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An Employment Contract "Instinct with an Obligation": Good Faith Costs and Contexts

Robert C. Bird*

Introduction

What claim do we employment scholars have upon such an important decision as *Wood v. Lucy, Lady-Duff Gordon*?[1] More than a mere echo of *Lucy*'s jurisprudential influence, we employment writers can abscond with the phrase for our very own. Eight years before the decision, little known intermediate appellate court judge Francis M. Scott penned the now-famous 'instinct with an obligation' phrase.[2] The opinion was no mere contractual prelude to *Lucy*, no simple dispute over bargained-for exchange between commercial partners, but rather a case involving the enforcement of an employment agreement. Judge Scott characterized an employment agreement as having an "instinct with an obligation" to not terminate an employee during the agreement's six year duration, even though the agreement did not explicitly impose the obligation.[3] Seven years later, Justice Cardozo cited Scott's opinion for the phrase and the rest is jurisprudential history.[4] For better or for worse, this patch of jurisprudential terrain is at least partially ours, though we shall permit our learned contractual cousins its occasional use.

But what shall we do with this fabled patch of legal real estate? When then-Judge Cardozo wrote in 1917 that a contract "may be instinct with an obligation, imperfectly expressed,"[5] the famed jurist triggered a ninety-year long effort, mostly in contract, to define and explain the duty. Given the

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1. 118 N.E. 214, 214 (N.Y. 1917).

2. McCall Co. v. Wright, 117 N.Y.S. 775, 779 (App. Div. 1909), *aff'd*, 91 N.E. 516 (N.Y. 1910). The court's exact words were "instinct with such an obligation," but there is no need to quibble. *Id.*

3. *Id.*

4. *Wood*, 118 N. E. at 214.

5. *Id.*

intertwining history of contract and employment, as well as the role of Judge Scott's decision, it is not surprising to see the famous *Lucy* case influence employment law.[6] Justice Cardozo's good faith obligation has helped form one of the three pillars of wrongful discharge, a concept which has helped neuter the harshest effects of the employment at will doctrine. Today, a web of obligations exist in the employment relationship beyond what Justice Cardozo could have imagined possible almost a century ago.

This article will briefly explore three challenges to the orderly development of the good faith doctrine in employment law. First, the meaning of good faith remains far from certain. Courts have intermingled good faith with other employment doctrines thereby hindering its widespread acceptance. Second, the good faith covenant in employment lacks mutuality. Usually bilateral in the contractual context, the covenant remains an obligation that usually runs only from the employer to the employee. The questions of whether the covenant should obligate employers and what the consequences of such an obligation could be remain unaddressed. Finally, and perhaps most interestingly, there is a limited understanding of the costs of the good faith duty. The emerging empirical work studying the effects of wrongful discharge law, of which the duty of good faith is a part, reveals potential economic costs of this important doctrine articulated by Cardozo ninety years ago.

I. The Tradition of Good Faith First-Level Heading

Tempting though it might be to herald the *Lucy* case as inventing a purely new theory, the notion of good faith was alive and well long before 1917. The ancient Greeks conceptualized the notion of good faith as a universal social norm measured by external references.[7] Ancient Romans characterized good faith

6. *See, e.g.,* Monique C. Lillard, *Fifty Jurisdictions in Search of a Standard: The Covenant of Good Faith and Fair Dealing in the Employment Context,* 57 Mo. L. Rev. 1233, 1234 (1992) (briefly discussing *Lucy*). *See generally* Franklin G. Snyder, *The Pernicious Effect of Employment Relationships on the Law of Contracts,* 10 Tex. Wesleyan L. Rev. 33 (2003) (explaining the intertwining history of contract law and employment law).

7. Robert C. Bird & Darren Charters, *Good Faith and Wrongful Termination in Canada and the United States: A Comparative and Relational Inquiry,* 41 Am. Bus. L.J. 205, 220 (2004).

as the embodiment of express terms as well as terms naturally implied from the agreement.[8] Canon law characterized good faith as an overarching principle requiring that a transaction be legally and morally conscionable.[9] As a more complex market economy dominated Europe in the Eighteenth Century, the scope of good faith narrowed to the protection of substantive justice and fair exchange.[10]

In the twentieth century, *Lucy's* "instinct with an obligation" conception of exchange contributed to the modern embodiment of good faith. Justice Cardozo carried the phrase with him to the United States Supreme Court and used it in a variety of contexts.[11] Courts and commentators have used the phrase to support arguments ranging from statutory interpretation to proper scope of application of equitable principles.[12]

Yet, if citations can be used as a measure, the *Lucy* case did not immediately capture the nationwide judicial imagination. Of the thirty-five cases that cite *Lucy* during the first ten years after its decision, only three are from courts outside of New York.[13] Citation from the first of the three out-of-state cases occurs in April, 1924,[14] implying that for almost seven years the

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8. James A. Webster, Comment, *A Pound of Flesh: The Oregon Supreme Court Virtually Eliminates the Duty to Perform and Enforce Contracts in Good Faith*, 75 OR. L. REV. 493, 498 (1996).

9. Larry A. DiMatteo, *The History of Natural Law Theory: Transforming Embedded Influences Into a Fuller Understanding of Modern Contract Law*, 60 U. PITT. L. REV. 839, 863-64 (1999). *See also* R. Wilson Freyermuth, *Enforcement of Acceleration Provisions and the Rhetoric of Good Faith*, 1998 B.Y.U. L. REV. 1035, 1051-52.

