{81} exemplifies the change in the reception of bad faith claims in the Texas Supreme Court. In 1989, the court took this wrongful termination case on appeal from a decision that held that the tort did not extend to the employment relationship.\textsuperscript{82} The case was briefed and argued as a bad faith case. In an opinion by Justice Spears, the majority held that the employee had a cause of action for wrongful termination on a more limited public policy ground because the employee alleged he was fired to deny him a pension.\textsuperscript{83} Justice Spears reserved the question of whether the tort of bad faith breach extended to the employment relationship.\textsuperscript{84} Justices Cook and Gonzalez dissented and argued that the court should reach the bad faith issue because that was the issue posed to the court and that it should refuse to extend the tort to the employment relationship.\textsuperscript{85} The United States Supreme Court took the case and held the pension claim to be preempted by federal law.\textsuperscript{86} When the case was remanded to the Texas Supreme Court in 1991, it reinstated the decision of the court of appeals, which had rejected the bad faith claim, without addressing the issue.\textsuperscript{87} A bad faith claim that was vigorously argued in 1989 was moribund in 1991.

\textsuperscript{77} Transportation Ins. Co. v. Moriel, 879 S.W.2d 10, 40 (Tex. 1994) (Doggett, J., concurring). The decision was nine to zero, with Justices Cornyn, Phillips, Gonzalez, Hightower, Hecht, Enoch, and Spector in the majority and Justices Doggett and Gammage in concurrence.

\textsuperscript{78} See Allstate Ins. Co. v. Watson, 876 S.W.2d 145, 150 (Tex. 1994) (holding that a third-party claimant does not have standing to sue an insurance carrier directly for unfair claim settlement practices). The decision was six to two with Justice Spector concurring. Justices Enoch, Phillips, Gonzalez, Hightower, Hecht, and Cornyn were in the majority, and Justices Doggett and Gammage dissented. The majority decision repudiates the reasoning that underlay \textit{Vail}.


\textsuperscript{80} Union Bankers Ins. Co. v. Shelton, 37 Tex. Sup. Ct. J. 1138, 1994 WL 278131 (June 22, 1994). The decision was four to three with Justices Hightower, Doggett, Gammage, and Spector in the majority; Justice Phillips concurred; and Justices Cornyn, Gonzales, and Hecht dissented arguing that there was no evidence of bad faith. Justice Enoch did not sit.

\textsuperscript{81} 779 S.W.2d 69 (Tex. 1989), rev'd, 498 U.S. 133 (1990).


\textsuperscript{83} McClendon, 779 S.W.2d at 71.

\textsuperscript{84} Id. at 70 n.1.

\textsuperscript{85} Id. at 74-75 (Cook, J., dissenting); id. at 75-76 (Gonzalez, J., dissenting).


\textsuperscript{87} McClendon v. Ingersoll-Rand Co., 807 S.W.2d 377, 377 (Tex. 1991) (per curiam).
The change in the reception of bad faith claims in 1991 may partly be due to a change in personnel. Justices Spears and Ray left the court in 1990 and were replaced by Justices Cornyn and Gammage. This switch may have cost plaintiffs a crucial vote in bad faith cases. Spears and Ray consistently sided with plaintiffs and Cornyn has sided with the defense (Gammage consistently has sided with plaintiffs). The eruption of bad faith litigation and the number of reported cases with large exemplary damage awards may also have influenced some justices.

The arguments made by the new conservative majority for restricting the tort often are as unprincipled\(^8\) as the arguments made by the old liberal majority in creating and extending the tort. The most important new restriction on the tort of bad faith breach is the rule stated in *Moriel* that exemplary damages are recoverable only if the insured suffered a serious injury beyond that normally associated with breach of contract.\(^9\) The majority justified this rule by citing to cases from other states.\(^9\) But, as Justice Doggett argued in concurrence, not one of the cited cases even suggests such a rule.\(^9\) In states that recognize the tort of bad faith breach, insureds can recover exemplary damages even though they suffer no extraordinary injury.\(^9\) The majority would have been on stronger ground in *Moriel* had it simply reversed *Arnold* and held that a tort claim would not lie for bad faith breach of contract. The most embarrassing spectacle are two cases involving statutory claims for bad faith in claims handling. The

\[\text{88. By unprincipled I mean that the arguments do not satisfy normal standards of validity in legal argument.}\]

\[\text{89. Transportation Ins. Co. v. Moriel, 879 S.W.2d 10, 23 (Tex. 1994).}\]

\[\text{90. Id. at 24.}\]

\[\text{91. Id. at 40 n.18 (Doggett, J., concurring). Only one of the seven cases is close. Anderson v. Continental Insurance Co., 271 N.W.2d 368 (Wis. 1978), holds that the recovery of mental anguish damages on a claim of bad faith requires a showing of substantial damages in addition to mental anguish and normal contract damages. Id. at 378. However, the case imposes no similar limit on the recovery of exemplary damages. Id. at 378-79. Thus, Anderson adopts a position opposite to that adopted in *Moriel*, which held that mental anguish damages but not exemplary damages could be recovered in a bad faith claim absent special harm. Three of the cases discuss the mental state required for exemplary damages with no mention of an element of special harm. Linthicum v. Nationwide Life Ins. Co., 723 P.2d 675, 680-81 (Ariz. 1986); Borland v. Safeco Ins. Co. of Am., 709 P.2d 552, 557 (Ariz. Ct. App. 1984); Weisman v. Blue Shield, 209 Cal. Rptr. 169, 173-74 (Ct. App. 1984). Two cases refuse to create a tort for bad faith in nonpayment of insurance and hold that exemplary damages may not be recovered in contract. Guarantee Abstract & Title Co. v. Interstate Fire & Casualty Co., 652 P.2d 665, 668-69 (Kan. 1982); Newton v. Standard Fire Ins. Co., 229 S.E.2d 297, 302-03 (N.C. 1976). The last was a per curiam opinion denying a jury award of exemplary damages after the jury had not found any damages on the tort claim as a basis for the award. Shimola v. Nationwide Ins. Co., 495 N.E.2d 391, 394 (Ohio 1986). The jury had awarded damages on a separate contract claim, but the court deemed those insufficient because the jury instruction required an award of damages on the tort claim as a basis for awarding exemplary damages. Id. at 393-94. If the jury had awarded the mental anguish damages sought by the plaintiff on the bad faith claim, such an award presumably would have supported the award of exemplary damages.}\]

\[\text{92. Moriel, 879 S.W.2d at 41 n.19 (Doggett, J., concurring).}\]
first case found a statutory claim in the first-party context through a con-
torted interpretation of the statutes; the second case found no statutory
claim by an injured party for mishandling a liability claim through the op-
posite interpretation of the same statutes while citing the first case as
authority.

The unprincipled quality of arguments in this area may partly be due
to the nature of the tort of bad faith breach. The tort opened a new rupture
in the membrane between contract and tort without any meaningful doctrin-
al limitation. Normally a tort claim will not lie when there is a breach of
contract or when a loss is purely economic or emotional and there is not
injury to person or property other than the subject matter of the con-
tract. Some torts protect against purely economic or emotional loss—
such as misrepresentation, defamation, infliction of emotional distress, and
interference with contract—but doctrinal limits on these torts have histori-
cally kept them out of most contract cases. The tort of bad faith breach as
formulated in English is not so easy to limit. The vague and highly sub-
jective terms characterizing the contracts to which the tort applies—special
relationships involving trust or confidence or relationships involving an
imbalance of bargaining power—fit employment, franchise, and other
long-term contractual relationships as well as they fit the insurance relation-
ship and better than they fit executive rights agreements in mineral leases.
Doctrinal arguments for or against extension of the tort inevitably seem un-
reasoned and driven by other unstated agendas.

II. Problems with the Tort of Bad Faith Breach

In Part I, I showed that the tort of bad faith breach represents a
significant change in Texas law. Now I will explain why the tort is bad
policy. I focus on the tort’s significant costs and limited benefits, but

the availability of a breach of contract action does not preclude a first-party action for bad faith breach
under the Insurance Code or Deceptive Trade Practices Act). See infra note 123 for a discussion of
the case.


96. See English v. Fischer, 660 S.W.2d 521, 524 (Tex. 1983) (Spears, J., concurring) (noting
that Texas courts have imposed the duty of good faith and fair dealing in contractual relationships
involving imbalances of bargaining power between the parties).

97. An argument for the tort is that certain breaches of contract are morally wrong and deserve
punishment. This could explain why punitive damages are imposed when a friend, family member,
or fiduciary (such as a lawyer) intentionally breaches a contract. See, e.g., Texas Bank & Trust Co.
v. Moore, 595 S.W.2d 502, 508-10 (Tex. 1980) (holding that a nephew was a fiduciary of his aunt,
who transferred property for his care taking, and was liable for exemplary damages for misuse of
the property). Breaking a promise in order to take advantage of someone in a close and personal relation-
ship is reprehensible. But it is hard to see why the tort should extend to more impersonal relationships
or to breaches that are, at worst, a result of negligence.
other objections to the tort exist. The tort is not well grounded in Texas precedent as Part I shows. A tort expanded beyond insurance would not conform to the law of most other states. Many (though not all) states treat mishandling of insurance claims as a tort, but very few states presently treat bad faith in the performance of contracts other than insurance as a tort. The tort has troubling distributional consequences: It enriches a few at the expense of many with significant transaction costs.

98. I am taken aback by Professor Patterson’s objection to the “form” of my argument. See Dennis Patterson, Good Faith in Tort and Contract Law: A Comment, 72 TEX. L. REV. 1291, 1294 (1994) (“[O]ne cannot criticize judicial expansion of the duty of good faith on the basis of economic justifications because those justifications have no force in law.”). Professor Patterson makes an important point in telling us to keep distinct arguments of law and arguments about law. Dennis Patterson, The Pseudo-Debate over Default Rules in Contract Law, 3 S. CAL. INTERDISCIPLINARY L.J. 235, 239-40 (1993). The truth or falsity of arguments of law is tested by norms of the legal discipline, whereas the truth or falsity of arguments about law is tested by norms of other disciplines such as economics or history. Id. at 241, 264-65. It is a mistake, as Professor Patterson has argued elsewhere, to assume that claims about the efficiency of a rule necessarily tell us anything about its legality. Id. at 269. I do not fall into this error. I question the propriety of the tort of bad faith breach on legal grounds—that it is not well grounded in precedent—and then make the further claim that the tort is probably economically undesirable. The second claim is a claim about the law, but that does not make it irrelevant, particularly if the legal argument is inconclusive.


