

# Forfeiture by Cancellation or Termination

by Charles Tiefer\*

## I. INTRODUCTION

Termination powers<sup>1</sup> and conditions of performance empower one party to treat its own obligations under the contract as discharged or cancelled based on something less, often much less, than material breach<sup>2</sup> by the other party.<sup>3</sup> Perhaps no current topic spanning a diverse subject within basic contract law invites doctrinal development as much as termination powers and conditions. Major examples of such powers include the employer's power to terminate employment at will,<sup>4</sup>

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1. The U.C.C. usefully defines "Termination" in § 2-106(3): "Termination' occurs when either party pursuant to a power created by agreement or law puts an end to the contract . . . ." U.C.C. § 2-106(3) (1977).

2. RESTATEMENT (SECOND) OF CONTRACTS §§ 241-42 (1979) (cancellation for material breach); U.C.C. §§ 2-703(f), 2-711 (1977) (including the right to cancel among the other remedies for breach of buyers and sellers).

3. One party's cancellation of its performance as an appropriate response to the other's material breach is defined in the language of conditions: "[I]t is a condition of each party's remaining duties to render performances . . . that there be no uncured material failure by the other party to render . . . performance due . . . ." RESTATEMENT (SECOND) OF CONTRACTS § 237 (1979). Breach or failure of terms that are not express conditions allows cancellation of performance only pursuant to the rules for material breach. *Id.* § 242. In contrast, for any express condition of performance, by definition "the non-occurrence of a condition discharges the duty when the condition can no longer occur." *Id.* § 225(2). In other words, any permanent failure of a condition of a party's performance allows that party—the cancelling party—validly to treat its own duties as discharged or cancelled.

4. For some of the recent key articles in the field regarding termination of employees, see, e.g., Katherine V. W. Stone, *The New Psychological Contract: Implications of the*

the government's power to terminate public contractors for convenience, the insurer's right not to pay otherwise covered insureds who fail to fulfill conditions,<sup>5</sup> and the government's right to penalize contractors who violate various public policy conditions. Employers, the government, and insurers each use provisions in their adhesion contracts,<sup>6</sup> arranging their power to terminate or to cancel for failure of a condition on a self-help basis and to be exercised relatively speedily and easily; thereby, serving their often valid interests of flexibility, control, and fulfillment of public policies.<sup>7</sup>

However, using the power to terminate or cancel for failure of an express condition often amounts to a more extreme and powerful remedy than obtaining damages or specific performance from a party for breach. The terminating or cancelling party<sup>8</sup> need not make the kind of showing required for cancellations based on ordinary terms, namely, a material breach by the cancelled party,<sup>9</sup> and also need not show any proportion-

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*Changing Workplace for Labor and Employment Law*, 48 U.C.L.A. L. REV. 519 (2001); Robert A. Hillman, *Questioning the "New Consensus" on Promissory Estoppel: An Empirical and Theoretical Study*, 98 COLUM. L. REV. 580, 603-06 (1998); David Charny, *The Employee Welfare State in Transition*, 74 TEX. L. REV. 1601 (1996); Martin H. Malin, *The Distributive and Corrective Justice Concerns in the Debate Over Employment At-Will: Some Preliminary Thoughts*, 68 CHI.-KENT L. REV. 117 (1992).

5. This denial of payment to the insured is being called, for short, a cancellation, without slighting some terminological nuances important in insurance law. *See infra* text accompanying notes 7-9.

6. Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263 (1993); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983); Matthew O. Tobriner & Joseph R. Grodin, *The Individual and the Public Service Enterprise in the New Industrial State*, 55 CALIF. L. REV. 1247 (1967); Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629 (1943); Karl Llewellyn, Book Review, 52 HARV. L. REV. 700 (1939) (reviewing O. PRAUSNITZ, *THE STANDARDIZATION OF COMMERCIAL CONTRACTS IN ENGLISH AND CONTINENTAL LAW* (1937)).

7. Cancelling further performance is a self-help remedy rather than a judicial remedy, because the cancelling party does not require a judicial judgment or order to refuse further performance. *See* RESTATEMENT (SECOND) OF CONTRACTS § 345 (1979) (not including cancellation on the list of judicial remedies for breach).

8. This Article often will use the single terms "cancelling party," "cancelled party," and "cancellation" to cover acts either of cancellation for permanent failure of a condition or of termination. This is not to ignore the distinctions between these acts, but because what matters in this context is the power that is common both to cancellation for failure of a condition of performance and to termination. That common element is the power of one party (the cancelling or terminating party) to declare that the contract is over and that its own further duties of performance toward the other party (the cancelled or terminated party) are discharged.

9. The U.C.C. expresses the same thought in another way: "termination" is putting a contract to an end "otherwise than for its breach," U.C.C. § 2-106(3), while "cancellation"

ality between the losses or situations it faces and those faced, after cancellation, by the cancelled party.<sup>10</sup> In other words, even an employer, the government, or an insurer justified in invoking such provisions may then inflict, by cancellation, disproportionate losses to the reliance interests—in a word, forfeiture<sup>11</sup>—upon a weaker contracting partner.

For the more powerful party to impose termination and condition provisions and then to invoke them has generated major controversy in the evolution of contract doctrine. A long-time stable<sup>12</sup> employee, a government contractor that has prepared expensively to perform, and an insured for whom the feared risk has occurred might all face serious forfeitures from the invocation of a termination or cancellation power. The question is when they should face these forfeitures due to an unbargained for provision when they cannot mitigate cancellation effectively by substitute arrangements without any melioration or compensation.<sup>13</sup>

Throughout the past century, contract law, as reflected in the Restatements (First) and (Second) of Contracts (hereinafter “First Restatement” and “Second Restatement”) and leading commentary, has increasingly struggled to ameliorate that potential for harshness.<sup>14</sup>

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occurs when either party puts an end to the contract for breach by the other.” *Id.* § 2-106(4).

10. Eric G. Andersen, *A New Look at Material Breach in the Law of Contracts*, 21 U.C. DAVIS L. REV. 1073, 1114-16 (1988).

11. RESTATEMENT (SECOND) OF CONTRACTS § 229, cmt. b at 185-86 (1979) (discussing connection of “forfeiture” in context of excusing conditions, and forfeiture of reliance interests as a general concept). *See infra* text accompanying notes 40, 41, 51, 160.

12. A distinction should be drawn in employment at will between “stable” employment, in which employees tend to retain their jobs over long periods or, if laid off during economic downturns, expect to resume those jobs at the next upturn in the cycle, and “contingent” employment, in which the employees develop no expectations of continuing or resuming regular employment. For a discussion of contingent employment see Mark Berger, *Unjust Dismissal and the Contingent Worker: Restructuring Doctrine for the Restructured Employee*, 16 YALE L. & POLY REV. 1 (1997).

13. Professor Issacharoff summarized the similar systemic bargaining imbalances in consumer insurance and at-will employment contracts that place them in controversy:

Like insurance, employment seemed to offer a number of characteristic indicators of impediments to full and equal bargaining: significant disparities in bargaining power between offeror and offeree; contracts of adhesion drafted by the offeror; asymmetries in the ability to breach the contractual guarantee of security; and the inability to seek a market remedy in the event of a breach.

Samuel Issacharoff, *Contracting for Employment: The Limited Return of the Common Law*, 74 TEX. L. REV. 1783, 1788 (1996). Further discussion of the absence of substitute arrangements is in the text accompanying *infra* notes 60, 61, 63.

14. Melvin Aron Eisenberg, *The Emergence of Dynamic Contract Law*, 88 CALIF L. REV. 1743, 1789-91 (2000); Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 237-38 (1995).

This Article suggests that the line of advance in this doctrinal area has gone, and should go, further than the previously discussed approaches. Contract law has been recognizing, and should further recognize, the next meliorating evolutionary steps in the law of conditions and termination powers: consolidating as a unified issue the potential forfeitures ensuing from express provisions of both conditions and termination, broadening the relevant factors determining the equity of their exercise, and providing sometimes for compensation<sup>15</sup> to the cancelled party. Specifically, invocation of the cancellation remedy ought to turn on a full array of factors.<sup>16</sup> These factors would include the ones already applicable to the cancellation remedy for material breach; interpretive presumptions about provisions of adhesion in contracts that serve important roles in the social safety net (e.g., for stable employment and for consumer insurance);<sup>17</sup> and public policy considerations,<sup>18</sup> particularly those touching on termination and penalization in government contracts. Providing for defined kinds of compensation in light of these factors may sometimes support the interests of both sides because it would authorize the continued exercise of power for ending contracts that serve the needs of employers, the government, and insurers, while meliorating the impact of cancellation on the weaker party.

To study these issues as they have progressed in contemporary controversies, this Article compares and contrasts public and private contracts.<sup>19</sup> Part II provides an overview of the factors relating to cancellation based on termination powers and conditions. In particular,

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15. For an existing example of compensation sometimes paid to a cancelled party, see Joseph M. Perillo, *Restitution in the Second Restatement of Contracts*, 81 COLUM. L. REV. 37, 49-50 (1981).

16. For background on the reliance interest, see Stewart Macaulay, *The Reliance Interest and the World Outside the Law Schools' Doors*, 1991 WIS. L. REV. 247; L.L. Fuller & William R. Purdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52 (1936). Compare Todd Rakoff, *Fuller and Perdue's The Reliance Interest as a Work of Legal Scholarship*, 1991 WIS. L. REV. 203 (finding enduring value in Fuller and Purdue), with Richard Craswell, *Against Fuller and Perdue*, 67 U. CHI. L. REV. 99 (2000) (finding the Fuller and Purdue article "not very useful").

17. The public policy of an earlier period was summed up: "When courts use waiver or estoppel to deprive [insurance] companies of policy defenses they move in the same direction as that taken by legislation or administrative action in enhancing the social value of liability insurance." Clarence Morris, *Waiver and Estoppel in Insurance Policy Litigation*, 105 U. PENN. L. REV. 925, 943 (1957).

18. See generally W. David Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1 (1974) (discussing how public policy and equity inform the implementation of terms in contracts of adhesion); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971) (same).

19. CHARLES TIEFER & WILLIAM A. SHOOK, *GOVERNMENT CONTRACT LAW: CASES AND MATERIALS* (1999 & Supp. 2001).

it traces the previous lines of amelioration of the impact of conditions through *Jacob & Youngs, Inc. v. Kent*<sup>20</sup> and the First and Second Restatements.<sup>21</sup> Respected articles by Professor Corbin in 1919<sup>22</sup> and Professor Childres in 1970<sup>23</sup> reflect the evolving academic commentary on how to define appropriate and inappropriate occasions for such harshness without sacrificing the practical usefulness conditions may often have.

Part III turns to the issue of compensating some parties faced with the exercise of a power of termination. It starts with the tremendous recent ferment over employers' power of termination of employment at will.<sup>24</sup> About two-thirds of all employees are employees at will,<sup>25</sup> and the stable forms of such employment are increasingly considered as a possible relationship contract,<sup>26</sup> making the law regarding their termination a matter of general importance. The analysis here draws

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20. 129 N.E. 889 (1921). See, e.g., Lawrence A. Cunningham, *Cardozo and Posner: A Study in Contracts*, 36 WM. & MARY L. REV. 1379 (1995); Arthur L. Corbin, *Mr. Justice Cardozo and the Law of Contracts*, 48 YALE L.J. 426 (1939).

21. These include such ameliorating doctrines as substantial compliance, waiver, interpretation against finding strict conditions, the implied covenant of good faith and fair dealing, and avoiding disproportionate forfeitures. RESTATEMENT (SECOND) OF CONTRACTS §§ 241-42 (1979) (substantial performance); *id.* § 227 (interpretation to avoid a condition); *id.* § 205 (good faith); *id.* § 229 (disproportionate forfeiture); *id.* § 84(1) (waiver).

22. Arthur L. Corbin, *Conditions in the Law of Contract*, 28 YALE L.J. 739 (1919).

23. Robert Childres, *Conditions in the Law of Contracts*, 45 N.Y.U. L. REV. 33 (1970). Further elaboration is in Robert Childres & Bruce Dennis Sales, *Restatement (Second) and the Law of Conditions in Contracts*, 44 MISS. L.J. 591 (1973).

24. For a sampling of the commentary debating this issue, see, e.g., Deborah A. Ballam, *Employment-At-Will: The Impending Death of a Doctrine*, 37 AM. BUS. L.J. 653 (2000); Note, *Employer Opportunism and the Need for a Just Cause Standard*, 103 HARV. L. REV. 510 (1989); Richard A. Epstein, *In Defense of the Contract At Will*, 51 U. CHI. L. REV. 947 (1984); Note, *Protecting At Will Employees Against Wrongful Discharge: The Duty to Terminate Only in Good Faith*, 93 HARV. L. REV. 1816 (1980); J. Peter Shapiro & James F. Tune, Note, *Implied Contract Rights to Job Security*, 26 STAN. L. REV. 335 (1974); Lawrence E. Blades, *Employment At Will v. Individual Freedom: On Limiting the Abusive Exercise of Employer Power*, 67 COLUM. L. REV. 1404 (1967).

25. Kenneth A. Sprang, *Beware the Toothless Tiger: A Critique of the Model Employment Termination Act*, 43 AM. U. L. REV. 849, 850-51 (1994).

26. In light of the extended duration characteristic of relationship contracts, Richard E. Speidel, *The Characteristics and Challenges of Relational Contracts*, 94 NW. U.L. REV. 823, 828 (2000), termination powers present a particularly complex problem. See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 940, 977 (1990); Paul J. Gudel, *Relational Contract Theory and the Concept of Exchange*, 46 BUFF. L. REV. 763, 789-91 (1998). See generally Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*, 94 NW. U. L. REV. 877, 897 (2000) (stating the relational contract of employment draws its law from sources like ERISA).

upon the public policy indicated in federal tax policy<sup>27</sup> and the Employee Retirement Income Security Act of 1974 ("ERISA").<sup>28</sup> promoting employment-based pension reliance interests,<sup>29</sup> a public policy of increased importance as permanent mass layoffs through downsizing became a major practice, even at stable employers, starting in recent decades and, now, even more so, in the economic slowdown of 2001-2002.<sup>30</sup>

Then, Part III turns to another area of termination powers in contracts, the governmental power of termination for convenience and the striking development in 1996, the demise of the *Torncello* doctrine that expanded contract termination power while keeping it subject to the compensation of public contractors' reliance interests.<sup>31</sup> The Article then discusses its salient concrete conclusion: that contracts for stable employment should be presumed to have an implied term of severance pay as a form of limited compensation for the reliance interests forfeited by terminated employees. Severance pay serves to temper the harshness of the exercise of termination powers without unacceptably depriving employers of the flexibility and disciplinary capacity they seek in termination powers.

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27. For background regarding the significance of the federal policies promoting employee pensions, see, e.g., Colleen E. Medill, *Targeted Pension Reform*, 27 J. LEGIS. 1 (2001); Dana M. Muir, *Changing the Rules of the Game: Pension Plan Terminations and Early Retirement Benefits*, 87 MICH. L. REV. 1034 (1989); Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. PENN. L. REV. 1349, 1355-76 (1988); Joseph Bankman, *Tax Policy and Retirement Income: Are Pension Plan Anti-Discrimination Provisions Desirable?*, 55 U. CHI. L. REV. 790 (1988).

28. 29 U.S.C. §§ 1001-1461 (2002). For relevant commentary from the context of ERISA and other benefits-protecting legislation, see, e.g., Alison M. Sulentic, *Promises, Promises: Using the Parol Evidence Rule to Manage Extrinsic Evidence in ERISA Litigation*, 3 U. PA. J. LAB. & EMP. L. 1 (2000); Rebecca Lewin, Comment, *Job Lock: Will HIPAA Solve the Job Mobility Problem?*, 2 U. PA. J. LAB. & EMP. L. 507 (2000); Catherine L. Fisk, *Lochner Redux: The Renaissance of Laissez-Faire Contract in the Federal Common Law of Employee Benefits*, 56 OHIO ST. L.J. 153 (1995).

29. Lorraine A. Schmall, *Keeping Employer Promises When Relational Incentives No Longer Pertain: "Right Sizing" and Employee Benefits*, 68 GEO. WASH. L. REV. 276 (2000); Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment At Will*, 92 MICH. L. REV. 8 (1993).

30. See, e.g., Lynne C. Hermle, *Reductions in Force: Obtain the Benefits While Avoiding the Pitfalls*, in REDUCTIONS IN FORCE: OBTAINING THE BENEFITS WHILE AVOIDING THE PITFALLS 9, 35 (Christopher P. Reynolds & Lynne C. Hermle, co-chairs, Practising Law Institute, 2001). ("[T]he 2001 U.S. economy has slowed . . . . [M]any companies . . . are implementing reductions in force. . . .").