10. Freyermuth, *supra* note 9, at 1051-52.

11. Norwegian Nitrogen Products Co. v. United States, 288 U.S. 294, 319 (1933) (stating "instinct with the recognition of a duty"); Nixon v. Condon, 286 U.S. 73, 87 (1932) (characterizing a state court decision as "the whole opinion is instinct with the concession").

12. Robert A. Hillman, *"Instinct with an Obligation" and the "Normative Ambiguity of Rhetorical Power,"* 56 OHIO ST. L.J. 775, 775 (1995) (citing numerous examples).

13. The author used Westlaw's citing reference system to determine the number of citations. The cite check was limited to any cases citing *Lucy* from the date of the decision, December 4, 1917, through December 4, 1927.

14. *See* Meader v. Incorporated Town of Sibley, 198 N.W. 72, 74 (Iowa 1924). The two other out-of-state cases during this period are Hendler Creamery Co. v. Lillich, 136 A. 631, 635 (Md. 1927), and Sovereign Camp, W.O.W. v. Todd, 283 S.W. 659, 672 (Tex.Civ.App. 1926). Special Chief Justice Hildebrand, writing in dissent in *Todd*, used the *Lucy* case in an eloquent critique of a badly drafted insurance policy:

Lucy case remained largely unrecognized outside its own jurisdictional borders. Although one cannot be sure, it may not have received its immediate jurisprudential dues simply because of the relative slowness with which cases diffused in an age without electronic databases.[15]

Like most cases, the *Lucy* phenomenon is a distinctively American one. The case receives few citations in foreign cases.[16] The *Lucy* case, however, does appear in an employment dispute in *Ryan v. Textile, Clothing and Footwear Union of Australia*, a 1996 decision by the Court of Appeal of the Supreme Court of Victoria.[17] In *Ryan* the court discusses the "instinct" language to help it determine whether a collective bargaining agreement was supported by sufficient consideration and mutuality.[18] The remaining cases involve traditional contract disagreements.

Discussion regarding the impact of the *Lucy* case continues today. Most recently, Victor Goldberg critiques the *Lucy* case as more doctrinally problematic than modern scholars have given it discredit for.[19] The agreement between Lady Duff-Gordon and her advertising agent, Otis Wood, allowed Wood to have the

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> [T]here are so many inconsistencies in this policy . . . with little attention being paid to the contradictions between the old and new provisions, that the policy, when spread upon the table, looks like a crazy quilt, and when read aloud sounds like a jazz melody. We believe in the freedom of contracts, but "the law has outgrown its primitive stage of formalism when the precise word was the sovereign talisman[.]" Wood v. Duff-Gordon, 222 N.Y. 88, 118 N.E. 214. And where an insurance company prepares as indefinite a contract as the one involved in this case—so vague that an astute lawyer could not be certain as to its meaning—it should not be heard to complain if the courts prevent it from perpetrating a fraud on its members.

Todd, 283 S.W. at 672.

15. *See generally* Alvin M. Podboy, *The Shifting Sands of Legal Research: Power to the People*, 31 TEX. TECH L. REV. 1167 (2000) (describing development of legal research through the twentieth century).

16. *E.g.*, O'Brien v. O'Brien Estate, [1998] Sask. R. 190 (Can.) (cited as a "classic discussion[ ] of 'illusory obligation'"); Dawson v. Helicopter Exploration Co., [1955] S.C.R. 469 (Can.) (citing "instinct with an obligation" language). In the United Kingdom, Lacy Duff-Gordon as an individual and not as a litigant is apparently mentioned briefly in *In re* Ross, (1930) 1 Ch. 377, 378 (Can.).

17. (1996) 130 F.L.R. 313 (Austl.).

18. *Id.* at 325.

19. Victor P. Goldberg, *Desperately Seeking Consideration: The Unfortunate Impact of U.C.C. Section 2-306 on Contract Interpretation*, 68 OHIO ST. L.J. 103 (2007).

exclusive right to place her endorsements on designs in exchange for half of the "profits and revenues" derived from the contracts.[20] Goldberg remarks that Cardozo could have easily ruled the other way noting that "because we are not to suppose that Lucy would put herself at Wood's mercy, she had not in fact done so. She would only be at his mercy if it were a legally binding contract."[21] Thus, Cardozo could have concluded that there was no legally binding contract.[22] Furthermore, Wood was embroiled in another "exclusive contract"-type dispute, and that contract contained an explicit best efforts clause.[23] The question remains why a court should imply best efforts at all into the contract between Wood and Lady Duff-Gordon.[24] The ongoing debate about the propriety of the *Lucy* case and good faith generally may have contributed to its uncertain application and development, the focus of the next section of this article.

II. Good Faith in Employment

A. *Nebulous Concept*

In the United States, the precise scope and obligation of good faith in employment remains unclear. One author found at least eight different definitions of good faith amongst employment cases.[25] The list included such widely accepted definitions such as "the benefit of the bargain," an act that is not in bad faith, or honesty in fact.[26] Other definitions included "[t]oo vague to discuss," "I know it when I see it," and community standards or business practice.[27] Good faith today remains one of employment law's most nebulous concepts.[28]

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20. Wood v. Lucy, Lady-Duff Gordon 118 N.E. 214, 214 (N.Y. 1917).