100. California briefly allowed a claim in tort for bad faith breach, defined as the denial without probable cause of the existence of a contractual obligation. See Seaman’s Direct Buying Serv., Inc. v. Standard Oil Co., 686 P.2d 1158, 1167 (Cal. 1984). More recently the California Supreme Court held that the bad faith termination of an employee was not tortious. Foley v. Interactive Data Corp., 765 P.2d 373, 389-401 (Cal. 1988). Even Seaman’s did not go as far as Texas has in treating bad faith in performance of an obligation as tortious because Seaman’s defined bad faith as the denial of the existence of an obligation without probable cause. Seaman’s, 686 P.2d at 1167. In Seaman’s, Chief Justice Bird argued in concurrence that any intentional breach ought to be tortious in contracts involving trust or confidence in the other party’s performance. Id. at 1171-77 (Bird, C.J., concurring).

Occasional cases do award exemplary damages for oppressive or malicious breach of contract outside the insurance context. See, e.g., Burkons v. Ticor Title Ins. Co., 798 P.2d 1308, 1309 (Ariz. Ct. App. 1989) (extending the tort remedy for bad faith to escrow contracts), vacated, 813 P.2d 710 (Ariz. 1991); Davis v. Gage, 682 P.2d 1282, 1286-87 (Idaho Ct. App. 1984) (upholding an award of punitive damages for willful disregard of a covenant not to compete); F.D. Borkholder Co. v. Sandock, 413 N.E.2d 567, 570-71 (Ind. 1980) (allowing punitive damages when a contractor willfully disregarded an architect’s specifications); Hibschman Pontiac, Inc. v. Batchelor, 362 N.E.2d 845, 848 (Ind. 1977) (allowing punitive damages against a car dealer who repeatedly refused to make warranty repairs); Joseph Schlitz Brewing Co. v. Central Beverage Co., 359 N.E.2d 566, 580-81 (Ind. Ct. App. 1977) (allowing punitive damages when a distributorship was terminated on pretextual grounds); Glidden v. Skinner, 458 A.2d 1142, 1144-45 (Vt. 1983) (allowing punitive damages against a defendant who had a pattern of reneging on sales contracts to capture a buyer’s improvements to his farm). Some states define the tort in insurance cases in terms broad enough to open the door to tort claims in other contract cases. See Mark Pennington, Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years, 42 ARK. L. REV. 31 (1989) (examining cases addressing the availability of punitive damages in suits for breach of contract). All states allow tort claims arising out of contractual transactions in cases involving independent torts as fraud, breach of fiduciary duty, intentional infliction of emotional distress, and negligence in personal injury. Id. at 34.

101. A few successful claimants are enriched. These costs are often passed on by the defendants.
The usual economic argument for treating certain breaches of contract as a tort with liability for emotional or exemplary damages is that a promisor otherwise would have too little incentive to perform because the contract would be underenforced. Underenforcement has several possible causes. The promisee may find enforcement prohibitively costly because of a lack of resources or because compensated damages are too small to warrant suit. Promisees may not know of their rights. Damages may be undervalued. For example, emotional harm or other speculative consequential damages to the promisee from breach may not be compensated. Or, courts may not hold promisors to a high enough standard of performance. Allowing emotional or exemplary damages may offset this disincentive by increasing the expected cost to a promisor found in breach.

One feature of Texas law greatly weakens any argument for expanding damages recoverable for breach of contract based on enforcement costs. In Texas, promisees may recover attorneys' fees in any successful suit for breach of contract. Requiring a promisor to pay a promisee's attorneys' fees on successful contract actions counteracts the underenforcement resulting from small claims and poor claimants because it makes successful litigation costless to the promisee. Fee-shifting also ought to customers through higher prices and lower yields. Transaction costs are significant because of the cost of resolving liability and determining emotional and exemplary damages. It is also possible that the addition of a large but uncertain payoff may suppress settlements.

102. E.g., Alan Schwartz, The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures, 100 YALE L.J. 369, 401-03 (1990). Compensating for underenforcement is also a common argument for punitive damages in tort. See WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW 160-63 (1987) (arguing that punitive damages are justifiable when high transaction costs make it socially efficient to bypass the market and the claims would not be enforced in the courts absent the potential award of punitive damages); STEVE SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW 146-51 (1987) (reasoning that because they sometimes escape suit, "injurers may not have adequate incentives to take care unless the amount they pay when they are sued exceeds the losses they cause in the particular case"); Marc Galanter & David Luban, Poetic Justice: Punitive Damages and Legal Pluralism, 42 AM. U. L. REV. 1393, 1448 (1993) (suggesting that damages will deter a targeted behavior if they are augmented so that economic actors must internalize the injuries they cause).

103. Cf. Schwartz, supra note 102, at 402 n.65 (noting that even punitive damages will not cure underenforcement when promisees are ignorant of the right to recover them).


106. TEX. CIV. PRAC. & REM. CODE ANN. § 38.001(8) (Vernon 1986).

107. A disincentive to sue due to litigation costs remains even with fee-shifting. Claimants or their attorneys are not compensated for the risk they bear on claims with less than 100% chance of success—the claimant or attorney bears the cost of suit on failure, but recovers only the actual cost on success.
encourage attorneys to advertise to inform people of their rights when ignorance of rights is pervasive. Furthermore, fee-shifting increases the expected cost of a breach to a promisor by increasing the damages for the breach by the amount of the promisee’s fees.

With fee-shifting, underenforcement should not be a problem in cases in which the promisee is sophisticated, damages are economic, and the standard of performance is clear. There is no need to extend the tort of bad faith breach to such cases. Extension of the tort with exemplary damages to mismanagement under an executive rights agreement probably is unjustified even without fee-shifting. Damages in such cases tend to be large and mostly economic, and usually the injured mineral rights owner is reasonably well-to-do and able to bring suit. The standard of performance governing the exercise of executive rights is vague, but in Texas that standard probably is too high; therefore, exemplary damages cannot be justified as a way to compensate for too low a performance standard.

Not only are the benefits of the tort of bad faith breach small, but there is also some harm from extending the tort to contract cases beyond insurance. The most immediate cost stems from uncertainty about the scope of the tort and the potentially unlimited amount of emotional or exemplary damages. The addition of a claim of uncertain value in a

without multiplication. See Wisznia v. Wilcox, 438 S.W.2d 874, 879 (Tex. Civ. App.—Corpus Christi 1969, writ ref’d n.r.e.) (disallowing the recovery of an attorney’s fee that included a premium for the uncertainties of litigation). Fee awards may be based on the complexity or difficulty of a case, however, which may partially compensate for risk bearing. Stine v. Marathon Oil Co., 753 F. Supp. 202, 204 (S.D. Tex. 1990) (allowing the complexity of the case to be a factor in determining an attorney’s fee), rev’d on other grounds, 976 F.2d 254 (5th Cir. 1992). In any event, the tort of bad faith breach responds poorly to this remaining disincentive to sue because the tort applies only when nonperformance is without apparent justification, and so the risk of failure on suit is small.

A problem with the Texas approach to fee-shifting is that it is asymmetrical: A promisor pays the promisee’s fees if a claim succeeds, but the promisee does not pay the promisor’s fees if a claim fails. In some situations, this asymmetry may give promisees too great an incentive to sue and over-deter promisors from breaching.

108. Executive rights holders are required to put their own interests aside and manage property exclusively for the benefit of the subject mineral rights owners. Manges v. Guerra, 673 S.W.2d 180, 183 (Tex. 1984). This standard of selfless dealing may be appropriate in the normal fiduciary context in which the concern is self-dealing (and not negligence in the management of assets) because we demand that fiduciaries put their interests entirely aside. The standard is inappropriate in cases like Manges in which the executive owns an interest in the property. In such cases, executives ought to be able to consider their interests as well as others’ in managing the property. Particularly if the interest of the executive and the other owner differ in character (e.g., the other owner also owns surface rights), the Manges standard requires that excessive value be placed on one set of interests, and so it creates an incentive for inefficient use of the property. It would be better to require the executive to manage the property to maximize the parties’ joint return. This result is achieved by the usual standard of care that requires the executive to act as if there is no adverse interest. See Ernest E. Smith, Implications of a Fiduciary Standard of Conduct for the Holder of the Executive Right, 64 Tex. L. Rev. 371, 372-75 (1985) (advocating acceptance of a general rule requiring executives to act as though there are no competing interests).
dispute makes settlement less likely and thus increases litigation costs.\textsuperscript{109} This problem may be exacerbated by fee-shifting. Adding a tort claim of uncertain but potentially enormous value on top of fee-shifting on a successful contract claim gives a plaintiff with a perceived strong contract claim even more incentive not to settle. A plaintiff in this situation bears only the unreimbursed costs from pressing a suit—such as the lost management time spent in the suit—and pressing the claim has a large potential payoff. A defendant in this situation might strip the plaintiff of the right to attorneys’ fees by tendering an amount in satisfaction of the contract claim.\textsuperscript{111} However, the tender must be made within thirty days of the plaintiff’s presentment of the claim,\textsuperscript{112} and it must be for the full amount that the plaintiff eventually recovers on the contract claim. Thus, this tactic will be viable only when a defendant can quickly establish the validity of the contract claim and estimate the amount of damages with some degree of certainty.

The tort may also have a harmful impact on contract performance and formation, though these effects are more speculative. If a promisor expects that he may pay damages in excess of the promisee’s actual damages on breach, the promisor will theoretically expend more resources in performance than is optimal—the promisor may perform though the cost exceeds the benefit to the promisee.\textsuperscript{114} And, in theory, people will be too

\textsuperscript{109}. It is commonplace that a greater variance in potential outcomes in litigation diminishes the likelihood of settlement. \textit{See} George L. Priest \& Benjamin Klein, \textit{The Selection of Disputes for Litigation}, 13 \textit{J. Legal Stud.} 1, 16 (1984) (arguing that where the difference between parties’ estimates of the outcome of the litigation is large, settlement is unlikely); \textit{see generally} Robert D. Cooter \& Daniel L. Rubinfeld, \textit{Economic Analysis of Legal Disputes and Their Resolution}, 27 \textit{J. Econ. Literature} 1067, 1076-78 (1989) (noting that legal rule changes that increase the optimism of plaintiffs about the outcome of trials will result in more trials and fewer settlements).