31. *Krygoski Constr. Co. v. United States*, 94 F.3d 1537 (Fed. Cir. 1996). An important article criticizing *Krygoski* is Frederick W. Claybrook, Jr., *Good Faith in the Termination and Formation of Federal Contracts*, 56 MD. L. REV. 555 (1997).

Part IV discusses conditions in two other diverse contexts. The law of conditions in consumer insurance cases has evolved in a way that unfolds the greatest potential in the Second Restatement section 229 on disproportionate forfeiture.<sup>32</sup> Moreover, the law of public policy in government contracts<sup>33</sup> has evolved with new federal appellate case law magnifying the role of conditions in penalization for false claims, which is exemplified by the court's major 1997 decision in *United States ex rel. Thompson v. Columbia/HCA Healthcare Corp.*<sup>34</sup>

The conclusion puts this Article's analysis in the form of a proposed section for the next Restatement of Contracts entitled "Forfeiture by Cancellation or Termination." This proposed provision treats powers of termination along with conditions and brings a wide range of factors to bear. It builds upon a synthesis of the Second Restatement's section 229 (excuse of condition for disproportionate forfeiture) and sections 241-42 (cancellation for material breach). It would distinguish actually negotiated terms from mere terms of adhesion and stake out an important role for public policy considerations and for the strength of the justification for the condition or termination power. In appropriate circumstances, it would sustain the exercise of a cancellation or termination power while providing a measure of compensation, like severance pay, for the terminated party. The proposed provision codifies, in effect, a direction in which contract law in this important area has been, and should be, developing.

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32. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 OHIO ST. L.J. 823 (1990); Stephen J. Ware, Comment, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461 (1989); Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151 (1981); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions* (pts. 1 & 2), 83 HARV. L. REV. 961 (1970). The challenge is to distinguish conditions in this context with those for which the parties' considered choice ought to be accepted as efficient. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988); R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

33. For background on public policy in government contracts, see, e.g., Steven L. Schooner, *Fear of Oversight: The Fundamental Failure of Businesslike Government*, 50 AM. U. L. REV. 627 (2001); Theodore Sky, *Defense Procurement Preferences as a Remedy for Subemployment: A Comment*, 82 HARV. L. REV. 1266 (1969); Arthur Selwyn Miller & W. Theodore Pierson, Jr., *Observations on the Consistency of Federal Procurement Policies With Other Governmental Policies*, 29 L. & CONTEMP. PROBS. 277 (1964); John W. Whelan & Edwin C. Pearson, *Underlying Values in Government Contracts*, 10 J. PUB. L. 298 (1961).

34. 125 F.3d 899 (5th Cir. 1997).

## II. FIRST AND SECOND RESTATEMENT VIEWS OF CANCELLATION BASED ON CONDITIONS

As Professor Fried describes, in ably recreating the late nineteenth century view of the doctrine of conditions: “Where a term of an agreement is treated as a condition, the result for the party on the losing end of that designation can be sharp and harsh.”<sup>35</sup> Classic contract doctrine readily treated terms as conditions, in accordance with the nineteenth century “will” theory of contracts. Namely, if a party found its terms unfulfilled, then it had not agreed (“willed”) to bind itself to proceed with its own performance. In other words, classic contract doctrine did not treat cancellation as a remedy governed by equitably weighed factors.<sup>36</sup> Rather, the classic approach treated failure to fulfill terms in a way that was often both rigidly harsh and, to use a term from discussions of damage remedies, supracompensatory.<sup>37</sup>

This meant, for example, that nineteenth century life and fire insurers could, and did, insert in their form contracts provisions that let them egregiously evade payout notwithstanding the occurrence of the hazards so often that it created a sort of reverse lottery in which an arbitrarily chosen group of vulnerable insureds was deprived of their paid-for

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35. CHARLES FRIED, *CONTRACT AS PROMISE* 120-21 (1981). In the late nineteenth century, courts would let contract provisions operate as conditions under circumstances that gave extraordinary power to the drafter of an agreement to impose severely upon the cancelled party. For one example, nineteenth century insurance law had inherited from Judge Mansfield the doctrine that the insurer’s performance was conditioned on the total absence of misstatements by the insured, even innocent and immaterial ones. For another example, in a contract for the sale and shipping of goods, the Supreme Court deemed contractual specifications of modes of performance to be conditions, so that if a seller or shipper did not precisely fulfill that mode, the buyer had the power to cancel. *Norrington v. Wright*, 115 U.S. 188 (1885); *Filley v. Pope*, 115 U.S. 213 (1885).

36. Although cancellation can be a remedy for breach, it can also occur without being a remedy for breach. For nonpromissory conditions (e.g., the insured’s death in a term life insurance policy), the mere nonoccurrence of the condition is not a breach of any promise or duty. Cancellation due to the nonoccurrence of a nonpromissory condition is more precisely described as simply an outcome or an elective power of the cancelling party rather than a remedy for breach. See *RESTATEMENT (SECOND) OF CONTRACTS* § 227 cmt. b (1979) (distinguishing conditions and duties).

37. Unlike damages, i.e., remedies scaled to how much injury a breach has done, the cancellation remedy operates without a calculation of whether the harm done to the cancelling party by the failure of condition, which might even be insubstantial, at all warrants the effect of the remedy of cancellation upon the cancelled party, which could be vastly greater. For supracompensatory remedies, see, e.g., Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 *YALE L.J.* 369 (1990).

protection for little reason other than to enrich the insurer.<sup>38</sup> The related law regarding unilateral powers of termination, such as the employer's power to terminate employees, illustrates similar classical firmness and sometimes harshness. Nineteenth century common law dropped the more moderate English doctrine that presumed an employment arrangement was for a period of time and instead adopted the doctrine that an employee without an expressly specified period of employment was terminable by the employer at will, i.e., at any time for any or no reason.<sup>39</sup> Thus, in the nineteenth century, often little or nothing stood between a party to an adhesive contract and cancellation for failure of an immaterial condition, or sometimes from termination at will, even when this produced unjustified forfeiture.<sup>40</sup>

Classical contract law had limited ways of countering this potentially unjustified harshness, starting with traditional equitable doctrines to restrain unacceptable forfeitures.<sup>41</sup> Starting in the Progressive Era, legislatures began adopting public policies of melioration, such as statutory controls on insurers' use of condition provisions incompatible with the very purpose of insurance.<sup>42</sup> By the period from World War I to the Depression, courts and legal commentators caught up with the

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38. Moreover, the classic contract doctrine declined to distinguish contexts by whether cancellation's adverse effect was limited or severe. In the classic phrase immortalized by Williston and still heard today, the same rules of construction were applied to policies of insurance as to all other contracts. LAWRENCE M. FRIEDMAN, *CONTRACT LAW IN AMERICA: A SOCIAL AND ECONOMIC CASE STUDY* 61 (1965).

39. For the debate over the nineteenth century background, see, e.g., Ballam, *supra* note 24, at 654 & n.5 (collecting commentary); Wythe Holt, *Essay, Recovery by the Worker Who Quits: A Comparison of the Mainstream, Legal Realist, and Critical Legal Studies Approaches to a Problem of Nineteenth Century Contract Law*, 1986 WIS. L. REV. 677.

40. This was coupled with the common-law rule that an employer's obligation to pay wages to employees or to pay a construction contractor was conditioned on their remaining in the job until the completion of the pay period, so that an employee or contractor who failed to remain at work until completion of performance might forfeit not only reliance expenditures, but even restitution for the benefit of what they had provided the employer. Holt, *supra* note 39, at 678-83.

41. A wide-open unilateral power of termination raised an issue about the doctrine of consideration with a court able to pronounce it lacking in mutuality and illusory. Whatever this formal rule did in other contexts, it did little to protect the cancelled parties discussed in this Article, such as at-will employees. In insurance cases, courts sometimes did justice in what would otherwise become harsh cases by such flexible notions as waiver, estoppel, and construing against the drafter. FRIEDMAN, *supra* note 38, at 107, 123.

42. Statutes established certain kinds of standard form contracts, incontestability rules for life insurance, and other minimum safeguards for consumer insureds against conditions. "The regulatory restraints placed on the use of policy conditions encouraged insurers to curtail the use of conditions . . ." Robert Works, *Coverage Clauses and Incontestable Statutes: The Regulation of Post-Claim Underwriting*, 1979 U. ILL. L.F. 809, 815; Thomas L. Wenck, *The Historical Development of Standard Policies*, 35 J. RISK & INS. 537 (1968).

public policy swing against the harshest uses of powers and provisions and enhanced the set of meliorating doctrines. Professor Corbin's 1919 article expounded the nascent doctrine<sup>43</sup> that the opportunity for cancellation due to failure to fulfill terms arose largely by implication or construction<sup>44</sup> and could, therefore, be limited by appropriately flexible approaches to interpretation, instead of deeming, by the will theory, each expression of the parties in a term as formally and inevitably entailing consequences such as cancellation. Cardozo's celebrated 1921 opinion in *Jacob & Youngs, Inc. v. Kent*,<sup>45</sup> probably the leading opinion in this century's law of conditions,<sup>46</sup> packed into a few pages his signature philosophy of escaping the formalist will theory of what gave rise to cancellation and, instead, equitably distinguished between justified and unjustified occasions for that remedy.<sup>47</sup>

The First Restatement, approved in 1932, set forth an elaborate doctrinal structure for this subject. It required a material breach for cancellation based on terms other than those clearly expressed as conditions,<sup>48</sup> promoted interpretations of provisions not as such conditions,<sup>49</sup> and strengthened the meliorating doctrine of restitution even for a party in material breach,<sup>50</sup> which became a way of somewhat compensating a cancelled party.<sup>51</sup> As the base for further evolution, it

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43. Perhaps the most famous marker of the developing view was Oliver Wendell Holmes's famous pragmatically skeptical question, "You can always imply a condition in a contract. But why do you imply it?" Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 466 (1897); also in OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 167, 181 (Harcourt, Brace & Co., 1921) (1920). Early twentieth century law began explicitly to move against reading provisions as conditions. For those surprised that this distinction emerged so late: "The very notion of construction [of conditions] in the American law of contracts goes back no further than Corbin's great article of 1919." Childres, *supra* note 23, at 36.

44. Corbin, *supra* note 22, at 744.

45. 129 N.E. 889 (1921).

46. See, e.g., Lawrence A. Cunningham, *Cardozo and Posner: A Study in Contracts*, 36 WM. & MARY L. REV. 1379 (1995); Arthur L. Corbin, *Mr. Justice Cardozo and the Law of Contracts*, 48 YALE L.J. 426 (1939).

47. 129 N.E. at 891.

48. To emphasize this, the First Restatement includes Chapter 10, "Conditions; and Breach of Promise as an Excuse for Failure to Perform a Return Promise." RESTATEMENT (FIRST) OF CONTRACTS §§ 250-311 (1932).

49. It gave emphasis to the interpretive presumption in favor of a provision not creating an express condition (with the accompanying strict doctrines leading directly to occasions for cancellation), but only a promise (which would invoke the doctrines relating to material breach as a prerequisite for cancellation). *Id.* § 261.

50. For a review of this area, see Perillo, *supra* note 15.

51. What might otherwise be a total forfeiture of the cancelled party's interests is mitigated to the extent it recovers the value of its performance. Because this Article

included section 302, which provided relief from the operation of a nonmaterial condition that produced an “extreme forfeiture.”<sup>52</sup>

In the following forty years, section 302 had only limited effect, perhaps because the term “extreme” as the requisite level of forfeiture for excuse of condition suggested rarity of application.<sup>53</sup> What happened instead was that, as discussed below, legal commentary and some decisional law increasingly approached adhesive provisions in general with willingness to consider not affording them full weight. Professor Childres’s 1970 survey of 168 appellate decisions in this period paved the way for further advancement by showing that, in practice, few decisions actually gave full-fledged force to failures of express conditions that were merely technical, rather than material in nature.<sup>54</sup>

To some extent, the Uniform Commercial Code (“U.C.C.”) of the 1960s and the Second Restatement, promulgated in 1979, further developed the meliorating approaches in this context. Professor Llewellyn, the primary architect of the U.C.C., pushed forth vigorously the implied covenant of good faith and fair dealing, which became an increasingly key factor when considering whether to allow cancellation or termination.<sup>55</sup> The Second Restatement recognized the increasing skepticism about the merely formalist warrant for terms of adhesion, such as many conditions in insurance contracts, by its section 211 on “Standardized Agreements.”<sup>56</sup> Most interestingly, the Second Restatement promulgated

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suggests a similar unbundling of the reliance interests of the cancelled party, it is worth an observation about how this works. The payment of restitution mitigates some of the harshness and inequity otherwise accompanying an uncompensated cancellation remedy, while it leaves the cancelling party with its core rights—self-help discontinuance of the contractual relationship—and, hence, leaves the cancelling party with what it primarily values, which is flexibility. Moreover, the cancelled party’s recovery, although helpfully meliorating the cancellation’s harshness, is limited. A breaching party can only recover in restitution the value of what it conferred, typically much less than if the breaching party had not cancelled and the cancelled party had received its expectation interest.

52. RESTATEMENT (FIRST) OF CONTRACTS § 302 (1932).

53. At least a few insurance cases did invoke section 302, notably one of the most influential early decisions on what is called the “notice-prejudice” rule, the then-controversial proposition that failure to fulfill an insurance contract’s notice condition should not defeat coverage unless lack of notice prejudiced the insurer. *Brakeman v. Potomac Ins. Co.*, 344 A.2d 555, 560 (Pa. Super. Ct. 1975) (Cercone, J., concurring).

54. Childres, *supra* note 23, at 37. Of the ten cases that applied technical conditions, four were insurance cases, and Professor Childres roundly criticized these. *Id.* at 47-53.

55. Article 2 of the U.C.C. treated the subject without a distinction between “express conditions” and “constructive conditions,” instead classifying termination as a power that operated without breach and cancellation as a remedy for breach along with damages and specific performance. U.C.C. §§ 2-703(f), 2-711 (1977).

56. RESTATEMENT (SECOND) OF CONTRACTS § 211, Reporter’s Note for cmt. e (1979); *id.* § 229 cmt. b & Reporter’s Note. For a fine review of the debates about adhesive terms

section 229 as a revised and enhanced version of the First Restatement's section 302, reflecting Professor Childres's 1970 article.<sup>57</sup> Section 229 replaced the rarely applied "extreme forfeiture" standard with the more available "disproportionate forfeiture" one, providing: "To the extent that the non-occurrence of a condition would cause disproportionate forfeiture, a court may excuse the non-occurrence of that condition unless its occurrence was a material part of the agreed exchange."<sup>58</sup> Section 229 used the term "forfeiture," as elsewhere in the Second Restatement, for "the denial of *compensation* that results when the obligee loses his right to the agreed exchange after he has *relied substantially*, as by preparation or performance on the expectation of that exchange."<sup>59</sup> So, while section 229 certainly did not reduce the remedies for failure of express conditions to the level of remedies for other terms, it advanced the process of treating the harshness even of clear express conditions as something to be meliorated in light of lost compensation for substantial reliance.<sup>60</sup>

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preceding their treatment in both the U.C.C. and the Restatement, see Meyerson, *supra* note 6, at 1282-89.

57. The Reporter's Note for section 229 begins: "This Section is based on former § 302," and after citing the Williston and Corbin treatises, cites Professor Childres's article as the only other pertinent academic commentary. RESTATEMENT (SECOND) OF CONTRACTS § 229, Reporter's Note (1979).

58. *Id.* § 229. Such a section, with this background, appears as the compromise between the strong reform proposal of Professor Childres and doing nothing. Professor Childres's 1970 article argued insightfully against any need for treating express conditions as different from other terms. Conditions should not be effective if immaterial. If material, then they could lead to their classic remedy of cancellation by the same mechanism as when any other terms do so, namely, by the doctrine of constructive conditions applying on the occasions of material breach. As Professor Childres concluded, "This would make the traditional contract law of conditions surplusage by eliminating the reason for distinguishing between conditions and promises. It would leave a body of law now called constructive conditions but which would better be called simply construction of contracts." Childres, *supra* note 23, at 58. It was an elegant argument, but went boldly far.

59. RESTATEMENT (SECOND) OF CONTRACTS § 229, cmt. b, at 185 (1979) (emphasis added).

60. Section 229 mined some more insight out of Judge Cardozo's opinion in *Jacob & Youngs, Inc. v. Kent* that the decision whether to give effect to conditions depended on a balancing of factors.

In determining whether the forfeiture is "disproportionate," a court must weigh the extent of the forfeiture by the obligee against the importance to the obligor of the risk from which he sought to be protected and the degree to which that protection will be lost if the non-occurrence of the condition is excused to the extent required to prevent forfeiture.