21. Goldberg, *supra* note 19, at 108.

22. *Id.*

23. *Id.*

24. *Id.* at 109.

25. Lillard, *supra* note 6, at 1249-58. A Texas court, for example, listed five interpretations of good faith. City of Midland v. O'Bryant, 18 S.W.3d 209, 213-14 (Tex. 2000).

26. Lillard, *supra* note 6, at 1249-58.

27. *Id.* at 1249, 1258.

28. Robert C. Bird, *Rethinking Wrongful Discharge: A Continuum Approach*, 73 U. CIN. L. REV. 517, 559 (2004). *See also* J. Wilson Parker, *At-Will Employment and the Common Law: A Modest Proposal to De-Marginalize Employment Law*, 81 IOWA L. REV. 347, 359-60 (1995) ("The use of the implied covenant of good faith is perhaps the most problematic response to improper employee discharges . . . [and

This uncertainty appears robustly in wrongful discharge law. Wrongful discharge is a term that represents a collection of doctrines that have limited the discretion of the employment at will doctrine over the past thirty to forty years.[29] Wrongful discharge law generally is comprised of three exceptions: 1) a discharge in violation of a public policy such as refusing to perform an illegal act or exercising a legal right, 2) a discharge that breaches an implied contract between the parties often established by a company handbook, and 3) a discharge that breaches an implied covenant that the employer will only terminate in good faith and fair dealing.[30] States have adopted these various exceptions to employment at will since the 1970s. Some states have adopted all three exceptions while others have incorporated none, one or two.[31]

The doctrine that has gained the least acceptance, and is subject to the most confusion, is the good faith exception. The good faith exception has been adopted by only eleven states, much less than the public policy and implied contract exceptions, which both have been adopted by well over forty states.[32] This may be because the good faith exception suffered from so much initial uncertainty.

In 1974, the New Hampshire Supreme Court read one of the earliest covenants of good faith and fair dealing into all employment arrangements.[33] The court's language defining the covenant was so broad and ambiguous that it could have been read to significantly weaken employment at will, no doubt causing great concern to employers. The court said:

> [A] termination . . . of employment at will which is motivated by bad faith or malice or based on retaliation is not in the best inter-

is the] most nebulous judicial exception to the employment-at-will doctrine."); Lillard, *supra* note 6, at 1260 ("[D]espite the combined efforts of [scholars and case law] . . . a generalized understanding of good faith has not been forthcoming.").

29. Bird, *supra* note 28, at 519.

30. *See generally* David J. Walsh, *On the Meaning and Pattern of Legal Citations: Evidence from State Wrongful Discharge Precedent Cases*, 31 LAW & SOC'Y REV. 337 (1997).

31. *See generally* David J. Walsh & Joshua L. Schwarz, *State Common Law Wrongful Discharge Doctrines: Up-Date, Refinement, and Rationales*, 33 AM. BUS. L.J. 645 (1996) (describing various adoption dates of three doctrines).

32. David H. Autor, John J. Donohue III & Stewart J. Schwab, *The Costs of Wrongful-Discharge Laws*, 88 REV. ECON. STAT. 211 (2006).

33. *See* Monge v. Beebe Rubber Co., 316 A.2d 549 (N.H. 1974).

est of the economic system or the public good and constitutes a breach of the employment contract. . . . Such a rule affords the employee a certain stability of employment.[34]

In 1980, *Cleary v. American Airlines, Inc.*[35] adopted an implied covenant of good faith and fair dealing in employment arrangements. The decision allowed for both contract and tort damages arising from its breach, and was generally considered one of the broadest and most influential of good faith cases.[36] Employers initially understood the decision to be their worst human resources nightmare – prohibiting termination of *any* employee without just cause.[37]

Subsequent opinions curtailed the scope of these rulings. *Howard v. Dorr Woolen Co.*[38] limited *Monge* to a quasi-public policy exception. The California Supreme Court significantly curtailed the reach of *Cleary*'s good faith ruling in 1988.[39] The jurisprudential damage, however, apparently had already been done. From those initial cases onward, the good faith exception in employment law never caught on like its implied contract and public policy counterparts. Today, the good faith exception is limited to "timing cases" where the employer improperly denies specific benefits of an agreed-upon employment bargain such as commission payments,[40] sick leave[41] and pension benefits.[42]

Further impairing the development of the good faith exception is its misapplication by interpreting courts. First, some courts interpreting the good faith exception have intermingled it with other wrongful discharge exceptions. In *Smith v. Ameri-*

34. *Id.* at 551-52. *See also* Scott A. Moss, *When There's At-Will, There Are Many Ways: Redressing the Increasing Incoherence of Employment at Will*, 67 U. PITT. L. REV. 295, 299 n.5 (2005) (characterizing the broad language of *Monge* as "possibly repealing employment at will").

35. Cleary v. Am. Airlines, Inc., 168 Cal. Rptr. 722 (Cal. Ct. App. 1980).

36. David H. Autor, William R. Kerr & Adriana D. Kugler, *Does Employment Protection Reduce Productivity?: Evidence from US States*, 117 ECON. J. F189, F191 (2007).

37. *Id.*

38. 414 A.2d 1273, 1274 (N.H. 1980).

39. Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988).