\textsuperscript{110}. The costs of pressing the tort claim may be largely reimbursed. When tort and contract claims involve the same facts, courts liberally permit costs to be allocated to the contract claim. \textit{See} Nottingham v. General Am. Communications Corp., 811 F.2d 873, 880 (5th Cir.) (stating that attorneys’ fees need not be allocated among claims when the matters giving rise to the claims are intertwined, arise from the same occurrence, and involve the same facts), \textit{cert. denied}, 484 U.S. 854 (1987).

\textsuperscript{111}. \textit{See} Southwestern Bell Tel. Co. v. Vollmer, 805 S.W.2d 825, 833 (Tex. App.—Corpus Christi 1991, writ denied) (stating that, in general, a defendant is not liable for a plaintiff’s attorneys’ fees if the defendant offers the amount owed and the plaintiff proceeds to trial); \textit{see also} Reservoir Data, Inc. v. Amoco Prod. Co., 793 F.2d 115, 117 (5th Cir. 1986) (noting that attorneys’ fees that would usually be paid by a losing insurance company defendant may be denied by the court if the insurer offers a settlement amount larger than the eventual jury award).


\textsuperscript{113}. \textit{See} Commercial Union Ins. Co. v. La Villa Indep. Sch. Dist., 779 S.W.2d 102, 107 (Tex. App.—Corpus Christi 1989, no writ) (noting that “a tender of an amount less than the amount claimed is legally insufficient to avoid the awarding of attorney’s fees”).

\textsuperscript{114}. That expectation damages give a promisor the optimal incentive to perform is, of course, the point of the theory of efficient breach. \textit{See} Kenneth S. Abraham, \textit{Distributing Risk} 178 (1986) (“The theory of efficient breach holds that awarding damages for breach of contract promotes efficiency by encouraging promisors to breach when breach would produce net gains even after the payment of damages to the promisee.”) \textit{See also} Richard A. Posner, \textit{Economic Analysis of Law} 121 (4th
cautious about entering into contracts with exposure to such damages because the expected cost to them on breach exceeds the true cost of breach.115 These effects are speculative because they assume people are aware of their potential liability in tort at the time they perform or enter into contracts. That people act with such foresight is questionable unless, as in an area like insurance, the risk of liability in tort is high, promisors are repeat players, and legal counsel play a significant role in business planning.

Another area in which such effects may be felt is employment. Some argue that wrongful discharge should be treated as a tort with emotional and exemplary damages.116 Employers confronted with the prospect of exemplary damages for wrongful termination may take greater precautions in hiring and firing employees. The monitoring of employees may increase so that employers can better document reasons for dismissal, or decisions to fire may be reviewed.117 Employers may choose not to hire risky prospects, or employers may take care to specify that positions are at-will (if that can save the employer from liability). Such costs do not make a rule giving emotional and exemplary damages for wrongful discharge inefficient, but to outweigh these costs, the rule would need to have significant benefits in terms of protecting employees’ reliance on their positions.

The arguments for enhancing damages are strongest in the area of insurance.118 Insurance claims are often small, claimants are unsophisticated or without resources to employ lawyers, and harms from nonpayment of claims may include significant emotional and other consequential damages.119 Thus, some contend that without the threat of

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115. Kenneth Abraham discusses the effect of the damage rule on contracting in the insurance setting, noting that tort remedies will affect the level of insurance. ABRAHAM, supra note 114, at 176-77. He explains that the effect may be positive or negative, depending on whether the tort remedy overcomes strategic problems that make insurers unreliable or whether it results in insurers taking too much care in processing claims and paying too many invalid claims. Id.


118. See ABRAHAM, supra note 114, at 178-79 (noting that because of undercompensation and the risk of opportunistic breach, the breach by insureds is likely to be inefficient).

119. See Sebert, supra note 104, at 1615-16 (listing disparity of bargaining power, the insured’s weakened condition, and the regulated nature of the insurance industry as reasons for awarding punitive damages); Leslie E. John, Comment, Formulating Standards for Awards of Punitive Damages in the
liability for emotional or exemplary damages, insurers may intentionally underpay on the assumption that only a small percentage of valid claims will be pressed. Alternatively, insurers may put too little effort into processing claims because of their insensitivity to the full cost to claimants of denials or delayed payments.

The tort of bad faith breach must be judged in the context of several other elements of Texas law that enhance remedies against insurers. In addition to liability for attorneys’ fees, insurers pay an eighteen percent penalty per annum for delay in payment of most first-party insurance claims. Liability for the eighteen percent penalty is strict—it does not depend upon a finding that the insurer mishandled the claim. Also, claimants may recover treble damages under the Insurance Code and the Deceptive Trade Practices Act if they establish that an insurer acted in bad faith in processing claims.

The standard of bad faith is similar to the Borderland of Contract and Tort, 74 CAL. L. REV. 2033, 2051 (1986) (contending that “punitive damages provide an incentive to sue where the defendant has harmed many individuals but is unlikely to be sued due to the relatively small recovery for any individual plaintiff”); David Pomerantz, Comment, The Insurer’s Exploding Bottle: Moving from Good Faith to Strict Liability in Third and First Party Actions, 46 OHIO ST. L.J. 157, 178 (1985) (noting that the insured “is often in a worse financial position as a result of the [misfortune] . . . that has given rise to the claim”).

120. E.g., Foley v. Interactive Data Co., 765 P.2d 373, 395-96 (Cal. 1988).
122. TEX. INS. CODE ANN. art. 21.55, § 6 (Vernon Supp. 1994). The statute is not meant to preempt other remedies for nonpayment of claims. Id. art. 21.55, § 7.
123. Two statutes provide a right of action. First, the Texas Insurance Code provides an individual cause of action with treble damages plus costs and attorneys’ fees for any unfair and deceptive act or practice as defined by § 4 of Article 21.21 of the Code, regulations of the Texas Board of Insurance, or § 17.46 of the Deceptive Trade Practices Act. TEX. BUS. & COM. CODE ANN. § 17.46 (Vernon 1987), TEX. INS. CODE ANN. art. 21.21, § 16 (Vernon 1986). Second, § 17.50 of the Deceptive Trade Practices Act provides for double or treble damages (depending on whether the violation was committed knowingly) plus costs and attorneys’ fees for any violation of Article 21.21 of the Texas Insurance Code or regulations promulgated thereunder. TEX. BUS. & COM. CODE ANN. § 17.50 (Vernon 1987).

The court in Vail v. Texas Farm Bureau Mutual Insurance Co., 754 S.W.2d 129 (Tex. 1988), found a cause of action under both statutes for unfair claims settlement practices, id. at 134, but the court’s interpretation of the two statutes is questionable. Article 21.21-2 of the Texas Insurance Code regulates unfair claims settlement practices, but no private right of action exists under that provision, TEX. INS. CODE ANN. art. 21.21-2 (Vernon 1981 & Supp. 1994), and that provision is not among the stated bases for an action enumerated in Article 21.21, § 16 of the Insurance Code or § 17.50 of the Deceptive Trade Practices Act. See id. art. 21.21, § 16; TEX. BUS. & COM. CODE ANN. § 17.50 (Vernon 1987). The majority overcame this problem in Vail by reasoning that a private action existed under the two statutes for violations of rules or regulations of the Insurance Board adopted under Article 21.21 of the Insurance Code. Vail, 754 S.W.2d at 133-35. Those regulations prohibited any practice defined by Texas law as unfair, which the majority read to include settlement practices defined as unfair by Article 21.21-2 of the Texas Insurance Code. Id. That is, the Article 21.21-2 prohibition on unfair settlement practices was brought into Article 21.21 through broad, vaguely worded regulations in order to create a private right of action for unfair settlement practices when none existed under the explicit language of the statute. It is debatable whether the Insurance Board had the power to create
standard in the tort of bad faith breach. A claimant may elect whether to recover statutory or common law exemplary damages.124

Traditional contract remedies may be inadequate to protect an insured against breach by an insurer, but that does not necessarily mean that tort remedies are the solution. Probably the best way to protect an insured person is through remedies like the eighteen percent penalty interest rate and fee-shifting.125 First, rules of liability and damages with predictable and certain consequences are preferable to rules with uncertain consequences because certainty promotes settlement and decreases litigation costs.126 Thus, the eighteen percent penalty and fee-shifting rule is preferable to the rule of bad faith because damages are fairly certain once the validity of a claim is established. The statutory penalty of treble damages for bad faith in processing claims is preferable to the tort rule of exemplary damages because the amount of damages is certain once bad faith and actual damages are established. A rule of bad faith with exemplary damages is the worst of these options because the rules governing exemplary damages, which give much discretion to the jury, make predicting liability and damages very uncertain.127

a private right of action for unfair settlement practices under Article 21.21 through regulations when Article 21.21-2 expressly covered such practices and gave no such right of action. Article 21.21, § 13(a) empowers the Board to issue regulations “necessary in the accomplishment of the purposes of this Article,” TEX. INS. CODE ANN. art. 21.21, § 13(a) (Vernon 1981) and that purpose is broadly defined as prohibiting unfair or deceptive practices in insurance, id. § 3. However, the statute then defines unfair or deceptive practices as misrepresentation, false advertising, defamation, coercion, unfair discrimination, false financial statements, stock operations, and hidden rebates. Id. § 4 (Vernon Supp. 1994). If the authority of the Board to bring unfair claims settlement practices under Article 21.21 is debatable, surely a court should not find this result accomplished indirectly through broadly and vaguely worded regulations. In Allstate Insurance Co. v. Watson, 876 S.W.2d 145 (Tex. 1994), the supreme court repudiated this part of Vail in the context of a third-party claim of bad faith on liability insurance. The court reasoned that a private right of action could not be created under Article 21.21-2 through Insurance Board Regulations. Id. at 150.

The Vail majority’s other grounds for finding a private right of action for unfair claims settlement practices are even more questionable. A second argument was that Insurance Board regulations defined as unfair any action “determined pursuant to law to be an unfair or deceptive act or practice,” which the majority concluded incorporated settlement practices condemned by Arnold v. National County Mutual Fire Insurance Co. and Aranda v. Insurance Co. of North America. Vail, 754 S.W.2d at 135. A third argument was that unfair settlement practices constituted “false, misleading, or deceptive” acts or practices covered by the general part of the Deceptive Trade Practices Act. Id. at 135-36. These provisions are aimed at misleading practices usually centered around contract formation and not around failures in performance when there is no attempt to mislead. Watson also repudiated this part of Vail. Watson, 876 S.W.2d at 149.