RESTATEMENT (SECOND) OF CONTRACTS § 229, cmt. b, at 185-86 (1979). The balancing of factors is an adaptation of what the court stated in *Kent* regarding whether to read a term as a condition: "Where the line is to be drawn between the important and the trivial

For all the advances through the Second Restatement, it still does not actively escape in this context some important elements of the narrowness and harshness of classical contract law. This is shown in the contrast<sup>61</sup> between the narrowness of the factors in section 229 for excusing failure of express conditions (i.e., when not to allow cancellation as a response to such failure), and the breadth of the factors in sections 241-42 for excusing the breach of a term of performance (i.e., when not to allow cancellation as a response for material breach of a term).<sup>62</sup> While sections 241-42 invite a court's broad equitable scrutiny of many factors regarding a party's cancellation for material breach of a performance term,<sup>63</sup> section 229 opens only a more limited scrutiny as to cancellation for failure of an express condition. The Second Restatement in 1979 is the latest pronouncement on this subject that applies across the entire span of contracts. To continue the analysis, this Article now looks at a variety of particular types of contracts in Parts III and IV.

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cannot be settled by a formula. . . . We must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence." 129 N.E. at 891. The new section paid particular heed to insurance conditions. This section's Comment on the meaning of disproportionate forfeiture concluded: "The character of the agreement may, as in the case of insurance agreements, affect the rigor with which the requirement is applied." RESTATEMENT (SECOND) OF CONTRACTS §§ 229, cmt. b, at 186 (1979).

61. The contrast was intended. RESTATEMENT (SECOND) OF CONTRACTS § 241 cmt. a, at 237 (1979) ("The application of the rules . . . turns on a standard of materiality that is necessarily imprecise and flexible. (Contrast the situation where the parties have, by their agreement, made an event a condition. See § 226 and Comments *a* and *c* thereto and § 229.)").

62. Section 229 mentions only the factors of "disproportionate forfeiture," a term still suggesting somewhat an infrequency of operation, and of whether the condition is a "material part of the agreed exchange." *Id.* § 229. In contrast, section 241 makes the issue of materiality of the failure of a constructive condition of performance turn upon five listed factors covering not just the "agreed exchange" but also the equitable aspects of the situation later on, including the extent of injury to the cancelling party, the potentially cancelled party's good faith, and the extent to which the cancelled party will suffer "forfeiture" (not "disproportionate" forfeiture). *Id.* § 241.

63. Section 242 then makes the power to cancel, even for the other party's material breach, turn on two other factors, continuing to give weight to the equities of the situation rather than the formal language of provisions. The express language of the agreement is only part of one factor, and the adverse effect of not cancelling on that party's making substitute arrangements—often the critical practical justification for cancellation—is expressly scrutinized and not just taken for granted. *Id.* § 242.

### III. COMPENSATING THE TERMINATED EMPLOYEE AND PUBLIC CONTRACTOR

#### A. *Ferment as to Termination of Employment At Will*

Employment termination may well provide the most important context for further doctrinal evolution of the termination remedy. No other contractual relationship can match the enormous social and economic significance of employment. The United States economic system makes employment the locus of most individuals' exchange of their productive effort in return for income. Moreover, with strong encouragement from public policy, employment is also the locus of such vital social safety net elements as pensions, health benefits, and unemployment insurance.<sup>64</sup> About two-thirds of all employees are employees at will,<sup>65</sup> making contract law regarding their termination a matter of general importance. Several changes from the harsh rules of the nineteenth century<sup>66</sup> on termination of at-will employment have already reflected the significance of remedial melioration.<sup>67</sup> While the federal public policy of promoting employment-based pension and health insurance benefits has not directly altered the common law doctrines regarding termination of at-will employment, indirectly that public policy has already advanced, and should further advance, meliorating doctrines for such termination.

**1. Off the "High-Road."** A review of recent employee termination law suggests both the acute legal problem of employment termination and the possible approaches to this problem that recognize legitimate employer desires for termination at will as a tool of flexible response to business change and, sometimes, of individual employee discipline as well. From the end of World War II to the 1970s, the postwar employment style, including the role for organized labor, seemed to have brought an increased measure of security into employment relationships. Employees could rely on certain types of employment to continue

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64. Schmall, *supra* note 29, at 295-300 (summarizing the public policy, expressed in the tax and pension laws, behind employment-linked pensions as a social safety net).

65. Sprang, *supra* note 25, at 851.

66. Holt, *supra* note 39, at 677.

67. The increasing acceptance of restitution for partially performed service contracts reflects one development reducing termination-induced forfeiture. Enactment in the first half of the twentieth century of statutes providing for frequent wage payments by changing the operation of the doctrine of construction conditions of performance reflects another development reducing termination-induced employee forfeiture.

indefinitely, with seniority rights for layoffs and job changes.<sup>68</sup> Meanwhile, through the corporate and individual income tax systems, Congress promoted a public policy favoring pension and other benefits for employees, which spurred the creation of a national system of employee benefit plans as a vital part of the social safety net.<sup>69</sup>

Theories of labor economics provided efficiency justifications for legal recognition of the system that emerged to stabilize employment even for at-will employees.<sup>70</sup> These labor economic theories explained that a firm could become its own internal labor market, offering employees stable employment with increasing pay and tax-subsidized benefits in order to bond the employees so that the firm received a return on its investment in the employees' human capital.<sup>71</sup> More recently, progressive labor economists expanded this approach to the "high road"<sup>72</sup>

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68. Forms of employee security characterized important sectors of the economy, either through collective bargaining agreements between management and unions that often conferred termination only for cause, seniority rights, grievance arbitration, or some combination thereof and comparable terms even in unorganized firms that similarly sought to offer employment security as an inducement to workforce stability and loyalty.

69. See sources in *supra* notes 27-30.

70. In his 1974 book *Human Capital*, the economist Gary S. Becker elaborated a seminal theory of the employment pattern that promoted the investment in specialized human capital—the knowledge and skills for employee productivity in many categories of work. GARY S. BECKER, *HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION* (Univ. of Chicago Press 2d ed. 1975). In the narrowest sense, this consists of training, especially in firm-specific skills. In a broader sense, it includes knowledge and skills of general use, including higher education, and even other investments that facilitate a combined productive effort, such as when the firm invests in upgraded facilities in a fixed situs and employees invest in a viable nearby community as the place they will live on a long-term basis. What employers require, Becker explained, is a form of bonding, such as pay and benefits that increase with seniority, so that employees stay around for the employer to receive the benefit from the investment.

71. In simplified form, a starting employee may require considerable firm-specific training and other investment—indeed, even sometimes the cost of relocating from another area—to start becoming even minimally productive. During this time, the firm does not receive a return commensurate with what it invests, and for that matter, the employee may be making reliance investments of his own, such as relocation. During the next phase, the employee may become an increasingly highly productive employee, with the firm reaping the reward for its investment, while the employee must rely, by remaining with the firm, on the promise that by staying he will eventually reap the full reward of his effort in terms of pay and benefits that improve with seniority. In the employee's later years before retirement, the employee receives the high payoff of the recoupment stage, with seniority rights and the expectation of pensions and other benefits, at a time when the firm is, in effect, foregoing cheaper arrangements for getting the work done by keeping faith with the employee in this way. See Stone, *supra* note 4, at 535-39; Wachter & Cohen, *supra* note 27.

72. This is adapted from BARRY BLUESTONE & BENNETT HARRISON, *GROWING PROSPERITY: THE BATTLE FOR GROWTH WITH EQUITY IN THE TWENTY-FIRST CENTURY* 205-

concept for how society as a whole benefits from such stable patterns of investment in employees.<sup>73</sup>

Consistent with this, contract law doctrines, or at least legal arguments for protecting employees from the total insecurity of classic contract law doctrines regarding termination at will, seemed at first to take on new vigor in the 1970s and 1980s.<sup>74</sup> Some progressive courts, such as the California Supreme Court of that period, experimented with defining employment relationships differently from pure termination at will.<sup>75</sup> In many states, courts seemed willing to recognize the implied security terms in particular employment contexts. For example, courts took employer personnel handbook discussions of discharge for specific cause as evidence of an implied term not to discharge without such cause.<sup>76</sup> Academic commentary argued the significance in this context of the implied covenant of good faith in section 205 of the Second Restatement<sup>77</sup> and the application of the reliance principle in promissory estoppel to late-career employment.<sup>78</sup>

Then, however, a counter trend developed in business practices, a change toward reducing employee security that began in the 1970s. More employment occurred in the form of contingent and provisional

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36 (2000); BENNETT HARRISON, *LEAN AND MEAN: THE CHANGING LANDSCAPE OF CORPORATE POWER IN THE AGE OF FLEXIBILITY* 189-216 (1994).

73. The employer makes productivity-enhancing investments, both directly in the employee by training and indirectly in upgrading the capital equipment with which the employee works, in reliance upon the employee staying. The employee sees that by taking this kind of employment and staying, she will receive steadily improving employment terms. Both sides share the productivity benefits from their commitments. Society benefits not only from this increased productivity, but also from the prevalence of high-benefits employment enhancing the social safety net.

74. Progressive legislation, such as antidiscrimination laws, expressly conferred important rights against some types of termination, at least for some kinds of employees.

75. *Foley v. Interactive Data Corp.*, 765 P.2d 373, 385 (Cal. 1988); *Pugh v. See's Candies, Inc.*, 116 Cal. App. 3d 311, 327 (1981); *Toussaint v. Blue Cross & Blue Shield*, 292 N.W.2d 880, 885 (Mich. 1980); Todd M. Smith, Comment, *Wrongful Discharge Reexamined: The Crisis Matures, Ohio Responds*, 41 CASE. W. RES. L. REV. 1209, 1218-19 (1991).

76. For cases reflecting this doctrine, see, e.g., *Robinson v. Ada S. McKinley Comty. Servs., Inc.*, 19 F.3d 359 (7th Cir. 1994); *Scott v. Pac. Gas & Elec. Co.*, 904 P.2d 834 (Cal. 1995); *Hanly v. Riverside Methodist Hosps.*, 603 N.E.2d 1126, 1129 (Ohio Ct. App. 1991).

77. For commentary, see, e.g., Kelby D. Fletcher, *The Disjointed Doctrine of the Handbook Exception to Employment at Will: A Call for Clarity Through Contract Analysis*, 34 GONZ. L. REV. 445 (1998-99); Murray Tabb, *Employee Innocence and the Privileges of Power: Reappraisal of Implied Contract Rights*, 52 MO. L. REV. 803, 831-32 (1987); Shapiro & Tune, *supra* note 24.

78. Charles L. Knapp, *Rescuing Reliance: The Perils of Promissory Estoppel*, 49 HAST. L.J. 1191, 1254-63 (1998) (discussing early 1980s employment termination cases).

jobs.<sup>79</sup> Even for jobs that had traditionally been long term and relatively stable, corporate downsizing caught on as a new “low road”<sup>80</sup> to profitability, and firms reduced explicit or implicit job tenure.<sup>81</sup> Some of this owed to reduced levels and strength of unionization; to global competition from increased trade, which weakened the employees’ position to bargain for security; and to changed models of production, organization, and work requirements.<sup>82</sup> To some extent, downsizing received such general approval in capital markets that corporate managers would consider resorting to it, even when its merits were debatable, just to improve the price of their company’s stock. In contrast to the pattern in early postwar recessions of mere temporary layoffs with the expectation of rehiring, by the economic downturn of 2001, downsizing was thoroughly established.<sup>83</sup>

A clash of trends developed in the realm of contract law after 1990 in the wake of this business practice trend toward reducing employment security.<sup>84</sup> Courts in some states, such as California, that had previously led the way in finding employee job security rights now went the other way.<sup>85</sup> Other courts continued to find implied contractual

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79. For an article noting the trend, but arguing that contingent workers should have legal protections, see Berger, *supra* note 12.

80. BLUESTONE & HARRISON, *supra* note 72, at 234 (contrasting the “low road” to profitability with the “high road”).

81. It was argued that the American free market requires that firms have the flexibility to choose their pattern of contracting for employment. This distinguishes the United States from the industrial sectors of Europe or Japan, which do not engage in such flexibility. It is argued that part of the dynamism and growth of the economy in the United States, in contrast to such countries, owes to such flexibility.

82. Employers shifting to flexible or just-in-time production and outsourcing either terminated categories of employment or shifted more of the risk onto the employee.

83. Hermle, *supra* note 30.

84. Part of the following discussion is based upon Robert A. Hillman, *The “New Conservatism” in Contract Law and the Process of Legal Change*, 40 B.C. L. REV. 879 (1999); Robert A. Hillman, *The Unfulfilled Promise of Promissory Estoppel in the Employment Setting*, 31 RUTGERS L. REV. 1 (1999). The Author is grateful for Professor Hillman’s valuable review of an article draft that offered many insights into the contemporary law of conditions. For employment cases, see, e.g., *Elliott v. Board of Trustees*, 655 A.2d 46 (Md. Ct. Spec. App. 1995) and *Ryan v. Dan’s Food Stores, Inc.*, 972 P.2d 395 (Utah 1998).

85. See, e.g., *Asmus v. Pac. Bell*, 999 P.2d 71 (Cal. 2000). The change in doctrine from the courts was quite possibly for reasons only partly relating to the parallel change in business practices and partly relating to trends in judicial appointments that involved noneconomic issues. For example, the politics of gubernatorial elections and the issues of criminal law, such as the death penalty, figured prominently in alterations over time of the California bench’s overall viewpoint. Employers and allied economic interests did exercise their electoral influence to promote their views on employment termination. Once economic and noneconomic aspects had combined to shift the overall judicial viewpoint,

protections for otherwise at-will employees,<sup>86</sup> and some courts split on the increasingly contested subject.<sup>87</sup> Contract law, in general, was said to enter an era of greater regard for formal and public choice arguments supporting party autonomy, which in labor matters were said to favor the employers who could formally disclaim any offering of security.<sup>88</sup> Employers supported these formal arguments with the renewed emphasis on their practical interests in the right to terminate at will, namely, their interests in flexibility and discipline.<sup>89</sup>

**2. Significance of ERISA Pension Vesting.** Even as changes in business practices, such as downsizing, made abrupt termination increasingly possible for employment that had hitherto been stable but was formally at-will, another trend, this one in public policy guidance, indicated a somewhat new route toward melioration of such termination. Congress enacted various statutes, especially (but not solely)<sup>90</sup> ERISA, to favor the preservation of employment-based benefits during job changes, including termination of at-will employment. In ERISA Congress directed that, under specified circumstances, employment-based pension rights become vested after a minimum period of ser-

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that viewpoint then took concrete form in the court-made doctrines about employment termination.

86. See, e.g., *Herrendeen v. DaimlerChrysler Corp.*, No. 99-2282, 2000 Ohio Misc. LEXIS 48 (Ohio Ct. Comm. Pl. 2000); *Gaudio v. Griffin Health Servs. Corp.*, 733 A.2d 197 (Conn. 1999); *Wood v. Wabash County Health Dep't*, 722 N.E.2d 1176 (Ill. App. Ct. 1999); *Brodie v. Gen. Chem. Corp.*, 934 P.2d 1263, 1265-66 (Wyo. 1997).

87. *Asmus*, 999 P.2d at 81 (4-3 split in California for employer); *Ex Parte Amoco Fabrics & Fibers Co.*, 729 So. 2d 336 (Ala. 1998) (5-4 split in Alabama for employee).

88. Jayne Zanglein, *Getting Something for Nothing: Are Employee Benefits an Entitlement or a Gratuity?*, 30 TEX. TECH. L. REV. 627 (1999).

89. To spell this out, employers faced either weaker union resistance or no resistance at all in putting disclaimers of security into written agreements and personnel manuals. Employers cited the changes to a less sheltered economy, such as globalization and deregulation, as increasing their need for flexibility. Finally, employers contended their interest in terminating individual employees to maintain discipline, which in theory could be served by showing cause for termination, in practice was hindered by requiring such a showing. Employees who considered themselves relatively safe from termination were asserted to be capable of a wide array of productivity-limiting behaviors, known as shirking, without giving employers readily provable cause. See, e.g., *In re Certified Question (Bankey v. Storer Broad Co.)*, 443 N.W.2d 112, 119-20 (Mich. 1989).