40. Fortune v. Nat'l Cash Register Co., 364 N.E.2d 1251 (Mass. 1977).

41. Metcalf v. Intermountain Gas Co., 778 P.2d 744 (Idaho 1989).

42. United Steelworkers of Am. v. Gen. Fireproofing Co., 464 F.2d 726 (6th Cir. 1972).

can Greetings Corp.[43] the court stated that "every employment relationship, even one terminable at will, contains 'an implied covenant of good faith and fair dealing . . . . This covenant prohibits discharge for a reason which contravenes public policy.'"[44] The court in *Magnan v. Anaconda Industries, Inc.*[45] also intermingled the public policy and good faith exceptions.[46] One Justice, writing in partial concurrence and dissent, called out the majority opinion on just this point, explaining that the majority's imposition of a good faith covenant on employers "gives the employee a covenant that is nothing more than an empty vessel."[47] Other state courts have also blended the two, creating further doctrinal uncertainty as to the scope and meaning of good faith.[48]

Second, courts have inadvertently equated good faith with just cause—a doctrine that would negate employment at will altogether. As mentioned above, early employers interpreting *Cleary* believed just that. A later California court acknowledged that the notions of good cause, bad faith and tortuous discharge "were rather badly admixed in *Cleary*."[49] In *Stark v. Circle K Corp.*,[50] the court held that to avoid a breach of the covenant of good faith, an employer must have a "fair and honest" reason for dismissal, language that implies just cause employment.[51] Given that in the 1980s the good faith doctrine was

43. 804 S.W.2d 683 (Ark. 1991).

44. *Id.* at 684.

45. 479 A.2d 781 (Conn. 1984).

46. *Id.* at 788-91, 791 n.25.

47. *Id.* at 792.

48. *E.g.*, Decker v. Browning-Ferris Indus. of Colo., Inc., 931 P.2d 436, 446 (Colo. 1997) ("In the absence of such declarations of [legislative or other governmental] public policy, there is no appropriate basis upon which to ground a tort of breach of an express covenant of good faith and fair dealing in employment contracts."); Wagenseller v. Scottsdale Mem'l Hosp., 710 P.2d 1025, 1036 (Ariz. 1985) ("We simply do not raise a presumption or imply a covenant that would require an employee to do that which public policy forbids or refrain from doing that which it commands.").

49. Koehrer v. Superior Court, 226 Cal. Rptr. 820, 827 (Cal. Ct. App. 1986).

50. 751 P.2d 162 (Mont. 1988).

51. *Id.* at 167. *See also* Huber v. Standard Ins. Co., 841 F.2d 980, 985 (9th Cir. 1988). The interpretation given in this case was later rendered invalid by a later state court. *See* Mundy v. Household Fin. Corp., 885 F.2d 542, 544 n.1 (9th Cir. 1989) ("Because we are bound by an interpretation of state law by the highest state court[,] . . . our discussion of the covenant of good faith and fair dealing in *Huber* no longer has validity.").

still in its formative years, the tendency to equate good faith with just cause may have been a reasonable one. The effect of the uncertainty and conflicting signals remains today, however, and a relatively-established principle that guides contract and insurance cases does not apply to most employment relationships.

B. *The Question of Mutuality*

Does Cardozo's "instinct with an obligation" travel in both directions? The normative obligations of the employer under a covenant of good faith and fair dealing have been widely discussed.[52] Much less discussion, however, has taken place to define to what extent employees have any good faith obligations towards employers.

The first place to begin in any discussion of employee obligation in the workplace is the law of employee loyalty. Authors as early as Horace Wood, author of the famed treatise that heralded the rise of employment at will, have commented on employee responsibilities.[53] After summarizing the employer's obligations, Wood wrote that an employee must serve his employer faithfully, obey all reasonable commands and perform his duties honestly, with ordinary care and due regard for the interests of the employer's business.[54] Today, these obligations survive in a collection of requirements invoking employee loyalty.[55]

Examples where this loyalty duty has been invoked include when a departing employee poaches co-workers away from his former firm, engages in employer disparagement, or misuses

52. *E.g.*, Katherine M. Apps, *Good Faith Performance in Employment Contracts: A "Comparative Conversation" between the U.S. and England*, 8 U. PA. J. LAB. & EMP. L. 883 (2006); Bird & Charters, *supra* note 7; Susan Dana, *The Covenant of Good Faith and Fair Dealing: A Concentrated Effort to Clarify the Imprecision of its Applicability in Employment Law*, 5 TRANSACTIONS: TENN. J. BUS. L. 291 (2004); Lillard, *supra* note 6.

53. *See generally* HORACE GAY WOOD, A TREATISE ON THE LAW OF MASTER AND SERVANT (2d ed. 1886). There may have been limited support for Wood's assertions regarding the employment at will at the time. *See* Jay M. Feinman, *The Development of the Employment at Will Rule*, 20 AM J. LEGAL HIST. 118 (1976).

54. *Id.* at 165-66.

55. *See* Benjamin Aaron & Matthew Finkin, *The Law of Employee Loyalty in the United States*, 20 COMP. LAB. L. & POL'Y J. 321, 330-31 (1999).

company assets.[56] Most recently, employee loyalty issues have arisen in the context of Internet blogging that is critical of the employer.[57] Faithfulness due by an employee is relative to the degree of trust and responsibility given by his or her employer.[58] At the highest levels of management, this duty imposes upon employees the obligation of "utmost fidelity."[59]

A mutual and binding good faith "obligation" between employers and employees might invoke notions of fairness, justice and the prohibition of advantage-taking against the other party in the relationship. Most employees need no such explanation of the obligation, however, as they already have a strong 'instinct' for the protections that are supposedly owed to them. Pauline Kim's research reveals that a large majority of workers untrained in the law apparently (and wrongly) believe that the law protects them from unfair discharge similar to a just cause standard in civil service jobs and collective bargaining agreements.[60] According to most respondents, firing someone to replace them with a lower wage worker, personal dislike and a mistaken belief of employee theft were all illegal reasons to discharge.[61] Employees may discern the employee's obligation through their own "fairness heuristic," in that what the employee perceives to be unfair must also be illegal.[62] This could encompass a seemingly unlimited range of actions limited only by the subjective perception of the individual worker.