125. Kenneth Abraham comes to a similar conclusion. See ABRAHAM, supra note 114, at 185 (arguing that punitive damages are inappropriate except in tort cases involving an intentional act, reckless conduct, or gross negligence).
126. See supra note 109 and accompanying text.
127. See Sebert, supra note 104, at 1619 (discussing the large variance of punitive damages awards in bad faith cases); cf. TEX. CIV. PRAC. & REM. CODE ANN. § 41.001-.008 (Vernon Supp. 1992) (limiting jury awards of exemplary damages in Texas to the greater of four times actual damages
Second, the penalty interest rate and fee-shifting rules in their general form, if not in their specific details, should address the problems that may lead to underenforcement of insurance claims. A penalty interest rate compensates claimants for the economic or emotional cost of wrongful denial and thereby brings an insurer’s damages closer to the actual cost of wrongful denial. Assessing a penalty interest rate rather than multiplying damages by a flat amount without regard to time accounts for the fact that the harm to the claimant increases with time of the delay. The current eighteen percent penalty rate corresponds to the cost of low quality consumer credit, a likely measure of the economic harm to a claimant denied funds. A higher rate may be justified if claimants often incur other damages such as emotional anguish. Fee-shifting makes insurers bear another cost of wrongful claim denial—the cost of dispute resolution. Fee-shifting lowers the barriers to challenges of denials when claimants are poor or ignorant of their rights because claimants’ attorneys look to insurers for compensation and attorneys have incentives to inform policy holders of their rights through advertising.

Finally, liability ought not depend on a finding that an insurer mishandled a claim, as it does under the Texas common law and statutory actions that make liability dependent on a finding of bad faith, because the standard of care we should demand of insurers in processing doubtful claims is unclear. Plainly there is some limit on what insurers ought to spend to investigate claims. For instance, it would be folly to require an insurer to spend thousands of dollars to investigate a claim worth only or $200,000 in cases involving fraud or gross negligence, but waiving this exception for cases involving malice or intentional torts; MARK PETERSON ET AL., PUNITIVE DAMAGES: EMPIRICAL FINDINGS 32-40 (1987) (documenting the increasing number and size of punitive damage awards in business cases in San Francisco and Cook County, Illinois from 1960 to 1984).

128. Typical state limitations on small consumer credit loans and sales have set the maximum interest rate at or near 18%. See DAVID THORNDIKE, CONSUMER CREDIT COMPUTATION AND COMPLIANCE GUIDE S7-S50 (1987) (surveying each state’s maximum interest rates for consumer credit transactions). Texas caps the interest rate on a consumer credit loan of an amount up to $900 at 18%. Id. at S44.

129. See supra note 123.

130. I assume that fault-based rules of liability, such as a rule of bad faith, ought not be used when courts cannot define the proper level of care. This assumption is grounded partly on the premise that a rule of strict liability can assure optimal care by an actor if damages are accurately measured. Thus, strict liability is preferable to negligence when actors can determine proper care better than courts. See SHAVELL, supra note 102, at 5-46 (evaluating several liability rules against the socially optimal outcome in various factual situations); see also LANDES & POSNER, supra note 102, at 64-65 (arguing that one advantage of strict liability over negligence is that the court does not have to expend any resources to determine what the level of due care is). The issue here is somewhat different from the usual comparison of strict liability and negligence. In the insurance context, there is strict liability for at least a significant part of actual damages for wrongful nonpayment with fault-based liability for additional actual damages in the form of emotional harm and exemplary damages. Obviously, if the standard of care under the bad faith rule is set too high (or if insurers expect that it may be set too high), it will elicit undue effort in processing claims.
hundreds of dollars when the expenditure would provide information that would only slightly increase the accuracy of the decision to grant or deny the claim. In determining proper claims procedure, we must balance the value of the claim, the value of accurate claim determination, the cost of additional precaution, and the improvement in the accuracy of claim determination from additional precaution. I do not know how to value accurate claim determination because accuracy has noneconomic value in terms of respect for individual rights and it is difficult to assess economic value in the effect on insurance holders in taking precautions and purchasing insurance. Also, even if we knew what the optimal balance of these variables was in theory,\(^1\) we could not implement that standard in practice because courts and juries would be unable to measure the relevant variables.

An argument exists for awarding exemplary damages when insurers deny plainly valid claims, but even a restricted rule of bad faith is probably unadvisable because its effects will extend beyond patently opportunistic denials. Severe sanctions of clearly harmful behavior—and patently opportunistic claim denials fit this description\(^2\)—may be defended economically because such behavior cannot be over-deterred (by definition) and may be undeterred without the severe sanction.\(^3\) But a rule has this quality only if it predictably produces no, or at least very few, false positives—findings of proper behavior as sanctionable. Otherwise, proper behavior will be deterred too. Even a restricted version of the rule of good faith, which requires a finding that an insurer believed a denied claim to be valid, is likely to produce some false positives because an insurer’s beliefs must be established inferentially. Obviously, the risk of false positives increases under a rule, such as there used to be in Texas, permitting an award of exemplary damages even if there is an apparently plausible basis for denying a claim.\(^4\)

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\(^1\) From one perspective, insurers ought to spend no resources investigating doubtful claims; instead, they should pay the amount of the claim discounted by the probability that the claim is valid because claims investigation primarily has distributive consequences (i.e., it determines how much the insurer pays the insured) and not allocative consequences. Accuracy in claims resolution may be valued, however, because of its secondary effects. For example, if conditions on coverage suppress undesirable behavior, accuracy in determining whether the condition is violated may better suppress that behavior. Alternatively, accuracy may be valued on a theory of entitlement.

\(^2\) Even someone concerned solely with minimizing the cost of resolving claims would condemn such denials because of the transaction costs when some denials are disputed.

\(^3\) See LANDES & POSNER, supra note 102, at 162 (arguing that in certain cases “punitive damages may be defensible as providing a surer deterrent than compensatory damages to conduct that we know we want to deter”).

\(^4\) See supra notes 34-54 and accompanying text. Conversely, requiring objective evidence that strongly correlates with the condemned behavior—such as evidence of a pattern of denying valid claims—reduces the risk of false positives.
III. The Atrophying of Good Faith as a Contract Doctrine in Texas

Good faith has atrophied as a contract doctrine while growing as a tort. Here the fault lies in the majority opinion in *English v. Fischer.*

The Fischers bought their home from English in 1967 by giving her a note. The note required the Fischers to insure the home and made any loss payable to English. A fire damaged the home in 1979, and a claim for $110,000 was paid by the insurance company. The Fischers wanted to use the insurance proceeds to repair the home. English’s note was adequately secured by the unrepaired home (the damaged home’s value was around $67,000, the note balance was $57,000, and repair of the home would have increased its value to around $200,000). English claimed the right to retain the proceeds to satisfy the note, which bore interest of five and one-half percent, well below the market rate in 1979. The Fischers claimed that they were unable to obtain other funds to repair the home.

The majority held that English could keep the proceeds up to the balance of the note because the contract made any loss payable to her.

The decision is wrong on the specific issue. Insurance is made payable to a noteholder to protect her security, not to allow the noteholder to take advantage of a repairable loss to call the note. Thus, an early Texas case held that insurance proceeds should be paid to the owner when the noteholder’s security is not threatened by the loss, and cases in other states follow this rule. The majority in *English* distinguished the earlier Texas case on the ground that the note in that case provided that the insurance was “for the benefit” of the noteholder, whereas the note in *English* provided that “the loss ... shall be payable” to the noteholder. The majority put too much weight on a slight difference in terms. The two clauses served the same purpose: protecting the noteholder’s security. The court in *English* allowed the noteholder to take advantage of a poorly drafted clause to reap a windfall, getting out of a term note with a disadvantageous interest rate.

The general importance of *English* to contract law in Texas results from the strong terms the majority used in rejecting the covenant of good faith.
faith and fair dealing. The majority described the covenant as "a novel theory of law enunciated only by California courts," stated that it was inconsistent with almost 150 years of Texas law, and warned that its adoption "would abolish our system of government according to settled rules of law" because it would empower judges and juries to rewrite contracts under a vague standard of fairness. Later cases read *English* to hold that the good faith doctrine may never be used to supplement or vary express terms of a contract.

Texas law has long required respect for express terms of a contract, but *English* goes beyond prior cases in insisting that it is improper for courts ever to invoke the doctrine of good faith to supplement or to alter contract terms. An early leading Texas case on the subject held that a covenant could be implied "when necessary to give effect to the actual intention of the parties as reflected by the contract . . . as constructed in its entirety in the light of the circumstances under which it was made and the purposes sought to be accomplished thereby." Probably even this standard is too conservative (as we will see), but it is more liberal than the rule in *English*. If this earlier standard had been applied in *English*, the court could have implied a covenant to require English to pay the insurance proceeds over to the Fischers since the purpose of having the insurance

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143. *Id.* at 522. Professor Crespi argues that I misread *English* and later Texas case law. His claim is that these cases do not reject the duty of good faith in absolute terms, but only find the duty inapplicable on the facts of each case. Crespi, *supra* note 20, at 1279-80. I wish he were right, but the cases do not support him. First, *English* refused to adopt the "theory" of good faith rather than finding it inapplicable on the facts. *English*, 660 S.W.2d at 522. Later cases reject good faith claims in absolute terms. See, e.g., Cockrell v. Republic Mortgage Ins. Co., 817 S.W.2d 106, 116 (Tex. App.—Dallas 1991, no writ) (*Texas law does not recognize an implied duty of good faith and fair dealing in every contract or business transaction.*). Second, good faith claims have been rejected on compelling facts. *See infra* notes 153-57 and accompanying text. If the duty does not apply in these cases, when may it apply? Third, and perhaps most damming for Professor Crespi's position, in the eleven years since *English*, no good faith claim has prevailed in a Texas state court in a reported decision.

The only case support for Crespi's position is weak dicta from Adolph Coors Co. v. Rodriguez, 780 S.W.2d 477 (Tex. App.—Corpus Christi 1989, writ denied). There the court rejected a good faith claim of wrongful termination and distinguished the tort of bad faith breach from the contract duty of good faith. *Id.* at 481. Moreover, the court limited contract claims of good faith to those that can be grounded in specific contract terms. *Id.* at 482. This position is similar to the position taken in the cases cited in note 168. As I argue there, this position denies good faith much of its traditional function.