90. Congress also recognized the major health insurance problems faced by employees who had to change jobs, including those who were involuntarily terminated. Congress directed that, under certain circumstances, an employee had a right to continue employment health insurance coverage after the end of the particular employment, including after an involuntary termination. Lewin, *supra* note 28, at 507-09, 512.

vice,<sup>91</sup> which Congress shortened in 2001 to a mere three years.<sup>92</sup> ERISA neither precludes employment termination,<sup>93</sup> nor obligates employers to establish pension plans; the inducement to do so remains, as before, favorable tax treatment of contributions to such plans, including plans with large benefits for a firm's own senior management.<sup>94</sup> However, once a firm establishes such a plan, then, as Justice O'Connor sternly admonished in 1997, ERISA "counterbalances [employer] flexibility by ensuring that employers do not 'circumvent the provision of promised benefits.'"<sup>95</sup> Case law<sup>96</sup> and commentary<sup>97</sup> reflect that ERISA precludes firms from downsizing specifically to avoid future accrual of pension benefits, even when the downsizing does not otherwise breach any legal rules in terminating employment that is fully at will.<sup>98</sup>

Legislative protection of these rights signals contemporary public policy on employment termination in several ways. First, the protection of the terminated employee's benefits occurs without directly impeding

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91. Peter M. van Zante, *Mandated Vesting: Suppression of Voluntary Retirement Benefits*, 75 NOTRE DAME L. REV. 125, 127 (1999).

92. Specifically, the 2001 tax cut law's pension provision provided that employees vest in their right to their employer's contribution to their pension accounts within three years or in increments of twenty percent for each year beginning with their second year of service. Lori Nitschke & Wendy Boudreau, *Provisions of the Tax Law*, CONG. Q.W., June 9, 2001, at 1390, 1394.

93. "ERISA has done nothing to change the employment-at-will doctrine." Schmall, *supra* note 29, at 280.

94. An employer's ERISA benefit obligations start simply from its choice to have a benefit plan whether written or unwritten. ERISA § 402(a)(1), 29 U.S.C. § 1102(a)(1). A series of key cases in the 1980s and 1990s found that an ERISA plan can exist even without a formal document or writing. *See, e.g.*, *Smith v. Hartford Ins. Group*, 6 F.3d 131, 136 (3d Cir. 1993); *Donovan v. Dillingham*, 688 F.2d 1367, 1372 (11th Cir. 1982); *Suggs v. Pan Am. Life Ins. Co.*, 847 F. Supp. 1324, 1330 (S.D. Miss. 1994); *Sulentis*, *supra* note 28, at 42-43 & n.218.

95. *Inter-Modal Rail Employees Ass'n v. Atchison, Topeka & Santa Fe Ry. Co.*, 520 U.S. 510, 515-16 (1997) (quoting *Ingersoll-Rand Co. v. McClendon*, 498 U.S. 133, 143 (1990)).

96. The leading cases are *Gavalik v. Continental Can Co.*, 812 F.2d 834, 851 (3d Cir. 1987) and *Pickering v. USX Corp.*, 809 F. Supp. 1501, 1550-52 (C.D. Utah 1992).

97. Dana M. Muir, *Plant Closings and ERISA's Noninterference Provision*, 36 B.C. L. REV. 201 (1995).

98. Once employers do choose to establish pension plans, ERISA does prevent the recurrence, as its legislative history stated, of "[e]xtreme cases . . . in which employees have lost retirement rights at advanced ages as a result of being discharged shortly before they would be eligible to retire." H.R. Rep. No. 93-807, at 12 (1973), *reprinted in* 1974 U.S.C.A.N. 4639, 4679. Section 510 of ERISA provides that "[i]t shall be unlawful for any person to discharge . . . a participant or beneficiary," that is, an employee who has interests in a benefit plan, "for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan." 29 U.S.C. § 1140.

the employer's prime justifications for termination at will: flexibility<sup>99</sup> and discipline.<sup>100</sup>

Second, what ERISA focuses on protecting is precisely the employee's concrete high-reliance interests. Pension vesting and benefit levels relate to the employee's years of contributions, that is, to the employee's years of reliance in the form of foregoing alternatives for retirement security, a different job with formally secure benefits during those years, or an alternative retirement savings arrangement. ERISA protects such reliance interests even when they are founded in employment agreements of adhesion, in part by enlarging judicial willingness to find implied rights without undue regard for fine points of employer drafting of formal instruments.<sup>101</sup>

Third, in terms of public policy, both employees and society need a social safety net to handle involuntary job terminations comparable to the widespread insurance against common hazards like auto accidents or untimely demise.<sup>102</sup> The defining characteristic of an involuntary termination, like that of such common hazards, is that the employee may fear its occurrence but does not control the timing and circumstances.<sup>103</sup> The involuntarily terminated employee experiences more intensely the personal impact of uncontrolled deprivations of the reliance

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99. Although the employer must now respect vested pension rights, the employer can still replace the employee, either with a new individual or with a different arrangement, such as exporting the work or outsourcing if the employer otherwise had that right.

100. The prospect of termination still strikes plenty of fear in employees even if they do not thereby forfeit their vested benefits. ERISA does not prevent such termination if the law otherwise allowed it without procedural protections for the employee.

101. An employee who invests years working in reasonable reliance upon the indications of benefits is protected to some degree, notwithstanding employer invocation of formal disclaimers. Sulentic, *supra* note 28, at 5-6.

102. Admittedly, the distribution of pensions and other benefits is skewed towards higher income, higher benefit, and more secure employees. Thus, although they do serve the safety net function, they serve it less for the people more at risk, i.e., lower income, lower benefit, less secure employees, and not at all for those most at risk, i.e., those who subsist for a prolonged period with no employment. On the other hand, the highest income individuals, such as senior management, tend to be less at the mercy of employer drafting of formal adhesive instruments relating to at-will employment. Thus, doctrines relating to the implications of at-will employment arrangements are in that respect tailored to those more related to the public policy of the social safety net.

103. In voluntary terminations, typically the employee chooses to leave to take another opportunity, often another job, although not uncommonly early retirement, or to devote more time to family. By definition, in a voluntary separation, the employee has exercised some control of the timing and the choice of what to do, and typically this involves an enlarged sense of what will come next and how to transition into it. With this comes mitigation to some extent of the transition problems by preparations and arrangements.

interests, besides pensions, built upon stable employment.<sup>104</sup> This factor explains why the law views the involuntarily terminated stable employee as someone, like an insured after the hazard occurs,<sup>105</sup> who cannot reasonably be expected to have made fully effective substitute arrangements to meliorate forfeitures.<sup>106</sup> Because the involuntarily terminated employee may be at risk for falling through the social safety net from deprivation of their high-reliance interests in employment, public policy may warrant some compensation to address forfeitures.

It is useful to study another important discretionary power of contractual termination, the government's power of terminating public contractors for convenience. This provides lessons about legal doctrine

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104. There is much less of a reason to imagine that the employee will go next to something that suits his situation, let alone to something that he hopes will promptly improve it. The lack of control and choice diminish the ability to mitigate the transition problems. The blunt way of putting this is that "termination of a work relationship through discharge [or] downsizing . . . is the equivalent of workplace capital punishment" or "a death in the family." Schmall, *supra* note 29, at 277-78 n.9 (internal quotation marks omitted).

105. What makes forfeiture of the employee's interests so acute is that an employee would have no effective means, after the triggering event of job termination, of belated substitution of an alternative means of dealing with her lost interests, just as an insured cannot substitute, after the hazard occurs, for a policy that does not provide the coverage she anticipated. That is, employment-based vested pension rights serve, for the employee, the function described below for insurance as its protective aleatory function. The terminated employee who forfeits reliance interests in stable employment, like the insured after the hazard occurs who does not receive anticipated coverage, has no effective means of arranging *XX instante* a substitute for the sharp impact. This contrasts with the merchant in marketable goods who can deal with a cancellation by its contracting partner by reselling (if a seller) or covering (if a buyer), and even when this occurs at a loss, there is less prospect of a forfeiture without mitigation and with traumatic impact. The significance of the factors of substitution and mitigation is also discussed in *infra* note 106.

106. An economist could reason, in theory, that the employee without rights of security should save out of her income in advance of termination to mitigate the impact of termination. An economist might figure that an employer who does not set aside any of its labor expenditure for severance pay would thereby put that much more into each employee's wages. Accordingly, the employee who knows she cannot count on security as a job benefit should then find it rational to set aside part of her wages to arrange the security for herself as a precaution.

Some employees with insecure jobs may act in line with the economic analysis as to precautionary and selective responses to supracompensatory remedies in general to which termination can be likened. See Craswell, *supra* note 16. However, many employees at will simply cannot or will not save out of income to provide for the impact of possible termination. Medill, *supra* note 27, at n.21 (regarding why people do not save for retirement, "the overwhelming major reason cited by non-savers (66%) was having too many current financial responsibilities"). When severance pay at a time of involuntary termination of stable employment serves important social safety net interests that employees are not generally addressing, it is economically efficient.

that can then be brought back to complete the analysis of termination of at-will employment.

*B. Termination for Convenience in Public Contracting*

**1. The 1996 Krygoski Case: Culminating a Century and a Half of Development.** Termination for convenience by the government provides a valuable field in which to study the doctrines of termination powers because it allows a look back at almost a century and a half of readily examined development. During that time, vigorous debate occurred between two positions: the position that public policy warrants the government terminating its contracts by paying for the contractors' reliance interest but not full expectation damages and the opposite position of contractors, often backed by sympathetic commentators, that such termination transgresses their legitimate contract rights to full expectation damages. It is a debate of particular interest when contrasted with the debate on employment termination because of the analogies between the termination power of the employer and the government.

The federal government's termination of contracts for convenience doctrine dates back to seminal Supreme Court cases following the Civil War.<sup>107</sup> During World War I, Congress provided legislatively for government termination for convenience,<sup>108</sup> producing two signal Supreme Court rulings. In the first, the Court reasoned that given the prospect of government termination of contracts at the war's end,<sup>109</sup> "[t]he possible loss of profits [from this] must be regarded as within the contemplation of the parties[,]"<sup>110</sup> and the remedy for the cancelled contractor could just compensate the reliance interest without also compensating for the contractor's lost anticipated profits. Second, in

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107. In the key case, the Court opined about the powers of the Secretary of the Navy that "the power to suspend work contracted for, whether in the construction, armament, or equipment of vessels of war, when from any cause *the public interest* requires such suspension, must necessarily rest with him." *United States v. Corliss Steam-Engine Co.*, 91 U.S. 321, 322 (1875). See Robert Sheriffs Moss & Paul H. Gantt, *A Steam Engine and Contract Termination Settlement Procedures*, 8 PUB. CONT. L.J. 188 (1976).

108. *Torncello v. United States*, 681 F.2d 756, 764-65 (1982) (citing *F. Trowbridge vom Baur, Fifty Years of Government Contract Law*, 29 FED. B.J. 305, 313 (1970)).

109. "[N]o prudent person, desiring to acquire this contract, would have paid for it the full amount which could be realized upon completion . . . . The contract, we must assume, was entered into with the prospect of its cancellation in view." *Russell Motor Car Co. v. United States*, 261 U.S. 514, 523-24 (1923).

110. *Id.* at 524.

*College Point Boat Corp. v. United States*,<sup>111</sup> the Court created the doctrine of constructive termination for convenience, allowing the government to compensate just for the reliance interest in diverse situations.<sup>112</sup>

The concept of termination for convenience received extensive use during and after World War II.<sup>113</sup> In 1982 the Court of Claims, hearing a major case en banc, heeded criticisms by commentators<sup>114</sup> in an important ruling that produced extensive debate over the following fourteen years: *Torncello v. United States*.<sup>115</sup> An opinion for three of the six judges of the en banc court traced the history of termination for convenience in detail and suggested that without greater protection for contractors the government contract would be illusory.<sup>116</sup> The court

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111. 267 U.S. 12 (1925).

112. The government could limit its compensation to the reliance interest even in situations in which it had not considered itself to be, or notified that it was, terminating for convenience. As Justice Brandeis contrasted in one of his classic analyses of government contracting, in an ordinary contract, “the ordinary liability of one who, having contracted . . . without cause, gives notice that he will not accept delivery . . . [is] for the prospective profits.” *Id.* at 14. However, because the government’s “right to cancel . . . [was a] continuing right of cancellation, which was asserted later . . . . Prospective profits were not recoverable.” *Id.* at 16.

113. It was applied to peacetime military procurement. *Torncello*, 681 F.2d at 765. In a much commented-upon 1963 case, the doctrine was applied even when the agreement had no termination for convenience clause, impressively disconnecting the doctrine from the formalities of contract formation. *G.L. Christian & Assocs. v. United States*, 312 F.2d 418 (Ct. Cl. 1963). “The termination clause limits profit to work actually done, and prohibits the recovery of anticipated but unearned profits. . . . Literally thousands of defense contracts and subcontracts have been settled on that basis in the past decades.” *Id.* at 426. See A. Sidney Alpert, *Recent Decisions, Invocation of Termination-For-Convenience Clause to Limit Contractor’s Recovery for Breach of Contract*, 32 GEO. WASH. L. REV. 898 (1964); John P. Sears & Edward P. Taptich, *Recent Decisions, Government Contracts*, 51 GEO. L.J. 842 (1963). In 1967 it was given general applicability to peacetime military and civilian procurement. *Torncello*, 681 F.2d at 765. In all these expansions, it served to standardize a government-wide measure of damages in diverse situations to omit anticipated profits. *G.L. Christian*, 312 F.2d at 426-27.

114. Commentators sympathetic to contractors had often criticized the broad use of termination for convenience. One case held government officers could exercise the power simply to get a better price at a later point than it had in the cancelled contract. *Colonial Metals Co. v. United States*, 494 F.2d 1355, 1360-61 (Ct. Cl. 1974). This elicited a wave of criticisms. Note, *Tying Together Termination for Convenience in Government Contracts*, 7 PEPP. L. REV. 711 (1980); Irwin Newman, *The Beginning of the End—The Encroachment of Federal Contract Termination Practices*, 33 BUS. LAW. 2143 (1978); Perlman & Goodrich, *Termination for Convenience Settlements—The Government’s Limited Payment for Cancellation of Contracts*, 10 PUB. CONT. L.J. 1 (1978).

115. 681 F.2d 756 (Ct. Cl. 1982).

116. Most notably, the court drew on perhaps the ultimate formal doctrine for the formation of contracts in a section entitled “The Requirement of Consideration.” *Id.* at 768-

concluded that refusing to allow expectation damages could not be so generally justified.<sup>117</sup>

During the following decade and a half, *Torncello* drew extensive attention in subsequent cases<sup>118</sup> and commentary.<sup>119</sup> The Federal Circuit, the newly created successor court to the Court of Claims, although generally adhering to Claims Court precedent, began visibly undermining *Torncello* in 1990<sup>120</sup> and sent a second major signal in 1995.<sup>121</sup> The Federal Circuit delivered the *coup de grace* against *Torncello* in 1996 in *Krygoski Construction Co. v. United States*.<sup>122</sup> *Krygoski* culminated in what might be called a public policy analysis of how government officials could be trusted not to abuse a termination power,<sup>123</sup> evoking commentary<sup>124</sup> both unfavorable and favorable, and

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72. Because the contracting officer could terminate the contract before buying anything, he might "do so without incurring legal detriment himself or benefitting the other party," so that, as the court quoted Corbin's treatise, the contract would be "like the mirage of the desert with its vision of flowing water which yet lets the traveler die of thirst, there is nothing there." *Id.* at 769 (quoting 1 CORBIN ON CONTRACTS § 145 (1963)). The opinion drew strenuous disagreement opinions from the court's other three judges, including such renowned authorities as Judge Davis, the author of the *G. L. Christian* opinion twenty years earlier, expanding the termination for convenience doctrine. *Id.* at 773 (Davis, J., concurring).

117. Accordingly, the three-judge opinion concluded that "we restrict the availability of the [termination for convenience] clause to situations where the circumstances of the bargain or the expectation of the parties have changed sufficiently that the clause serves only to allocate risk." *Id.* at 771.

118. By 1996, "*Torncello* has been cited for various legal propositions in 90 board of contract appeals decisions, 46 Claims Court and Court of Federal Claims decisions, and 12 Federal Circuit decisions." 10 THE NASH AND CIBINIC REPORT, para. 52, at 149 (Oct. 1996).

119. Stephen N. Young, Note, *Limiting the Government's Ability to Terminate for its Convenience Following Torncello*, 52 GEO. WASH. L. REV. 892 (1984).

120. *Salsbury Indus. v. United States*, 905 F.2d 1518, 1521 (Fed. Cir. 1990).

121. Both were noted by the commentators. Major Causey, *Torncello and Terminations for Convenience: The Government's Broad Rights Just Got Broader*, ARMY LAW., Oct. 1995, at 30 (commenting on *Santmeyer*); Major Karl M. Ellcessor, III, *Torncello and the Changed Circumstances Rule: "A Sheep in Wolf's Clothing,"* ARMY LAW., Nov. 1991, at 18 (commenting on *Salsbury*).

122. 94 F.3d 1537 (Fed. Cir. 1996). *Krygoski* again traced a history of termination for convenience differently than *Torncello*, elaborating the justifications for such termination. *Krygoski* pointed out how the key statements in *Torncello* were "dicta." *Id.* at 1541.