If Cardozo's "instinct" comes with an "obligation," what should that obligation be? It is far from certain that employees expect that they will be bound by their own reciprocal obliga-

56. Bird, *supra* note 28, at 563 (citing cases).

57. *See* Konrad Lee, *Anti-Employer Blogging: Employee Breach of the Duty of Loyalty and the Procedure for Allowing Discovery of a Blogger's Identity before Service of Process is Effected*, 2006 Duke L. & Tech. Rev. 2.

58. *E.g.*, United Teachers Ass'n Ins. Co. v. MacKeen & Bailey, Inc., 99 F.3d 645, 649 (5th Cir. 1990).

59. Scott W. Fielding, *Free Competition or Corporate Theft: The Need for Courts to Consider the Employment Relationship in Preliminary Steps Disputes*, 52 Vand. L. Rev. 201, 206 (1999).

60. Pauline T. Kim, *Bargaining with Imperfect Information: A Study of Worker Perceptions of Legal Protection in an Employment at Will World*, 83 Cornell L. Rev. 105 (1997).

61. *Id.* at 133-34.

62. Cynthia L. Estlund, *How Wrong are Employees About Their Rights, and Why Does it Matter?*, 77 N.Y.U. L. Rev. 6, 22 (2002).

tions to the employer. No doubt few employees would accept an arrangement whereby they could only leave (translation: 'fire') their employer for a good cause such as an economic downturn or a manager's substandard performance. Employees would no doubt characterize such impositions as forced servitude. Yet, good faith's "instinct with an obligation" should carry with it some mutual responsibilities. The extent of these responsibilities, however, is far from certain in the employment context.

Just how far good faith can extend can be seen in the unusual example of *Hudson v. Moore Business Forms, Inc.*[63] In *Hudson,* plaintiff Ida Hudson (Hudson) sued her employer under various state and federal employment laws arising from the alleged unequal pay practices and sexually discriminatory actions of her employer, Moore Business Forms (Moore).[64] Moore responded with its own counterclaim, which included an allegation that Hudson breached an implied covenant of good faith and fair dealing.[65] Moore alleged that Hudson breached this covenant by rejecting opportunities to remain with the firm, accepting special payments from Moore tied to termination, and then responding with a lawsuit claiming that her termination was unlawful.[66] According to Moore, Hudson denied the existence of a contract in which she allegedly agreed to be terminated in exchange for severance benefits.[67] As a result of Hudson's departure, Moore sought $4 million in damages from Hudson.[68]

Reasoning that only the party in the stronger position can be held liable for a breach of the duty of good faith in the employment context, and noting the lack of evidence of any special severance payments-for-termination agreement, the court called Moore's claim, "wholly without merit."[69] Even if some arrangement existed between Moore and Hudson, recognizing a good faith duty in this scenario would create a specter of liability over any employee wishing to leave their job. The implications of this could be far reaching. Employers could reduce

63. 609 F. Supp. 467 (N.D. Ca. 1985).
64. *Id.* at 470.
65. *Id.* at 478.
66. *Id.*
67. *Id.* at 477.
68. *Id.* at 480.
69. *Id.* at 479.

employee pay and benefits, and then threaten a breach of good faith action if an employee sought to look for better employment elsewhere. The effect would be to drastically reduce employee mobility, impeding a wide variety of economically useful actions ranging from free competition among actual and potential employers[70] to the creation of individual start-up enterprises.[71] Thus, a *Hudson*-style good faith duty could impose significant transaction costs on job-switching activities.

Given the likely suppressive effect of even the possibility of litigation,[72] the mere viability of the employer good faith claim as an argument might negatively impact employee behavior. The district court may have recognized this when it painted Moore's good faith counterclaim as an "unconscionable claim for $4 million dollars punitive damages against an unemployed woman over 50 years of age whose husband is living on retirement . . . [and] an overzealous attempt on the part of defendants' counsel to intimidate this and other plaintiffs from pursuing wrongful discharge litigation."[73] After a *sua sponte* order to show cause, the court imposed Rule 11 sanctions upon Moore's counsel totaling $14,692.50.[74]

Moore appealed.[75] The court ruled that Rule 11 sanctions were not improper, reasoning that Moore's counsel had admitted that the figure was chosen to offset Hudson's $4 million claim against Moore and various employees.[76] The court remarked that this "strongly suggests a retaliatory motive and

70. Phillip J. Closius & Henry M. Schaffer, *Involuntary Nonservitude: The Current Judicial Enforcement of Employee Covenants Not to Compete—A Proposal for Reform*, 57 S. CAL. L. REV. 531, 532 (1984). *See also* Christina L. Wu, *Noncompete Agreements in California: Should California Courts Uphold Choice of Law Provisions Specifying Another State's Law?*, 51 UCLA L. REV. 593, 608 (2003) ("California's strong public policy toward employee mobility therefore contributed to swift economic and technological development in the state.").