144. E.g., Exxon Corp. v. Atlantic Richfield Co., 678 S.W.2d 944, 947 (Tex. 1984); Texstar N. Am., Inc. v. Ladd Petroleum Corp., 809 S.W.2d 672, 677-78 (Tex. App.—Corpus Christi 1991, writ denied); City of San Antonio v. Forgy, 769 S.W.2d 293, 296 (Tex. App.—San Antonio 1989, writ denied).

145. Danciger Oil & Ref. Co. v. Powell, 137 Tex. 484, 490, 154 S.W.2d 632, 635 (1941). The decision also states that the fact that the covenant would make the contract fair or that without the covenant the contract would be improvident or unwise is not enough to justify implying a covenant of good faith into a written contract. *Id.*

146. *See infra* Part IV.
paid to English was to protect her security and her security was not impaired by the fire.

Contrary to the views of the majority in English, the implied duty of good faith was well grounded in prior Texas law. Many cases implied a duty of good faith to regulate a party's performance under a contract without express performance standards, as, for example, in contracts regulating the development of mineral property by a lessee or a mineral rights holder, settlement of a claim by a liability insurer, or in other situations. Occasional cases even invoked principles of good faith to impose an obligation that was inconsistent with the literal terms of a contract. A well-established example is the rule in oil and gas law that a lessee must protect against his own drainage of a lease even under a lease that disclaims or limits the duty to protect against drainage. Another example is a case holding that a contract giving a salesman a fifteen-year, "non-cancellable" exclusive sales agency did not require the manufacturer to remain in business to preserve the agency, but did require the manufacturer to act in good faith in selling the business. In this case, the court ignored the express terms of the contract to permit the manufacturer to terminate the agency, but used the doctrine of good faith to temper the power given the manufacturer.

147. See, e.g., Amoco Prod. Co. v. First Baptist Church, 611 S.W.2d 610, 610 (Tex. 1980) (implying good faith performance on the part of a working interest owner in a mineral rights contract); Schlitter v. Smith, 128 Tex. 628, 631, 101 S.W.2d 543, 545 (1937) (holding that a grantee of royalty rights in an oil and gas tract conveyance owed a duty of good faith to protect the amount of royalty reserved to the grantor).


149. See, e.g., Anbeck Co. v. Zapata Corp., 641 S.W.2d 608, 614 (Tex. App.—Houston [14th Dist.] 1982, writ ref'd n.r.e.) (holding that if part of the consideration for a purchase is contingent on the performance of the buyer's subsidiary in which the purchased assets are placed, the buyer must use good faith in operating the subsidiary); Super-Cold Southwest Co. v. First Baptist Church, 219 S.W.2d 569, 573 (Tex. Civ. App.—Waco 1949, writ ref'd n.r.e.) (holding that a seller of an air conditioner unit must act in good faith in replacing thermometers to determine if the unit satisfies a pre-set standard).

150. E.g., Shell Oil Co. v. Stansbury, 401 S.W.2d 623, 632 (Tex. Civ. App.—Beaumont), writ ref'd n.r.e. per curiam, 410 S.W.2d 187 (Tex. 1966). Such a provision will limit a lessee's duty to protect against drainage by others. Magnolia Petroleum Co. v. Page, 141 S.W.2d 691, 693 (Tex. Civ. App.—San Antonio 1940, writ ref'd). It seems that Texas courts defer to a clear provision stating that a lessee is under no duty to develop a lease, but that a duty will be imposed if there is any ambiguity. Thus, a duty to develop has been imposed when a lease stated that "development shall be at the discretion of the lessee." Cowden v. Broderick & Calvert, Inc., 131 Tex. 434, 443, 114 S.W.2d 1166, 1171 (1938).

151. See Achterberg v. Gillett, 322 S.W.2d 306, 308 (Tex. Civ. App.—El Paso), writ ref'd n.r.e. per curiam, 159 Tex. 591, 325 S.W.2d 384 (1959) (remanding the case for factual findings to determine if a manufacturer acted in "good faith" in selling his business).

152. Id. at 309.
English seems to have prompted lower Texas courts to reject strong good faith claims in later cases. The most troubling case is *Texstar North America, Inc. v. Ladd Petroleum Corp.* Texstar drilled a well in a tract in which Ladd owned eleven and one-fourth percent of the minerals. Ladd also operated wells on adjoining tracts. Ladd did not help pay Texstar’s drilling costs, but, as was Ladd’s right, it “backed into” the Texstar well once Texstar recovered its investment in the well, taking a share of future production and agreeing to share future production costs by entering into a joint operating agreement. The joint operating agreement required the consent of both parties to rework the well. Ladd later refused to consent when Texstar sought to fracture the well to stimulate production. Texstar argued that Ladd refused because Ladd’s other wells were draining the same area as the Texstar well. Ladd argued that it denied consent because of a concern that fracturing would diminish production. Following English, the court held that a covenant of good faith could not be implied into the joint operating agreement and that the court therefore could not examine whether Ladd’s objection was bona fide. The decision is troubling because Ladd may well have denied consent to facilitate its drainage of the property.

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153. Another troubling case rejected a claim that the duty of good faith requires a party to disclose information about a potential loss on a construction contract to the contractor. In City of San Antonio v. Forgy, 769 S.W.2d 293 (Tex. App.—San Antonio 1989, writ denied), the court rejected a claim by a contractor that good faith requires the city to disclose known flaws in a project specification to bidders on the project. *Id.* at 298; cf. Manufacturers’ Hanover Trust Co. v. Kingston Investors Corp., 819 S.W.2d 607, 612 (Tex. App.—Houston [1st Dist.] 1991, no writ) (rejecting a claim by guarantors of a note that the lender’s failure to warn them of the financial weakness of someone the guarantors relied on to provide permanent financing and additional funds for the borrower constituted breach of a duty of good faith). Some courts hold owners liable to contractors for undisclosed problems in construction projects known to the owner that increase the contractor’s cost. See, e.g., Pedler v. MCP Facilities Corp., 471 F. Supp. 1344 (E.D.N.Y. 1979) (denying a motion for summary judgment on the grounds that a contractor’s recovery for damages caused by undisclosed defects was possible).

The case of Jhaver v. Zapata Off-Shore Co., 903 F.2d 381 (5th Cir. 1990), is also troubling. Zapata promised commissions to Jhaver for any oil drilling contracts in India that Zapata obtained with Jhaver’s assistance. After Jhaver obtained one contract for Zapata, the company stopped using his services and obtained its own contracts. *Id.* at 382-83. The court held that this action could not be a breach of a duty of good faith under Texas law because it did not violate an express term of the contract. *Id.* at 385-86. However, the court remanded the case because it thought Zapata’s action may have been a breach of the commission agreement. *Id.* at 385-86.

154. 809 S.W.2d 672 (Tex. App.—Corpus Christi 1991, writ denied).

155. *Id.* at 674.


157. *Texstar*, 809 S.W.2d at 678.

158. One unusual fact in the case may justify the outcome. Under the standard form joint operating agreement, Texstar would have had the right to fracture the well after Ladd objected so long as Texstar was willing to bear the entire cost. American Association of Petroleum Landmen, *supra* note.
opportunistic behavior weakens the joint operating arrangement, a result that is particularly troubling because an owner of a partial mineral interest such as Ladd has the right to insist that a co-owner enter into a joint operating arrangement. Operators in Texstar’s position who hold a lease subject to a minority interest that is held by someone with an interest in an adjoining lease face the unattractive prospect that the minority-interest holder will use that interest to impede development to benefit the other lease.

Little life seems left in the doctrine of good faith in Texas. The court in English denied the entire theory of good faith and refused to apply the doctrine despite compelling facts. Later cases echo English’s absolute denial of the theory, and some have refused compelling good faith claims. This does not mean good faith is entirely dead in Texas. The duty of good faith in contract performance is codified in the Uniform Commercial Code. But after English, this statutory duty is meager—it merely serves as a gloss on specific terms of a contract and cannot be used to supplement or amend contract terms.

IV. The Proper Use of Good Faith

Courts properly use the good faith doctrine to supplement and, sometimes, even to amend the terms of a contract to serve the parties’ clear expectations or interests. This Part will establish this point by surveying cases from other states and other authorities. I do not attempt to address the values served by the doctrine or its costs and benefits. The

156, at 115. The parties in Texstar apparently struck this provision from their agreement because Ladd’s objection would not have otherwise barred Texstar from proceeding. The fact that the parties intentionally omitted a term that would have empowered Texstar to proceed over Ladd’s objection may suggest that the parties intended Ladd to have veto power over subsequent operations. But one could argue that such power must still be exercised in good faith.

159. See Richard W. Hemingway, The Law of Oil and Gas § 5.1, 203, 202-06 (3d ed. 1991) (“Each non-joining co-tenant has the right to receive his proportionate share of the products produced, but must bear the reasonable costs of development, production, and marketing.”).


161. See Adolph Coors Co. v. Rodriguez, 780 S.W.2d 477, 482 (Tex. App.—Corpus Christi 1989, writ denied) (rejecting the duty of good faith for fear that every contract “would be subject to being re-written to better suit the court or jury’s view of what the parties should in ‘good faith’ have provided in the agreement”).

162. Generally, I see the benefits of the doctrine as, first, improving performance or reducing the cost of resolving contract disputes by preventing a party from using a power or right granted by a contract in a way that is harmful to the parties’ joint interests and, second, reducing the cost of entering into a contract by preventing parties from taking advantage of imperfectly drafted terms to redistribute returns under a contract. Realization of these benefits requires that the doctrine be limited in scope and predictable in application. Frequent and unpredictable judicial revision of contract terms may invite disputes over performance, hamper settlement, and increase the cost of contracting by inducing parties to take precautions to ensure that obligations are indiscernible.
economic argument for the good faith doctrine is weaker than the argument against a tort of bad faith breach. Partly this is because the functions served by the good faith doctrine may be served in other ways, such as through contract interpretation\textsuperscript{163} or through impracticability and other rules that apply in changed circumstances.\textsuperscript{164} In addition, the uncertainty about the meaning of good faith has significant harmful effects in promoting litigation and disturbing contract performance. Given these costs, it is difficult to justify the doctrine on economic grounds.