123. A private enterprise might terminate a contract simply to take opportunistic advantage of predictable developments, ranging from swings in market prices of volatile commodities to the employer's savings in terminating older employees who accrued the benefits of seniority for years of work. In contrast, government "contracting officers have no incentive to terminate a contract for convenience except to maintain full and open competition under CICA. With an adequate contractor in place, the contracting officer has no interest to reprocure." *Id.* at 1544. In fact, "where an officer must choose between modifying or terminating a contract, ease of administration usually imparts a bias in favor

even attempts at overruling.<sup>125</sup> In particular, one note recalled that termination for convenience had been analogized to “terminable at will”<sup>126</sup> contracts, like at-will employment contracts, with which the *Krygoski* approach was consistent.

**2. Lessons on the Factors for Termination.** The unfavorable commentary on *Krygoski* continues to make the case for terminated contractors receiving a bigger remedy.<sup>127</sup> It urges that the government must obey the doctrine that “[a party] with discretion to terminate should be required to terminate only in good faith.”<sup>128</sup> To illustrate how contractors’ rights should expand, commentators cite employee termination cases, including “employment-at-will situations,” in which the courts held “that an employer violates good faith duties when it discharges an at-will employee to avoid paying her benefits earned.”<sup>129</sup>

In the face of this emphasis on good faith, two other factors justify the post-*Krygoski* government termination powers: public policy and the compensation of contractors’ reliance interests. The government’s broad power of termination is derived from a solid history of public policy that is recognized in legislation, regulations, and Supreme Court decisions for

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of modification.” *Id.*

124. Pro-contractor commentators assailed it as “not persuasive,” “no improvement” over the prior law, and a decision that “effectively overrules” *Torncello* “although the panel did not have this authority.” Joseph J. Petrillo & William E. Conner, *From Torncello to Krygoski: 25 Years of the Government’s Termination for Convenience Power*, 7 FED. CIR. B.J. 337, 367 (1997). The article develops the matter in impressive depth before reaching these conclusions. What the quote alludes to is that *Krygoski* does not say that it is overruling the decision in *Torncello* on the terms it was decided, but rather that the development subsequent to the *Torncello* of the 1984 enactment of the Competition in Contracting Act is what justifies no longer following *Torncello*. The article disputes that Congress, in enacting CICA, was addressing *Torncello*.

125. A bar group even attempted to overthrow it by seeking an amendment of the regulations. For a description of this effort, see Michael D. Garson, Note, *Krygoski and the Termination for Convenience: Have Circumstances Really Changed?*, 27 PUB. CONT. L.J. 117, 121-22 n.17, 152 n.176 (1997).

126. *Id.* at 142 (citing *Davis Sewing Mach. Co. v. United States*, 60 Ct. Cl. 201, 217 (1925)).

127. Claybrook, *supra* note 31. *Krygoski* is also criticized in Petrillo & Conner, *supra* note 124.

128. Claybrook, *supra* note 31, at 561 (quoting STEVEN J. BURTON & ERIC G. ANDERSEN, CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT 93, 130-34 (1995)).

129. *Id.* at 571. Claybrook objects that while the government’s power to terminate does have a good faith exception, a difficult burden of proof has been imposed on contractors attempting to show an absence of good faith. *Id.* at 576-77.

investing government authorities with flexibility and control.<sup>130</sup> That is, public policy supports allowing higher authorities in the government—Congress, the President, the heads of departments and agencies, and other senior officials—the power to change law or policy (in legislation, appropriation, or regulation) by terminating inconvenient contracts without being regarded as having breached the contract.<sup>131</sup>

Yet, the government's broad termination power avoids inequitable harshness because its exercise occurs with protection for the terminated contractor's reliance interests.<sup>132</sup> These reliance interests may fall far short of the contractor's expectations or anticipated profits, particularly when the government terminates a contract that had much potential for profitability long before full production occurred. Still, the compensation may shield a contractor who has invested heavily in performing the contract much better than if the cancellation forfeited the contractor's

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130. As an immediate self-help remedy, cancellation always has as its strongest benefit in the instant flexibility it provides to the cancelling party. In wartime, termination for convenience allowed the government to place massive orders for supplies while being able to adapt to an earlier end of hostilities or a change away from initial choices rendered obsolete. In peacetime, and in civilian government contracting, termination for convenience allows the government to adapt to its many diverse constraints and opportunities. This quest for flexibility accords with other aspects of modern government contract law, such as the elaborate system for handling express and constructive changes, which has many overlaps with termination for convenience. The government requires contractors to accept changes that, in a private contract, would necessitate a voluntarily agreed-to modification, and the government pays an equitable adjustment for such changes. It is possible that sometimes the government pays a premium, as contractors price their offers to compensate them for carrying the risk of a termination for convenience. If so, it is a price the government pays willingly for the flexibility. For a discussion of changes, see TIEFER & SHOOK, *supra* note 19, ch. 6, at 259-99.

131. This has particular significance in the context of constructive terminations for convenience, situations in which the government might otherwise breach a contract by its action, but instead, the breach is converted into a constructive termination with the corresponding measured remedy for the contractor. While Justice Brandeis' *College Point* opinion developed the logic of constructive termination, it took a generation of creative regulation writers and judges on the boards of contract appeals and the Court of Claims to extend it.

132. The government's standard termination clause provides a roadmap of this compensation. In sum, the terminated contractor submits a settlement proposal, and if the contracting officer and the contractor can agree on a settlement, there are few constraints on what the contractor can get, or in other words, the contractor can do very handsomely. TIEFER & SHOOK, *supra* note 19, at 479. If, however, the parties cannot settle and a tribunal must resolve the issue, the contractor still gets the total of the costs incurred in the work terminated plus profit on those costs and such items as the cost of settling terminated subcontracts and the expenses of preparing the settlement proposal. *Id.* at 480.

reliance interests.<sup>133</sup> This starkly illustrates the potential separation elsewhere in contract law between the sensibility of the self-help remedy of cancelling a contractual relationship and the distinct issue of whether to compensate the cancelled party. Just as that remedial unbundling occurs all the time in this prominent context, it could occur elsewhere, particularly in employee termination.

*C. The “Why” and “How” of an Implied Severance Term for Employees*

Drawing on this background of general contract law, public policy expressed in ERISA, and parallels from government contractor termination, this Article can now bring together the various bases for finding an implied severance term in stable employment relationship contracts notwithstanding their being formally terminable at will. First, courts shaping the law of employee termination, with its major social significance, have traditionally sought to reflect sound public policy. In this regard, it is significant that in the downsizings of the past decade, severance payments to terminated employees have become common in certain contexts<sup>134</sup> and that the Model Employment Termination Act also supports a movement toward general and simple relief for terminated employees.<sup>135</sup> More broadly, ERISA represented an enormously important expression of contemporary federal public policy regarding the need to protect the high-reliance interests of employees even during termination, while not interfering with the employers’ powers of at-will termination.<sup>136</sup> An implied right of severance pay preserves precisely

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133. Significantly, the government provides a much more generous measure of relief for the contractor terminated for convenience than it does for the contractor terminated for default or cause. Such a contractor basically gets a remedy like restitution—the value to the government of the accepted work—and so receives no compensation for expenditures out of the contractor’s pocket that did not yet ripen to the point of benefit to the government.

134. Employers have used settlement proposals to seek voluntary departure of employees deemed surplus and to seek waivers of employee rights, which of course raises various collateral legal issues beyond this Article. The point is that the level of employer resort to severance payment has become high enough in some contexts to suggest that courts may generalize from that common resort to a limited employee right that may be filled in as an essential omitted term. Alfred W. Blumrosen, Ruth G. Blumrosen, Marco Carmignani & Thomas Daly, *Downsizing and Employee Rights*, 50 RUTGERS L. REV. 943 (1998).

135. For a description of the model act by its chief drafter, see Theodore J. St. Antoine, *The Making of the Model Employment Termination Act*, 69 WASH. L. REV. 361 (1994).

136. Before ERISA, employers might have described their entire arrangement with employees legally as part of the at-will doctrine coupled with their control of the formal instruments to which employees adhered. With ERISA, the larger society’s public policy

that balance: it protects employees' interests without constraining the employer's flexibility in termination.

In the leading ERISA case of *Fort Halifax Packing Co. v. Coyne*,<sup>137</sup> the Supreme Court reviewed a Maine statute that provided a one-time severance payment to employees in the event of a plant closing. Employers argued that ERISA preempted this state law because ERISA's broad preemption provision<sup>138</sup> applied to all state laws "relating to" benefits,<sup>139</sup> which the Maine law providing for severance allegedly did. However, the Court recalled that the preemption provision only applies to state law relating to benefit "plans" in ways that subject the administration of these plans to conflicting requirements in different states.<sup>140</sup> The Court looked favorably upon the severance pay requirements as an "attempt[] to address uniquely local social and economic problems" when plant closings impose "a significant burden on local public and private social service agencies."<sup>141</sup> In other words, the Court favorably noted, as previously described, that involuntary termination is a point of individual trauma for the employee, producing

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also becomes a factor in termination, not by constraining the power prospectively to terminate, but by safeguarding the employee's reliance interest.

137. 482 U.S. 1 (1987).

138. ERISA § 514(a), 29 U.S.C. § 1144(a). For a start on the complexities of ERISA preemption, see *Pegram v. Herdrich*, 530 U.S. 211, 237 (2000) and *Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504, 524-25 (1981).

139. The Supreme Court strikes down state law that, in the course of maintaining the employment benefits, subjects employer ERISA plans to conflicting administrative requirements. *Alessi*, 451 U.S. at 526 (striking down a New Jersey statute that prohibited offsetting worker compensation payments against pension benefits). This serves both to federalize the law of pension and employee benefit law and to preserve a statutorily defined degree of autonomy for employers who administer such plans. ERISA's preemption provision intends that nationwide employers, operating in states that may have highly diverse laws on various employment-related matters, can use single uniform benefit plans without undue interference and administrative burden from those differing state legal regimes. Employers argue that to require the benefit plan to be differently administered for terminated employees in a particular state would interfere with the employer's right to an easily administered uniform national system. *Standard Oil Co. v. Agsalud*, 633 F.2d 760 (9th Cir. 1980), *aff'd*, 454 U.S. 801 (1981). *Agsalud* is discussed in *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1, 12-13 (1987). In *Agsalud*, the court struck down a Hawaiian law requiring that employers provide employees with a comprehensive health care plan that might have required employers to administer their health benefit plans differently for employees in Hawaii than in other states. *Id.* at 13. However, ERISA preemption does not preclude the state law of contractual employment from protecting employee reliance interests during termination where the state law does not unduly complicate the administration of benefit plans.

140. *Id.* at 8-14.

141. 482 U.S. at 19 & n.13.

burden and vulnerability for the social fabric.<sup>142</sup> Its ruling reflected the public policy of ERISA, to meliorate the impact of termination at will upon employees and the social fabric without blocking employer flexibility and discipline—in this instance, by a compensating payment to the terminated employees.

Second, the rest of contract law furnishes models for coupling the kind of unrestricted discretionary power to terminate that employers desire with an essential obligation to make some kind of payment to compensate for the cancelled party's reliance interest. The government's power to terminate for convenience serves as a useful model of the relevant factors.<sup>143</sup> Contract law in the instance of the terminated government contract allows the government to exercise sweeping power to terminate and thereby wipe out the other party's (the contractor's) expectation interest, a power largely unconfined, in the interest of flexibility, by good faith or by specific showings of justification. However, the government can terminate only if it compensates the cancelled party for the party's high-reliance interests.<sup>144</sup> The same logic applies to termination by employers. Their sweeping power to terminate in the interest of flexibility, a power largely unconfined by a need to demonstrate

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142. The system of unemployment insurance recognizes the terminated employee's immediate need for support. It could be argued that unemployment insurance goes just as far as its public policy warrants. In fact, this is why the discussion here speaks of a "limited" right to severance pay. However, trying to push the argument to the point of not having any severance pay rights other than those the employer grants expressly, is like arguing that employees need no more protection against retirement destitution than social security—yet ERISA went further. ERISA's codified public policy shows that some kinds of employment relationships—in terms of both the nature of the employer's general arrangements and the particular employee's tenure—warrant more than the enacted social security pension. The same is true of severance pay.

143. As that model reflects, the power of termination at will without cause—either by the government or the employer—serves so valuable a practical interest in flexibility that a limited payment to the terminated contractor or employee does not deprive it of its prime value. The government derives the benefits it desires, i.e., subservience of the contract to its operating imperatives and flexibility, from the power to cancel at will, even though it must make a payment in compensation for the cancelled contractor's reliance interest.

144. That is, as the law regards the matter, if the terminating government or employer would otherwise have the right to terminate without this being deemed a breach of its contractual promises, the obligation to make a payment to the terminated party still leaves its actions not deemed such a breach, let alone a tort. Part of the courts' reluctance to alter the at-will employment doctrine may have a normative dimension—the unwillingness to recognize an employee's rights at the cost of branding an employer wrong for the act of termination that has not been regarded as a breach of contract all these years. Unbundling cancellation from payment for reliance interests frees the court from this normative conundrum.

justification in the individual instance, also supports the proposition that there should be compensation for the employees' forfeited interests.<sup>145</sup>

Third, just as the government contract's nature as a relationship contract of adhesion, suggests how the courts assess a compensation level as an implied term, the at-will employment contract's nature as, typically, a relationship contract of adhesion suggests how the courts would assess a compensation level as an implied term. The Second Restatement provides a sound mechanism for courts to construe an agreement of adhesion by filling in omitted essential terms of this nature by looking at contextual sources.<sup>146</sup> These sources would be the usages of the trade, the employer's course of dealing with other employees, the performance of this particular employment contract, and general sources of public policy guidance. These aspects define where the individual employment relationship fits on a spectrum of appropriateness in inferring an implied right to severance pay,<sup>147</sup> going from high-benefits<sup>148</sup> to low-benefits<sup>149</sup> employment.

To be concrete about this severance right, commentators have drawn upon the European experience and the experience in arbitration proceedings to offer guidance about the appropriate scale of severance pay.<sup>150</sup> Following these patterns, severance pay may start accruing after an initial period of work, such as three or six months, with the amount proportional to the pay rate at the end of employment. The

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145. The analogy is straightforward that one who hires an employee or contractor with a clear retained right to cancel continuation of the work might have an obligation in restitution to pay the reasonable value of the part of the work completed and accepted, even though cancellation was in no sense a breach. The restitutionary interest is analogous to the reliance interest.

146. For the explanation of how the relational nature of long-term employment leads to the model of the implied severance term, see Issacharoff, *supra* note 13, at 1798-1800.

147. This is not a matter of just the words chosen for a formal job application, agreement, or personnel handbook when the employee is hired, for the degree of mutual reliance in a relationship contract such as employment is not presentiated in the initial exchange or in such formal documents of adhesion. Rather, in the course of the employment, the particular employer may have treated similar employees in general as shorn of benefits and without any hope for security, and this particular employee's experience may demonstrate a clear status of contingency, or being probationary, that negates benefits or hopes for security.

148. At one end, an industry may often make severance payments, and the particular employer may have similarly treated its employees in general, and the terminated employee, in particular, with indications of a noncontingent, benefit-receiving status—even though the indications do not go so far as to require cause for termination.

149. At the other end of the spectrum, an industry may allow a type of employee to be treated as entirely contingent. In that situation, the implied right to severance payment would be appropriately limited.

150. Issacharoff, *supra* note 13, at 1788 n.15.

exact rate of severance pay increases in proportion to the period of employment, eventually reaching a ceiling, and is proportional to the employee's pay rate at the time of termination.<sup>151</sup> In effect, this rate serves as a liquidated sum for the difficult-to-measure forfeited reliance interests. Having such compensation does not seriously burden this sector of contracting—certainly not compared to the alternative of depriving the employer of the flexibility it obtains from being able to terminate at will<sup>152</sup> or the harshly inequitable approach of reading an adhesion contract to put upon the employee the entire burden of forfeiture without compensation.

This Article returns to this issue in the conclusion, which takes the form of a proposed Restatement provision. Because the conclusion seeks a set of principles that would apply to termination and cancellation situations generally, Part IV addresses two aspects of conditions, those in consumer insurance and those in public contracts, that are needed before attempting an overall conclusion.

#### IV. CONDITIONS AND THE BALANCE OF FACTORS IN INSURANCE AND PUBLIC CONTRACTS

The Second Restatement already balances equitably an appropriately wide variety of factors regarding when to allow cancellation in response

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151. Severance pay would accrue, to take a low rate, at one or two weeks of severance pay per year of employment. There has been discussion of the more reasonable figure of one month per year—up to a ceiling of three month's wages reached, at that rate, after a period of up to twelve years of work. Section 4(b) of the Model Act allows the supplanting of a good-cause requirement for discharge by a liquidated damages provision of one month's severance pay for each year of service. Professor Issacharoff looked at the European model and found that "[i]t would yield a liquidated damages recovery of one month per year of hiring." Issacharoff, *supra* note 13, at 1807. While a legislature might well decide, in enacting such a system to use that figure (one month per year), a common law court, might decide, just from caution, to use a lower figure (one or two weeks per year).