71. *E.g.*, Charles Tait Graves, *The Law of Negative Knowledge: A Critique*, 15 TEX. INTELL. PROP. L.J. 387, 406-07 (2007).

72. *Cf.* Michael J. Garrison, *Limiting the Protection for Employees from Compelled Noncompete Agreements under State Whistleblower Laws: A Critical Analysis of* Maw v. Advanced Clinical Communications, 20 LAB. LAW. 257, 286 (2005) (noting threat of litigation arising from enforcement of non-compete would have negative effects on employee mobility).

73. *Hudson*, 609 F.Supp. at 480.

74. *Id.* at 481.

75. Hudson v. Moore Bus. Forms, Inc., 836 F.2d 1156 (9th Cir. 1987).

76. *Id.* at 1163.

'erases the factual underpinning from . . .' [the firm's] damage claims."[77] The court also stated that the assertion of the good faith claim alone did not support the imposition of sanctions. The court remarked that "[t]he rapid and recent evolution of the law in this area highlights the precariousness of drawing a line between plausible and sanctionable arguments."[78]

Although neither the trial nor the appellate court found Moore's novel good faith claim compelling, it apparently was not so implausible to cross the line into frivolousness. This leaves the door open for future employers to attempt this argument again. Mitigating this possibility has been the retraction of the good faith doctrine in employment since its broadest interpretation in the 1980s, when the *Hudson* case was decided. This does not mean, however, that any possibility of an employer good faith claim has disappeared. An expansion of an employee's 'instinct with an obligation' beyond that of traditional duty of loyalty doctrine remains a possibility.

C. *The Costs of Good Faith*

When courts have adopted the good faith exception, common reasons given include that employment is similar to other special relationships that have a good faith duty (e.g. insurer-insured), the duty is recognized under common law or in the uniform commercial code, or it has already been recognized in other states.[79] Courts rejecting the good faith exception commonly did so because it could not be reconciled with employment at will, other states had rejected the adoption, or it was a change best left to the legislature.[80] Only rarely did a court focus on the costs of good faith on employers or employees when considering its adoption.[81]

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77. *Id.* at 1163 (quoting Greenberg v. Sala, 822 F.2d 882, 887 (9th Cir. 1987)).

78. *Id.* at 1160.

79. Walsh & Schwarz, *supra* note 31, at 661.

80. *Id.*

81. One notable exception is Whittaker v. Care-More, 621 S.W.2d 395 (Tenn. 1981), which remarked when considering whether to adopt a wrongful discharge exception:

> Tennessee has made enormous strides in recent years in its attraction of new industry of high quality designed to increase the average per capita income of its citizens and thus, better the quality of their lives. The impact on the continuation of such influx of new businesses should be carefully con-

Does the covenant of good faith and fair dealing impose economic costs? Although there has been an increasing number of empirical papers dealing with the effect of employment laws,[82] we know little about the empirical impact of good faith in the employment context. The earliest studies appear to be those that focused on the costs of wrongful discharge jury cases and verdicts, of which good faith claims are a subset. The results showed plaintiff success rates ranging between 46 percent and 78 percent.[83] Median verdicts ranged between $76,500 to $400,938 and average verdicts ranged between $238,221 and $2,506,132.[84] One of the early studies specifically examining the costs of breach of good faith claims found that plaintiffs received an average award of $540,899.[85] A California law firm reported that there were 249 California employment verdicts in 1998.[86] The firm classified the various employment claims brought according to their success rate.[87] Claims of a breach of the covenant of good faith and fair dealing were found to be successful only 35 percent of the time, compared with greater success rates for "public policy tort (66%), disability discrimination (56%), and sexual harassment (56%) to sex discrimination (50%), breach of contract (50%), [and] age discrimination (37%)" actions.[88] Only race discrimination claims (13 percent) and na-

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> sidered before any substantial modification is made in the employee-at-will rule.

Id. at 397.

82. *See, e.g.*, Minna J. Kotkin, *Outing Outcomes: An Empirical Study of Confidential Employment Discrimination Settlements*, 64 WASH. & LEE L. REV. 111 (2007); Laura Beth Nielsen & Robert L. Nelson, *Rights Realized? An Empirical Analysis of Employment Discrimination Litigation as a Claiming System*, 2005 WIS. L. REV. 663; Kevin M. Clermont & Stewart J. Schwab, *How Employment Discrimination Plaintiffs Fare in Federal Court*, 1 J. EMPIRICAL LEGAL STUD. 429, 429 (2004).

83. David Benjamin Oppenheimer, *Verdicts Matter: An Empirical Study of California Employment Discrimination and Wrongful Discharge Jury Verdicts Reveals Low Success Rates for Women and Minorities*, 37 U.C. DAVIS L. REV. 511, 518 (2003).

84. *Id.*

85. *See* David J. Jung & Richard Harkness, *The Facts of Wrongful Discharge*, 4 LAB. LAW. 257, 263 (1988).

86. Oppenheimer, *supra* note 83, at 521-22 (citing *Litigation: Law Firm Provides Survey Data on Jury Verdicts in Employment Cases*, DAILY LAB. REP., Dec. 12, 1999, at 1).

87. *Id.* at 522.