Two theories defining good faith in contract dominate recent contract scholarship. The most important posits that good faith requires a party to perform consistently with the other party's contract-based expectations.\textsuperscript{165} A second theory posits that good faith requires conformity with customary norms of behavior.\textsuperscript{166} I propose a third theory to supplement the other two: Good faith forbids a party from acting to harm the parties' joint interest in matters left open by the contract. Among the three and with some overlap these theories explain all good faith cases that I know of.\textsuperscript{167}


\textsuperscript{164} German courts have invoked § 242 of the Civil Code, which requires good faith in contract performance, to do things that United States courts do with rules on waiver, laches, estoppel, mistake, impracticability, and unconscionability. \textit{See} E.J. Cohn, \textit{Manual of German Law}\ 96-101 (2d ed. 1968) (summarizing the special doctrines and rules which German courts have developed based on Section 242); Jean-Louis Baudouin, \textit{Theory of Impracticality—Judicial Intervention to Change a Contract, in Essays on the Civil Law of Obligations}\ 151, 155-56 (Dainow ed., 1969) (noting that German courts examine the fairness of a contract "not only by reference to what existed at the time of its conclusion but also by reference to the circumstances surrounding its performance"). Two pre-war experiences dramatically illustrate the expansive use of the doctrine of good faith in Germany. The doctrine was used to adjust contracts to account for rapid inflation in the 1920s and 1930s. John P. Dawson, \textit{The Oracles of the Law}\ 474 (1986); Cohn, supra, at 99. And it was used to abrogate contracts with Jews in the 1930s as violative of communal mores. Raphael Powell, \textit{Good Faith in Contracts}, 9 \textit{Current Legal Probs.}\ 16, 35 (1956).

\textsuperscript{165} \textit{See} Steven J. Burton, \textit{Breach of Contract and the Common Law Duty to Perform in Good Faith}, 94 \textit{Harv. L. Rev.}\ 369, 371-73 (1980) (arguing that parties perform in good faith when the reasonable expectations of the parties are met).

\textsuperscript{166} \textit{See} U.C.C. § 2-103(1)(b) (1993) ("Good faith' in the case of merchants means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."); \textit{see also} Dennis M. Patterson, \textit{Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittenstein, and the Uniform Commercial Code}, 68 \textit{Tex. L. Rev.}\ 169, 200-01 (1989) (arguing that "good faith" should mean "lack of surprise" and that "courts must protect the reasonable expectations of the parties").

\textsuperscript{167} Another theory, which goes by the heady title of "excluder analysis," is that the concept of good faith has no meaning in itself. This theory argues that the meaning of good faith is to be found in cases or other legal authorities (\textit{e.g.}, Restatement illustrations) that proclaim certain behavior to be in bad faith. Under this theory, good faith consists of adherence to those rules and others that can be adduced from them by normal processes of legal reasoning. \textit{See} Robert S. Summers, \textit{The General Duty of Good Faith—Its Recognition and Conceptualization}, 67 \textit{Cornell L. Rev.}\ 810, 821-24 (1982) (defending "excluder analysis" against claims that it allows judges to create law according to no fixed principle).
As in Texas, courts in some other states insist that the doctrine of good faith may not be used to supplement or to alter the obligations expressed in a contract. Under this theory, the doctrine exists only to ensure that obligations imposed by a contract are performed in good faith. Viewed uncharitably, this theory of good faith nullifies the doctrine. If good faith means no more than compliance with obligations expressly imposed by a contract or by other rules of law, then the doctrine serves no function. A more charitable view is that this theory of good faith protects expectations grounded in a contract in ways that go beyond a contract's literal terms; however, those expectations must be strongly grounded in the contract. Thus, this theory of good faith may be a conservative version of the first theory that good faith protects contract-based expectations.

A. Acting Consistently with Contract-Based Expectations

The theory that the doctrine of good faith requires acting consistently with contract-based expectations explains most cases. Many of these cases involve misuse of discretionary power. A common situation is when power with a single proper objective is exercised to accomplish an improper objective. For example, if a landowner has the right to cancel a sale of land in the event that clean-up of environmental waste proves "economically impracticable," it may be bad faith for the landowner to cancel a proposed sale in order to sell at a higher price. A related situation is where power with multiple but limited proper objectives is exercised to accomplish improper objectives. For example, when an employer reserves for itself "sole-discretion" to set bonus-determining quotas, it has been held bad faith for an employer to change quotas for other than the customary reasons of matching reward to employee effort or to the employer's profitability. Even a power with ostensibly unlimited objectives may be exercised in bad faith if the power is exercised to defeat a right expressly


169. See Greer Properties, Inc. v. LaSalle Nat'l Bank, 874 F.2d 457, 461 (7th Cir. 1989) (remanding the case to the trial court for a determination of whether the landowner's refusal to sell his land constituted bad faith).

170. E.g., Tymshare, Inc. v. Covell, 727 F.2d 1145, 1154-55 (D.C. Cir. 1984); cf. Martin v. Prier Brass Mfg. Co., 710 S.W.2d 466, 473 (Mo. Ct. App. 1986) (holding that it was bad faith for an employer to terminate promised insurance coverage without notice under a plan that gave the employer the right to terminate and made the employer the final authority for questions arising under the plan).
granted to the other party. For example, it has been held bad faith for an employer to discharge an at-will employee to avoid paying the employee a promised bonus. 171

Other cases involve bad faith in satisfying conditions. For example, it has been held bad faith for a buyer to fail to make a reasonable effort to obtain financing under a purchase contract that is subject to a condition of financing. 172 Here the purpose of the condition is to protect a party from a risk outside its control—obtaining a loan approval. It is bad faith to use the condition to avoid liability for reasons other than the risk against which the condition protects.

These are the least controversial good faith cases. The implied term—the valid or invalid objectives in the exercise of a discretionary power or the purpose of the condition—is likely to be something the parties actually expected, though we can never know this for certain. The term would be implied even under a conservative standard that requires it to “appear from the language used that [the term] was so clearly within the contemplation of the parties that they deemed it unnecessary to express it.” 173 Or, it would be implied under the more delightfully expressed English standard for implying terms in a contract. This standard asks if “while the parties were making their bargain an officious bystander were to suggest some express provision for it in their agreement, they would testily suppress him with a common, ‘Oh, of course!’” 174

The use of the term “good faith” in these cases is also closest to its ordinary usage. “Good faith” means sincerity in its Latin form “bona fide.” 175 Sincerity requires an object to which one can be true. Here the

171. E.g., Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 438 (7th Cir. 1987), cert. dismissed, 485 U.S. 901 (1988); Fortune v. National Cash Register Co., 364 N.E.2d 1251, 1258 (Mass. 1977); cf. Morris v. Macione, 546 So. 2d 969, 971-72 (Miss. 1989) (declaring that a defendant’s attempt to dissolve a corporation and transfer all assets to a new entity solely to avoid its obligation to pay former shareholders a discount on purchases constituted bad faith); K Mart Corp. v. Ponsock, 732 P.2d 1364, 1372 (Ne. 1987) (holding that while at-will employees generally may be discharged at the discretion of their employers, the “special relationship of trust” among the parties in the suit meant that discharging an employee six months before he retired was bad faith).

172. See Plaisted v. Fuhr, 367 N.W.2d 541, 545 (Minn. Ct. App. 1985) (applying a good faith standard to a buyer’s effort to obtain financing); Davidson & Jones Dev. Co. v. Elmore Dev. Co., 921 F.2d 1343, 1351-52 (6th Cir. 1991) (remanding a case to the trial court to determine if a mall developer failed to make a reasonable effort to secure financing, a condition precedent to a contract); cf. Jacobs v. Tenneco W., Inc., 231 Cal. Rptr. 351 (Ct. App. 1986) (holding that failure to submit a sales contract to the board of directors for required approval raises an inference of bad faith); Grill v. Adams, 463 N.E.2d 896, 900 (Ill. App. Ct. 1984) (holding that failure to find exchange property, which was the condition of sale, constitutes bad faith).


175. See BLACK’S LAW DICTIONARY 177 (6th ed. 1990) (defining bona fide as “[i]n or with good faith; honestly, openly, and sincerely . . . ”); THE OXFORD ENGLISH DICTIONARY 379 (2d ed. 1989) (defining bona fide as “[i]n good faith, with sincerity . . . ”).
Cautionary Tale

object is the end of a discretionary power or a condition, and good faith is exercising that power or invoking that condition for the sincere reason of advancing that end.

But not all good faith cases fit this mold. Consider cases holding that it is bad faith for a lessor, who has given a long-term lease for space in a mall with a no-compete clause to a tenant, to lease a store in an extension of the mall opened years after the signing of the original lease to a competitor of the tenant. This outcome cannot be explained by the parties' expectations in making the original lease, because they almost certainly did not consider the possibility of a mall extension when the interval between the lease and the extension was many years. Nor is it easy to accuse the landlord of insincerity, for it is difficult to state the object to which the landlord has breached a duty of fealty. In the strongest case for the tenant, the landlord rents to the competitor in order to drive the tenant out of an advantageous lease. One could say that such action violates the landlord's duty not to interfere with the tenant's lease, but, as we will see, there is no general duty of non-interference.

The law allows parties to interfere with other parties' receipts of benefits under a contract if there is sufficient benefit in it for themselves. I will suggest that the proper standard in this case is whether the landlord's action is clearly inimical to the parties' joint interest. This standard might suggest the parties' joint interest is the object to which the landlord owes fealty. However, joint maximization is not and should not be a general duty in contract; it should be only a factor courts should weigh in determining how parties should act in unanticipated circumstances.

B. Acting in Conformity with Trade Norms

The theory that good faith is defined by trade norms has a long historical lineage, but the concept has had an impact in only a few cases.


177. Some good faith cases espouse the principle that a party has a duty not to interfere with the other party's receipt of benefits under the contract. See infra note 209.

178. In what may be the first cases invoking good faith as a general rule prohibiting sharp commercial practices, Lord Mansfield said he looked to customary commercial practices to define the norms of good faith. See EDMOND HEWARD, LORD MANSFIELD 101-03 (1979) (noting that Lord Mansfield thought that a merchant was more competent than a lawyer to direct the incidence of paper credit). One case stated that the duty of good faith forbade parties to a contract from concealing material facts. See Carter v. Boehm, 97 Eng. Rep. 1162, 1165-68 (K.B. 1766) (holding that an insured has a duty to disclose to the insurer risks known only to the insured). The other case held that the duty of good faith forbade an auctioneer from placing an agent in the crowd to bid up the price of a good. Bexwell v. Christie, 98 Eng. Rep. 1150 (K.B. 1776).