152. Critics of according rights to at-will employees often contend that the market will cause any such rights to reduce correspondingly the regular pay rate of employees because the employer has a fixed total amount out of which to pay all labor costs, both the regular pay rate and benefits. This kind of debate is linked to many others regarding public policy and employment law, such as whether increasing the minimum wage keeps wage levels up or merely results in precluding legal hiring below the minimum.

In any event, unlike other kinds of benefits, severance pay can go just to the fraction of employees exposed to the shock of involuntary termination. Employers must budget an amount for the transition cost of terminating one employee and replacing the productive effort or otherwise dealing with that aspect of its operation. Even assuming the debated proposition that the whole amount did come out of a corresponding reduction of other forms of employee pay, if the implied rate is as low as one or two weeks of severance pay per year of employment with a low ceiling and only gets paid to the fraction of employees involuntarily terminated, then the impact would likely be a fraction of a percent.

to a material breach of a term of performance.<sup>153</sup> A similarly wide variety of factors increasingly has informed, and should inform, when to cancel or to impose some other supracompensatory remedy in response to a failure of express conditions. Two contexts particularly shed light on this development: consumer insurance contracts and public contracts involving policy conditions in the context of False Claims Act (FCA) suits.

*A. Insurance: Adhesive Conditions in Aleatory Contracts for Risk Protection*<sup>154</sup>

As previously noted, melioration of the effect of conditions in consumer insurance contracts dates back to the legislation of the Progressive Era concerning inappropriate condition provisions in life and fire insurance contracts. In terms of common law doctrines, the First and Second Restatements made valuable progress by employing the doctrines, respectively, of “extreme” and then “disproportionate” forfeiture, identified now with section 229 of the Second Restatement.<sup>155</sup> Soon after the promulgation of the Second Restatement, a signal judicial opinion—one that has become an important entry in basic contracts casebooks—expounded that section, thereby advancing the law in this

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153. RESTATEMENT (SECOND) OF CONTRACTS §§ 241-42 (1979).

154. This Article uses the shorthand that insurers “cancel” an insured’s coverage as their remedy for failure of express condition. It uses this shorthand to bring disparate legal subjects regarding conditions and termination powers into a unified perspective. In doing so, there should be an acknowledgment of the complications of using this terminology for insurance conditions, which operate in ways that do not fit readily into this terminology. First, an insurer may quite benignly decline to pay based on the nonoccurrence of a condition—e.g., for life or fire insurance, that the insured does not die and experiences no fire losses before the end of the contract term—without that being a cancellation. Second, the term “cancellation” of an insurance policy can have a specific narrow meaning, such as a deliberate insurer action of a kind that is often closely regulated, different from the general meaning of the term cancellation in the U.C.C. as a response to material breach or in the Second Restatement of Contracts as a response to diverse bases for a party treating its remaining duties as discharged. Third, in different insurance contexts depending on their legal heritage, some failures of express condition do give the insurer a right to cancel, but others do not.

The same terminological problem has occurred for the entire past century when the First Restatement and the Second Restatement both addressed the subject of conditions by provisions that purported to apply to all contracts, including insurance contracts. This Article has chosen to use the shorthand, notwithstanding the nuances the term “cancellation” has in insurance law, not to slight these, but rather than bog the discussion down in use of an elaborate terminology specific to insurance that would be distracting to the readers not especially focused upon insurance law.

155. *Id.* § 229.

area and providing a lead that other courts have followed, including a significant 2001 ruling.<sup>156</sup>

In *Aetna Casualty & Surety Co. v. Murphy*,<sup>157</sup> the insured on a liability policy gave late notice of his claim, thereby failing to fulfill a contract condition requiring prompt notice. Justice Peters<sup>158</sup> gave a disquisition on the “conflict between two competing principles in the law of contracts,”<sup>159</sup> namely, that they should be enforced as written and “that the occurrence of a condition may, in appropriate circumstances, be excused in order to avoid a ‘disproportionate forfeiture.’”<sup>160</sup>

After drawing guidance from *Jacob & Youngs, Inc. v. Kent*,<sup>161</sup> Justice Peters cited a series of decisive considerations, focusing on the special characteristics of conditions in consumer insurance contracts,<sup>162</sup> namely, the adhesive terms in aleatory contracts for risk protection. Taking those aspects one at a time, Justice Peters noted, and other courts echoed, that first, consumers buy “an insurance policy that is a ‘contract of adhesion.’”<sup>163</sup> The rising “reasonable expectations”<sup>164</sup> doctrine in insurance law in recent decades holds that in appropriate circumstances, courts should resolve issues about insurance policies, such as conditions of coverage, not just by interpreting the express language of the provisions, but rather by looking to the reasonable expectations of an insured in purchasing the policy.<sup>165</sup> Critics of the

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156. *Clementi v. Nationwide Mut. Fire Ins. Co.*, 16 P.3d 223 (Colo. 2001) (declining to enforce notice-prejudice condition and reviewing the case law trend since *Aetna*).

157. 538 A.2d 219 (Conn. 1988).

158. Justice Peters brought together her background as contracts professor at Yale Law School—Corbin’s old role—and her state’s premier position as the headquarters of the insurance industry.

159. 538 A.2d at 221.

160. *Id.* (citing RESTATEMENT (SECOND) OF CONTRACTS § 229 (1981)). Justice Peters quoted the entire section and its comment b on “disproportionate forfeiture” in a footnote. *Id.* at n.2.

161. 129 N.E. 889 (N.Y. 1921).

162. See *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 447 (Del. 1996) (regarding why “Insurance is different”).

163. *Aetna*, 538 A.2d at 222. Justice Peters cited the classic modern articles on adhesion contracts. See, e.g., *Clementi*, 16 P.3d at 229 (adhesive nature of auto liability insurance contract as one of the chief reasons not to sustain notice condition); *Alcazar v. Hayes*, 982 S.W.2d 845, 850 (Tenn. 1998).

164. This doctrine arose from pathbreaking opinions by key courts brought together in the scholarly work of Professor Robert E. Keeton, which became the font of further caselaw and commentary. See Keeton, *supra* note 32.

165. See William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 (1986); Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323 (1986).

doctrine<sup>166</sup> argue it unduly slights the express language of the formal contractual instrument.<sup>167</sup> However, consumers neither negotiate the instrument's drafting nor usually decipher many of its technical details, so the courts properly treat the drafting of the provisions, including conditions, as coming with a potentially limited warrant.<sup>168</sup>

Second, courts and scholars describe insurance contracts as aleatory,<sup>169</sup> from the Latin word for dice-rollers, which means the insurers' obligations depend on contingent events. This contrasts with what consumers and payers in general mostly buy, namely, a seller's certain, definite, noncontingent, and non-aleatory promise to provide goods, services, or whatever else. Because the eventual occurrence of the contingency in an aleatory contract dramatically changes the relationship of the parties, many of the techniques used to ameliorate the harsh conditions set forth in non-aleatory contracts do not apply. Notably, the insured has no effective way to substitute, in the changed situation after the hazard occurs, if relied-upon coverage is denied at the moment of need.<sup>170</sup> As Justice Peters put it, for the insurer to cancel "is a forfeiture of the interests of the insured that is, in all likelihood, disproportionate,"<sup>171</sup> something that other courts agree is an "inequity."<sup>172</sup>

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166. As Professor Peter Nash Swisher, a leading commentator on the reasonable expectations doctrine, introduced a 1998 symposium devoted to that topic, "A majority of American courts today, however, have neither expressly adopted nor expressly rejected the doctrine of reasonable expectations, and a number of these courts arguably apply a 'middle ground' interpretive approach to insurance coverage disputes . . ." Peter Nash Swisher, *Symposium Introduction*, 5 CONN. INS. L.J. 1, 8 (1998) (footnotes omitted).

167. Ware, *supra* note 32, at 1487-93; Susan M. Popik & Carol D. Quackenbos, *Reasonable Expectations After Thirty Years: A Failed Doctrine*, 5 CONN. INS. L.J. 425 (1998).

168. See Meyerson, *supra* note 6 (adhesive terms in consumer contracts).

169. Roberts Oil Co. v. Transamerica Ins. Co., 833 P.2d 222, 230 (N.M. 1992) (declining to give full effect to voluntary payment clause in policy regarding environmental cleanup).

170. For example, for employment fulfilled at least partly by the employee or for sale of land or goods for which the buyer has made a down payment, cancelled employees or buyers can recover a good deal by demanding in restitution the value of what they have conferred. In contrast, once the insured-against contingency occurs, restitutionary remedies for cancelled insureds, i.e., receiving from the insurer their previously-paid premium, will often be trivial comfort. For another example, those transacting in land or goods, payers for services and labor, and even service providers and employees who receive progress or piecemeal payments all receive some protection from constructive conditions. If the other side cancels on them, at least they can withhold what they have not yet provided. In contrast, when a contingency has occurred, if the insurer cancels, it is too late for the insured to start withholding payment. Above all, after the contingency, if a condition is invoked, it is too late for the insured to make alternative insurance arrangements.

171. *Aetna*, 538 A.2d at 223; *accord*, e.g., *Coop. Fire Ins. Ass'n v. White Caps, Inc.*, 694 A.2d 34, 38 (Vt. 1997) ("forfeiture").

While the whole category of aleatory contracts would include speculation and even gambling as well as insurance, insurance in particular has the function of protection against risks, i.e., its aleatory component serves to protect vulnerable insureds against the financial impact of the occurrence of the covered risk.<sup>173</sup> Consumer insurance's protective role thereby knits up what might otherwise be the hole torn by occurrence of an unprotected-against risk in that part of the social safety net. Taking all these factors together, the adhesive nature of an aleatory protective contract supports a "public policy"<sup>174</sup> in favor of certain kinds of solicitude regarding the interests of insureds who are faced with denial of reasonably anticipated coverage after the insurance contingency occurs due to some kinds of express conditions in their contracts.

On the other side of the balance of factors, insurers usually can cite justifications for including conditions in insurance contracts to appropriately define and limit the insurer's—and the risk pool's—exposure<sup>175</sup> to risks of physical hazard,<sup>176</sup> moral hazard,<sup>177</sup> or juridical hazard.<sup>178</sup> For example, liability insurers include conditions about

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172. *Clementi*, 16 P.3d at 230 n.9 ("inequity" of "windfall" for insurer); *accord, e.g., Alcazar*, 982 S.W.2d at 852 ("inequitable").

173. Elementary microeconomics and sociology distinguish the socially supportive function of such a protectively aleatory contract from the role of gambling as mere diversion. There are, of course, theories of the economic and social value of gambling. That dispute is beyond the scope of this Article. All that matters is that judges consider insurance contracts differently than gambling contracts.

174. *Clementi*, 16 P.3d at 229-30 (focusing on the "public interest" in coverage of those involved in auto accidents and describing other insurance policy provisions not upheld on public policy grounds); *Alcazar*, 982 S.W.2d at 851 (same).

175. Insurers argue that conditions defining and limiting their physical, moral, and juridical hazards maintain the boundaries of the risk pool and keep payments appropriately limited, letting rightful insureds pay the minimum premiums. Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions in Order to Avoid Disproportionate Forfeiture: Claims—Made Formats as a Test Case*, 5 CONN. INS. L.J. 505, 627 (1999).

176. As to physical hazard, insurers commonly condition coverage, for example, on the absence of material misstatements in the application or vacancy of insured properties. *Id.* at 617.

177. As to moral hazard, for example, insurers used to include in property insurance policies a condition voiding them if the property were mortgaged because of the risk that insureds will take less care to avoid damage. *Id.* at 615-16; Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

178. "Juridical hazard" is a term used to describe the risks to insurers arising from the resolution of uncertainties in a judicial process rather than some idealized mechanism. "The insurance business probably deserves credit also for having first realized the full importance of the so-called 'juridical risk,' the danger that a court or jury will be swayed by 'irrational factors' to decide against a powerful defendant." Kessler, *supra* note 6, at 631.

evidentiary showings by claimants,<sup>179</sup> time limits on claims,<sup>180</sup> sworn proofs of loss, and the claimant's submission to examination under oath to let insurers investigate, evaluate, screen out misclaiming and fraud, and control litigation.<sup>181</sup> Legal scholars using an economics approach analyze when remedies for breaching or nonfulfillment of a contract term produce an efficient level of conduct.<sup>182</sup> The efficient inclusion of an express condition can involve either the parties pricing the condition in the formation of the contract or the provision's beneficial effect on the precaution and selection decisions,<sup>183</sup> which are exemplified in insurance contracts by conditions that combat moral hazard.<sup>184</sup> Justice Peters appropriately placed the factor of the insurers' justification squarely on the table in considering Section 229's test of whether the condition was a material part of the exchange.<sup>185</sup> With respect to some conditions, that test turns on whether the failure of the condition prejudices the insurer.<sup>186</sup>

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179. Insurers with a defined type of coverage will include evidentiary rules, such as the condition in a burglary policy requiring visible external marks of forced entry, to avoid claims of a kind not intended to be covered, such as for inside jobs. Works, *supra* note 175, at 617-18; C&J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169 (Iowa 1975); Ferguson v. Phoenix Assurance Co., 370 P.2d 379 (Kan. 1962).

180. Accident insurers providing coverage for death, disability, or dismemberment will include time limits for the period from accident to loss to avoid disputes over causation. W.F. Young, *Insurance Policy Defenses: In Search of Restatements* 34 ARK. L. REV. 507, 521-23 (1981); Eric M. Holmes, *Interpreting an Insurance Policy in Georgia: The Problem of the Evidentiary Condition*, 12 GA. L. REV. 783 (1978).

181. *Draconian Forfeitures of Insurance: Commonplace, Indefensible, and Unnecessary*, FORDHAM L. REV. 825, 834-36 (1996).

182. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (Little, Brown & Co., 1977) (1972). For example, because the parties would opt for simple compensation for lost expectations when sellers breach, the courts should give just that. To give more, such as punitive remedies, has the effect of creating a kind of a lottery that redistributes money from some buyers to others in a way most buyers would not choose. Craswell, *supra* note 32, at 640-45.

183. Craswell, *supra* note 32, at 646-53. To adapt Professor Craswell's reasoning, insurance risks may be somewhat subject to control by the insured's precautions. An owner who insures a building against the risk of damage may be able to reduce the risk somewhat by keeping the building from being vacant. Insurance contracts condition coverage on not having prolonged vacancy of an insured premises. Enforcing such a condition motivates insureds to take maximum precautions to avoid forfeiture. *See id.* at 647 (effect of remedies on precaution).

184. If an insurance condition will induce greater precautions against arson or burglary, there is certainly a stronger case for that condition than there would be for conditions without much chance of inducing risk-controlling precautions.

185. *Aetna*, 538 A.2d at 223.

186. *Id.* at 224. For a notice condition, the test depended upon whether late notice had prejudiced the insurer. Making this a factor considered *ex ante* on the subject of remedies

This Article's proposals follow the lead on conditions in consumer insurance contracts that are suggested by Justice Peters' opinion. Although other courts have gone further in certain respects, the direction and the main approaches are clear. One point of further development might be compensation. Most disputes over whether an insurance condition involves unjustified forfeiture of the insured's reliance interests should still be resolved, as the *Aetna* opinion indicates, on an all-or-none basis of either giving the condition full effect or excusing the condition fully. The discussions about compensating for termination in Part III, regarding employment termination and termination of government contracts for convenience, have limited application to insurance when a major hazard has occurred before the condition receives attention.

Yet, the approach of compensation might occasionally play a role in insurance cases when the insurer's justification for a condition that has come into play after a hazard's occurrence turns out to have some, but not overwhelming weight. For example, when the insured gives late notice in violation of a condition, cases have tended either to apply fully the condition and to uphold an insurer's denial of the late claim's payment due to prejudicial effect or to excuse fully the late notice and to require full payment by an insurer that was not prejudiced. However, in situations in which the insurer shows some distinct prejudice but not severe prejudice from a claim's lateness, to avoid undue forfeiture of the insured's interests while respecting the insurer's concrete justification, sometimes the insured might receive a compensatory insurance payment without full payment in proportion both to what the insured anticipated receiving and to the extent of insurer prejudice. In the long run, the insurance industry may find reason to put forth some form of such a proposal.<sup>187</sup>

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does not undermine the acknowledged utility of most standardized conditions. It should remain efficient for insurers to use a standardized contract with standardized conditions, so long as the insurers, anticipating the situation of such provisions' triggering, have good reason to expect the conditions' justification to pass muster because it has regularly passed muster in the courts in the past, like the anti-arson conditions in a fire insurance contract.