88. *Id.*

tional origin claims (1 percent) were reported to be less successful.[89]

These high victory percentages and award amounts, however, may be attributed to the fact that all of the studies mentioned examined California cases. California is generally viewed as a pro-employee jurisdiction.[90] During the time period these studies were undertaken, the mid-to-late 1980s, California was still governed by the broad pronouncement in *Cleary v. American Airlines, Inc.*,[91] which held that lucrative tort remedies, as well as contract remedies, were available under a breach of good faith claim. Only in late December of 1988 did the California court restrain *Cleary*'s broad reach and limit good faith plaintiffs to contract-based recoveries.[92] These studies and the scholarship analyzing them may have contributed to an inflated perception of wrongful discharge law as a major threat to employers.[93]

Scholars have not studied the empirical impact of good faith in employment in isolation. Rather, most empirical work addressing good faith in employment stems from studies on the impact of all three wrongful discharge exceptions on wages, employment and other economic variables. Theories predicting the effect of discharge protections may be ambiguous. For example, wages may decrease as bureaucratic and legal costs imposed upon an employer by discharge protections are passed on to employees. On the other hand, employee wages might increase due to an employee's increased bargaining power arising from potential threats of litigation if discharged. Firm productivity

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89. *Id.*

90. *E.g.*, Ken Matheny & Marion Crain, *Disloyal Workers and the "Un-American" Labor Law*, 82 N.C. L. REV. 1705, 1746 (2004); Mary LaFrance, *Nevada's Employee Inventions Statute: Novel, Nonobvious, and Patently Wrong*, 3 NEV. L.J. 88, 111 (2002). *See also* Alexander J.S. Colvin, *Institutional Pressures, Human Resource Strategies, and the Rise of Nonunion Dispute Resolution Procedures*, 56 INDUS. & LAB. REL. REV. 375, 379 (2003) (reporting interviews with managers who, in expressing fear of employment litigation, cited California as a state that "posed a particularly strong threat").

91. 168 Cal. Rptr. 722 (Cal. Ct. App. 1980).

92. Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988).

93. *Cf.* Lauren B. Edelman, Steven E. Abraham & Howard S. Erlanger, *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 LAW & SOC'Y REV. 47 (1992) (studying influence of professional and legal professions on managerial decision making through surveying characterizations of the implied contract exception in professional personnel and law journals).

might decline as managers become more reluctant to dismiss unproductive workers because of the legal risks. Consequently, dismissal protections may cause firms to hire fewer employees and thus select more productive employees. There may even have been a capital deepening effect whereby firms invest more in capital rather than human resources, thereby shifting away from the optimal allocation based upon imposed costs. This theoretical uncertainty makes empirical studies on the issue all the more important.

Thomas J. Miles, for example, found that the adoption of the good faith exception in a given state correlated with significant increases in the temporary help industry in that state.[94] This finding dovetails well with David Autor's findings that adoption of wrongful discharge exceptions explained twenty percent of the growth of the temporary help services industry in the United States.[95] Autor, however, emphasizes the impact of this growth to the implied contract exception of employment at will rather than the good faith covenant.[96]

Max Schanzenbach examined the impact of wrongful discharge exceptions on job tenure and wages.[97] Schanzenbach used the Current Population Survey (CPS)[98] and Panel Study of Income Dynamics (PSID),[99] the only two nationwide datasets available that possess information about tenure and wages for the relevant years. Schanzenbach found no consistent effect of the good faith exception upon job tenure and limited but not

94. Thomas J. Miles, *Common Law Exceptions to Employment at Will and U.S. Labor Markets*, 16 J.L. ECON. & ORG. 74 (2000). *See generally* George Gonos, *The Contest over "Employer" Status in the Postwar United States: The Case of Temporary Help Firms,* 31 LAW & SOC'Y REV. 81 (1997).

95. David H. Autor, *Outsourcing at Will: The Contribution of Unjust Dismissal Doctrine to the Growth of Employment Outsourcing,* 21 J. LAB. ECON. 1 (2003).

96. *See id.* at 4 n.2.

97. Max Schanzenbach, *Exceptions to Employment at Will: Raising Firings Costs or Enforcing Life-Cycle Contracts?*, 5 AM. L. & ECON. REV. 470 (2003).

98. The Current Population Survey is "a monthly survey of about 50,000 households conducted by the Bureau of the Census for the Bureau of Labor Statistics . . . [which provides estimates on] employment, unemployment, earnings, hours of work, and other indicators." Current Population Survey, http://www.census.gov/cps/ (last visited Sep. 20, 2007).

99. The Panel Study of Income Dynamics is a longitudinal study of 8,000 U.S. families gathering data on economic, health and social behavior since 1968. Panel Study of Income Dynamics, http://psidonline.isr.umich.edu/ (last visited Sep. 20, 2007).

completely robust effects on wages.[100] These conclusions are presented tentatively, however, due to the limited number of states that have adopted the good faith exception, which in turn limits the number of testable observations.[101] These findings dovetail those obtained by Autor, Donohue and Schwab, who found no strong evidence of employment or wage effects based upon the good faith exception.[102]

In 2004, Adriana Kugler and Gilles Saint-Paul examined whether increases in firing costs arising from wrongful discharge laws may cause employers to prefer hiring employed workers who are less likely to be unproductive.[103] The authors found that wrongful discharge protections did in fact reduce the employment probabilities of the unemployed relative to the employed.[104] These observations were found most robustly from the adoption of the good faith exception.[105] Kugler and Saint-Paul report that the good faith exception triggered a 23 percent reduction in the probability of the unemployed finding work, accounting for the majority of the effect in unemployment-to-employment flows in the study.[106]

Efforts to study the impact of good faith have now expanded into specific costs imposed upon firms as compared to broader economic variables. A study of the impact of wrongful discharge exceptions on firm productivity revealed that the adoption of the good faith exception in a given state reduced annual employment fluctuations and the entry of new establishments.[107] The results suggest that the exception caused employers to retain unproductive workers thus reducing overall efficiency.[108]

Steven Abraham studied the influence of watershed California and New York employment cases on shareholder re-

100. Schanzenbach, *supra* note 97, at 500-01.

101. *Id.* at 501.