The concept of good faith first appears in the common law as part of a rule to protect bona fide purchasers for value from the claims of true owners for goods. This rule was taken from the law
In reading several hundred recent federal and state cases invoking good faith, I found only a few that explicitly drew on evidence of trade practice or community mores to vary or to supplement the obligations in a contract under the doctrine of good faith. Other cases take the position that evidence of trade norms cannot vary or supplement the terms of a contract. I state the issue this way—to "vary or supplement the terms of a contract"—to distinguish the many cases in which custom is used to define the standard of an obligation that is express or clearly implicit in a contract. For instance, a mineral lessee must use good faith or due care in drilling, and industry practice defines due care.

Modern scholars also attribute the practice in merchant courts of enforcing promises made without formalities (such as a statement of the cause for a promise) to the idea of good faith. Wyndham A. Bewes, The Romance of the Law Merchant 19 (1923); Mitchell, supra, at 105-10; Leon E. Trakman, The Law Merchant: The Evolution of Commercial Law 10 (1983). In Roman law, the principle of good faith also may have been used to imply customary terms. Powell, supra note 164, at 19-21; E. Allan Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666, 669-70 (1963). Appeals to custom as a source of norms of good faith recur through the years, most prominently in the Uniform Commercial Code, which defines good faith for merchants, in part, as "the observance of reasonable commercial standards of fair dealing in the trade." U.C.C. § 2-103(1)(b) (1993).

179. See, e.g., K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 760-63 (6th Cir. 1985) (holding that a lender must give notice before terminating a line of credit because notice was customary); Conoco Inc. v. Inman Oil Co., 774 F.2d 895, 908 (8th Cir. 1985) (holding that a manufacturer cannot compete against a jobber in bidding on a construction job for a current customer of the jobber and basing this decision partly on trade practice); Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d 772, 805-06 (9th Cir. 1981) (holding that it was bad faith for a seller to refuse to "price protect" a buyer in the event of a price increase when that was the trade practice); Oloffson v. Coomer, 296 N.E.2d 871, 875 (Ill. App. Ct. 1973) (holding that a buyer should have covered in the event of an anticipatory repudiation because that was customary); cf. Misco, Inc. v. United States Steel Corp., 784 F.2d 198, 203-04 (6th Cir. 1986) (remanding with an instruction that the trial court should consider trade practice in determining what notice was reasonable for a franchise termination); Don King Prods., Inc. v. Douglas, 742 F. Supp. 741, 767-68 (S.D.N.Y. 1990) (stating that a promoter who represents both boxers in a match ought not intervene to favor one, but suggesting that a lower industry standard of practice may be shown on remand); Banque Keyser Ullman v. Skandia Ins. Co., [1987] 2 W.L.R. 1300, 1342 (Q.B.) (basing its holding that an insured has a duty to warn its insurer of the fraud of an intermediary partially on the testimony of participants in the trade who thought it proper to give such a warning). Occasionally, the absence of evidence of a custom is cited as a reason for rejecting a claim of bad faith. See, e.g., Personal Touch, Inc. v. Lenox, Inc., 708 F. Supp. 108, 110 (E.D. Pa. 1989) (granting summary judgment based in part on an absence of evidence that "the common trade usage mandates confidentiality or exclusivity" between a manufacturer and the developer of a commemorative plate).

180. See, e.g., Corenswet, Inc. v. Amana Refrigeration, Inc., 594 F.2d 129, 136 (5th Cir.) (explaining that trade usage will not override an express contract term if no reasonable construction of that term can be reconciled with trade norms), cert. denied, 444 U.S. 938 (1979).

181. See Hemingway, supra note 159, at § 8.9, at 480, 479-81 (stating that industry custom is a relevant factor in determining whether a lessee committed "some act which, a reasonably prudent
Courts should be wary of altering contract terms based on trade norms. Such norms are difficult to evaluate.\textsuperscript{182} There is a risk that a factfinder will substitute his or her judgment of what is right for trade norms. And even if relevant norms can be identified, some norms may best exist without legal enforcement because of the cost or risk of error in legal enforcement.

The appeal and dangers of imposing obligations in contracts based on trade norms are suggested by two recent cases that do so: \textit{K.M.C. Co. v. Irving Trust Co.}\textsuperscript{183} and \textit{Nanakuli Paving & Rock Co. v. Shell Oil Co.}\textsuperscript{184} The court in \textit{K.M.C.} held that it was bad faith for a lender to cancel a line of credit without giving advance notice if the loan seemed adequately secured.\textsuperscript{185} The court in \textit{Nanakuli Paving} held that a seller could not change its policy of price-protection, which involved selling asphalt at what was the posted price when the buyer informed the seller it was bidding on a construction job for which it would use the seller’s asphalt,\textsuperscript{186} even though the contract between the buyer and seller provided that the buyer would pay the price posted at the time of delivery.\textsuperscript{187}

\textit{Nanakuli Paving} seems to be a strong case for imposing an obligation based on trade practice. The buyer clearly relied on the practice by using the original posted price in a bid on a construction job.\textsuperscript{188} There was strong evidence of the practice in the industry; documents and testimony

\begin{footnotesize}
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\item [\textsuperscript{182}] Lord Mansfield and Karl Llewellyn tried to solve the problems of ascertaining commercial norms by using merchant juries. \textit{See generally} Zipporah B. Wiseman, \textit{The Limits of Vision: Karl Llewellyn and the Merchant Rules}, 100 HARV. L. REV. 465, 512-15 (1987) (describing the views of both Mansfield and Llewellyn on merchant juries). But Lord Mansfield often found himself at odds with his merchant juries. \textit{See id.} at 514 n.218 (noting that Mansfield’s rules of law for merchants oftentimes conflicted with merchant jury general verdicts). Furthermore, Llewellyn was unable to convince the authors of the Uniform Commercial Code to adopt merchant juries. \textit{See Wiseman, supra,} at 528 (noting that Llewellyn’s merchant jury proposal died in 1942 when the National Conference of Commissioners on Uniform State Laws rejected it). There are deep and maybe good reasons for this refusal to cede contract law-making to merchants. Lawyers and courts are reluctant to give up control over the interpretation of contracts, and lay juries are uncertain law-givers—they are unpredictable, inconsistent, and may be inclined to compromise disputes or to be influenced by the broader equities in a case. \textit{See generally} Wiseman, \textit{supra,} at 515 (discussing the “difficult questions” raised by Llewellyn’s proposal, which include a concern that merchant juries should not be empowered “to decide . . . potentially value-laden questions as the ‘reasonableness’ of [their] own practices”).
\item [\textsuperscript{183}] 757 F.2d 752 (6th Cir. 1985).
\item [\textsuperscript{184}] 664 F.2d 772 (9th Cir. 1981).
\item [\textsuperscript{185}] \textit{K.M.C.}, 757 F.2d at 760-63. \textit{But see} Bloomfield v. Nebraska State Bank, 465 N.W.2d 144, 148-49 (Neb. 1991) (refusing to follow \textit{K.M.C.} when a bank refused to roll over a loan without warning and holding that there could not be an implied duty of good faith when there was no continuing contractual agreement to provide funds).
\item [\textsuperscript{186}] \textit{Nanakuli Paving}, 664 F.2d at 777-79.
\item [\textsuperscript{187}] \textit{Id.} at 778.
\item [\textsuperscript{188}] \textit{Id.} at 777.
\end{enumerate}
\end{footnotesize}
of several witnesses showed that a policy of price protection was universally followed in the trade,\textsuperscript{189} which involved a small number of closely connected firms.\textsuperscript{190} Furthermore, the case involves a determinant obligation in unusual circumstances—this reduces the likelihood that the decision will affect people’s behavior in the future. Asphalt producers could easily avoid litigation over the issue in the future by informing buyers that they no longer will follow a policy of price protection. People outside the asphalt industry are unlikely to think the case relevant to their circumstances.

\textit{K.M.C.} is more troubling. The evidence of a norm of giving notice before cancelling a line of credit was thin; the only evidence was the testimony of one banker.\textsuperscript{191} The plaintiff’s counsel has said that he thinks that the finding of bad faith was based mainly on evidence that a bank manager cancelled the loan out of animosity for the borrower.\textsuperscript{192} It is not clear, moreover, what the decision requires of banks, and this uncertainty stimulates litigation. A flood of bad faith lending claims against banks has been reported, though most such claims fail.\textsuperscript{193} Perhaps benefits in the improvement of loan management caused by the imposition of a duty to act in good faith when cancelling credit may offset the costs of processing good faith claims. But the effect of bad faith suits on loan management is a difficult theoretical question.\textsuperscript{194} Some suggest that

\textsuperscript{189} Id. at 784-85.
\textsuperscript{190} The asphalt business at issue in \textit{Nanakuli Paving} was dominated by two asphalt suppliers and two paving companies that were large enough to compete for major contracts. Each paving company had a relation with one supplier. Shell, the defendant in the case, had worked closely with Nanakuli to help Nanakuli compete with the other paving company for large jobs. Nanakuli’s success directly benefited Shell. \textit{Id.} at 778-80.
\textsuperscript{191} \textit{K.M.C. Co. v. Irving Trust Co.}, 757 F.2d 752, 761 (6th Cir. 1985).
\textsuperscript{192} Lisabeth Weiner, \textit{Advice on How to Avoid Lender Liability Lawsuits}, \textit{AM. BANKER}, Dec. 26, 1986, at 12. If this was the true basis for the decision, it may have been grounded on the view that good faith prohibits actions done purely out of the desire to harm another. \textit{See Squirrel Creek Assocs. v. United States}, 11 Cl. Ct. 212, 218 (1986) (requiring “evidence of some specific intent to injure the plaintiff” before finding that a party performed in bad faith).
\textsuperscript{194} I know of no empirical work on the question. For an economic argument against lender liability, see generally Daniel R. Fischel, \textit{The Economics of Lender Liability}, 99 \textit{YALE L.J.} 131 (1989). His analysis, however, is incomplete. Fischel focuses on the need for lenders to monitor debtors and the value of discretionary termination provisions in reducing monitoring costs. \textit{Id.} at 136. He would allow a suit only when a lender acts opportunistically. He defines an opportunistic act as exercising a power to recapture some benefit given up in the contract. \textit{Id.} at 138-40. An example might be when a lender takes advantage of a violation of an unimportant condition to call a term loan with a below-market interest rate. In the context of a demand loan, it seems that Fischel might consider it opportunistic for a lender to call the loan to exact a higher-than-market interest rate from the borrower when it is not possible for the borrower to obtain funds elsewhere. \textit{See id.} at 139 (discussing the availability of alternative sources of credit in the context of opportunistic behavior by the lender). Opportunistic behavior is troubling, though perhaps more on moral than on economic grounds. To
the most significant effect of decisions like *K.M.C.* has been to provide borrowers slightly more leverage in negotiating loan workouts. The author expresses no opinion on whether this is a good or bad development.