187. If the industry finds that the courts do not give effect to its conditions about timely claims, its logical next step would be to couple those provisions with a provision to arbitrate disputes about the effect of untimeliness. The industry would find in such provisions a way to reduce litigation costs, as well as possibly to control payouts. The courts would likely prefer to see such issues arbitrated, if this were done in a way that seemed reasonable from the insureds' viewpoint, than to have to try them. Such a provision seems unlikely to undermine the goal of encouraging prompt claiming because an insured would never do better by being late.

*B. Public Contracts: Conditions in False Claims Act Cases*

The federal appellate courts have developed valuable new law in recent years on public policy conditions in government contracts due to a somewhat unusual cause of action. Federal contracts may well be said to have two tracks of litigation: regular cases that resolve contract disputes and False Claims Act<sup>188</sup> (“FCA”) cases. While the regular dispute track remains important, the dynamism in this part of the law in recent years has been more in the FCA cases.<sup>189</sup> The FCA makes persons such as public contractors liable to suit in federal district court for presenting false claims to the government with scienter, i.e., knowingly or recklessly.<sup>190</sup> Although the FCA dates back to 1863, it became much more important after major statutory amendments in 1986 and especially with the Supreme Court’s upholding in 2000 of a contested aspect of the FCA’s operation in *Vermont Agency of Natural Resources v. United States ex rel. Stevens*.<sup>191</sup>

The FCA remedy for violating a contract condition differs from the remedies previously discussed in this Article. It involves penalization,<sup>192</sup> but not necessarily cancellation, particularly because the claim may not be discovered until the government has already fully paid and has nothing further to cancel. Still, one central line of similarity remains: because of the trebling of damages, the FCA remedy is commonly supracompensatory and punitive, and the statutory penalties can also mount up for certain kinds of false claims.<sup>193</sup> As seen below,

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188. 31 U.S.C. §§ 3729-3733 (2002).

189. Regular disputes about conditions between the government and contractors would be resolved, pursuant to the Contract Disputes Act, 41 U.S.C. §§ 601-613 (2002), initially by contracting officers, then by the agency boards of contract appeals or the Court of Federal Claims, and finally by the United States Court of Appeals for the Federal Circuit. Hence, the other federal circuits do not have the opportunity to opine about conditions in those regular disputes that they have in False Claims Act cases, which usually start in federal district courts around the country.

190. It provides that any person who “knowingly presents . . . to an officer or employee of the United States Government . . . a false claim . . . is liable . . . for a civil penalty of [\$5,000 to \$10,000], plus 3 times the amount of damages which the Government sustains.” 31 U.S.C. § 3729(a)(1).

191. 529 U.S. 765 (2000) (upholding the FCA’s qui tam mechanism).

192. A contractor’s FCA liability amounts to treble damage plus statutory penalties rather than cancellation by the government of payment. Whereas, a terminating party, like an employer or the government in a termination for convenience, can terminate on a simple and easy self-help basis. Relatively speaking, imposing an FCA remedy requires litigation, often very extensive, slow, and complex.

193. These include certain kinds of health care provider false claims, in which the provider submits many individual false claims, each with thousands of dollars in statutory

there are marked variations in what counts as the damages to be trebled. To the extent that particular provisions of the government contract, i.e., conditions, invite such infliction of penalties, they have some of the effect of the termination and cancellation remedies hitherto discussed. Their impact raises the question of what factors, such as public policy, justify treating some provisions, such as conditions, as the basis for imposing potentially harsh remedies.

By 1996 the federal courts of appeals had established that “[v]iolations of laws, rules, or regulations alone do not create a cause of action under the FCA.”<sup>194</sup> The “archetypal”<sup>195</sup> FCA action against a government contractor concerns false claims about the central exchange terms, i.e., those of pricing and standards of performance, involving overcharging or substandard performance.<sup>196</sup> However, the courts have found FCA violations for false express or implied certification of compliance with conditions<sup>197</sup> of various kinds, including: conditions for receiving contracts,<sup>198</sup> for providing the contractual products and services, or for fulfilling ancillary duties.<sup>199</sup> Thus, the question becomes what distinguishes conditions, even if noncentral, that may support such liability from other contractual provisions that if noncentral would not.

The answer explores the public policy use of conditions. A modern era<sup>200</sup> of government-wide codes of contract regulations<sup>201</sup> started in

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penalties.

194. United States *ex rel.* Hopper v. Anton, 91 F.3d 1261, 1266 (9th Cir. 1996).

195. *Id.*

196. Some government contract conditions directly concern the contractor’s performance. These include specifications in the contract’s “Statement of Work” or ancillary arrangements having to do with payment and performance. For example, for cost-reimbursement contracts of a sufficient scale, Congress statutorily imposes the requirement of disclosure of cost accounting methods. This was Congress’s way, in enacting the Cost Accounting Standards Act of 1970, 50 U.S.C. App. § 2168, of assuring full compliance by contractors and not merely the contractors’ compliance to a degree of their own choosing.

197. “In [some] cases in this category, the defendant makes false certifications of . . . the existence (or non-existence) of certain conditions, which are alleged to be a prerequisite to the government’s payment.” JOHN T. BOESE, CIVIL FALSE CLAIMS AND QUI TAM ACTIONS 1-39 (2d ed. 2000 Supp).

198. *Ab-Tech Constr., Inc. v. United States*, 31 Fed. Cl. 429, 433 (1994) (false implied certification of continuing status as minority-owned small business), *aff’d without written opinion*, 57 F.3d 1084 (Fed. Cir. 1995).

199. *Shaw v. AAA Eng’g & Drafting, Inc.*, 213 F.3d 519 (10th Cir. 2000) (false implied certification of compliance with contractual obligations properly to dispose of toxic waste residue from providing photographic services).

200. After the New Deal and World War II, federal public contracting became a feature of steady, rather than only wartime, importance in the economy. For an introduction to the background of government contract law, see TIEFER & SHOOK, *supra* note 19, at 28; JAMES F. NAGLE, HISTORY OF GOVERNMENT CONTRACTING (2d ed. 1999).

1962 with the doctrine that the mandatory terms and conditions in such codes received automatic incorporation in public contracts.<sup>202</sup> These codes include terms and conditions for contractor obedience to special public policies, such as the public policy regimes for equal opportunity, labor standards, environmental standards, and the like. Sometimes Congress itself literally prescribes that compliance with specific laws and regulations be a “condition,” as with the Cost Accounting Standards disclosure requirement<sup>203</sup> that had produced FCA liability in the courts of appeals<sup>204</sup> and that went inconclusively to the Supreme Court in 1995.<sup>205</sup> More often, Congress or the regulation promulgators simply indicate that compliance with the law or regulation is a prerequisite for payment.

A particular federal appellate decision in 1997 resolved the issue of the connection between FCA coverage and public policy conditions. In *United States ex rel. Thompson v. Columbia/HCA Healthcare Corp.*,<sup>206</sup> Columbia/HCA Healthcare was sued for submitting Medicare claims for services that it had actually rendered and priced validly, but had obtained by referral in violation of the Stark laws.<sup>207</sup> The Stark laws prohibit kickback-type referral incentives from providers, such as Columbia/HCA, to physicians who make referrals.<sup>208</sup> Columbia successfully argued in district court<sup>209</sup> that even services arranged in violation of the Stark laws would not sustain a FCA suit. After all, the hospital had actually provided the service, had not overcharged, and had not rendered a service in a substandard way. Columbia argued that violation of a statute or regulation like the Stark laws might lead to

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201. Specifically, it took the entire post-World War II era for various precursors and the Federal Acquisition Regulations (“FAR”) in 1984 to provide the elaborate machinery for government-wide contracting rules.

202. This occurs pursuant to the doctrine of *G.L. Christian & Assocs. v. United States*, 312 F.2d 418 (Ct. Cl. 1963), described in TIEFER & SHOOK, *supra* note 19, at 32-38. Pursuant to this doctrine, if a statute or regulation makes a certain term or condition mandatory for inclusion in government contracts, then even if the particular contractual instrument omits the words, the term or condition will be deemed included.

203. 50 U.S.C. App. § 2168(g) (2000) (“The [CAS] Board is authorized to make . . . regulations . . . Such regulations shall require defense contractors and subcontractors as a *condition* of contracting to disclose in writing their cost accounting principles . . .”).

204. *United States ex rel. Oliver v. Parsons Co.*, 184 F.3d 1101 (9th Cir. 1999)

205. *Hughes Aircraft Co. v. United States ex rel. Schumer*, 520 U.S. 939 (1997) (decided the narrow issue of statutory nonretroactivity).

206. 125 F.3d 899 (5th Cir. 1997).

207. *Id.* at 900-01.

208. *Id.* at 901-02.

209. *United States ex rel. Thompson v. Columbia/HCA Healthcare Corp.*, 938 F. Supp. 399 (S.D. Tex. 1996).

those laws' specified particular penalties, but should not lead to the treble damages and statutory penalties of the FCA.

However, the Fifth Circuit reversed, declaring that "where the government has *conditioned* payment of a claim upon a claimant's certification of compliance with, for example, a statute or regulation, a claimant submits a false or fraudulent claim when he or she falsely certifies compliance with that statute or regulation."<sup>210</sup> The Fifth Circuit's test, fitting with that of other courts,<sup>211</sup> was the extent to which payment for defendants' services "was *conditioned* on defendants' certifications of compliance."<sup>212</sup> Congress had made certification of compliance with the Stark laws a condition of payment after studies showed that physicians with referral incentives tended to send patients for medically unnecessary services. As a prophylactic measure, the Stark laws condition payment for services on the providers not violating the Stark laws, regardless of whether the particular services are shown to be unnecessary.<sup>213</sup>

Because of the potency of the FCA and the variety of public policy conditions in government contracts, some may argue that the FCA could operate harshly and inequitably as with other supracompensatory remedies relating to conditions, such as cancellation. It can be argued that the prospect of FCA penalties,<sup>214</sup> by forcing excessive compliance with a host of specialized governmental requirements,<sup>215</sup> could produce inefficient contractor overcaution and defensiveness,<sup>216</sup> make private commercial firms eschew competing for the dubious privilege of selling

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210. 125 F.3d at 902 (emphasis added).

211. This was not an isolated test. Numerous other courts in FCA cases are drawing the same line as to whether payment was conditioned on a certification of compliance with the statute or regulation rather than just whether the government received goods or services for which it paid. *United States ex rel. Hopper*, 91 F.3d at 1266 (finding FCA "liability when certification is a prerequisite to obtaining a government benefit" and otherwise no liability); *United States ex rel. Fallon v. Accudyne Corp.*, 880 F. Supp. 636, 638 (W.D. Wis. 1995) (finding FCA liability on the reasoning "that the contracts expressly required compliance with environmental regulations and that defendant . . . falsely certified that it had so complied in order to induce payments under the contracts").

212. 125 F.3d at 903 (emphasis added).

213. *Id.* at 902.

214. William E. Kovacic, *Whistleblower Bounty Lawsuits as Monitoring Devices in Government Contracting*, 29 LOY. L.A. L. REV. 1799 (1996).

215. William E. Kovacic, *Regulatory Controls as Barriers to Entry in Government Procurement*, 25 POL'Y SCI. 29, 31, 36 (1992).

216. *Id.* at 32.

to the government,<sup>217</sup> or subject contractors to opportunistic blackmail by government enforcers.<sup>218</sup>

Considering these critiques, the justification for the potent FCA remedy for government conditions rests primarily upon the authority to establish the public policies that underlie those conditions. In private contracts, even a party with full control over the drafting does not have the authority to pronounce public policy, and the party's inclusion of terms and conditions does not establish that the terms and conditions represent public policy. In contrast, in public contracting, Congress and regulation promulgators have the authority to pronounce public policy, and the promulgation of statutes or regulations that condition payment upon compliance with a specific regime is an expression of such public policy. In this way, the courts neither couple the FCA remedy to all laws, regulations, or terms in government contracts, nor refuse it for all. Rather, the case law draws a line between the federal laws and regulations that create conditions or prerequisites for payment, thereby supporting FCA liability, and those that produce mere terms in the contract for which the ordinary system of remedies for breach will suffice.

Of course, in private contracts, a major issue has been when to infer that a term constitutes an express condition and when, as in *Jacob & Youngs*, it does not. In the government contract context, determining whether a term constitutes a condition consists largely of the court discerning the Congressional and agency judgments about public policy as expressed in establishing prerequisites for payment. This is in accord with the general analysis of the role of public policy in government contracts.<sup>219</sup> A case that contrasts interestingly with *Columbia/HCA Health Care* is *Luckey v. Baxter Healthcare Corp.*,<sup>220</sup> deciding whether certain rules of the Food and Drug Administration (FDA) constituted a

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217. *Id.* at 34, 36. Patrick J. DeSouza, Note, *Regulating Fraud in Military Procurement: A Legal Process Model*, 95 YALE L.J. 390, 403-05 (1985).

218. William E. Kovacic, *The Civil False Claims Act as a Deterrent to Participation in Government Procurement Markets*, 6 SUP. CT. ECON. REV. 201 (1998).

219. General statutory enactments about policy would often be expected to be translated into public contract conditions, even when Congress in no way suggested that they become translated into implied conditions in any or all private contracts. Policies from the Buy American Act, 41 U.S.C. § 10a (2000), to payment of prevailing wages become conditions in public contracts without becoming conditions in private ones. For discussions of the role of public policies in government contracts, see the sources cited in *supra* notes 27-30.

220. 2 F. Supp. 2d 1034 (N.D. Ill. 1998).

condition.<sup>221</sup> In *Luckey*, a producer of plasma products for medical use, including government-reimbursed use, did not follow FDA procedures and faced a FCA suit.<sup>222</sup> The court concluded that plaintiff “failed to demonstrate that Baxter’s compliance with any statutes or regulations was a material condition to receiving payment from the government.”<sup>223</sup> It was not that the government would disregard noncompliance with quality-control procedures, but rather that its rules specified a complex arrangement for FDA supervision with a single remedy (not the FCA) for quality-control issues.<sup>224</sup> Conversely, public contractors have some ability, as an influential group, to relieve themselves through the political process from the high exposure to liability engendered by government conditions when such exposure threatens to interfere with other public goals, such as the movement toward commercial and simplified public contracting.<sup>225</sup>

Contractors have other ways to argue for limits on the FCA remedy for violating a public policy condition. Contractor reliance interests do count in the sense that while treble damages plus penalties can be a strong remedy, it does not necessarily include the forfeiture of contractor interests. While courts may sometimes assess and treble the fullest measure of damages,<sup>226</sup> whether they do so depends on the specifics of the contractor violation. For example, in *United States ex rel. Compton v. Midwest Specialties, Inc.*,<sup>227</sup> the contractor failed to perform contrac-

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221. *Id.* at 1044 (section entitled “The Undisputed Facts Show Regulatory Compliance Was Not A Condition to Receiving Payment Or Another Benefit from The Government”).

222. *Id.* at 1037-42 (allegations). *See also id.* at 1043-44 (regulations).

223. *Id.* at 1045.

224. *Id.* at 1046.

225. Schooner, *supra* note 33, at 664. Congress or regulators will abolish requirements of certifications for disclosure of cost and pricing data. For example, the Federal Acquisition Streamlining Act of 1994, 31 U.S.C. §§ 6101-6106 (2000), expanded the category of simplified procurements to all under \$100,000 and eliminated from such contracts the provisions relating to contingent fees, access to records, kickbacks, the Miller Act, 40 U.S.C. § 270(a) (2000), and the Drug-Free Workplace Act 15 U.S.C.S. § 654 (2000). Howard W. Cox, *FASA and False Certifications: Procurement Fraud on the Information Superhighway*, 25 PUB. CONT. L.J. 1 (1995). The quest by contractors for further elimination of terms or conditions continues. Richard J. Wall & Christopher B. Pockney, *Revisiting Commercial Pricing Reform*, 27 PUB. CONT. L.J. 315, 327 (1998); Carl L. Vacketta & Susan H. Pope, *Commercial Item Contracts: When is a Government Contract Term or Condition Consistent with “Standard” or “Customary” Commercial Practice?*, 27 PUB. CONT. L.J. 291 (1998). For an analysis of such a quest in the enactment of FARA, see Charles Tiefer & Ron Stroman, *Congressional Intent and Commercial Products*, 32 PROCUREMENT LAW. 22 (Spring 1997).

226. A large measure of damages would derive from a “but for” causation test, in which the government recovers the entire claim it paid if it would not have paid but for the falsely reported compliance with a condition.