102. Autor, Donohue & Schwab, *supra* note 32.

103. Adriana D. Kugler & Gilles Saint-Paul, *How do Firing Costs Affect Worker Flows in a World with Adverse Selection?*, 22 J. LAB. ECON. 553 (2004).

104. *Id.* at 578.

105. *Id.* at 575.

106. *Id.*

107. David H. Autor, William R. Kerr & Adriana D. Kugler, *Does Employment Protection Reduce Productivity?: Evidence from US States*, 117 ECON. J. F189 (2007).

108. *Id.* at F190-91.

turns.[109] One of the decisions studied was the now familiar *Cleary v. American Airlines, Inc.*[110] Abraham found that over the three-day window surrounding the date of the ruling, shareholder returns decreased by 1.52 percent in response to *Cleary*.[111] When the California Supreme Court decided *Foley v. Interactive Data Corp.*,[112] an opinion that significantly curtailed the broad reach of the good faith doctrine as articulated in *Cleary*, shareholder returns increased 1.3 percent during the three days surrounding the decision.[113]

Recently, another paper (of which this author is a co-writer) explores the impact of wrongful discharge laws, including the good faith exception, upon firm efficiency.[114] The challenge of studying the effect of state good faith law on firms is that many have operations that cross state lines. As a result, it becomes difficult to isolate the impact of a particular state's legal rules on a multi-state or national enterprise. Abraham addressed this problem by using Compustat, a commercial research database, which uses a variable called "State" that identifies the primary location of each firm's operations.[115] We addressed this problem by studying a single industry, commercial banks, in detail. Until the early 1990s, Congress restricted state chartered banks to interstate operations, thus controlling for the multi-state problem inherent in studying private firms.[116] The majority of state adoption of wrongful discharge exceptions, including good faith, also occurred before the early 1990s.[117]

After testing for the presence of increased numbers of full time employees, increased salaries, increased capital expenditures and decreased return on assets, we did not find a statisti-

109. Steven E. Abraham, *An Empirical Assessment of Employment at Will: A Tale of Two States*, 46 MANAGERIAL LAW 3 (2004).

110. 168 Cal. Rptr. 722 (Cal. Ct. App. 1980).

111. Abraham, *supra* note 109, at 11.

112. 765 P.2d 373 (Cal. 1988).

113. Abraham, *supra* note 109, at 13.

114. Robert C. Bird & John Knopf, Do Wrongful Discharge Laws Impair Firm Performance? (unpublished manuscript on file with the authors).

115. Abraham, *supra* note 109, at 9. Abraham also notes that given the time lag between the relevant events and the date of study, the firm's primary location was coded manually. *Id.* at 9 n.32.

116. *See generally* Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221 (2000).

117. Knopf & Bird, *supra* note 114, at Exhibit 1.

cally significant and robust correlation between these measures and good faith.[118] The good faith exception did appear to positively relate to firm labor expenses, the implication being that increased difficulty in discharging workers caused by this requirement increased legal and human resource expenditures.[119] These results, however, were not significant at conventional levels. We also found a significant relationship between the adoption of the good faith exception and an increase in full time employees.[120] This may imply an increased retention in unproductive employees due to the threat of legal disputes and their associated costs arising from the exception. This relationship, however, could not be sustained under our robustness checks. Like other empirical studies of wrongful discharge, the implied contract exception and not its good faith counterpart appeared to have the greatest impact on our measures.[121]

Conclusion

Ninety years after Cardozo's landmark decision, we still know little about the appropriate role of good faith in employment. After riding the initial wave of wrongful discharge adoptions, good faith has settled into a secondary role. Few states have adopted the covenant and those that have are limiting its application to contractual "benefit of the bargain" cases. The result is that the good faith covenant remains absent from most employment relationships.

Is this necessarily a bad thing? There is some empirical evidence that a good faith covenant may impose costs, but these costs are limited and not uniformly found. This implies that the covenant may not impose large costs on employers if applied. On the other hand, the limited effects may be because good faith in employment is interpreted so narrowly where it exists at all. The impact of a robust good faith obligation similar to that articulated in *Monge* and *Cleary* remains unexplored.

Over the past ninety years, almost 1,200 cases, commentators and litigants have cited *Wood v. Lucy, Lady Duff-Gordon*

118. *Id.* at 25-29.
119. *Id.* at tbl. 4.
120. *Id.* at tbl. 3.
121. *Id.* at 25-29.

for one reason or another. According to Westlaw, only a tiny fraction of these citations constituted "negative citing references." The strong imprint that *Lucy* has placed on the development of American law remains unchallenged. The benefit of that imprint over the past ninety-years, however, especially in the employment context, remains open to debate for the next ninety years.