C. Acting to Further the Parties’ Joint Interest in Matters Left Open by a Contract

Some good faith cases require a party to act to further the parties’ joint interest in matters left open by a contract. Strong examples include the rules that regulate performance under contracts with open performance terms—terms that leave a party’s performance obligation undefined or defined vaguely—such as the duty of good faith in output and requirements contracts, the duty of a mineral lessee to perform in good faith or with reasonable prudence, and the duty to use good faith or best efforts in exclusive dealing contracts like publishing contracts. Plainly these rules require a party with discretion in performance to weigh the other party’s interests. Elsewhere I argue that these rules should be defined as a duty to maximize the parties’ joint return on performance, though that is not the current standard except under a standard of best efforts.

Generally, courts imply a duty to mind the other party’s interest when a contract gives a party discretion in performance and circumstances create a conflict between that party’s interest in performance and the parties’ joint interest. The implied duty is similar in form and function to the duty of reasonable care implied in professional service contracts. It is defend a rule prohibiting this opportunist behavior on economic grounds, one would have to show that the social cost of enforcing the rule is less than the social cost of the behavior the rule deters.

One may also question Fischel’s analysis because he fails to consider the possibility that a lender may be insufficiently sensitive to a borrower’s interests when deciding whether to call a loan. The cost to the borrower of calling a loan may be very high if it cannot quickly obtain credit elsewhere and if it will suffer great loss from the deprivation of credit. At the same time, the cost to the lender may be low because it can cheaply loan the same funds elsewhere with equal security. In this situation, a lender might take precautions that are insufficient from the parties’ joint perspective in deciding whether to call a loan even without acting opportunistically.


196. See U.C.C. § 2-306(1) (1993) (requiring the use of good faith and honesty when purchasing or selling goods under an output or requirements contract); see also id. cmt. 2 (“The essential test is whether the party is acting in good faith.”).

197. See generally HEMINGWAY, *supra* note 159, §§ 8.1–9, at 445-85 (discussing the express and implied covenants between lessors and lessees in oil and gas leases).

198. See U.C.C. § 2-306(2) cmt. 5 (1993) (“An exclusive dealing agreement brings into play all of the good faith aspects of the output and requirements problems in subsection (1) [of 2-306].”).


200. See id. at 1066 (noting that the best efforts standard “requires a party to consider the other party’s interest” while performing under a contract).

201. See supra at 1010-11; see generally Moody v. Messer, 489 S.W.2d 319, 321 (Tex. Civ. App.—Corpus Christi 1972, no writ) (holding that a professional services contract includes an implied term...
relatively easy to imply a duty when a party’s obligation is vaguely defined because the openness of the contract invites a court to specify the obligation undertaken and the implied duty is well established by statute or precedent.

Sometimes a concern that parties act to further their joint interest motivates the implication of duties in more complete contracts—contracts with terms that precisely dictate the parties’ obligations for most major contingencies. A fairly uncontroversial example is the implication of a duty to disclose known but hidden risks that might impose a loss on the other party, as in a contract to sell a good or land with hidden defects known to the seller or in a construction contract for a project with hidden problems known to the buyer. Compelling disclosure of information about loss-causing risks reduces the other party’s search costs and potential loss on entering into the contract. Here good faith serves a function similar to the doctrines of fraud, misrepresentation, and warranty by imposing upon the seller or owner a loss because of undisclosed risks.

The most interesting and difficult cases fall outside the familiar categories. Consider two examples. One case mentioned earlier holds that a mall owner who promised a tenant the exclusive right to sell goods of a particular type in the mall could not lease space to a competitor in an extension of the mall. It was apparent that the second lease was made to undercut the first tenant who was paying a below-market rent. The second example is a case ruling that a bank which held a first mortgage on a property acted in bad faith towards a subordinate mortgage holder when it made an unsecured loan to the mortgagee and then applied all of the mortgagee’s payments to the unsecured loan.

that the services are to be rendered with “care, skill, reasonable expedition and in a good workmanlike manner”).

202. See, e.g., AMPAT/Midwest, Inc. v. Illinois Tool Works Inc., 896 F.2d 1035, 1041 (7th Cir. 1990) (holding that a manufacturer must disclose potential defects in materials that may be the source of a buyer’s difficulties); U.C.C. § 2-314 cmt. 3 (1993) (stating that the duty of good faith requires nonmerchant sellers to disclose all known material, though hidden, defects to buyers).

203. Achterberg v. Gillett, 322 S.W.2d 306 (Tex. Civ. App.—El Paso), writ ref’d n.r.e. per curiam, 159 Tex. 591, 325 S.W.2d 384 (1959), is a Texas case involving radical reconstruction of a contract that does not fit in any of the familiar categories. The court there refused to construe a provision for a fifteen year “non-cancellable” sales agency as non-cancellable regardless of events, but it also ruled that the provision could not be construed as giving the manufacturer an absolute right to terminate. Id. at 309. The court remanded the case to allow the jury to evaluate the manufacturer’s argument that it had sold its business in good faith because it was unprofitable. Id. at 308. In effect, the court ruled that a “non-cancellable” contract was cancellable so long as the manufacturer acted in good faith. The duty of good faith filled in a gap created by the court’s disregard of an express contract term.


205. Id. at 116.

206. Id.

While these cases are genuinely difficult, I think the results are defensible because they prevent a party from acting opportunistically—acting in a way that diminishes the parties’ joint return on a contract in order to capture a larger return for itself—under circumstances that the parties probably did not anticipate when drafting the contract. Thus, in the mall case, the landlord’s attempt to undercut the tenant may have been jointly harmful because the landlord’s gain from breaking a below-market lease would be significantly less than the tenant’s loss if the tenant had good will in the location. And in the loan case, the court used good faith to prevent the bank from putting much of the risk of the unsecured loan on the subordinate mortgage holder, an action that may have led the bank to undervalue the risk when making or holding the unsecured loan in the first place.

These two cases are problematic not because of their particular results, which seem just and even possibly efficient, but because of their broader implications. Cases varying contract terms may promote litigation, or courts may rewrite contracts in a harmful manner. The magnitude of these costs is difficult to evaluate though there are some troubling cases. Some courts, for example, have invoked the duty of good faith to bar parties to a contract from competing with each other outside the contract even when such competition may be socially beneficial and the contract does not bar or even expressly permits competition. Often these cases assert a rule that a party to a contract may not interfere in good faith with the other party’s receipt of benefits under the contract. This extension of the good faith doctrine undercuts a long-standing common law rule against implying covenants not to compete in contracts not involving personal service. I think the asserted rule, stated in such terms, is clearly wrong. As a counter-example, consider Meier’s Trucking Co. v. United

208. See Conoco Inc. v. Inman Oil Co., 774 F.2d 895, 909 (8th Cir. 1985) (holding that a manufacturer’s competition with a jobber for the business of a customer was bad faith); Scheck v. Burger King Corp., 756 F. Supp. 543, 548-49 (S.D. Fla. 1991) (holding that it was bad faith for a franchisor to create a competing franchisee even though the contract gave the franchisee no exclusive territorial rights); St. Benedict’s Dev. Co. v. St. Benedict’s Hosp., 811 P.2d 194, 200 (Utah 1991) (holding that it may be bad faith for a hospital to open a competing professional building after it had leased land to a developer for a professional building). But see M/A-COM Sec. Corp. v. Galesi, 904 F.2d 134, 136 (2d Cir. 1990) (per curiam) (holding that a party may advance its own interests in an unrelated transaction at the expense of another party to a contract).

209. See Williams v. Jader Fuel Co., 944 F.2d 1388, 1395 (7th Cir. 1991) (holding that a surface miner’s actions that prevented its contract partner, a subsurface miner, from performing to its benefit under the contract may have been bad faith), cert. denied, 112 S. Ct. 2306 (1992); Bank of China v. Chan, 937 F.2d 780 (2d Cir. 1991) (holding that a bank’s interference with a guarantor’s relationship with its customers may be bad faith).

Construction Co., a case in which a subcontractor proposed cost-saving changes in a construction job that enriched the subcontractor, but diminished the return to the general contractor. The court in Meier's Trucking rejected a claim by the general contractor that the subcontractor acted in bad faith. That decision seems right even though the subcontractor's actions undercut the general contractor because the subcontractor's actions benefitted the party employing the general contractor—in this case the state or, to be precise, the taxpayers.

Texas law prior to English v. Fischer plainly allowed claims under the first theory of good faith—to protect contract-based expectations. The plaintiffs in English should have prevailed under that theory. The court's error was in requiring too close a connection between the literal terms of the contract and the duty claimed as a matter of good faith. Good faith should protect expectations reasonably grounded in the terms of a contract. The second and third theories are more novel, and dangerous, because they allow a court to subvert the express terms of a contract based on its views of trade practice or the parties' interests. Still, these theories are well grounded in the law, including Texas law prior to English. Courts have assumed the power to redraw contracts to serve the parties' clear expectations or interests, but they should do so only when it is clear that the written contract does neither.

V. Conclusion

The tort of bad faith breach was a mistake from its inception. It was not well grounded in Texas law, and there was no need for the tort because other elements of Texas law addressed the problems of underenforcement of contract claims, particularly in the area of insurance. The new conservative majority on the Texas Supreme Court has confined the tort to the area of insurance and has limited the tort in various ways. But these cases are as flimsily reasoned as the cases that created the tort. The court would be on sounder ground, and Texas law would be tidier, if the court would simply abolish the tort of bad faith breach.

The court also needs to revive the duty of good faith in contract. The doctrine of good faith is one of several devices courts use to reconstruct contracts to ensure they function as the parties intended or to deal with unexpected circumstances. English gets the point precisely backwards; such use of the good faith doctrine is not "novel," and it does not threaten to "abolish our system of government according to settled rules of law" by

212. Id. at 3-5.
213. Id. at 7.
setting judges and juries over contracts. Instead, the notion that bad faith breaches of some contracts are tortious was novel and disruptive.

214. *Contra English*, 660 S.W.2d at 522.