227. 142 F.3d 296 (6th Cir. 1998).

tually required testing of Jeep brake shoe kits, so that the kits did not fulfill the quality assurance condition.<sup>228</sup> The Sixth Circuit upheld a damage award that trebled the entire contract price, a strong remedy indeed.<sup>229</sup> There, the unfulfilled condition went to the safety of the lives of the soldiers who would use the Jeeps.<sup>230</sup> In *BMY-Combat Systems Division of Harsco Corp. v. United States*,<sup>231</sup> a supplier of howitzers submitted a claim for additional payment for extra work. The Government discovered the supplier had violated the contract requirement of inspection and invoked the FCA. The court imposed a high damages remedy,<sup>232</sup> but it did not forfeit the contractor's reliance interests.<sup>233</sup>

In contrast, in the well-known 1994 ruling in *Ab-Tech Construction, Inc. v. United States*,<sup>234</sup> which played a major role in launching this line of FCA cases about public policy conditions, the contractor had obtained a contract pursuant to the section 8(a) program for disadvantaged small businesses by misrepresenting its actual arrangements inconsistent with that status. The court rejected the government's request to deem the entire amount of progress payments received by the contractor as a "but for" measure of damages because "the Government got essentially what it paid for"<sup>235</sup> in terms of providing services. The court went only so far as to accept the Government's request to impose statutory penalties.<sup>236</sup> Like a judgment in a private contract case that

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228. *Id.* at 297.

229. The Sixth Circuit quoted "the general rule recognized in the Uniform Commercial Code that a buyer may reject goods outright 'if the goods or the tender of delivery fail in any respect to conform to the contract.'" *Id.* at 305 (quoting U.C.C. § 2-601).

230. "Midwest's argument in favor of a setoff based on value purportedly received would create a perverse incentive system in which government contractors could endanger the lives of American soldiers by providing substandard material . . . . [T]he government . . . bargained for the confidence that comes with a product that has been subjected to production testing." *Id.* at 305 n.8.

231. 38 Fed. Cl. 109 (1997).

232. On the one hand, the court found the supplier liable for damages under the FCA, using the relaxed scienter standard of whether the supplier had been reckless because the withheld information about failure to inspect was "critical" in the supplier's actions. *Id.* at 123-27.

233. On the other hand, the court found that the government did not make the higher scienter showing—by clear and convincing evidence of an intent to deceive—for forfeiting the contractor's whole claim. *Id.* at 128.

234. 31 Fed. Cl. 429 (1994).

235. *Id.* at 434.

236. It did so in light of the burdens and expenses to the government of investigations to uncover the contractor misconduct "and, most significantly, the societal cost associated with Ab-Tech's abuse of the section 8(a) program." *Id.* at 435. The progress payments were \$1.4 million, so had they been trebled the government would have received \$4.2

gives weight to failure of a condition but respects the reliance interests of a cancelled party, this tailored remedy drew a distinction in vindicating the justification underlying the condition without imposing a remedy that would be harsh and inequitable.<sup>237</sup>

#### V. CONCLUSION: A NEW RESTATEMENT PROVISION

This Article's approach to the evolution of the doctrines of conditions can now be summed up in the form of a new section of the Restatement of Contracts. This would pick up where the provision in the First Restatement about "extreme forfeiture" and in the Second Restatement about "disproportionate forfeiture" left off.

Such a provision might state the following:

##### *Forfeiture by Cancellation or Termination*

1. When cancellation by the operation of a condition, or by a power of termination, would result in a forfeiture, the balance of factors in Subsection (2) may justify either noncancellation, or compensation to the cancelled party by the measures in Subsection (3).
2. The following factors are significant in determining whether cancellation should occur and whether to compensate the cancelled party:
  - (a) whether the cancelled party's forfeiture is disproportionate, and whether the cancelled party could not reasonably have been expected to mitigate;
  - (b) the justifications for cancellation with or without compensation;

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million. The statutory penalties were \$220,000. *Id.* at 434-35. In effect, the court took the contractor's violation of the contractual condition as warranting the imposition of a potent penalty, but not warranting the most severe remedy for the government, as it did not undermine the value of the contractor's performance.

237. More generally, several kinds of tension in the current appellate case law regarding FCA remedies confirm this tendency to impose a potent remedy, but leave the door open to tailoring a remedy not harshly inequitable. Some cases have followed a "but for" causation standard for damages, but many have not. In the older *United States v. Woodbury*, 359 F.2d 370, 379 (9th Cir. 1966), a contractor did not disclose some factors that reduced the government's security, leading the government to make progress payments that it would have delayed had it known. The government argued that the damages were the funds that would not have been paid out but for the falsity about security, but the court held that because the government might have ultimately paid out the same, the court would not deem the whole of those payments to be damages. *Id.* at 379. And in the case of *Cooperative Grain*, the court found FCA liability for some charges in grain storage contracts, but it restricted these to the percentage unlawfully delivered. *United States v. Coop. Grain & Supply Co.*, 476 F.2d 47, 63 (8th Cir. 1973).

- (c) whether the condition or power arose from standardized terms as treated in section 203(d) and applicable public policy factors from section 178(3), including whether the cancelling party is governmental; and
- (d) how each party's behavior comports with standards of good faith and fair dealing.

3. A level of compensation for the cancelled party may be deemed an omitted essential term to be established by the court, measured either as:

- (a) the actual injury to its reliance interest, if readily calculable; or
- (b) a reasonable liquidated measure derived from sources including course of performance, course of dealing, usage of trade, and public policy.

A brief exposition of this proposed Restatement section sums up the approach of this Article. The first subsection advances beyond section 229, which only considers conditions and whether to preclude cancellation altogether. Now the section would include both conditions and powers of termination. It would also address both the previous issue of whether cancellation is precluded and the added issue of compensating for forfeiture, deciding these by a common list of factors in subsection 2.

For those factors, subsection 2 draws considerably upon the model of section 242 regarding cancellation for material breach of a performance term. Section 242 lists seven factors as significant, and this proposed subsection picks up many of those<sup>238</sup> with some reorientation, including factors of forfeiture, compensation, substitute arrangements, good faith and fair dealing,<sup>239</sup> and the limited role of the agreement's express language.<sup>240</sup> Of these, the proposed provision starts with the

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238. Section 242 incorporates the five factors of section 241 and two additional factors of its own.

239. Section 241(b) ("compensated"), (c) ("forfeiture"), and e ("good faith and fair dealing") and section 242(b) ("substitute arrangements"). However, sections 241 and 242 consider some of these matters only from the vantage point of the "injured party," who in these provisions is the putative cancelling party. Section 241 considers how the "injured party" suffered from a failure of good faith and fair dealing and how that party fares as to the adequacy of potential compensation and substitute arrangements, while the proposed section also considers how the cancelled party fares in these regards. Section 241 considers the good faith and fair dealing of the party failing to perform, who in section 242 is the putative canceled party, while the proposed section considers this as to both parties.

240. Section 242(c) provides that "the extent to which the agreement provides for performance without delay" is a significant factor, but failure "to perform on a stated day does not of itself discharge the other party's remaining duties." It then provides for considering "the circumstances, including the language of the agreement." Another way

extent of the forfeiture. In retaining the question of whether the forfeiture is “disproportionate,” while no longer making this a universally decisive criterion, the provision may suggest that a forfeiture should usually be disproportionate before the strong step of precluding cancellation altogether, but it certainly need not be disproportionate before the milder step of merely providing for compensation to accompany cancellation.<sup>241</sup>

The subsection then asks whether the condition or power was a standardized (adhesive) term<sup>242</sup> and otherwise qualifying the significance of the language of standardized terms.<sup>243</sup> In the context of negotiated terms between merchants of marketable goods, conditions and powers of termination, even if harsh and unscaled in their potential effect upon reliance interests, may serve valid risk allocation purposes and presumptively represent the parties’ considered weighing of alterna-

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of putting this is that when an agreement has the express term that “time is of the essence,” this is a factor of whether nonfulfillment of that term supports cancellation, but this is only one factor among the rest of “the circumstances.” RESTATEMENT (SECOND) OF CONTRACTS § 242(c) (1979).

241. On the other hand, the inclusion of the other factors may allow courts more nuanced analysis of whether cancellation is precluded than could occur when the “disproportionate” nature of the forfeiture stood alone as decisive. It may even be that when the cancelling party has strong grounding in some of the other factors to cancel, even a disproportionate forfeiture might now occur with a full measure of compensation.

242. It refers to the Second Restatement section 203(d) to incorporate the established distinction between treatments of negotiated and of standardized terms, i.e., terms of adhesion, in employing interpretive presumptions. The potent and unscaled impact of the cancellation remedy has caused courts to question when to allow it based on a contract provision, as distinct from the occasions of uncured material breach elaborately analyzed in section 242. In this century, courts have long used, as one of the basic strategies to control the harsh effects of conditions, the tool of presumptively interpreting ambiguous provisions as terms rather than conditions. To reach the next step, courts should go further than just interpreting contracts with ambiguous provisions on a multi-factor basis. Rather, courts should interpret contracts on a multi-factor basis even though their provisions are worded clearly enough to be unambiguous in formally conveying the concept of a condition when those provisions were adhered to, rather than negotiated by, the canceled party. The warrant of standardized language is weaker and admits consideration of other factors, regardless of whether the language was drafted with clarity.

243. Demoting in significance, without denying all significance to, the language of standardized terms of express conditions and termination powers tracks how section 242, regarding when a material breach justifies cancellation, has demoted in significance such language as boilerplate provisions that time is of the essence. Section 242 makes an express term regarding time of performance one of the circumstances regarding whether untimeliness in one party’s performance justifies cancellation by the other. Section 242 provides the model that an express term may matter, but cancellation is too serious and potentially disproportionate a remedy to turn wholly on express terms.

tives.<sup>244</sup> In contrast, powers of termination and conditions affecting insured consumers, long-term employees, and sometimes even government contractors are much less likely to represent both parties' considered weighing of alternatives or capabilities to salvage their reliance interests by reasonable substitute arrangements.<sup>245</sup> Then, the provision raises the factor of public policy considerations by referring to the Second Restatement section 178(3).<sup>246</sup> It especially raises whether the government is a party, building upon the contrast developed in this Article between provisions in public and private contracts.<sup>247</sup>

Lastly, subsection 2 raises the factors of the cancelling party's justification for the condition or power,<sup>248</sup> and it brings over from section 241 the factor of good faith and fair dealing. Important aspects of the cancelling party's justification for such powers will often consist

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244. Often, commentators use the short UCC-oriented term of "cover" for what a canceled party does to handle the gap caused by cancellation. The Restatement uses the term "substitute arrangements" in section 242(b), which seems a little more general. For a terminated employee, the ready availability of a similar job without transition problems seems to furnish a substitute, but involves a good deal of arranging—more than is involved in simple forms of "cover" like spot purchases or sales of fungible goods.

245. Hence, the balance of factors in this latter type of situation will involve less judicial deference to the formal language of the agreement established in advance and more to the parties' exposure as the problematic situation has actually occurred. Standardized conditions and cancellation powers would receive closer scrutiny and weighing than negotiated ones, but that only indicates selective outweighing of such standardized terms by the other factors without implying general invalidation or even universally presumptive nonfollowing of such terms.

246. Section 178(3) provides the Restatement's general portal for public policy in statutes or precedent to determine the validity of contracts. This Article has discussed why provisions imposing forfeiture by cancellation or termination should be considered a special class for which the courts should closely consult sources of public policy. ERISA law and precedent, in how they separate the continuing allowability of employment termination at will from the appropriateness of respecting employees' reliance interests by compensation during such termination, illustrate the kind of consideration meant by including legislative and judicial sources of public policy as a factor.

247. On the one hand, public contracts expose the public contractor to FCA penalties for knowing falsehoods in violating public policy conditions, which derive their original justification from the high degree of policy direction that the state expects its contractors to take. Public contracts also carry a presumption that the government has the power to terminate for its convenience. On the other hand, the government must compensate a terminated contractor's reliance interest. The line of federal appellate cases from *Torncello* to *Krygoski* clarifies that public authorities legitimately reserve a fully discretionary power of termination to implement their need, even at late stages of a contract's performance, for flexibility and control, while paying for this by assured compensation to the terminated contractor.

248. These could include the material benefit of the provision's operation to itself, a factor recognized both in existing section 229 on disproportionate forfeiture and in section 241 regarding material breach.

of any strong need for flexibility the party can cite, including difficulties an employer or the government would face in conducting their affairs if not allowed flexibility to cancel or terminate. The factor of justification will quite often support allowing a party to exercise its power to terminate or to cancel, while obliging it to compensate the cancelled party.<sup>249</sup> Applied to the context of termination of some employment-at-will contracts, this may justify compensation in the form of an implied severance term.<sup>250</sup> In contrast, an inadequate factor of justification for an adhesive condition in a consumer insurance policy might lead to not allowing cancellation altogether.<sup>251</sup>

The final subsection of the provision, subsection 3, deals with the measure of compensation. Standardized contracts drafted entirely by the cancelling party may simply not be worded in any way helpful to a court in determining what compensation appropriately accompanies cancellation. Section 204<sup>252</sup> offers the court a dual measure. It may

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249. For example, an employer may have a demonstrable and often implemented need for layoffs due to a highly variable need for labor consistently brought home to the employees, both in formal instruments and informal communication. However, the employer has treated the employees as having a status closer than mere benefit-free contingent workers or independent contractors. And, the pattern in the industry may be that termination of such employees, while it comes without warning or cause, often includes some impact mitigation, such as severance pay. Such an employer could offer its need for flexibility as justification for termination at will, but not as justification for foregoing compensation.

250. To provide a further demonstration of justification of cancellation without compensation, the employer might well show that some employees work on an entirely contingent status, not just indicated by merely formal expression in adhesive terms and disclaimers, but by the actual and practical job arrangements. For example, an employer may treat some employees as independent contractors in many respects, with work patterns that establish no close or stable relationship and remuneration systems that suggest just pay and no benefits. This negates a basis for employees to receive benefits like severance pay. More precisely, a terminated contingent employee would be remitted to the relevant set of arguments about challenging unjust dismissal, such as employee protection laws that should apply to all employees. Such an employee would not be deprived of protections as a mere independent contractor. Berger, *supra* note 12. That would justify cancellation of employment without compensation.

251. This is reflected in the notice-prejudice rule that precludes insurers from denying coverage to late-notifying insureds. When the insurer's justification for the notice—its potential for prejudice—does not carry weight, cancellation is not allowed. The inclusion of all these other factors allows both parties' good faith to play its proper role, as it always has in tempering the potentials for oppression and opportunism in cancellation, while not itself capturing all the considerations relevant to what should occur.

252. This subsection provides the model for how a court fills in the missing term in such a situation. A court that rules upon a contract in which the parties "have not agreed with respect to a term which is essential to a determination of their rights and duties" considers itself tasked to "Supplying an Omitted Essential Term," section 204's heading.

provide the actual measure of reliance damages when they are reasonably calculable.<sup>253</sup> Alternatively, the subsection offers a different possible measure, if the first is not readily calculable, in the form of a liquidated measure derived from the traditional sources for filling in an implied omitted term.<sup>254</sup>

When Professor Corbin and Professor Childres published their 1919 and 1970 articles advancing this issue, they combined analysis of the existing case law on the doctrines of conditions with proposals for the direction in which they hoped the law would continue to evolve. Contract law will not, and should not, do away with provisions as functional as the condition or the power of termination. However, contract law can, and should, seek to meliorate the potential of such provisions for harshly inequitable operation. Offering a draft Restatement section as a conclusion has in no way meant to suggest that this is the only true path. From the past doctrines about conditions and termination powers, there are many roads ahead that could be followed. No single path is foreordained. What matters is to continue the progress forward for the doctrines of conditions and termination powers in the law of public and private contracts.

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In that case, "a term which is reasonable in the circumstances is supplied by the court." RESTATEMENT (SECOND) OF CONTRACTS § 204 (1979).

253. Here, the analysis may continue for the example of the employer who establishes a right to terminate at will, but had a relationship with the employee the opposite of contingent employment, which justifies a full measure of compensation. One measure would be actual damage to the employee's reliance interest. An employee could show that her sudden and unheralded termination imposed concrete expenses, such as heavy costs to continue her family's health insurance coverage outside of employment, before she could obtain her next job.

254. This measure would have its most important application in the exercise of cancellation power at a late stage of a relationship contract, when compensation matters most, these traditional sources should provide the greatest guidance. The measure would be derived from course of performance, course of dealing, usage of trade, and public policy. These would assist in several ways in filling the gap by the agreement not having a useful express term on the subject. First, they would suggest a range of measures commonly used, e.g., severance pay calibrated to the length of employment and the rate of pay just before termination. Second, they would situate the particular contract, such as a particular employment relationship, by comparing other similar relationships, to decide whether to pick a high or low measure: high-benefits employment of a kind in which severance is often ample would suggest a high measure, while low-benefits employment of a kind in which severance is often ungenerous would suggest a low measure.